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Economic Analysis

NAFTA: the uncertainty will continue and so therefore will exchange rate volatility

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Over the past two years movements in the peso's rate of exchange against the dollar have tended to follow more than anything the prospects for the North American Free Trade Agreement (NAFTA) and trade relations between Mexico and the United States in general. This has been particularly clear in the past six weeks, in which the peso first depreciated by 5% before later appreciating by 9%. These are unusually high levels of volatility. In this period, uncertainty regarding NAFTA was a much more important factor in determining the exchange rate than the doubts that always hang over a presidential election.

The peso's recent appreciation is due to the improved prospects of a successful negotiation of NAFTA 2.0, especially following the presidential elections, since the indications are that initial contacts between Andrés Manuel López Obrador and the Trump administration have been positive. In fact president Trump recently tweeted: "We had a great talk with Mexico and its new president…we're getting on well with our trade agreement. Let's see what happens". Despite these good signs, dark storm clouds remain on the horizon.

In the first place, and despite this declaration, we must not forget that there are a number of demands on the part of the US, such as the 'sunset clause' and the changes to the rules of origin in the automotive sector that are clearly protectionist and are not acceptable for Mexico or Canada. Secondly, Trump's threat to impose 25% tariffs on auto imports, if carried out, would no doubt have a negative impact on the NAFTA negotiations and would also mean significant damage to the Mexican economy due to the fact that auto exports account for around a third of the total. And thirdly, Trump's recent assertions that he prefers negotiating bilateral agreements and that he would like to start with Mexico. It seems to me that to go down the path of bilateral agreements would be a mistake. Mexico and Canada would have greater bargaining power against the protectionist stance if negotiations were three-way. And needless to say an agreement that included Canada would have greater economic benefit.

I also believe that the path to NAFTA 2.0 will be complicated by an additional factor. It is clear that president Trump does not like trade deficits, even though this reflects an erroneous mercantilist stance that assumes that deficits are bad. But the most likely outcome is that the deficit will increase in the near future, due to two factors. The first is the tax reform in the United States. This reform will lead to a decline in public savings which in turn will mean an increased trade deficit. Secondly, the more restrictive monetary policy adopted by the US Federal Reserve will lead to a stronger dollar and therefore a deterioration in the US balance of trade. It seems to me that an increased trade deficit will lead to more protectionist policies from the Trump administration, which will complicate the future of NAFTA 2.0.

The uncertainty around trade relations between Mexico and the United States will continue and consequently so will volatility in the foreign exchange market. This volatility is however a perfectly appropriate response to the uncertainty: that is why it is a flexible exchange rate. To absorb external shocks; a deterioration in NAFTA prospects is followed by a depreciation of the currency, which makes Mexican exports more attractive and imports more expensive, allowing net exports to grow and so mitigating the impact of uncertainty on aggregate demand. As long as this volatility is not translated into higher inflation or inflationary expectations slipping their anchor, Banco de México should not react to exchange rate movements with rate hikes that would affect the credit market.

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