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# President Obrador's politics cool Mexico's economy

By Angelo Katsoras

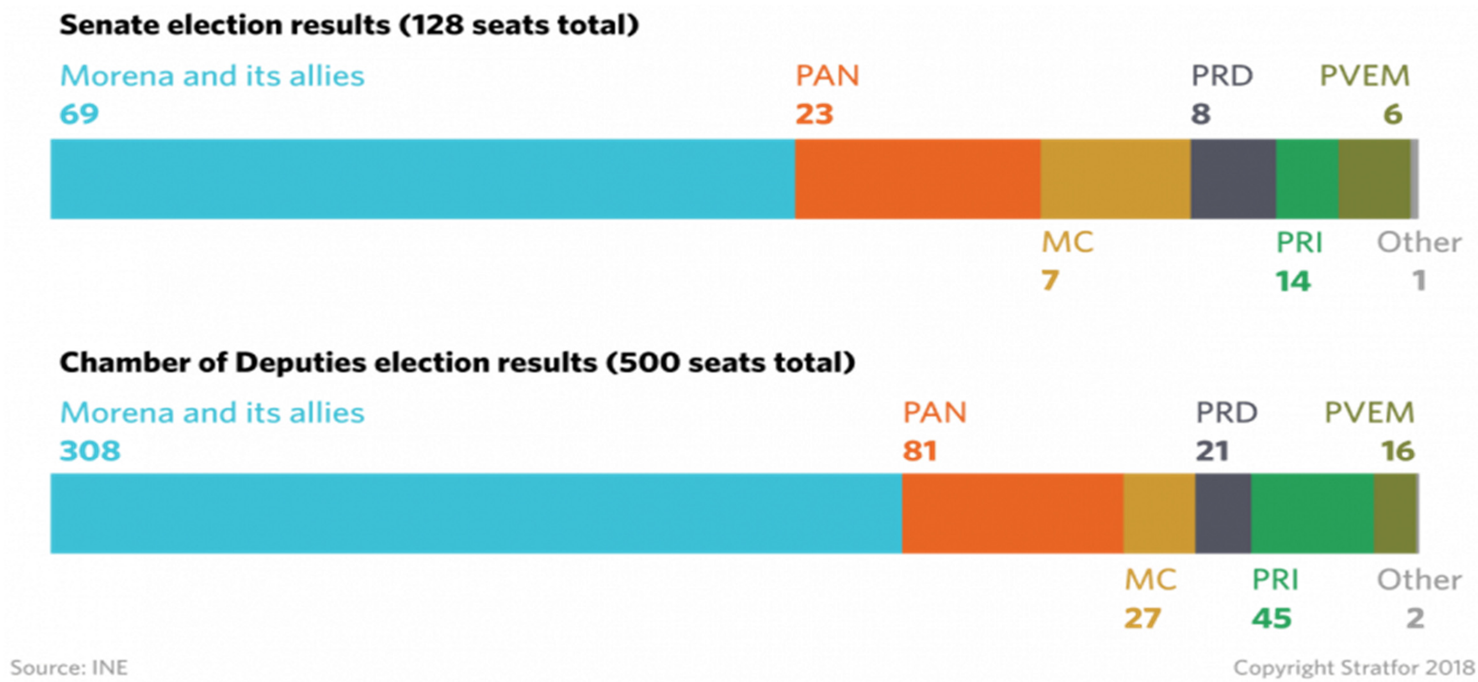
Since taking power this past December, President Andres Manuel Lopez Obrador has wasted no time enacting major changes. He has raised pensions, launched bursary and apprenticeship programs for students and advanced ambitious infrastructure projects. More controversially, he has also cancelled the partially built airport, he has stopped new private investment in the energy sector, and he plans to use referendums to drive the government's agenda forward.

While many of his actions resonate with voters who have given him close to an 80% approval rating in recent polls, they have also caused alarm among investors, who fear that new restrictions on foreign investment and concerns over government overspending are beginning to weigh on Mexico's economy and credit ratings.

As if all this was not enough, Mexico is also struggling with a surge in cartel-related violence and crime that has spread to previously untouched sectors of the economy.

## Obrador's massive political victory

Angered by the nation's rampant corruption and violence and by its slow economic growth, voters gave Obrador a massive electoral victory last July. Obrador and his National Regeneration Movement coalition, known as Morena, won the presidency, gained control of both chambers of Congress, and obtained majorities in 19 of the 32 state legislatures.




## Has Obrador abandoned the pragmatism that marked his governing style in the past?

Investors were initially comforted by the fact that his far-left rhetoric was not reflected in his track record. As mayor of Mexico City from 2000 to 2005, he generally got along with business and entered into several public-private partnerships. He left office with an 84% approval rating. Obrador also promised during the presidential campaign not to raise taxes or government debt levels.

However, since winning the election, Obrador appears to have veered sharply to the left. Here's how.

### *Concentration of power*

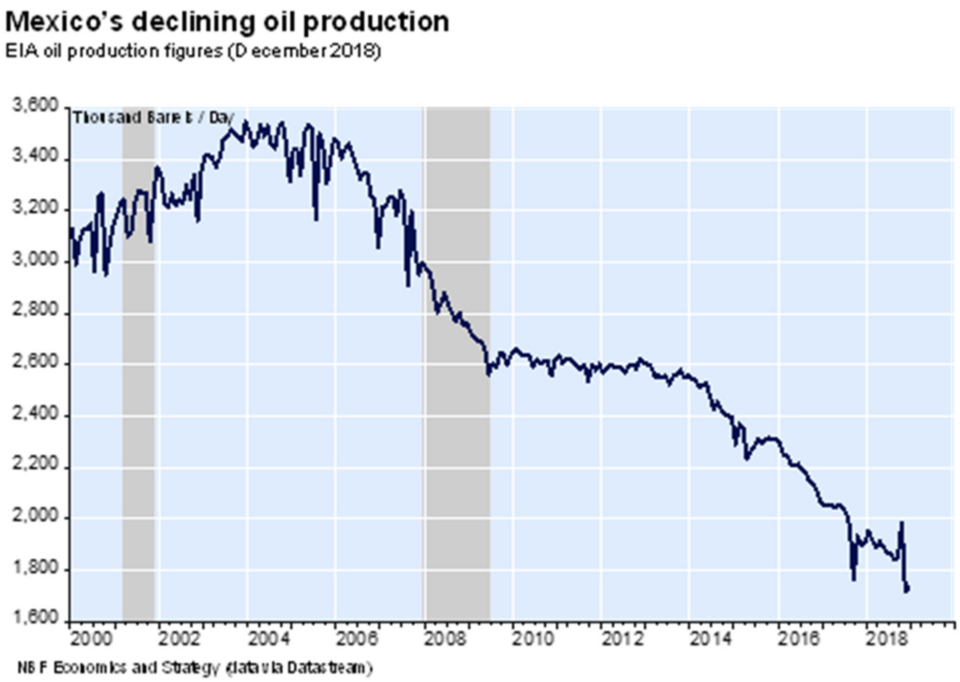
Obrador has slashed the budgets of several regulatory agencies, which he has accused of being biased in favour of business. Regulators have also reportedly been pressured to leave their posts in order to be replaced by government allies. Further, Obrador plans to create federal "super delegates" answerable to the executive in order to monitor state spending.

### *Using referendums to set policy*

In October, two months before he officially took power, his party held a referendum on the partially constructed $13-billion Mexico City airport. Critics slammed the vote, which came out against the project, because only about 1% of the Mexican electorate bothered to cast a ballot. Obrador nonetheless cancelled the project upon taking office and triggered billions of dollars in losses. The government has indicated that further referendums could be held to help determine government policy and approve infrastructure projects.

## Obrador exerts greater state control over the struggling oil sector

Oil production fell from a peak of 3.4 million barrels per day (bpd) in 2004 to 1.6 million as of last January. The primary reason for this is that Pemex has long been deprived of funds to invest in exploration and production. Over the past two decades, 95% of Pemex's pre-tax profits have been transferred to the government.[1] Pemex is also burdened with a debt of $106 billion, the largest of any state-owned oil firm in Latin America, and with unfunded pension liabilities of close to $70 billion.




In an attempt to reverse the decline in oil production, the previous government led by Enrique Peña Nieto enacted a series of reforms starting in December 2013 that ended Pemex's monopoly in the oil and natural gas sector and opened the industry to greater foreign investment. It was hoped at the time that partnering with foreign investors on certain energy projects would not only make Pemex's debt easier to manage, it would also allow Pemex to acquire know-how and technology.

**While private contracts have not been revoked, the Obrador administration has postponed further energy auctions for oil and natural gas projects until existing ventures show positive results.**

In an effort to increase oil production without resorting to foreign capital, Obrador recently unveiled a $5.2-billion package in tax breaks and capital injections for Pemex. The government's goal is to increase oil production to 2.4 million bpd by 2024. Obrador has also promised to reduce reliance on imported refined fuels by building a new $8-billion refinery. In 2018, two thirds of Mexico's gasoline, distillates and liquefied petroleum gas needs were met by imports, up from half in 2016.[2]

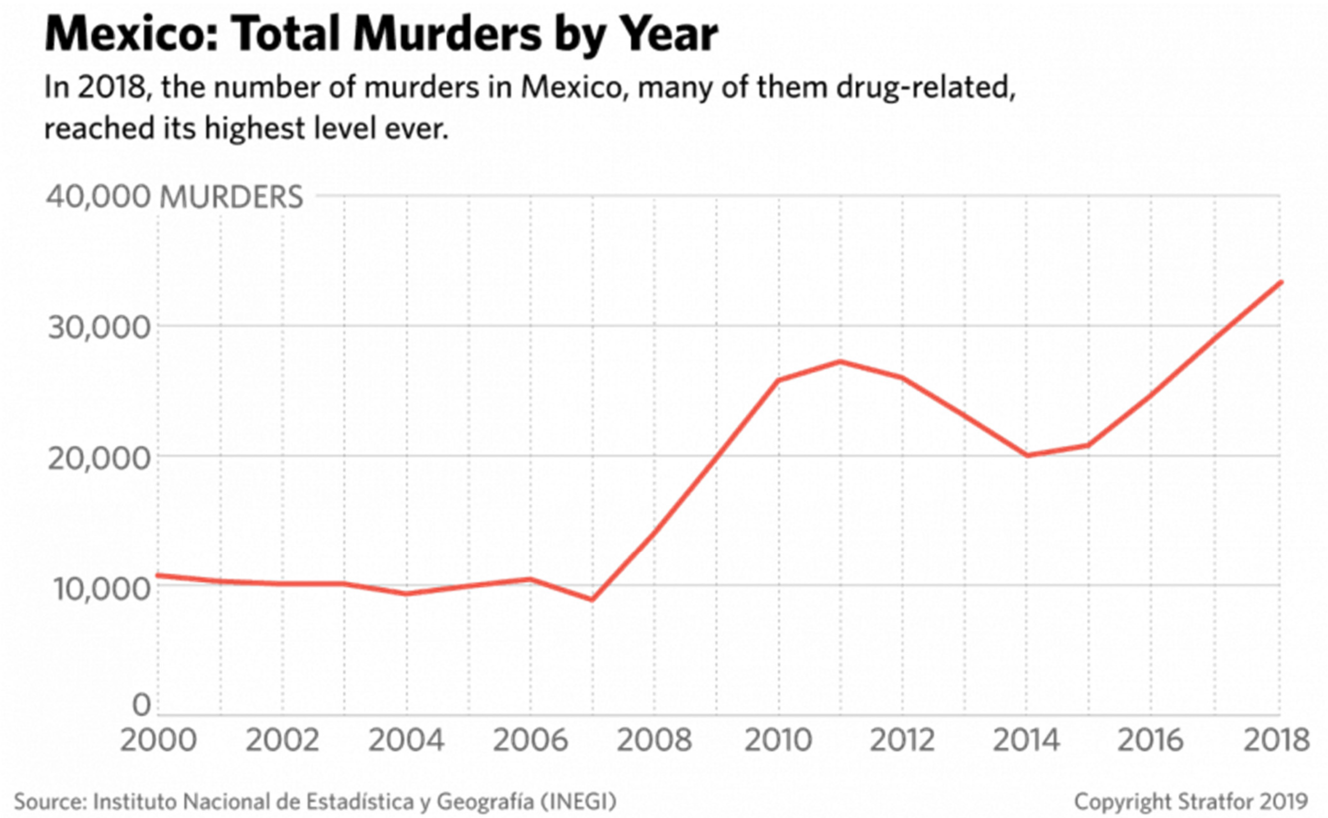
If the $5-billion bailout package fails to reverse the decline in oil production (which appears to be the most likely scenario), the government could be forced to increase the financial support it provides Pemex, especially if foreign investment continues to be restricted. S&P recently stated that Pemex could require at least $20 billion annually over many years to turn things around.

Further, while Obrador's Morena coalition does not yet have the two-thirds majority needed in both chambers of Congress to undo energy reforms, it can still shape energy policy by adjusting local content requirements and contract terms.

[1] "Mexico: Investment grade no more?" FT, March 15, 2019
[2] "Mexico's gas crisis, explained," Reuters, January 21, 2019

## Spike in cartel violence

Mexico registered a record 30,499 murders last year, up more than 15% from 2017.




The driving force behind this significant increase in violence has been the arrest of many narco kingpins in recent years. This has led to violent battles for control among their underlings and to a splintering of the cartels. These smaller groups in turn have branched out into previously untouched sectors of the economy, such as tourism and merchandise theft.

### *The fuel sector has been particularly hard hit by criminal groups*

Fuel theft has been a problem in Mexico for decades but the situation has worsened considerably in recent years. Thieves are currently siphoning off the equivalent of about one-fifth of total national gasoline consumption (about 150,000 bpd). The government estimates that this widespread theft costs Pemex more than $3 billion annually.[3]

Since December, the government has deployed the military and shut down certain pipelines in an attempt to prevent theft. Some of the challenges with this strategy include the following: 1) Trying to protect Pemex's 5,500 miles of fuel pipeline is a massive task; 2) Shipping gasoline by truck is 13 times more expensive than by pipeline.[4] Despite the massive challenges involved, the government has indicated this a battle it cannot afford to lose.

### *Examples of other sectors targeted by criminal groups*

**Mining:** In May 2018, Canada's Pan American Silver temporarily reduced operations and suspended staff movements at its Delores Mine in Chihuahua because it faced security threats along the roads used to transport personnel and equipment to its mine. In the same month, mining and infrastructure firm Grupo Mexico claimed that several freight train derailments between the key commercial port of Veracruz and central Mexico were caused by sabotage.

**Bottlers:** In June 2018, companies bottling and distributing soda for Pepsi and Coca-Cola (Group Gepp and Femsa, respectively) shut down operations on account of gang threats in the city of Ciudad Altamirano.

[3] "Explainer: Mexico's fuel woes rooted in chronic theft, troubled refineries," Reuters, January 20, 2019
[4] "Fuel Crisis Hits Mexico After Pipelines Are Closed," Wall Street Journal, March 9, 2019

## Declining economic growth

There are growing signs that the cumulative impact of restrictions on foreign investment, cancelled contracts, increased government spending, and the potential use of more referendums to advance policy is hurting the economy. The Mexican central bank recently revised its GDP growth projection for this year to between 1.1% and 2.1%, down from its earlier estimate of 1.7% to 2.7%. This forecast is a far cry from Obrador's promise of an average annual growth rate of 4% over his six-year term.

### *Finances under pressure*

Last January, Fitch Ratings downgraded Pemex's debt to BBB, just one notch above junk status. Standard and Poor's and Fitch both maintained the Mexican government's investment grade status at BBB+ but lowered their outlook from stable to negative. Investors are concerned that if Pemex loses its investment grade status, Mexico's sovereign debt rate could also be downgraded.

By the end of 2018, Mexico's ratio of sovereign debt to GDP stood at 53%. About 23% of this debt is denominated in foreign currencies. This excludes Pemex's debt, which many analysts feel the government implicitly guarantees. Mexico's benchmark interest rate is currently at a decade high of 8.25%. Finally, Mexico's foreign exchange reserves total $177 billion.[5]

### *Rising wages*

Unlike many countries in Latin America, Mexico has not seen its manufacturing sector hollowed out by Chinese competition. The strength of Mexico's manufacturing sector is underpinned by low wages and a web of over 40 free-trade agreements.


Source: "American manufacturing companies have a spring in their step," The Economist, February 7, 2019

[5] IMF, November 2018

***However, wages are starting to rise for the following reasons:***

- After taking office December 1, in a bid to address decades of stagnant real wage the President doubled the daily minimum wage to 176.20 pesos (about $9.30) in communities along the U.S. border, where the cost of living is higher than elsewhere in Mexico. Although maquiladoras, which assemble such manufactured goods as electronics and industrial equipment for export, often pay more than the minimum wage, the salaries paid by some companies are designed to automatically go up by the same percentage as any increase in the minimum wage.
- In January, 50,000 workers in the eastern border town of Matamoros went on strike to demand higher wages. Many companies in the end agreed to a 20% wage increase and a one-time bonus of 32,000 pesos ($1,655).[6] This will no doubt inspire workers in other regions to make similar demands.

Other drivers of higher wages could come from the U.S.-Mexico-Canada Agreement (USMCA), under which Mexico is required to pass legislation making it easier for workers to freely choose their unions. If so, this could encourage labour movements to become more combative in a nation where unions have long been seen as docile. The USMCA clause stipulating that 40%-45% of cars must be produced in areas paying $16 an hour is another factor that could drive wages up over the longer term. Mexico is expected to approve the USMCA in the near future provided that the United States agrees to lift tariffs on steel and aluminum.

## Investment Conclusion

While President Obrador's approval rating is currently very high, the biggest threat to his popularity is the economy. His restrictions on foreign investment in the energy sector, increased government spending, and the use of referendums to cancel contracts are weighing more and more on Mexico's economy. The spike in cartel violence only adds to the headwinds.

We feel that the slowing economy risks eroding Obrador's public support over time. This will eventually force him to modify his policies, but only after having wasted valuable time. More specifically, the massive challenges facing Pemex and the oil sector will likely force Obrador to reopen the energy sector to foreign capital down the road.

Investors are advised not to increase their exposure to Mexico until there are signs this course correction has begun. Already, the Finance Ministry has announced it would cut $6.2 billion from this year's $296 billion budget in an effort to maintain its goal of keeping the budget deficit to 2.5% of GDP.

Finally, despite Trump's threat, we do not feel the recent tensions over the influx of migrants into the United States will lead to anything close to a shutdown of the United States-Mexico border. The economic consequences would be too damaging. Almost $1.7 billions of goods and services goes across the border every day. Indeed, just the act of reassigning 750 U.S. Customs and Border Protection officers from their normal assignments at specific ports of entry to help process the surge in migrants who have crossed the border has resulted in wait times for trucks delivering goods to the US to increase from 1 or 2 hours on a normal day to as high as 10 hours since late March.

Further, since taking office the normally outspoken Obrador has remained quiet regarding Trump, and has even agreed to a controversial plan whereby some Central American asylum seekers have to wait in Mexico for their cases to be heard in U.S. immigration courts. Obrador has taken this stance in an attempt to avoid having an already slowing Mexican economy being targeted by trade tariffs or even more delays on Mexican goods entering the border.

[6] "Labor Lawyer Takes On Mexico's Exporters, Wins Higher Wages," Wall Street Journal, March 14, 2019

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