

Economic Analysis

Faced with Trump, Mexico needs rule of law and to revive Texcoco

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In what would be an act contrary the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO) rules, President Donald Trump has announced that he will impose tariffs on all imports from Mexico. What would be the impact of these measures? It will depend, of course, on the tariff levels applied. Tariffs of 20 to 25% would have a more than proportional impact than tariffs of 5 to 10%. With regard to the trade channel, the flexible exchange-rate regime will help to absorb the shock. Given that tariffs would apply to all exports, a depreciation of similar value to the tariffs could mean that Mexican exports remain just as competitive without creating distortions.

The Bank of Mexico should not try to prevent this depreciation, as it is exactly what is required when faced with an external crash. Monetary policy should only become more restrictive insofar as depreciation will affect inflation expectations, but this seems unlikely to happen while depreciation remains low at around 15%, especially considering the significant level of clearance that the Mexican economy currently demonstrates. In any case, these events make it clear that the level of concentration that should, so significantly, depend on just one market (the United States) represents a significant risk. It is necessary to take policy measures in order to diversify both exports from and imports into the country. One of them is to strengthen the Pacific port infrastructure so as to reinforce trade with countries in the Trans-Pacific Partnership Agreement. Another is to encourage increased foreign investment from other countries.

A greater impact may be felt in investment, where Trump's actions will cause greater uncertainty. Even if the new commercial treaty (USMCA) is approved, the perception is that Trump may impose restrictive measures on trade at any time for issues that are very external to trade. This means that, even if the USMCA is approved, the uncertainty will continue and investment may fall as a result. The greatest benefit of NAFTA has been to provide certainty to investors in a country that has a weak rule of law, by adopting a more robust legal framework through a trade agreement. Trump's actions weaken this legal framework and it is therefore necessary to strengthen the domestic legal framework and take measures to provide more certainty to investors.

How can this be done? Firstly, it would be necessary to work on strengthening the rule of law (the major unresolved issue in the country), which means, above all, building a competent and independent judicial authority. This will take time of course, but other signals may be sent in the short term in order to reduce uncertainty among investors. One of them is to renew the private partnership schemes between Pemex and private companies, the so-called *farmouts*, and also the electricity and oil field auctions. At a time when investment is very likely to decrease as a result of the uncertainty surrounding the commercial relationship with the United States, the country cannot afford to close its doors to investors willing to take risks in Mexico. More practicality and less ideology is required. Another measure, which would be even more powerful, would be to resume construction of the Mexico City airport in Texcoco. Cancellation of this work resulted in an increase in the country risk premium, and in lower levels of investment due to the uncertainty it created. At present, all possible measures should be taken to offset losses in investments. The margin of action in order to contain external uncertainty is limited. But the Government has tools to reduce domestic uncertainty. At such a critical time, they must be used. The revival of the Mexico City airport is the only measure capable of achieving this in such a short period of time. The circumstances require this to happen.

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