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The Mexican Economy at a Crossroad:
Direction of Renegotiation on NAFTA and Presidential Election

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Summary

- Mexico has promoted its aim to build itself as a trading nation since it joined the North American Free Trade Agreement (NAFTA) in 1994. Nowadays, it has established a strong position as a production base in North America for automobiles and electric machines.
- However, the main players of such advanced industries are foreign companies while the position of local industries still remains weak. At the same time, the increase of production is often accompanied by an increase of imported parts, and the values added domestically are not so large.

  Further, high ratio of informal sector (a group of entities with a characteristic of a home industry) has resulted in lowering productivity of the nation.
- Fiscal situation used to be relatively sound before the failure of Lehman Brothers, but a deficit structure has since taken root in the budget balance and the government has been forced to make efforts to consolidate the fiscal balance. Although there is no impending risk, it has little room for the government to rely on the budgetary expansion when the economy starts to deteriorate in the future.
- Comparing to the days in the 1990s when Mexico was hit by a currency crisis (Tequila shock), the financing of foreign currencies has been improved. Mexico now meets the reserve adequacy indicators the IMF provides as a safety guideline (foreign exchange

reserves equivalent to more than three months of imports, more than 100% of short-term external debts and 100-150% of reserves on ARA Metric base)

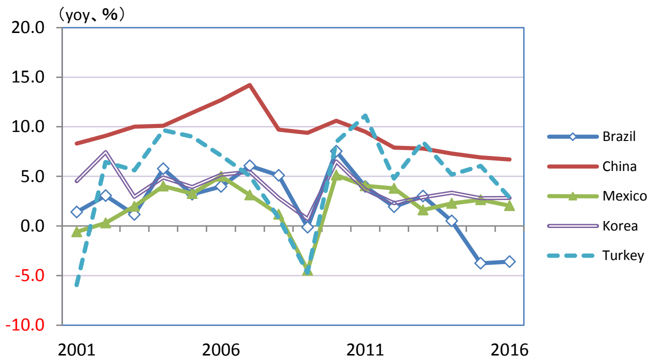
- However, it will require a careful watch whether the capital inflows that exceed the current account deficits will be maintained in the future. If a conflict between Mexico and the Trump administration should increase concerns about the prospect of the Mexican economy trigering a decrease in inflow of foreign capital, it would become a matter of life and death to the Mexican economy.
- There are two risks down the road: the directions of renegotiation on the NAFTA and the coming presidential election in 2018. Although the relationship is in a temporary lull now, the Trump administration is leaning toward protectionism with hard negotiations expected ahead. The main scenario for the election is a prospect of victory of a candidate with a cooperative attitude to the U.S (with probability of 40%). But as an anti-American sentiment is rising in Mexico, there is a possibility that the candidate who appeals for a showdown with the U.S. may gain public support. Therefore, the case should also be assumed with a probability of around 30% that a leftist candidate with anti-American sentiment would be elected to the president amid the rough going of the NAFTA negotiations. In such a situation, foreign investment in Mexico may also decrease.

1. Mexico Aimed to Build a Trading Nation since the 1980s

In the 1970s Mexico started to aim at building itself as an oil exporting country, but it fell into a heavy debtor country with bankruptcy of the public finances due to a reverse oil shock of falling oil prices in the 1980st. Learning from this experience, Mexico tried to change its national strategy, shifting to building an export-oriented country centered around the manufacturing industry. The participation in the North America Free Trade Agreement (NAFTA) in 1994 was an epoch making event to mark an arrival of new era. Since then, Mexico has become an important production base for the North American market, with its exports to the U.S, growing by six times of the amounts seen before the participation in NAFTA.

Despite the remarkable growth in trades, the growth rate of real GDP is rather low among the emerging economies. The average growth rate for 2001 to 2016 stands at only 2.2% as compared to 2.4% for Brazil, 3.9% for South Korea, 5.0% for Turkey, and 9.5% for China. It fell to a negative growth of 4.5% in 2009, showing a not-a-small volatility. (Chart 1)

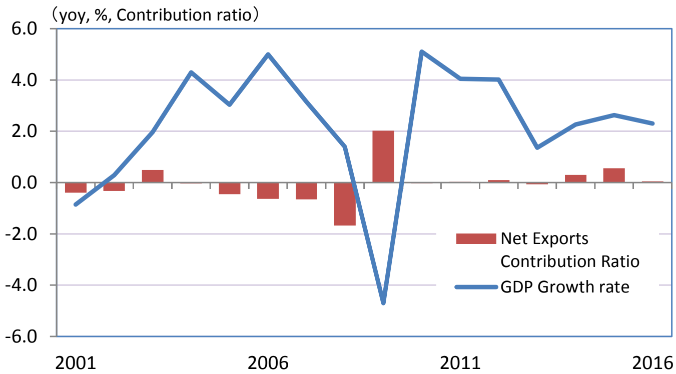
Chart 1　Growth Rates of Major Emerging Economies



(Source) Statistics of individual countries

The contribution of net exports to the growth is also small (Chart 2), because imports have increased along with the increase of exports. Although Mexico has concluded FTAs with 46 countries to promote trade, differing from its image, external demands have not contributed directly to raise the growth rate. It recorded a trade deficit of $13.1 billion against the world, even though it had a surplus of $123.0 billion with the U.S. (2016, Banco de México)

Chart 2　Real GDP Growth Rate of Mexico



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2. Integration of 3 North American Economies through NAFTA

In the meanwhile, the integration of the North American economies has made substantial progress owing to NAFTA. Let us verify it by using international interindustry table. Tables 1 to 3 show the input and output of the secondary industry, including manufacturing, in Canada, Mexico and the U.S. in the past 10 years. Looking at them laterally, we can see where products of the industry are put in.

In 2004, the secondary industry in Mexico produced $145.4 billion of products for the U.S. secondary industry ($65.3 billion for intermediate use and $80.1 billion for final use). By 2014, the output increased by 1.7 times to $242.8 billion ($123.6 billion for intermediate use and $119.2 billion for final use), with its rate of increase slightly exceeding that (1.6 times) for domestic use.

What is more conspicuous is the faster increase ($58.3 billion) of shipment for intermediate use in the U.S. than that ($39.0 billion) for the final use. The same tendency is seen with the shipment of Canada. The shipment to the U.S of the secondary industry in Canada increased by $75.4 billion for intermediate use in ten years while that for final use increased only by $2.7 billion.

This reflects the fact that a cross-border supply chain has been established among the three countries by the formation of NAFTA where parts with low value added are collectively produced in Mexico and supplied to the U.S. and Canada. On the other hand, parts with high value added (e.g., engines for large cars) are supplied by the U.S. to Mexico. The increase in input of the U.S. and Canada of products for intermediate use reflects it. While exports from the U.S. of products for final use increased by $30.0 billion to Canada and by $16.2 billion to Mexico, those for intermediate use showed a bigger increase of $66.9 billion to Canada and of $56.8 billion to Mexico.

Table 1 Input-Output Table for NAFTA in 2004

(US$ billion)

		Intermediate input			Final Demand		
		Canada	Mexico	U.S.	Canada	Mexico	U.S.
Canada	Primary	27.3	0.5	4.5	8.1	0.1	1.9
	Secondary	133.9	2.1	147.7	65.1	1.0	77.8
	Tertiary	534.0	0.3	13.3	724.5	0.4	19.7
	Total	695.3	2.8	165.5	797.7	1.5	99.5
Mexico	Primary	0.0	24.7	0.8	0.1	11.2	2.6
	Secondary	4.2	168.8	65.3	3.8	150.5	80.1
	Tertiary	0.2	269.0	4.2	0.2	528.7	4.2
	Total	4.4	462.6	70.3	4.1	690.5	87.0
U.S.	Primary	4.4	3.2	227.5	1.5	0.4	53.1
	Secondary	95.3	69.1	2,721.9	52.2	22.4	1,689.6
	Tertiary	11.7	4.4	5,613.4	5.7	2.3	10,392.9
	Total	111.4	76.7	8,562.8	59.4	25.2	12,135.5

(Source) World Input-Output Table 2004

Table 2 Input-Output Table for NAFTA in 2014

(US$ billion)

		Intermediate input			Final Demand		
		Canada	Mexico	U.S.	Canada	Mexico	U.S.
Canada	Primary	39.7	1.1	7.2	12.1	0.1	2.6
	Secondary	284.5	4.1	223.1	128.4	1.5	80.6
	Tertiary	893.4	1.0	17.3	1,330.7	0.5	19.7
	Total	1,217.6	6.2	247.6	1,471.1	2.1	102.9
Mexico	Primary	0.0	36.8	1.7	0.3	15.6	8.5
	Secondary	8.8	290.2	123.6	9.6	218.9	119.2
	Tertiary	0.5	320.6	6.8	0.5	880.2	7.6
	Total	9.3	647.6	132.1	10.5	1,114.7	135.3
U.S.	Primary	4.4	6.5	367.3	2.9	1.3	66.9
	Secondary	162.2	125.9	3,738.7	91.2	38.6	2,453.9
	Tertiary	21.1	3.7	8,058.1	10.0	2.5	14,359.1
	Total	187.7	136.2	12,164.1	104.2	42.4	16,879.8

(Source) World Input-Output Table 2014

Table 3 Changes in 2004-2014

(US$ billion)

		Intermediate input			Final Demand		
		Canada	Mexico	U.S.	Canada	Mexico	U.S.
Canada	Primary	12.3	0.6	2.7	3.9	0.0	0.7
	Secondary	150.6	2.0	75.4	63.2	0.5	2.7
	Tertiary	359.4	0.7	4.0	606.2	0.1	0.0
	Total	522.2	3.3	82.0	673.4	0.6	3.4
Mexico	Primary	0.0	12.0	0.9	0.2	4.5	5.9
	Secondary	4.6	121.4	58.3	5.9	68.4	39.0
	Tertiary	0.3	51.6	2.6	0.3	351.4	3.4
	Total	4.9	185.0	61.8	6.4	424.3	48.3
U.S.	Primary	0.0	3.3	139.8	1.5	0.8	13.8
	Secondary	66.9	56.8	1,016.8	39.0	16.2	764.3
	Tertiary	9.4	-0.7	2,444.7	4.3	0.2	3,966.2
	Total	76.3	59.4	3,601.3	44.8	17.3	4,744.3

(Source) World Input-Output Table 2004, 2014

3. Expanding "Assembly" Plants in Mexico

In the integration of the economies through free transactions, the principle of comparative advantage works to make the best use of ones' specialties, promoting to place the right people in the right place. If there is a wage gap, a country with lower wages is preferred as a production base for a bigger consuming region. It is even more preferred when it has a better access to the market.

However, when the country with low wages has a weaker technology, it tends to have a production process that it just imports parts and assembles them. A knockdown production in the auto industry is one such example. Let us now get closer to Mexico's ability as an industrialized country.

Table 4 compares the ratio of imports for intermediate use in the major manufacturing industries (top 5 sectors) in Mexico with the ratio in rival countries having relatively similar income levels. First, it shows that the Mexican food-processing industry imports 10.4% of intermediate goods from abroad, and coal and petroleum processing industry imports 13.0% of intermediate goods. Although production is declining due to aging equipment caused by a lack of investment, Mexico is still an oil producing country and has a lower dependency ratio on foreign intermediate goods.

On the other hand, chemical industry imports 21.2% of intermediate goods from abroad, having higher foreign dependency ratio than Brazil and Korea. It is considered to be because it has a limited domestic supply capacity for such basic intermediate goods as naphtha and ethylene. In the electrical machinery industry like computer which needs larger number of parts and components, the foreign dependency ratio reaches 62.4% in Mexico, the highest among 5 countries, while in auto industry it stands at 30.6%, second highest after Turkey. From these figures becomes apparent a structure that the more intricate and sophisticated the industry is, the more difficult it will find to procure the necessary parts and components from domestic supply. Since Mexico does not have a broad base of supporting industries, it has not been yet in a position to become a real industrial country that manufactures from materials to parts and components, even if it can become an assembling country by importing parts from overseas[1].

Table 4 Ratio of foreign made intermediate goods in intermediate input

(%)

	Brazil	China	Korea	Mexico	Turkey
Foods	3.6	2.3	9.9	10.4	11.1
Coal/Oil Refinery	19.1	14.6	65.1	13.0	20.7
Chemicals	14.1	5.9	16.3	21.2	28.0
Electric Machine	25.1	13.2	19.4	62.4	35.2
Automobiles	11.0	3.5	10.8	30.6	35.0

(Note) Comparison of output of 5 largest Mexican industries with corresponding figures in major emerging economies. The shares of output are 21.9% for foods, 9.8% for petroleum refinery, 7.6% for chemicals, 8.4% for electric machines and 18.6% for automobiles.

(Source) World Input -Output Table, 2014

4. Increase of Productivity on Foreign Affiliates vs Stagnant Local Industries

Currently it is the foreign affiliates established in Mexico after the close of NAFTA that play an active role in large-scale manufacturing industries. We can see typical examples in its auto industry.

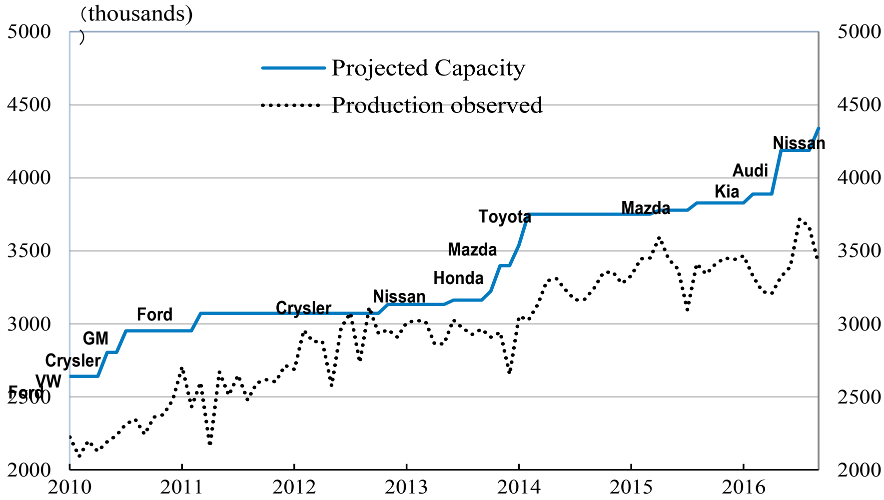
Auto industry is a key industry in Mexico which accounts for 18.6% of its domestic

[1] Similar things are pointed out in the report by the Japan Bank for International Cooperation (JBIC) titled "Investment Environment in Mexico", November 2014.

The report says on p.215 that as the material processing industry in Mexico such as steel and resin is still underdeveloped, these materials are mainly supplied by imports and there is little complete local production of parts. Although some investment has been made on the basic material industry, including by POSCO, a Korean steel maker that started to construct its second factory for steel sheet in 2014, it is considered to take a long time for Mexico to foster the industry.

manufacturing industry (on an output base). Internationally, Mexico ranks 7th in the world auto production and is the 4th exporter in the world. However, it is the major auto makers of Japan, the U.S. and Europe that support its production.

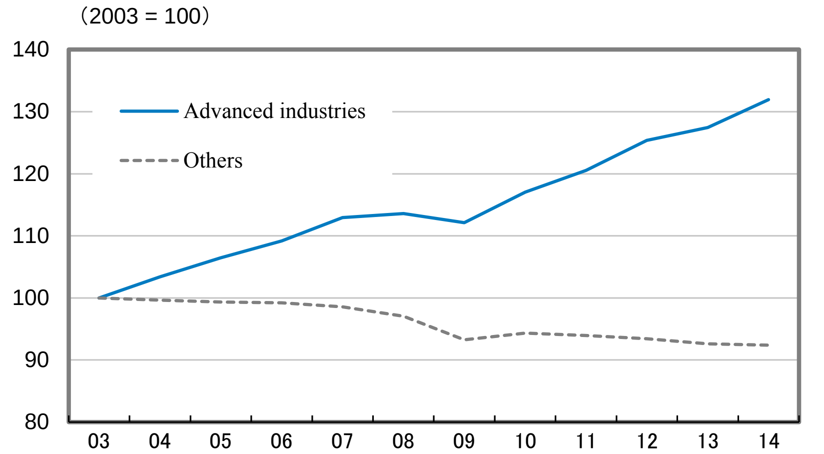
Chart 3　Production Capacity in Mexico's Auto Industry and Investment by Foreign Makers



（Note）Names of car makers indicate the time of building their plants
(Source) OECD

The production capacity has dramatically increased since 2010 with expanded investment by foreign car makers. Not only their plants of finished car makers, but those of primary and secondary parts suppliers have been accommodated with state-of-the-art equipment, boasting high productivity. Thanks to their contributions, productivity in several industry sectors has improved greatly.

Chart 4　Mexico's Total Factor Productivity by Industry

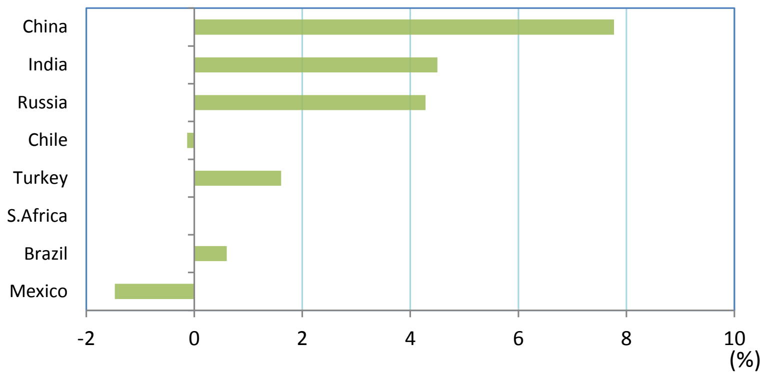


(Note) Advanced industries refer to top 10 industrial sectors such as automobiles, and telecommunications that showed the highest increase in total factor productivity
（Source) Based on OECD Data

Let us look at other industries than the auto industry. Chart 4 compares the index of total factor productivity that indicates the improvement of productivity by technology advancement and streamlining of production process between advanced industries (including the top 10 sectors like automobiles and telecommunications with high improvement in productivity) and other 55 industry sectors (based on NAICS triple-digit classification). The productivity of advanced industries increased by 1.3 times as high as in 2003, but that of other sectors has slowed down. While Mexico has succeeded in attracting advanced industry enterprises from other countries, the national productivity as a whole has grown at a sluggish pace. Here is hidden a problem that Mexico confronts.

Chart 5 shows a comparison of productivity rise between Mexico and its "rival" countries with similar income level. Mexico's stagnation is outstanding among them.

Chart 5　Rise in Total Factor Productivity (2000 to 2011)



(Source) OECD　http://dx.doi.org/10.1787/888932802990

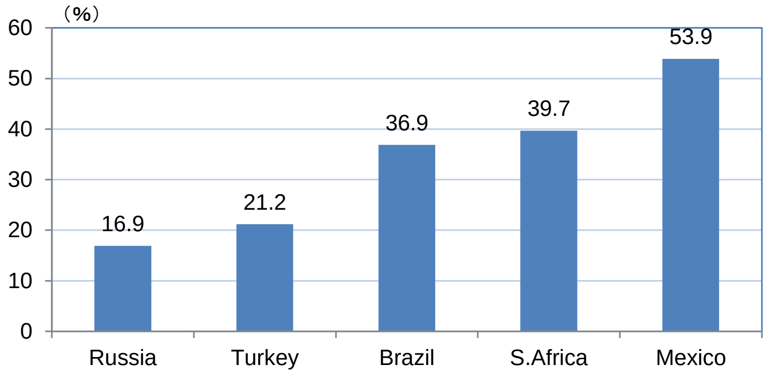
5. Informal Sector that Drags Down the Economy

Then, what are the factors that impede the growth of productivity in Mexico? That is the existence of a big informal sector. Informal sector refers to "all kinds of active entity that has a characteristic of home industry without corporate status" and is a broader concept than so-called "underground economy" which cannot be covered by statistics (according to the definition of International Labor Organization.)

They are in most cases entities that operate while avoiding the tax and social security burdens. Specifically, they include street vendors, temporary employed workers in construction industry, car window washers, garbage collectors, and unlicensed car drivers. The employment in the informal sector is called informal employment.

Even formal enterprises sometimes employ their workers without proper procedures to avoid costs of medical insurance, pensions and workers compensations. Such employment is also classified as the informal employment. Chart 6 shows the comparison of informal employment ratio in non-agricultural sector between Mexico and other countries on a similar development level. As is seen from the chart, Mexico markedly stands out for the ratio of informal employment.

Chart 6　Ratio of Informal Employment in Non-agricultural Sector



（Note）Data for Brazil and Mexico are for 2013, others for 2015
(Source) ILO

Following reasons can be pointed out for low productivity in informal sector.

(i) Most of the enterprises of home industry type that belong to informal sector (hereinafter referred to as "informal enterprises") are micro businesses that cannot take advantage of an economy of scale and fail to ride the wave of technological innovation.

(ii) The employees of informal enterprises are low-skilled workers with the improvement of their skills hardly expected.

(iii) They cannot get finance from normal financial institutions, and are unable to expand their business.

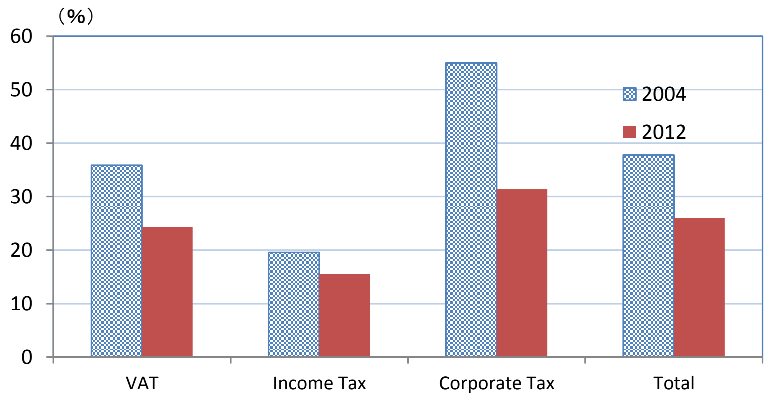
And the expansion of informal sector with low productivity not only directly lowers the growth potential but also produces a negative side effect for the growth.

First, as informal enterprises tend to use low-cost labor rather than introducing new equipment and new technology, they invite lowering, rather than improving of productivity, which in turn leads to a decline of wages. In Mexico, the real wages in small enterprises fell by 2.4% annually during 1999 to 2009. The decline of wages has produced income gaps, blocking the growth of middle income group.

Secondly, the existence of a big informal sector lowers the ability of the government to collect taxes. The fact that more than half of non-agricultural sector employment account for informal employment means that the rest 40+% of the employed bear the tax burdens, creating a sense of unfairness on the tax burdens. It is even more so with Mexico as it has low dependency on indirect taxes. Although it should be taken into account that the budget in Mexico highly depends on oil income, there is no doubt that the informal sector has been eroding the Mexican tax base.

Recently an improvement has been seen in the ratio of tax cheating (virtual tax evasion), yet about a quarter of tax burdens still remain uncollected.(Chart 7) Smaller scale of government revenues will inhibit increased expenditures for improvement of infrastructure and enhanced education of human resources which are indispensable for the future development.

Chart 7 Ratio of Tax Avoidance to Potential Tax Revenues



(Source) OECD

Although there is a negative impression on expansion of the government sector in advanced economies, in the process of transition from middle-income to high-income countries there is a wide and high expectation for the role of the government. Much is expected not only for the improved infrastructure but enhanced public services and welfare policies such as pensions and healthcare, as well as for a strengthened function of income redistribution through those measures. Mexico is approaching to such a phase of development and to meet the challenge it is all the more necessary to encourage the formalization of the informal sector[2].

6. Other Potential Risk Factors

Although there is no impending risk ahead, let us check and confirm the data on the fiscal balance and external transactions which are considered to constitute potential risk factors.

(1) Budget Has No Room for Expansion with Belt-Tightening Needed

The government implemented in 2014 a tax reform trying to increase tax revenues. The impact has been seen in the non-oil tax revenues which increased from 9.7% of GDP in 2013 to 13.6% of GDP in 2016.

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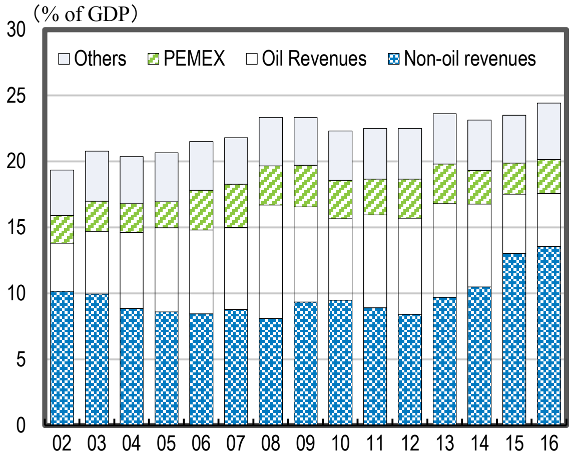
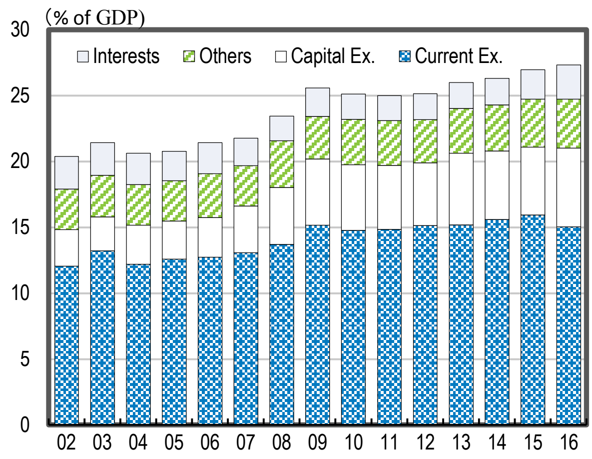
[2] For more details on the adverse effects of the informal sector, please refer to "Bright and Dark Sides of the Mexican Economy", IIMA Newsletter No.18, 2017 (Available only in Japanese)

Chart 8 Breakdown of Revenues



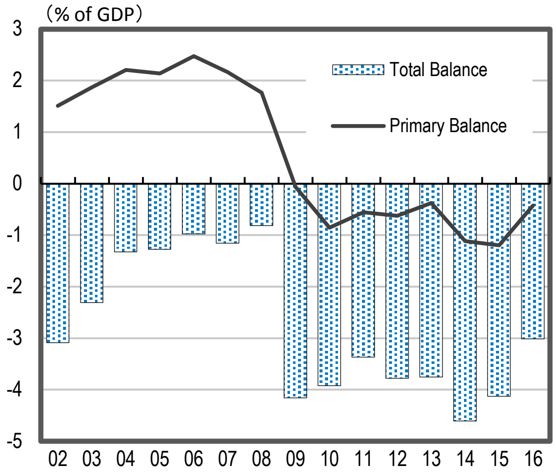
(Source) OECD

Chart 9 Breakdown of Expenditures



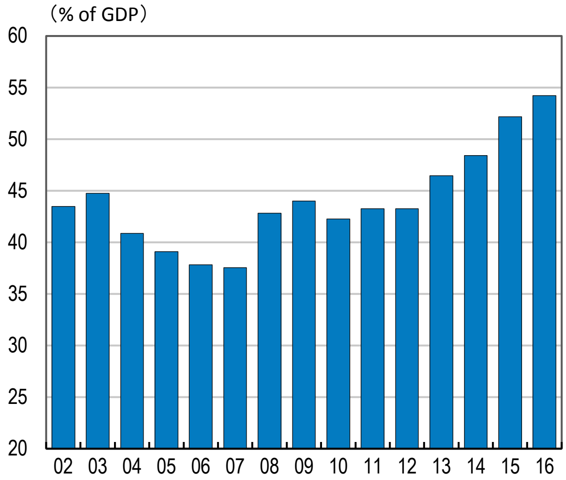
(Source) OECD

Chart 10 Federal Government Fiscal Balance



(Source) OECD

Chart 11 Public Debt Outstanding



(Source) OECD

However, as the oil revenues decreased by 3.1% points of GDP in the same period, total revenue remained at an increase of only 0.8% of GDP from 23.6% to 24.4%.

The expenditures increased to 27.3% of GDP in 2016 reflecting an increase in interest payment as well as in subsidies and pension payments to PEMEX, a state-owned oil company that is included in the "other" category. As a result, the total balance stood at a deficit of 3.0% of GDP although it was narrowed a bit.

Public debt outstanding amounted to 54% of GDP in 2016. It increased by 5.8% points in the past two years. If this pace of increase is maintained, the debt outstanding is likely to reach

60%[3] of GDP in several years, a level that is regarded as a limit to the fiscal soundness.

Taking into account these situations, Mexico has little room to expand its expenditures, and if the economy happens to deteriorate in the future, not only it cannot rely on the expansion of fiscal expenditures, but also it will be forced to tighten the budget belt, which will then accelerate the deterioration of the economy.

(2) So Far No Change in the Capital Inflows

Mexico experienced a balance of payment crisis (so-called Tequila shock) towards the end of 1994. In 2001, 6 years after the crisis, the foreign exchange reserves amounted to mere $44.8 billion, or 16.9% of GDP, as compared to its net liability consisting of direct investment, portfolio investment, and other investment which stood at $264.4 billion. By 2016 the foreign exchange reserves rose to 27.4% of GDP.

What is more striking is the change in its structure of external position. Excluding the direct investment which is considered not to flow out easily, more volatile portfolio and other investments recorded a deficit of $135.2 billion (net outflow of $118.2 billion and $17.0 billion respectively) of which external reserves covered only 33% in 2001. However, in 2016, the external reserves increased to cover 53% of total outflow of $335.5 billion of portfolio investment (net outflow of $390.2 billion) and other investment (net inflow of $54.9 billion). Thus the reserves to cover the capital outflows have been rising, and it can be evaluated that Mexico is now less vulnerable to a balance of payment crisis than before.

Table 5 External Investment Positions

($ billion)

	Direct Investment	Assets	Liabilities	Portfolio investment	Assets	Liabilities	Other Investment	Assets	Liabilities	Total	Foreign Reserves	Net External Position
2001	−129.1	37.8	166.9	−118.2	18.3	136.5	−17.0	60.1	77.1	−264.4	44.8	−219.5
2002	−124.1	42.2	166.3	−108.9	16.5	125.4	−17.3	58.4	75.7	−250.3	50.7	−199.6
2003	−131.4	40.7	172.1	−126.6	15.3	141.9	−20.0	58.3	78.4	−278.1	59.0	−219.1
2004	−158.8	42.9	201.7	−151.9	17.0	168.9	−15.5	63.6	79.1	−326.1	64.2	−261.9
2005	−190.6	53.9	244.4	−170.4	37.6	207.9	−24.5	57.8	82.3	−385.4	74.1	−311.3
2006	−217.1	61.0	278.1	−216.0	39.3	255.3	−22.8	61.9	84.7	−455.9	76.3	−379.6
2007	−233.8	75.3	309.0	−219.4	54.0	273.4	−23.8	80.7	104.5	−476.9	87.2	−389.7
2008	−195.3	66.1	261.5	−232.1	39.9	272.0	−14.8	99.4	114.3	−442.2	95.3	−346.9
2009	−252.6	88.8	341.4	−191.2	47.5	238.7	−26.0	78.4	104.4	−469.8	99.9	−369.9
2010	−268.1	120.7	388.8	−251.5	52.8	304.4	−31.6	105.5	137.0	−551.3	120.6	−430.7
2011	−267.8	117.7	385.5	−264.4	46.8	311.2	−26.7	109.1	135.8	−558.9	149.2	−409.7
2012	−306.0	149.3	455.4	−374.9	55.4	430.3	−10.6	115.4	126.0	−691.6	167.0	−524.6
2013	−340.4	140.5	480.9	−418.9	57.0	476.0	2.9	142.7	139.8	−756.4	180.2	−576.2
2014	−340.2	146.7	486.9	−423.9	57.1	481.0	9.1	163.6	154.5	−755.0	195.7	−559.3
2015	−362.9	146.4	509.3	−400.4	55.4	455.9	27.3	176.3	149.0	−736.1	177.6	−558.5
2016	−324.9	148.6	473.5	−390.2	55.1	445.3	54.9	200.6	145.8	−660.2	178.0	−482.2

(Source) IMF

Even judging from the reserve coverage indicators the IMF provides (reserves equivalent to

[3] The Maastricht standard of the EU sets 60%.as a threshold for warning.

more than three months of imports, more than 100% of short-term debts, and 100~150% of ARA Metric, Mexico meets the guideline standards considered to show a level of safety[4].

In addition, Mexico has been provided by the IMF a Flexible Credit Line equivalent of $86.0 billion[5], and if this is included, it can be said Mexico has cleared the safety standard with a sufficient margin.

Table 6 External Stability Indicators

	2013	2014	2015	2016
FX Reserves($ billion)	180	196	178	178
Months of imports	5.2	5.4	5.0	5.1
% of short-term debts	169.2	183.3	209.2	168.8
ARA Metric（%）	107.9	115.1	112	113.8

（Source）IMF Country Report No.17/129

（Note）ARA Metric is an indicator developed by the IMF. 100～150% is regarded as an appropriate level.

Nonetheless, it will need a close watch whether or not the capital inflow that exceeds the current account deficit will continue in the future. If the friction with the U.S. Trump administration should raise the concerns for Mexico's future prospects and reduce the inflow of foreign capital, it will become a matter of life or death flor the Mexican economy.

Table 7 Balances on Current Account and Financial Account

（% of GDP）

	2013	2014	2015	2016	2017（forecast）
Current Account Balance	-2.5	-2.0	-2.9	-2.7	-2.4
Net Capital Inflow	5.5	4.7	3.1	3.4	2.6
Direct investment	2.7	1.6	2	2.6	1.8
Portfolio investment	3.9	3.6	2.4	2.9	2.1
Other investment	-1.1	-0.4	-1.3	-2.1	-1.3

（Source）IMF Country Report No.17/129

4 The assessing reserve adequacy (ARA) metric is an indicator assessing external safety, developed by examining the past data at the time of currency crises. In the case of countries adopting flexible exchange rate regimes, it comprises 5% of export income, 5% of broad money (5-20%), 30% of short-term debt, and 15% of other external liabilities (like medium- and long-term debts). In the case of countries with fixed exchange rate regimes, it comprises 10% of export income, 10% of broad money, 30% of short-term debt, and 20% of other liabilities. The IMF Report can be downloaded from the following site. .
http://www.imf.org/en/Publications/CR/Issues/2017/05/23/Mexico-Review-Under-the-Flexible-Credit-Line-Press-Release-Staff-Report-44934

5 SDR62..389 billion

7. Current Situation: Receding Uncertainties and Resilient Economy

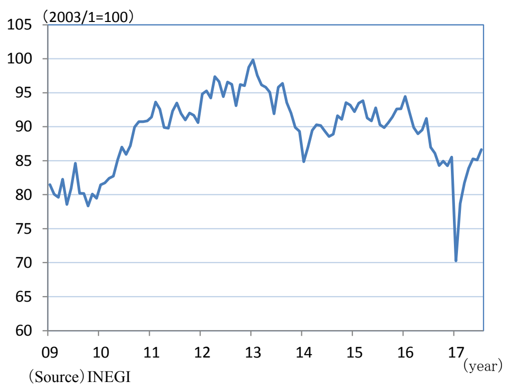
For the Mexican economy, the year of 2017 started with a concern for deteriorated relations with the U.S., but the real GDP growth rate (preliminary) showed in the first quarter a relatively solid increase of 2.6% over a corresponding period of the previous year. The growth rate on a seasonally adjusted basis recorded an increase of 0.7% over the previous quarter, rising by the same rate as in the previous quarter.

Although the consumer confidence index sharply fell due to cautious attitude against the policies of anti-Mexican President Trump, the uncertainties have been receding reflecting the administration’s stumbling measures like a failure to secure a source of finance for building a wall on the Mexican border or no specification on border adjustment tax.

Business confidence is also improving and foreign exchange market is regaining calmness. Exchange rate of peso which fell to the level of 20 pesos per dollar in January has been recovering the level of 18 pesos. As long as the Trump administration lasts, a blind optimism on the U.S.-Mexican relationship will not be warranted, but for the moment Mexican people seem to have regained a peaceful daily life.

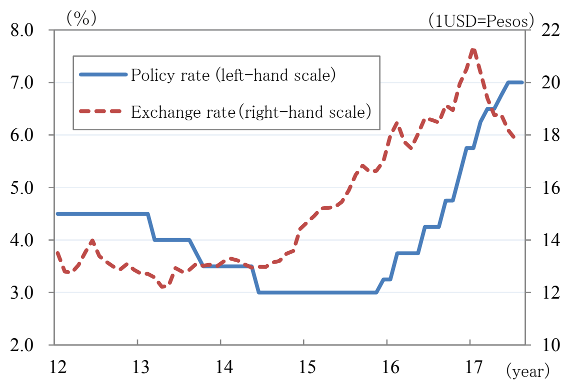
However, even though excessive sense of caution is weakening, it has not receded enough to give hope for an acceleration of future growth. Consumer price rose in April by 5.8% over the same month in the previous year. Although the fall of exchange rate came to an end for a while and upstream inflation rate (producer price) peaked out, inflation has started to spill over from import related goods to non-energy services, with a rise in core inflation rate becoming apparent. Inflation will continue to erode the purchasing power of consumers for the moment.

Chart 12 Consumer Confidence



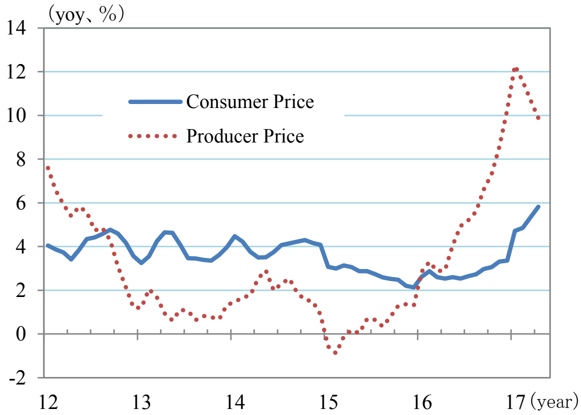
(Source) INEGI

Chart 13 Interest rate and FX rates



(Source)Thomson Reuters

Chart 14 Prices



(Source) Data from Banco de México

8. Two Risk Factors Mexico Faces

Apprehensions over the policies of the Trump administration have subsided for the moment, but it is not to say the administration has shifted to support a free trade regime and there still remains an anxiety over the Mexican relationship with the U.S. In this context, the next attention point will be the renegotiation of NAFTA. The next presidential election slated for in 2018 could also be a risk. Let us see the reasons for them.

(1) Renegotiation of NAFTA

President Trump has committed to the renegotiation of NAFTA, and although it was delayed in its implementation, the consultation is expected to start at the end of August among three countries concerned. NAFTA is considered to have much room for improvement as it has not responded to the electronic transactions and electronic verification because it came into effect before the arrival of full-fledged digital age. If only it deals with the digital technology, it is nothing more than a updating of the treaty, and a revised NAFTA can be concluded by the end of the year.

However, the Trump administration basically affirms protectionism even though it recently stopped publicly stating about imposing 25% tax on imports, and therefore it is likely to make various requests including stricter application of country-of-origin rule[6]. Also it will request an expanded opportunity of participation by the U.S. enterprises in the development of petroleum field in Mexico which used to be protected as a national property, or market liberalization for

[6] According to the draft the USTR submitted to the Congress in March, items to be negotiated include abolition of non-tariff barriers, change of rule of origin, more flexible application of import safeguard, improvement of regulatory and counseling system related to environment and labor, abolition of dispute settlement system on anti-dumping and countervailing duties, etc.

such sectors as healthcare, drugs and medicines, software and financial services over which the U.S. companies are considered to have a competitive edge. It is highly likely that the negotiations will have rough going as the U.S. high-handed attitude to demand on Mexico a market opening while it try to protect its own market will naturally provoke strong protest on the Mexican side[7].

(2) Presidential Election of Mexico (July 2018)

The approval rating for the incumbent president Enrique Peña Nieto is hovering at a low level due to low economic growth at around 2%, unstable civil order that is hard to improve, rampant political corruption and the like. As the unpopularity is not limited to the President himself but extends to his party Institutional Revolutionary Party (Partido Revolucionario Institucional PRI), it is seen that the possibility is low that any candidate from PRI wins the 2018 presidential election[8]. The election campaign will be fought mainly between the middle-right National Action Party (PAN) and the leftist party Morena (National Regeneration Movement).

And the central figure viewed as an eye of the storm is Mr. Andrés Manuel López Obrador, party leader of Morena. Mr. Obrador is originally an influential figure who left the leftist Party of the Democratic Revolution to establish Morena and enjoys high popularity among low income class. As the Mexican presidential election is conducted by only one round voting with no runoff, the candidate who gets the largest number of votes is elected. That means there is a possibility that the candidate who gets the votes of lower level of 30% becomes the top, and Mr. Obrador is regarded as the most likely candidate.

If Mr. Obrador is elected, there is a risk that the open and business-friendly economic policies under the Peña Nieto administration will be revised.

9. Medium -term Scenarios

Having in mind the outcomes brought by the two risk factors noted above, I would like to discuss the medium-term scenarios (down to around 2020).

(1) Status quo (40%)

This is a scenario that holds, with a prospect that more realistic center-right PAN will gain a political power rising, the relationship with the U.S. will undergo no dramatic improvement nor

[7] On the other hand, President Peña Nieto has set following 10 items as objectives for renegotiation of NAFTA. (i) rights and treatment of Mexican emigrants, (ii) handling of repatriation of emigrants, (iii) cooperation on the development of Latin American and Caribbean countries, (iv)guarantee on freedom of remittance, (v) prohibition of illegal drag-in of weapons, (vi) maintenance of free trade in North America, (vii) inclusion in the agreement of new sectors like communications, energy, and electronic transactions, (viii) improvement of wages of Mexican workers, (ix) preservation of environment for investment, and (x) cooperation on border administration.

[8] The constitution of Mexico does not permit re-election of a president.

deterioration, while the status quo continuing. Investment in Mexico of foreign enterprises will see no big increase nor withdrawal and support the Mexican economy.

Yet, the Trump administration will have to take more time off to deal with Russia related allegations domestically and issues on the Middle East and North Korea diplomatically. As a result, the NAFTA negotiations will be protracted with a sense of uncertainty not wiped out completely. Also the Trump administration will not be able to implement extreme anti-Mexican policies due to fiscal and judicial constraints, which will keep the peso at around a current level, supporting the economy to grow at lower level of 2%.

The probability of this scenario is estimated at 40%.

(2) More protracted Tensions between Mexico and the U.S. with the Establishment of the Leftist Administration (30％)

Last year, Mr. Trump had loaded the Mexican people with insults during his election campaign. One of the reasons that the approval ratio of the incumbent administration has been stagnant comes from its seemingly obsequious attitude against the Trump administration because it did not adopt any confrontational approach to the latter.

For that reason alone, the opposition party candidate is highly likely to adopt a tactic to criticize the soft and weak stand of the present administration and intensify anti-Trump sentiment with a campaign saying “It is only this party that can assert the benefits of Mexico”. What is concerned is an escalation of a sentimental confrontation of the anti-Mexican sentiment on the U.S. that may be reignited by such campaign. In the end, it will lead to a scenario that Mr. Obrador who has a hard-line anti-American attitude will win the election.

Mr. Obrador once served as Mayer of Mexico City and has a recognition that he actually maintained a more realistic middle-of-the-road attitude. However, different from being a top of local government, even though that of capital, a president has been given far broader freehand and some warries that the risk for his policy shift may not be negligible.

In any case, an establishment of the leftist administration with anti-American attitude will heighten the uncertainties for the Mexican economy. The NAFTA negotiations will see more conflicts and it will become harder to expect an early completion of the negotiation. As a result, investment will be reduced in a wait-and-see attitude, and the economic growth will falter at the level of 1% until 2019 at the earliest when the policy stance of the new administration becomes clear. Exchange rate of the peso will also renew the record low to fall to more than 22 pesos against the dollar. Outflow of portfolio investment may also increase.

In this scenario, cheaper peso will not work as a driving force to exports, and Mexico will face a period with low economic growth and relatively high inflation coexisting.

Probability is estimated at 30%.

(3) Frictions Avoided for Co-existence and Co-prosperity (15％)

In the presidential election the center-right candidate will win and both the U.S. and Mexico will recover their composures, reconfirming the merits of free trade. The review of NAFTA will be completed promptly since most of the issues are those for updating. And this will become the best case to aim at co-existence and co-prosperity through open trade policy. The exchange rate of the peso will rise to above 17 pesos to the dollar, attracting more investment and the growth will be accelerated reflecting an expectation for the economic integration in North America. The growth rate will rise up to 3% and growth without inflation will be realized.

Probability ratio is estimated at 15％.

(4) Negotiations Break Down with the U.S. Withdrawing from NAFTA (15％)

This scenario incorporates further downward risks in the protracted tension scenario shown in (1) above. Here a strong leftist administration will be formed in Mexico and take a tougher line against the protectionist demand of the Trump administration.

As a result, the NAFTA negotiations will break down, with the U.S. declaring its withdrawal from NAFTA in a unilateral way. The relationship between the U.S. and Mexico will become more acrimonious, resulting in a less investment in Mexico and more extradited illegal workers from the U.S.

The real growth rate of Mexico will fall to negative territory with the exchange rate of the peso plummeting to 25-30 pesos per dollar. Even a balance of payments crisis might occur caused by a large scale of capital flight in portfolio investment.

Expected probability is 15％.

As we have seen thus far, there remain many structural issues in the Mexican economy. If the investment in the advanced industrial sector that has pulled the economy will stagnate, the productivity growth in Mexico will slow down instantly, which might bring the structural vulnerabilities to the fore. Since the main players of the advanced industry are foreign enterprises, any policy that could weaken their incentives to enter the Mexican market will give nothing more than a disadvantage to Mexico. Thinking rationally, the government of Mexico should continue to negotiate perseveringly with the Trump administration even if their pride should be injured.

Since last year, however, in many countries it happened that the public opinions did not always support a rational choice but got swayed by emotion. This is the reason why the scenario (2) is given a high probability.

It should be seen what kind of choice the Mexican people will take. Since the 1980s Mexico has promoted open economic policies as a national policy, but it now stands at an important crossroad.

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