



LatAm

DID MEXICO LOSE OR WIN WITH THE NEW TRILATERAL DEAL?

Cristobal Arias

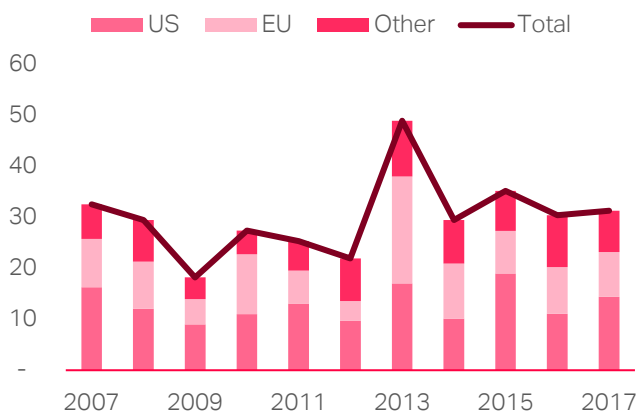
- The new trilateral deal set to replace NAFTA does not significantly address the core issues for which the deal was renegotiated: the erosion of US manufacturing jobs and the US trade deficit with Mexico.
- At the micro level, the new guidelines reduce the competitiveness of the automotive industry but provide safeguards against potential trade tariffs in this sector.
- At the macro level, the end of a forced renegotiation reduces trade uncertainty, improves business sentiment and lifts the country's outlook.
- The next challenge is to have the new deal approved by the Canadian parliament and the US Congress – the Mexican Senate has already expressed its willingness to ratify it.
- Overall, the final deal makes Mexico and North America somewhat more protectionist and fulfils the aspirations of some stakeholders to “turn this hemisphere into a manufacturing powerhouse”.

The road to a rebranded NAFTA

Credit is due to the Mexican negotiating teams for the completion of the NAFTA renegotiation.

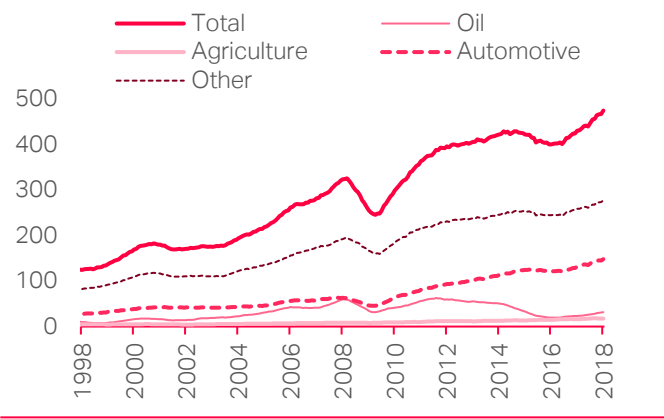
Just over a year ago, President Trump notified US Congress about his intention to renegotiate NAFTA. The aim was to obtain a deal favourable to the US so that it could narrow its trade deficit with Mexico and prevent US companies from shifting operations to Mexico, where they enjoy lower labour costs. Trump threatened to shred the treaty altogether if no such deal were reached. Last August, Mexico and the US announced a preliminary agreement to allow the current Mexican President to sign it before leaving office on 1 December. Last week, successful trade talks between Canada and the US led to the announcement by Washington of a new trilateral agreement (USMCA) to replace the existing NAFTA. Some observers consider the US has pushed relatively small economies like Mexico and Canada into accepting a deal that is not good for any of the NAFTA member countries – including the US itself. In our view, this interpretation misses the bottom line from a pragmatic Mexican perspective: it removes the uncertainty associated with the potential withdrawal of the US from NAFTA, which would trigger a negative economic and political reaction across Mexico and North America.

Chart 1: FDI by region, US\$bn



Sources: INEGI, TS Lombard.

Chart 2: Mexican exports, US\$bn



Sources: INEGI, TS Lombard.

A new deal with modest changes to the original NAFTA has been achieved. A detailed document incorporating the guidelines agreed on by the three countries belonging to the [USMCA](#) was submitted to the Mexican Senate on 1 October. The key elements of the deal include raising the rules of origin (or the minimum NAFTA content necessary for transport vehicles to be tariff-exempt) from 62.5% to 75% starting in 2020. At the same time, 40-45% of the vehicle should be assembled by workers earning at least US\$16 per hour. The new deal includes a sunset clause stipulating that the treaty is to expire after 16 years with annual revisions from the sixth year onwards, but it allows any of the three countries to extend the expiry date at each annual revision. The renegotiated treaty also includes initiatives across a wide range of sectors, such as removing tariffs for e-commerce and enhancing property rights. Most of these guidelines had already been negotiated for the TPP multilateral deal under the Obama administration that Trump withdrew from last year.

Micro-level changes are unlikely to modify the macro picture. The successful trade talks between Canada, Mexico and the US has reduced aggregate uncertainty by decreasing the likelihood of NAFTA dissolving. Although FDI into Mexico has declined very gradually over the last few quarters (see Chart 1 above), prolonged uncertainty risks a sharper slowdown, which

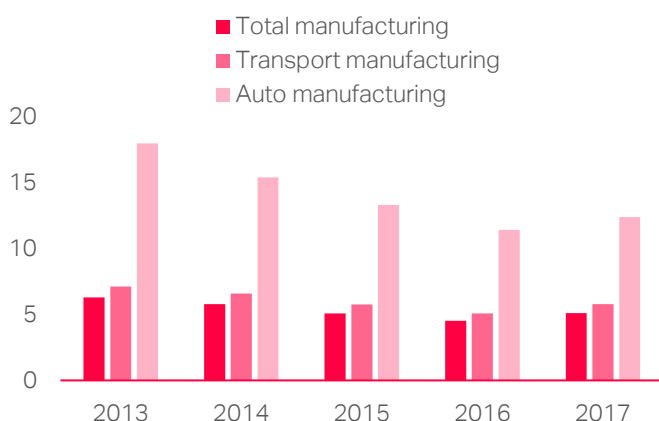
could impact the wider economy. And while the modifications to the existing treaty mentioned above will impact certain industries, such as the automotive one, we believe the changes will be negligible in the short term. At most, they will nudge up the wage bill for companies operating in this sector across the region.

Light adjustment to the auto industry

The auto sector has been behind booming exports. During the past 20 years, the automotive industry has established itself as one of the most important drivers of exports. Last August, auto exports amounted to almost US\$ 150bn, well ahead of previously important industries such as agriculture and oil (see Chart 2 above). Indeed, auto exports grew by more than 40% between 2012 and 2017, accounting for almost 35% of total manufacturing exports in the country. The upscaling of production capabilities in this industry, which has doubled its value over this five-year period, is a reflection of this impressive growth. Moreover, without the large trade surpluses in the automotive industry, the total trade deficit – which currently stands at US\$10.9bn – would be even larger. Although most car companies are foreign, few domestic auto-parts companies have integrated into the supply chains through the provision of intermediate goods.

The new rules of origin will not significantly disrupt the automotive industry. According to the representative body of the Mexican business association (CCE), which was involved in the NAFTA renegotiation, around 70% of auto and auto-parts exports already fulfil the new content requirement of 75% in order to be exempt from the trade tariffs set for the USMCA. This means that the auto industry is protected against any potential unilateral tariff imposed by the US government, given that that most auto exports would be exempt from such a duty if they abide by the rules of origin. Moreover, another point agreed on in the renegotiation is that up to 2.6mn cars – out of the almost 2.7mn exported last year – are to be exempt of any potential car import tariffs from the US. Meanwhile, the US import tariffs on steel and aluminium from Mexico implemented more than three months ago are likely to be lifted, possibly before the Mexican Senate ratifies the final trade deal.

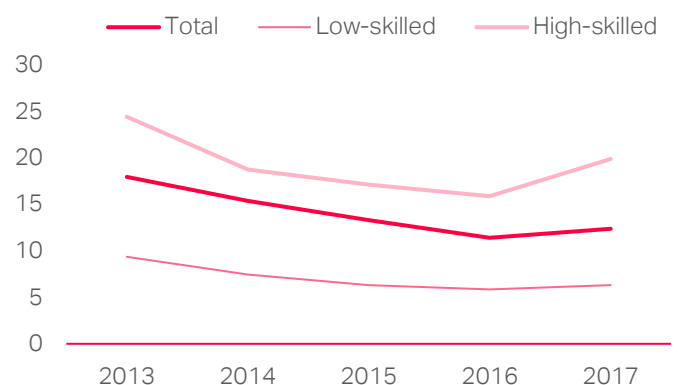
Chart 3: Wage per hour, US\$



Sources: EMIM-INEGI, TS Lombard.

Chart 4: Wage per hour, US\$

Auto manufacturing



Sources: EMIM-INEGI, TS Lombard.

Wage hikes required by the USMCA are limited to a relatively small workforce. Although the auto industry has been booming, wage growth has lagged. As of 2017, there were almost 3 million people working directly in the manufacturing sector, but only less than 76,000 were employed in the automotive industry (no more than 0.1% of the total economically active population). Employment in this sector has grown by 50% over the past five years, whereas

average wages in local currency have increased by just over 20% during the same period. Moreover, average wages in dollar terms have dropped by almost 20% since 2013 owing to the depreciating peso. However, at more than US\$12 per hour, wages in the auto manufacturing industry are three times those in the broader manufacturing industry (see Chart 3 above).

But the large wage gap between high- and low-skilled employees persists. The new stipulation that 40-45% of a car is to be produced by workers earning at least US\$16 per hour would require a significant adjustment in the wage bill: high-skilled workers in this industry already earn almost US\$20 per hour, while low-skilled ones earn just over US\$6 per hour. This means that workers who fall under the new trade guidelines will see their wages grow by more than 150% (see Chart 4 above).

Sectoral wage increases do not pose a significant risk to inflation. Given that the number of workers in the auto industry remains very small and most manufacturing companies are located in a handful of states in the country, any ripple effects from the wage hike into the wider economy is unlikely. Although the wage hike would be large, its full implementation would be gradual – over the next three years. More important, the risk of higher inflation from a sectoral wage hike is negligible compared with a fall in the peso if NAFTA were to have been abolished.

The Mexican auto-parts industry has welcomed the new rules. Although the new deal will add pressures to the wage bill in the auto industry, auto-parts companies are set to grow under the USMCA. According to the auto-parts business association, most non-US car companies import auto-parts from world regions other than North America, but under the new guidelines they will have to source them from either Mexico, Canada or the US. Given that Mexico will remain the most competitive country from which to source inputs, local auto-parts companies are expected to grow the domestic market – currently worth US\$90bn – by US\$10bn. Despite the sector-specific technical implications of a new trilateral deal mentioned above, our view is that the new agreement points to political gains across the board.

Lifting the geopolitical curtain

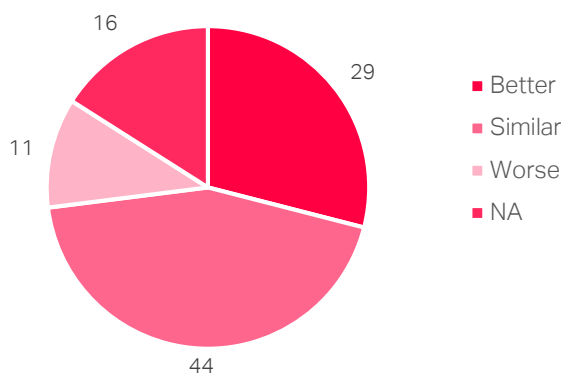
Political timing was crucial in securing a new trilateral deal. By the time Mexico and the US announced they had reached an agreement in August, the incoming Mexican administration, who was elected on 1 July, had become more involved in the renegotiation. At the same time, Trump had opened several trade fronts (see our [6 August 2018 EM Watch](#)) and was facing renewed domestic political pressures. He needed to score some form of political victory, and the USMCA appeared to deliver him that victory. But the truth is that the USMCA will neither reverse the erosion of US manufacturing jobs nor correct trade imbalances between Mexico and the US. Most changes to the trilateral deal are minor, as pointed out above, and technology will continue to replace labour-intensive processes, predominantly in the US. Very active lobbying from US business associations trading in global supply chains across North America was another force behind the new deal.

The deal is a modest political victory for the US President and the Mexican President-elect. For now, the new trilateral deal might go some way to meeting Trump's vision of greater parity between Mexican workers and their US counterparts. As for Mexican President-elect Andres Manuel Lopez Obrador (AMLO), boosting sectoral wages and removing macro uncertainty associated with the NAFTA renegotiation appears enough to deliver on some of his campaign pledges to improve the domestic economy. These were important considerations in securing his support for the new trilateral agreement. But Mexico's victory is seen only as modest by the majority of Mexicans. According to a poll conducted last week by local daily *El Financiero*, just 29% of Mexicans believe Mexico will be better off under the new USMCA, while

44% think it will remain the same as under the existing NAFTA and 11% believe Mexico will be worse off (see Chart 5 below).

The new USMCA trade deal includes a “China clause”. There is a key geopolitical component to the NAFTA renegotiation: containing China’s ascension in the world market as the US-China trade war escalates (see Jonathan Fenby’s [9 October 2018 China Watch](#)). Chapter 32 of the USMCA includes a clause that prevents any USMCA member country negotiating a trade deal with a country not considered market-friendly without three months’ notice; if it fails to give such notice, the country faces a penalty of being expelled from the USMCA. As we highlighted in our [6 August 2018 EM Watch](#) the incoming Mexican administration had started trade talks with high-level Chinese officials to explore ways in which they could work together to expand trade and fund AMLO’s infrastructure programme (see our [3 August 2018 Mexico note](#)). Similarly, Canada was reportedly holding trade talks with China.

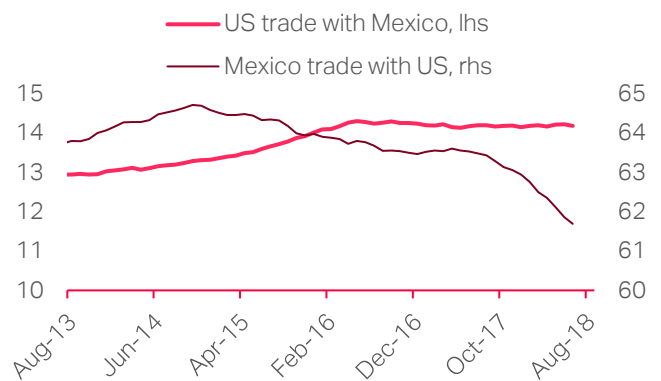
Chart 5: USMCA vs NAFTA, %



Sources: El Financiero, TS Lombard.

Chart 6: Mexico-US total trade

Imports + exports, 12-month rolling, % of total trade



Sources: ITC Trade Map, TS Lombard.

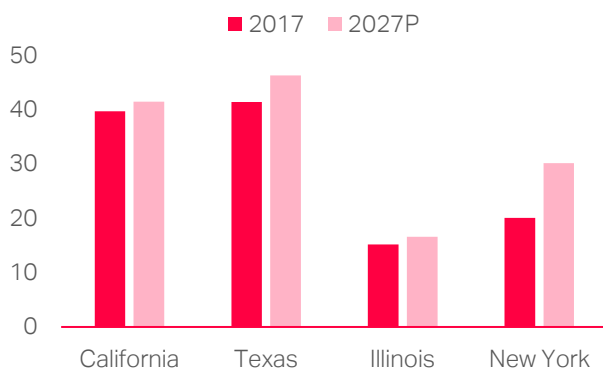
The US administration is betting on regional geopolitical stability. Moreover, it seems the US decision to wrap up the trade talks underscores prioritizing short-term regional stability over long-term political unpredictability. By keeping “historical allies” together, the US believes it has prevented Mexico from reaching out to countries less aligned with US interests, such as China and Russia. But the reality is that Mexico will continue diversifying its trade basket away from the US under the wide range of trade and investment deals it has already concluded. Trade ratios between the two countries (see Chart 6 above) already reflect this trend and will contribute towards mitigating future economic and political shocks originating in the US. Indeed, diversifying trade in non-manufactured final goods is compatible with the prevalence of supply chains in the manufacturing sector.

North America is slowly becoming a Hispanic-led manufacturing powerhouse. In our view, the US administration may have chosen to avoid a confrontation with Mexico, which had begun to look likely given President Trump’s anti-Mexican stance before the July Mexican presidential election, in order to prevent uncontrollable political instability in predominantly Hispanic communities, including Mexico. Some high-profile decision-makers across Mexico and the North American region have alluded to the creation of a “North American manufacturing powerhouse”. But this statement masks another reality of which the US administration appears to be aware. Southern US states still host most manufacturing jobs and have witnessed significant organic growth of the Hispanic – predominantly Mexican – population in recent decades. Indeed, official estimates place Hispanics at almost 50% of the total population in first-

tier US states from an economic standpoint, such as California and Texas. And US government projections indicate this trend will continue for at least the next 10 years (see Chart 7 below). For some observers, the upside to this trend is not only that net migration from Mexico to the US has been reversing over the last decade ([see our 30 July 2018 EM Watch](#)) but also that the new USMCA is likely to leave unchanged or even accelerate current net migration patterns. Indeed, most Mexicans believe that under the new trilateral deal, Mexican migration to the US will either remain the same or fall, according to last week's poll by *El Financiero* (see Chart 8 below).

Chart 7: US Hispanic population

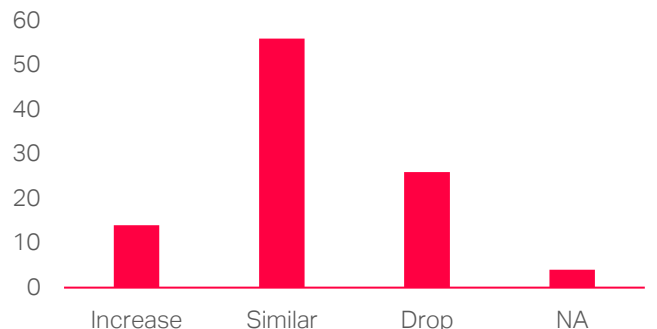
% of total state population



Sources: US state governments, TS Lombard.

Chart 8: Poll on migration under the USMCA, %

■ From Mexico to the US



Sources: *El Financiero*, TS Lombard.

Conclusion

The USMCA is likely to prevent Mexico-US relations deteriorating further. One year ago it looked that negotiating a trade agreement between Mexico and US would prove difficult. But the election of AMLO as the next Mexican president on 1 July helped paved the way for this outcome. His election has changed how President Trump relates to Mexican power, presumably for the better. Trump and AMLO are similar insofar as they both claim to represent the interests of "ordinary" people while promoting a strong sense of nationalism. They believe that trade deals are important as long as they are compatible with building a stronger domestic economy. And Trump seems to believe that an independent and stronger economic future for a Mexico aligned to US interests is a better guarantor of regional security, rather than a broad confrontation with a Mexican President-elect who is willing to shake up the geopolitical status quo.

There is a long way to go to turning a North American manufacturing powerhouse into a political union. But the long-term political sustainability of a North American manufacturing hub that would make use of the economic advantages of each member is based on at least two factors: freedom of labour movement across countries and the right to exercise cross-border political rights. The rapid rise of the Hispanic population, historically led by Mexicans, requires efforts across the board to build closer ties so that these people can be culturally accommodated. Otherwise, there is a risk of the economically successful southern US states unravelling alongside with Mexico. Such a threat might not be enough to avert the political consequences of long-held migration biases engrained among Mexican and North Americans. But at least it would delay any attempt by Mexico to go it alone to pursue its own independent path, alongside other countries, in the important areas of trade, migration, security and defence. For now, the trade truce looks like a win-win situation for two countries bound by geography.

Author



Cristobal Arias
Economist