Economic Analysis

Trump's Tariff Threat has the potential to be a game changer for the Mexican Economy

Incremental tariffs (up to 25%) would likely push the Mexican economy into a recession; inflation risks, an overly hawkish Banxico and fiscal constraints would limit the room for countercyclical fiscal and/or monetary policies

Javier Amador / Arnulfo Rodríguez/ Carlos Serrano

- **Trump's announcement that a tariff rate of 5% across the board on all US imports from Mexico will come into a week and a half away from now (on June 10) suggests that it will likely be introduced even in view of AMLO's intention to push for dialogue**

- **The incremental rise in the tariff rate (by 5% each month until it reaches 25%) unless Mexico "substantially stops" migration flow to the US is more uncertain. Yet, the progress would be "solely judged" by the US government and given that the time windows are so short and the problem so big, the chance that the tariff rate increases is not low but is not the base case scenario at the moment as Mexico will push for negotiation and will likely attempt to show results on the southern border**

- **If implemented, the negative effect on the Mexican economy would mainly be through the investment channel and its magnitude ultimately depend on two factors: i) the tariff rate, and ii) on how the exchange rate (ER) reacts. The flexible exchange rate will work as a shock absorber to limit the effects on the trade channel. The impact of the potential starting tariffs of 5% would likely be offset by a further depreciation of the Peso (from the current 3% to 5%). Since the 5% tariff rate would be imposed across the board, a depreciation of a similar magnitude (with a likely overshooting due to heightened uncertainty) should help offset the effect on exports without introducing distortions within sectors**

- **However, with a large tariff rate the real ER depreciation might not be enough to offset a likely decline in US demand as a large share of Mexican exports are produced in value chains with many imported components. The reduction in competitiveness from the imposition of a large tariff rate would translate into higher prices within the US and would in turn affect US demand for Mexican exports. That is, the real depreciation of the ER would help but not completely offset the negative effect due to the large share of imported components in the production process within value chains. A larger depreciation would be necessary but due to its effects on inflation might be unlikely as eventually Banxico would use monetary policy to avoid a large depreciation**

- **The possible introduction of tariffs would also have a negative effect on the US economy, particularly on US firms which have value chains with Mexico and on consumers through higher prices. As such, we would expect a negative reaction from US firms as competitiveness of value**

chains would be affected and possible opposition from Republicans. That aside from likely legal challenges that the unilateral break of trade-pact rules implies. The possible introduction of any tariff rate across the board is a violation of both NAFTA and WTO rules and puts a halt to the possible ratification process of the USMCA by the US Congress. However, the US government is arguing that the imposition rests on national security issues

- **Even if the US government leans towards not imposing tariffs after negotiations or the rate is not risen each month, some (considerable?) damage is already done. Uncertainty will now linger. Trade deals in general, and the current NAFTA and possible USMCA in particular, seem now more fragile than ever. Signs now point to the fact that they can be easily broken or violated unilaterally**

- **With uncertainty back, investors are likely to remain on the sidelines. The possible approval of the USMCA has less significance now. Even with an agreement in place, investors would know that trade restrictions may come at any time and for any reason. Unless uncertainty is tackled (and right now it seems unlikely) US manufacturing firms would have no reasons to go forward with investment plans to expand supply chains with Mexico**

- **As investment will be negatively affected, our 1.4% growth is no longer realistic. We now think that 2019 growth will likely be less than 1% and a recession cannot be ruled out and would depend on the possible final tariff rate. That said we are not changing our forecast until we know if this tariffs are going to be implemented and the final rate that they would reached**

- **In our view, Banxico should not react neither intervening with reserves to try to limit the Peso depreciation (which would be pointless and ineffective) nor through monetary policy as it would not stop potential depreciation and if anything would only partially limit the shock absorber purpose of the flexible exchange rate. In short, these measures would be ineffective and would have a cost**

- **That is particularly true if the tariff rate is 5% as a depreciation of a similar magnitude is unlikely to cause a new round of pass-through and thus, significant effects on inflation should not be expected. We think that calls for 50bp hikes are an overreaction. In fact, market monetary policy expectations have not reacted strongly to the news. Banxico's reaction to higher tariffs and a much larger depreciation should depend on the effect of the ER on inflation and inflation expectations**

- **Having said this, the tariff threat is likely a game changer for monetary policy. We were expecting Banxico to start easing monetary policy later this year. This will not happen following Trump's announcement. That is, there is little room for a countercyclical monetary policy in the short term, and the room for fiscal policy seems even more limited on a more permanent basis**

Chart 1. **MXN vs EM currencies*, Oct 2018 - May2019**
(Index, 1 Oct 2018=100)

Source: BBVA Research / Bloomberg
* Own calculations based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN

Chart 2. **CDS: Mexico vs Peers with similar rating***
(Bp; S&P local currency ratings)

Source: BBVA Research / Bloomberg
*BBB+ is the average of Thailand, Peru & Philippines; BBB is the average of Russia & Colombia

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