LatAm

MEXICO: THE RACE TO MEET TRUMP'S DEMANDS

Grace Fan

The AMLO administration's success at averting the start of the Trump tariffs this week – originally set to begin at 5% and to rise as high as 25% by 1 Oct – by making major concessions on migration policy has postponed, but by no means eliminated the tariff threat. Despite the near-term relief that this has offered Mexico, it now faces a new 45-90 day deadline to slash surging migrant inflows or the likely return of the tariffs should it fail to adopt "additional measures". In addition, US President Trump's eagerness to use tariffs as a one-size-fits-all bludgeon to get his way on non-trade related matters adds to risks for Mexico in the nearly 17 months left before the US 2020 presidential election.

Key judgments

- Mexico has – in effect – agreed to become the de facto 'wall' that Trump has long promised but failed to build; whether it will succeed is another matter.
- This shift will add to increasingly unsustainable fiscal pressures on the AMLO government and rising risk of future sovereign ratings downgrades.
- Trump's willingness to tie tariffs to non-trade issues not only further trims the odds of NAFTA 2.0 (USMCA) approval this year in the US Congress, but also devalues the deal's importance – hurting Mexico's investment outlook.
- The irony is that if Mexico succeeds in disrupting near-term migration inflows, it could aid Trump's re-election, thereby prolonging Trump risk beyond 2020 to 2024.
- Yet because the US-Mexico migration deal does not address the deep structural problems that are sparking the Central American migration exodus, longer term risks will persist.

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Ebrard buys time for Mexico

Foreign Minister Marcelo Ebrard succeeded in averting a worst-case outcome last Friday (7 Jun) when he achieved a migration deal with the Trump administration. Two days before the planned imposition of 5% tariffs on all Mexican goods by the Trump administration (with the threat of progressive tariff escalation to 25% by 1 October), Foreign Minister Ebrard – aided by bipartisan support from US legislators – managed the tough balancing act of delaying US President Trump's tariff threat without fully caving into his demands. Still, in a sign that the threat has only been postponed, not eliminated, the migration deal as announced on Friday set an official 90-day timeline for the two countries to revisit the issue if the US government fails to be satisfied with the results. To add to the pressure on the Mexican government, Ebrard admitted this Monday that the preliminary timeline for Mexico to produce concrete results is, in fact, only 45 days. At that point, the Trump administration plans to conduct an initial evaluation of the migration deal to assess results; and if there is no sizeable improvement, then the two countries will begin further discussion of "additional measures" to impede soaring migrant inflows.

The current deal centres on two key elements, starting with a significant expansion of the "Remain in Mexico" programme – a measure that will further tax a fragile economy. In the biggest concession that Mexico has made thus far, the government of President Andrés Manuel López Obrador (AMLO) agreed to accept the return of many more migrants, by allowing the US to ship "all" illegal migrants who enter the US via its southern border back to Mexico to wait there while their US asylum requests are being processed – a policy informally known as "Remain in Mexico". While the AMLO government had already opened the door to this policy early this year in a big change from the previous administration, just over 11,000 Central American migrants have been returned to Mexico as of 8 June, according to data released by the National Institute of Migration (INM) this Monday. That represents just 2.5% of the roughly 440,000 illegal migrants who have been apprehended at the US border in the first five months of this year (see Charts 1-2 below).

Still, an ongoing lawsuit filed by US civil rights groups against the "Remain in Mexico" policy could potentially scuttle the new deal if US courts rule in their favour. If so, however, a risk is that Trump's tariff threat could re-emerge on the front burner if Mexico fails to make other concessions on migration by then. In the meantime, it is as yet unclear whether the deal will ship back only new Central American migrants who enter the US from now on or will include migrants who are already in the US awaiting asylum hearings. In either case, the influx of more migrants on an exponential scale will greatly overburden Mexico's border cities which have already been strained by a growing wave of migrants at a time that the economy has been visibly slowing down and 2019/20 GDP forecasts continue to dwindle (for more background, see our 28 May 2019 note Urzúa's uphill battle).

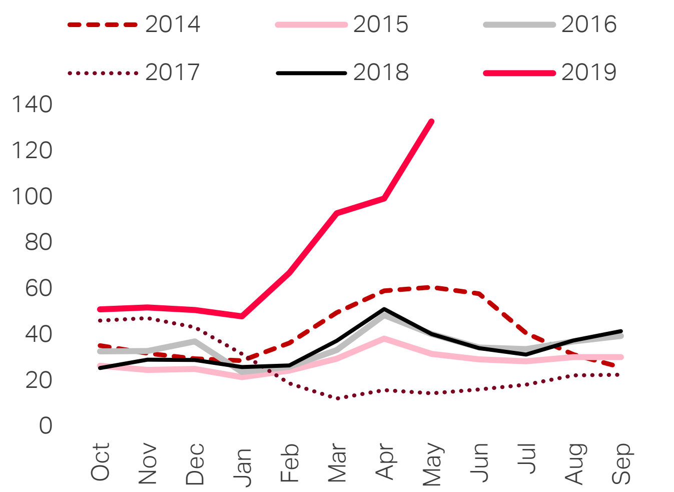
To add to the challenges ahead, Mexico has agreed to provide "jobs, healthcare and education" for the migrants – something that the country is already struggling to deliver for its own citizens. As we highlighted last month, sharp government budget cuts to key public hospitals and healthcare workers as part of the Finance Ministry's austerity programme recently created a wave of negative news; it also made it abundantly clear that the country's already overburdened public healthcare system has little capacity to provide for still more patients. If already scarce budgetary funds are funnelled toward this cause, it would only further complicate the Finance Ministry's challenge of meeting its primary surplus target of 1% of GDP in 2019 and 1.3% in 2020.

The second element of the deal includes Mexico's agreement to militarize its southern border with Guatemala by sending 6,000 troops from its new National Guard to a priority 11 municipalities. In addition, the Mexican government announced that it would open 10 new border control posts and has also suspended the bank accounts of more than two dozen people believed to have helped organize Central American migrant caravans from October 2018 onward.

One seasonal trend that could help Mexican authorities in the next few months is the fact that migrant inflows often peak in the spring before dipping in the summer, as traffic tends to diminish during the often brutally hot summer months, as we highlighted last week (see our 3 June 2019 note Trump tariff trouble). In addition, there is anecdotal evidence that the number of Central American migrants spiked in recent months in part because of fear that the Trump administration would soon impose more draconian measures – thereby frontloading the migrant wave. That trend too could help Mexico in its task of reducing the successive tides of new migrants entering the country.

Chart 1: US southwest border apprehensions*

Thousand people

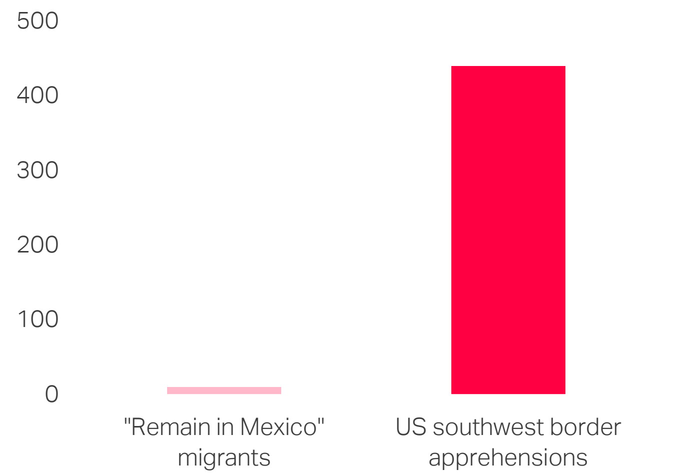


*Does not include those ruled inadmissible at ports of entry; fiscal year runs from Oct-Sept.

Source: US Customs and Border Protection.

Chart 2: "Remain in Mexico" vs US border apprehensions, Jan-May 2019

Thousand people



Sources: INM, US Customs and Border Protection.

Positive as these measures could be for disrupting short-term migrant inflows, they are likely palliative for three reasons:

1. **The porous Mexico-Guatemala border** spans more than 850km and has limited fencing, thereby throwing the effectiveness of controlling migration into question with so few troops; it also means that as time goes on, migrants are likely to begin to cross from other points on Mexico's southern border, up to and including neighbouring Belize.
2. **Scarce funding.** As part of its fiscal austerity programme, the Mexican government dramatically slashed funding to its immigration agencies in its 2019 budget, leaving it with little bureaucratic capability to process sizeable numbers of new migrants, unless those funds are restored. In addition, the new National Guard has just been created (after secondary legislation was passed last month), similarly adding to uncertainty

about its eventual effectiveness at a time of record homicide levels in the country. Critics have also warned that the National Guard's new border patrol responsibilities could complicate its main mission of lowering crime levels nationwide and reducing public insecurity..

3. **New 'Marshall Plan' has sparked little US interest.** From a structural point of view, AMLO's cherished plan of reinvigorating the region via a new 'Marshall Plan' that would encourage regional economic development if an annual US$10 billion were invested every year over the next decade is a far better bet for attacking the root causes of the Central American migration crisis. However, the Trump administration has shown little enthusiasm in committing resources to date.

Despite the upcoming headaches for Mexico, Foreign Minister Ebrard did manage to avoid a worse fate by evading the imposition of a "safe third country" deal . . . for now. Under such an agreement, as we highlighted last week, the US would have the automatic right to deport all illegal migrants to Mexico if they entered the US from its southern border – without having to first jump through the hoops of US immigration law and the "Remain in Mexico" programme to do so. Still, while Ebrard succeeded in convincing the Trump administration to wait and see if less drastic measures could work first, recent reports that US and Mexican negotiators have already begun to explore more sweeping changes to immigration policy via a "safe third country lite" deal are an indication of what could be on the table if the current deal fails to quell surging migrant inflows.

One upcoming possibility is an agreement in which Central American migrants would have to apply for asylum in the first country they enter, rather than the US. For Guatemalans, this would be Mexico; for Hondurans and El Salvadorans, it would be Guatemala. Such a deal could offer Mexico a way to partially mitigate the dramatic economic implications of changing its immigration policies, as Hondurans have reportedly made up a sizeable percentage of the recent migration inflows. Still, such a deal would also require Guatemala's agreement; but because the country is holding presidential elections next weekend – and its new government will take office in January 2020 – that part of the equation remains up in the air. On Monday, Foreign Minister Ebrard highlighted that his broader dream is to change regional asylum laws in a shift that would include, not just Mexico and Central America, but also Brazil and Panama. However, such a change would require the other countries' cooperation and it is unclear what sweeteners Mexico might offer to persuade them to agree to a "first country asylum" policy, even if the US were to express support for this too.

In the meantime, Ebrard has tried to limit speculation, by stressing that Mexico still has more than 40 days to show the US it can reduce migrant inflows. At the same time, he flatly denied Trump's affirmation this Tuesday that Mexico had made a "secret" immigration pact with the US which would impel the Mexican Senate to ratify new legislation. (In a similar vein, the Foreign Minister earlier this week refuted Trump's statement that Mexico would "immediately" purchase "large quantities" of agricultural products as part of the deal.) Still, Ebrard acknowledged this Tuesday that should Mexico fail to curb migration inflows by late July, the US would likely bring up a "safe third country" deal again, at which point the AMLO government could well be forced to choose between approving some variation of a "safe third country" agreement (which would indeed have to be ratified by the Mexican Senate) or to face the imposition of tariffs again. On this point, his comments dovetail with Trump's statements and it appears that Trump was likely referring to this next potential agreement as a done deal.

In a sign that the AMLO administration understands the imperative of acting quickly, the President early this week announced three concrete steps on the matter. The first was an announcement that some of the 6,000 National Guard troops would begin to arrive in Chiapas this Tuesday (although at the time of publication, there were no local news reports that confirmed that soldiers had indeed appeared at border municipalities). The second was the creation of a special committee on illegal migration, which will be headed by Foreign Minister Ebrard, and will have the task of coordinating the deployment of the National Guard at the southern border.

The third measure was AMLO's announcement that one of his priority social assistance programmes – "Planting Life" ('Sembrando Vida') – will be immediately expanded in a bid to offer jobs to Central American migrants. The programme – which launched in February – originally had the goal of planting 1 million hectares of fruit and other trees to create 400,000 jobs, with a monthly salary of MXN5,000 for workers. The expanded programme now has a target of planting an additional 200,000 hectares in the country's south to create an additional 80,000 jobs for Central American migrant workers.

Although this sounds positive on paper and the programme's fiscal cost in the 2019 budget (at MXN15 billion) is also fairly low – the larger problem is that, even prior to this week's announcement, there was already increasing concern that the programme could be a big failure from the point of view of productivity and reforestation. This is because of the programme's lack of the proper technical support and scientific know-how, in addition to the use of marginal land with which to plant many of the trees. In a previous federal tree-planting programme run under the Calderón government, only a low percentage of the trees actually survived or thrived; this highlights the underlying problems of creating sustainable jobs via this type of programme, even if it is extremely useful for temporary job creation and winning votes, come election time. Still, it is one thing to create these jobs for Mexican workers and another thing to reserve such posts for Central American migrants at a time of weak economic growth and falling formal job creation. This means that unless AMLO can jumpstart the economy, local tensions could easily grow as a result.

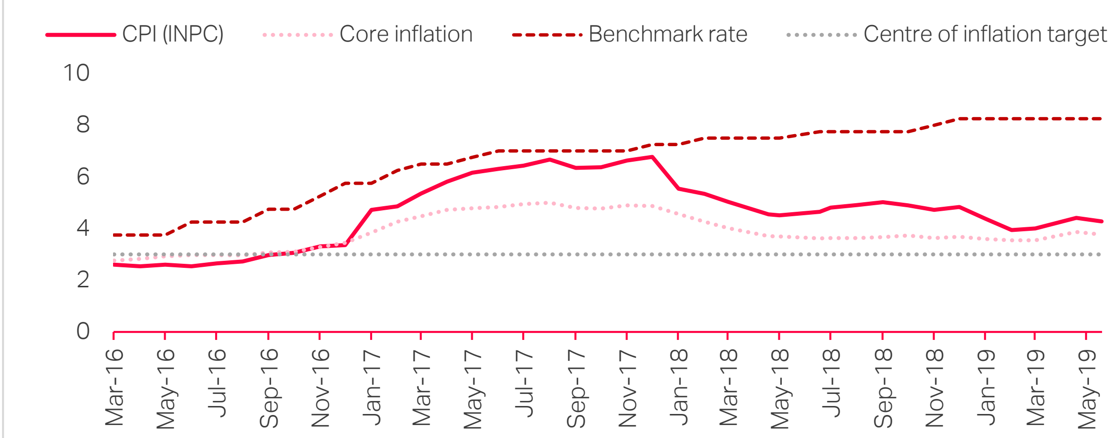
Rising structural risks, amid near-term relief

In the meantime, clouds continue to loom for the Mexican economy. Last week, as it became clear that investor uncertainty was likely to persist as a result of the tariff threat – notably with Trump's stance that US tariffs could be imposed anytime for issues other than trade, irrespective of his signing of the NAFTA 2.0 (USMCA) deal – two ratings agencies dealt a blow to the Mexican government. Fitch downgraded Mexico's sovereign credit rating by one notch to BBB, with a stable outlook, and cut Pemex's long-term foreign and local currency ratings to junk, with a negative outlook, as it cited "unpredictable" policy making as a key factor. Moody's altered the outlook of its A3 sovereign credit rating for Mexico from stable to negative.

Part of the problem for Mexico is that Trump risk is likely to remain elevated in the nearly 17 month countdown to the US 2020 presidential election, not least because the US President was elected on a hard-line stance on illegal immigration fed by Mexico-bashing, and there is little reason for him to change his tune as his re-election campaign fires up. Another problem is that the Trump administration's stance of explicitly tying tariffs to migration inflows not only further slashes the already long odds of USMCA approval in the US Congress before yearend; it also makes it simultaneously less important, because its ratification will not automatically guarantee companies a tariff-free environment for regional trade. Yet without more investor certainty, the outlook for Mexico's economy will remain dim, adding to the AMLO administration's growing problems.

Still, the bright side of the Trump tariff suspension is that it should help to reduce FX volatility for the time being, aiding Banxico's task of controlling inflation. While the longer-term consequences of Trump's Mexico policy appears negative for the country, the near-term positive is that the Mexican government has avoided a trade war, for the time being, with its most important market. This is likely to decrease short-term FX volatility and bolster the peso, which will help to reduce inflationary pressures. In May, as Chart 3 below illustrates, the CPI came in above Banxico's inflation target range of 3%, +/- 1pp for the second consecutive month at an annual 4.28%, although its monthly decline (-0.29%) was below average market estimates (-0.23%). Falling inflation coupled with a stronger peso would keep the door ajar for a Banxico rate cut later this year, especially if the US Fed cuts rates up to three times by yearend.

Chart 3: CPI (INPC) vs key rate
%



Sources: INEGI, Banxico.

Conclusion

Trump's success at advancing on key political goals by wielding the tariff threat likely emboldens him to continue on the same path for the near future, adding to Mexico risks. Like it or loathe it, the US President's latest gambit of playing hardball against Mexico by brandishing tariffs as his ultimate weapon has indeed produced visible results, as Trump crowed this Tuesday. In effect, he has succeeded in forcing Mexico to agree to become his de facto 'wall' against illegal migrants. Regardless of whether this occurs via the significant expansion of the "Remain in Mexico" programme or the possible adoption of some variant of a "safe third country" deal (should either Mexico's current efforts fail or US courts rule against "Remain in Mexico"), this will pose ample structural fiscal risks for Mexico longer term, as the country becomes responsible for sheltering a significant influx of migrants and offering them jobs, healthcare and education. And while visible Senate Republican dissent on the tariffs last week did set outside limits on presidential overreach, it is also clear that their rebellion was not enough to thwart Trump. Still, whether they succeed at some future date at imposing strict limits on his tariff-wielding powers bears monitoring.

In the meantime, Trump is likely to reap further political benefits from his bullying of Mexico, as he kicks off his official re-election campaign next Tuesday (18 June). It is worth pointing out that despite all of his rhetoric, Trump has conspicuously failed thus far to meet two of his core campaign promises to date – 1) building a wall; and 2) controlling illegal immigration. Yet by outsourcing the "dirty work" to the Mexican government as a result of the US-Mexico deal last week – something that AMLO last year insisted he would never agree to do – Trump has at one stroke turned the tables and bolstered his electoral outlook. And while the good news is that Mexico has evaded a worst-case scenario, the bad news is that medium-term risks continue to rise. The bitter irony is that should Mexico ultimately succeed in reducing short-term illegal immigration inflows to the US, its reward could be that such a trend will aid and abet Trump's re-election bid, potentially extending Trump risk from beyond 2020 for another four years.

Authors

Grace Fan
Senior Director,
Brazil/Latin America
Research