



# Monarch News

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## CEO's Executive Summary

Four developments in Mexico over the past few weeks stand out for their importance for economic and political stability and for U.S.-Mexico relations. First is the release of the 2021 budget, which has very important implications for investors despite its ultimately unsurprising content. Second is the economy, noting that investors should take the highly positive economic numbers we expect to see during the fall with a grain of salt. In addition, recent policy changes suggest that the energy sector will be an additional drag on growth. Third is President Andrés Manuel López Obrador's (AMLO) proposal for a referendum to put five past presidents on trial in a blatantly political move. Fourth is the conflict in northern Mexico over water flows from the Boquilla Dam, which has the potential to escalate in violence and impact both the upcoming U.S. presidential election as well as Mexico's mid-term election next June.

### I. The 2021 Budget Proposal

As required by law, the Finance Ministry delivered the [federal government's budget proposal for 2021](#) on September 8. The budget content is unsurprising but consequential in at least five ways.

First, it sustains or deepens austerity in most of the budget to free up funds for AMLO's infrastructure and social policy priorities, without creating new taxes or raising existing ones (other than the gasoline excise tax). Equally unsurprising is its lack of any COVID-related stimulus. Both spending and revenue estimates are just slightly below 2020 levels. In the absence of fiscal reserves which were spent in 2019 and 2020, the budget proposes keeping up tax revenues through a continuation of the tax authority's anti-avoidance efforts, which have been highly effective but have begun to cause anger and frustration in the private sector.

Second, it is based on optimistic estimates about growth, inflation, and oil revenues – on both sales price and production. While the 2021 growth and inflation estimates (4.6% growth with 3% inflation) are within the range of expert forecasts, they are among the most optimistic scenarios. The budget proposal's oil price estimate of \$42.10/barrel is 24% higher than [the average price of the Mexican mix](#) during the first six months of 2020, despite the likelihood that COVID will continue to suppress demand in 2021, and budgeted production is 8.4% above the April 2020 peak despite output declining steadily over the last 4 months. Nor is there any consideration of the potential for a sovereign debt downgrade during the year.

These optimistic estimates will allow the government to continue current spending levels throughout the first half of 2021, which should help the incumbent government in the June 6 mid-term elections. After the election, however, we expect the government will have to cut spending for the remainder of the year.

Third, the big budgetary winner is infrastructure. The defense ministry budget will increase 15%, most of which cover expenditures for a series of infrastructure projects, although it also includes a 22% increase for the National Guard. The Tourism budget will increase 641.5%, but this is due to the transfer of spending for the Mayan Train from the Communication and Transportation Ministry to Tourism. The big losers are the Finance Ministry, a.k.a. *Hacienda*, (-17%), the Presidency (-15%), and the Labor Ministry (-20%). The latter is of particular concern, since it raises questions about the capacity of Labor to oversee the implementation of the labor reforms required by the USMCA.

Fourth, the budget also proposes a 5.5% reduction in transfers to state governments, which will only reinforce the ire of the ten rebellious governors in the Federal Alliance. These governors have been sharply critical of what they consider to be insufficient federal government transfers to their states to address the COVID-related health and economic crises, particularly in light of the large proportion of federal tax revenues that comes from their states.

Finally, all budget proposals are modified by the Congress and none are ever implemented as approved. So we will keep an eye on how this budget proposal progresses. The revenue side must be approved by the Chamber of Deputies by October 20 and by the Senate by October 31. The spending side is only approved by the Chamber, and must be completed by November 15.

## **II. The Economy and Energy Sector**

The Mexican economy is beginning to show signs of life [after dropping 18.7% during the second quarter](#) this year. The economy [expanded 5.7% in July](#) and [90,000 new jobs were added in August](#). Unsurprisingly, AMLO has been crowing about these numbers and the economic recovery they portend. But these advances are just a tiny percentage of the losses incurred since March. While we expect economic activity to pick up in the coming weeks and months, the economy will still contract about 10% this year and is expected to take a decade to recover to its pre-crisis per capita GDP level. Rather than a “V” recovery, Mexico is on route to a “curb” recovery in which economic activity quickly rebounds late this year making up a portion of the spring losses, but levels off after that. [Current estimates are for 0.7% average growth for the six years](#) of the AMLO presidency. This is likely to put pressure on the balance sheets of Mexican banks, as well as test the patience of Mexican voters.

Nor is the energy sector apt to be a tool to revive economic growth. On September 23, [Mexico’s energy regulators endorsed a 17-point energy policy agenda announced by AMLO on July 22](#). While promising to honor contracts signed by previous administrations (except where corruption is detected), this agenda will stop all new concessions to private actors in the energy sector. More significantly, it aims to reestablish Pemex and the Federal Electricity Commission (CFE) as the dominant actors in their respective energy markets. In the case of Pemex, this means government

assistance to ensure that it does not lose any more of the gasoline market, and for the CFE it will favor state-produced electricity over private generators. Put differently, the AMLO administration currently plans to reverse the 2013 energy reform without modifying the Constitution. If, however, the two companies do not bounce back under the current legal framework, AMLO has made it clear that [he will be forced to change it](#). As a result, the energy sector will likely create a new break on growth given the low probability that these two state-owned firms will be able to meet the country's energy needs.

### **III. A Referendum, Morena, and the Mid-Term Elections**

President López Obrador [formally proposed a nation-wide referendum](#) on whether or not the country should try five past-presidents (Salinas, Zedillo, Fox, Calderón, and Peña Nieto) for purported crimes against the nation. The “crimes” of the first two amount to implementing neo-liberal economic policies, Fox is accused of intervening in the 2006 electoral process, and Calderón is accused of initiating a militarized anti-drug strategy. Only Peña Nieto is accused of anything that might actually be a crime, the illegal financing of his 2012 presidential campaign.

Nothing in Mexican law would prevent the authorities from bringing any past-president to trial for actual crimes, a fact that points to the real political purpose of this proposal. With the June 6 mid-term elections on the horizon, AMLO needs a mechanism to keep his supporters mobilized, despite a pandemic that is pounding Mexico and its associated economic crisis. AMLO needs to reinforce among voters the view that the economic crisis is due to a virus, and more importantly to the neo-liberal economic policies of the past.

The proposal is currently being reviewed by the Supreme Court to determine its constitutionality. Based on similar rulings in the past, Court watchers believe this proposal will be found unconstitutional. In that case, AMLO will almost certainly plan for an informal referendum along the lines of the November 2018 vote against completing Mexico's new international airport project. In other words, it will be non-binding and is apt to be organized in a manner that biases the results against the ex-presidents.

At the same time, in AMLO's Morena party three factions (radical left, moderate, and those closely allied with AMLO) have been vying for control for the past year, making it impossible to agree on a process to select a new leader. This increasingly acerbic stalemate [required the National Electoral Institute](#) (INE) to take charge of the election and to use polling among party members and sympathizers to determine who the next party president should be. This approach has been challenged in the courts and on the ground with the registration of an unwieldy 47 candidates for the party presidency. Currently, INE is moving forward with a two-step polling process and is scheduled to announce a victor on October 10.

A sharply divided Morena during 2021 could hinder the party's ability to organize an effective campaign in advance of the mid-term elections, leaving it to AMLO to generate voter enthusiasm and thereby reinforcing the need for his referendum strategy.

#### **IV. A Fight Over Water – The Boquilla Dam Conflict**

On the New Mexico/Chihuahua border, the Boquilla Dam provides water to Mexican farmers in a region of Mexico prone to droughts, as well as to cities as far away as Reynosa and Matamoros. It is also a key source of water flowing into the Rio Grande and from there to farmers in Texas. According to a 1944 treaty, Mexico must send a fixed amount of water downstream into the Rio Grande (just as the United States must do on the Colorado River). Mexico is currently behind on its water deliveries with an October 24 deadline rapidly approaching. It has thus been releasing millions of acre feet of water through the dam to fulfill its treaty obligation.

In Northern Mexico, however, farmers watched as water they believe is essential for their crops flowed to the United States. For months they requested a hearing with the federal government to express their concerns. [Frustrated farmers, with support from local politicians, took control of the dam](#) and stopped the outflow of water. In a failed attempt by the National Guard to retake the dam, two protesters were killed giving the farmers another grievance to rally around.

The federal government's response has been to demand that the farmers withdraw and allow the flow of water to the U.S. to resume, and [to accuse the "conservative" opposition of leading the protest](#) to score political points against the president. AMLO



has also [demanded that the protesters pay for the damage](#) to generators caused during the occupation. Currently, National Guard troops are waiting to retake the dam and no serious talks seem to be taking place.

If Mexico fails to pay its water debt in an election year in which the polls in Texas are tight, President Trump could play hardball with Mexico, potentially closing the border to score points in Texas. At the same time, Chihuahua farmers and politicians are infuriated with the AMLO administration and how it has handled the Boquilla Dam crisis. With neither side in a mood to compromise there is a potential for more violence. This could then play into the June 6, 2021, gubernatorial election in Chihuahua and deepen opposition among the group of ten largely northern governors who have formed a political alliance in opposition to the federal government. We will be watching this issue closely.

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