

What a Changing NAFTA Could Mean for Doing Business in Mexico

by Antonio Martinez

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Multinational companies operating in Mexico are facing a great deal of uncertainty. The possibility of a contentious renegotiation of the North American Free Trade Agreement (NAFTA) has led to delayed or canceled investments in what has been one of Latin America's most economically stable markets. Mexico's fast-approaching July 2018 general election, of which the populist leftist candidate Andrés Manuel López Obrador is the current frontrunner, is further making the case for

incremental investments by multinationals corporations. While consumer spending has proven resilient, with same-store retail sales rising 6% YOY in April, most multinational corporations are developing contingency plans to mitigate risks to their businesses and reassessing the country's role in their global market portfolio and supply chains.

Renegotiating NAFTA

With the confirmation of Robert Lighthizer as United States trade representative, the long-delayed start of the formal process to begin renegotiation of NAFTA with Canada and Mexico can move forward. Indeed, on May 18 the Trump administration notified the U.S. Congress of its intent to begin the process. My firm, Frontier Strategy Group (FSG), expects that formal talks will begin in late August or early September, after the required 90-day waiting period. Both Canada and Mexico are hoping that adjustments to the trade agreement will deepen integration rather than promote protectionist economic policies; the Trump administration has provided conflicting signals over what kind of measures it will pursue.

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The Trump administration may no longer be advocating for 25% tariffs on manufacturing imports from Mexico, but it is likely to push hard for trade policies that would severely cripple the benefits offered for multinationals under the current trade agreement. For example, a key source of concern for some companies is more-restrictive rules of origin, which would reduce the amount of materials allowed to be used tariff-free for products traded to and from NAFTA member countries. This would amount to higher tariffs for inputs or final goods, which, though unlikely to reach the 25% tariff levels suggested during Trump's campaign, would still raise costs for multinationals and further inhibit cross-national supply chain integration.

However, new tariffs or more-restrictive rules of origin would likely only fall on a few industries, such as the automotive sector. More companies are concerned that their current supply chain would be more vulnerable to unilateral protectionist measures, such as lower standards for import safeguards. So, if a company manufactures products in Mexico to export to Canada and the U.S. (and vice versa) and can no longer take for granted continued and uninterrupted access to each other's markets, it would need to radically rethink its localization and sourcing strategy. That would likely lead to closing factories, seeking new sources for inputs, and raising prices to mitigate higher production cuts.

Multinationals are heavily pushing for either minor tweaking to the agreement or a modernization of NAFTA. Companies would like to see process improvements and better infrastructure at the border to reduce costs to import. Firms in innovation-driven industries, such as pharmaceuticals and medical devices, have long supported greater standardization across borders, with stronger intellectual property protections and enforcement of regulatory standards. Possibly the greatest improvement to the current trade agreement would come from incorporating industries that were relatively nascent when NAFTA was first negotiated (such as e-commerce and the digital industry), industries that were nationalized at the time (such as Mexico's energy sector), or industries in the service sector (such as the insurance, accounting, and express delivery industries). These changes would allow for greater standardization across borders, allowing for better access to each other's markets and increased trade. A revamped NAFTA that incorporates even some of these changes would make renegotiation a net plus for most multinationals – but this would be somewhat counter to the protectionist rhetoric that the Trump administration has previously voiced.

An agreement that expands NAFTA is more likely to be negotiated and implemented relatively quickly, while an agreement that incorporates new protectionist measures, especially on discretionary import safeguards and tariffs, would likely be prolonged and contentious. FSG predicts that the renegotiation of NAFTA will incorporate at least some modernization measures mentioned before, particularly those that were previously negotiated under the Trans-Pacific Partnership, but that the Trump administration will push for new import controls, which would prolong a final agreement. The bottom line is, multinationals will not know what will be in the final agreement for years.

Growing Populist Movement in Mexico

Multinational executives are also paying attention to the country's upcoming presidential elections. Mediocre growth, continued narco-related violence, and persistent corruption have crippled the electorate's confidence in the status quo. The current government of Enrique Peña Nieto suffers from record-low approval ratings ([link in Spanish](#)), making the ruling party, the PRI, unlikely to retain the presidency.

In mid-February FSG surveyed 25 Mexico country managers of multinationals and found that half of them expected the center-right's candidate, which is likely to be either Margarita Zavala, the first lady during Felipe Calderon's presidency (from 2006 to 2012), or Ricardo Anaya, the current

president of center-right National Action Party (PAN), to win the next presidential election in Mexico.

However, leftist candidate and former mayor of Mexico City Andrés Manuel López Obrador is considered the frontrunner in most recent polls, and his populist agenda is considered to be at least somewhat harmful by most of these same executives. Multinational executives fear that his populist programs (such as to implement massive increases in social spending while eschewing tax increases) would severely destabilize Mexico's already fragile public finances, and that his opposition to the current administration's structural reforms, particularly in energy and labor, will drive down investments in the market, cause further peso devaluations, and lead to greater confrontation with the Trump administration.

FSG believes that López Obrador is the prohibitive favorite, but companies should avoid panicking over his election. If he wins with only a narrow victory, as seems likely, his administration would have a limited mandate for populist reforms that would severely damage foreign investment flows and public finances. His MORENA party remains unlikely to win a clear majority in Mexico's Congress, which would force him to either moderate his expansionary fiscal policy or face perpetual legislative gridlock from a more conservative Congress. Mexico's economic performance isn't likely to significantly improve over the 2% YOY average of the last few decades, but this would not necessarily lead to a major economic downturn.

Of course, a narrow victory for López Obrador is not guaranteed. If the center-right PAN candidate wins, whether it is Zavala or Anaya, it would likely help cement business's confidence in the country's economic and political stability.

Navigating the Next Two Years in Mexico

Many of the companies we work with that have operations in Mexico have taken up scenario planning to prepare for a range of potential economic and political changes in the country that could affect their businesses. Most Mexico country managers believe one of the following scenarios is likely:

1. **A long period of populist-driven uncertainty.** In this case, prolonged and contentious negotiations over NAFTA and a close victory for López Obrador leaves executives confronting a long period of uncertainty, which will fuel depreciation of the Mexican peso and reduce

investment. FSG expects that the Mexican peso would depreciate to 22 MXP/US\$ over the next two years and that the economy would average growth of 1.8% YOY in 2017-2018. Multinationals anticipating this scenario have delayed major capital investments (including new factories and distribution centers), pursued a cautious approach to price increases (despite rising pressure on margins from a stronger dollar), and increased investments in monitoring customer spending patterns and on lobbying and regulatory support in Mexico and the U.S.

2. **The status quo persists.** In this case, NAFTA negotiations remain undecided beyond Mexico's 2018 elections, but the populist surge fails to materialize in the country and the center-right PAN narrowly defeats López Obrador. In this scenario the Mexican peso would likely only depreciate to 20.5 MXP/US\$ over the next two years and the economy should grow closer to 2.1% YOY in 2017-2018. Executives who are planning against this scenario are continuing to urge corporate headquarters to invest in the Mexican market, while monitoring the evolution of trade talks and resourcing lobbying efforts in Mexico and the United States.

Beyond these two scenarios, most multinationals want their teams to prepare for potential upside and downside scenarios:

1. **A pro-business turn.** If NAFTA is renegotiated relatively quickly and largely avoids protectionist measures, this would help shore up investments in Mexico and boost prospects for a center-right PAN candidacy to win next year's elections. This would help keep the peso at an average 19.5 MXP/US\$, while economic growth could increase to an average of 2.7% YOY over the next two years. Under this scenario, multinationals would redouble on previously paused investments, increasing manufacturing and supply chain capacity in Mexico in particular and integrating shared services across the border. Furthermore, sales and profitability targets would need to be raised, especially if foreign exchange stability and a broad-based recovery in domestic demand were to occur.
2. **A tit-for-tat trade war.** If negotiations break down over NAFTA, it would create severe disruptions for the Mexican economy and open the door for populism to take hold. Economic growth would fall to -1.5% YOY in 2017-2018, while the Mexican peso would fall to 25 MXP/US\$ over the next two years. In this scenario, which most now deem highly unlikely, multinationals would require a full strategic reset for their short-term operating plans. Companies would have to reassess the weakness of their current supply chain structure, raise prices due to the higher cost of imported goods, and significantly reduce sales targets. If trade conflict persisted, multinationals would need to begin reducing head count and deprioritizing the Mexican market, not just as a manufacturing platform for the U.S. market but also as a priority market in their global portfolios.

Antonio Martinez is Director of Global Economics Research at Frontier Strategy Group (FSG), the leading information and advisory services partner to senior executives in emerging markets. Learn more about his recent report: Plan B for Mexico – Scenarios Businesses Need to Monitor.

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