Mexico:

A political risk assessment

Final Paper: Managing Political Risk II

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This paper aims to provide a macro assessment of political risks facing investors with exposure to Mexican assets over a short, medium and long-term horizon. It will also provide a comparative assessment with China insofar as is relevant to prospective US-based manufacturers facing a plant location decision.

Short-term (0-12 months)

Presidential and Congressional elections will take place on 1st July 2012. With new terms of office beginning in December, **political grid-lock** will remain the order of the day through late 2012.

With solid, double-digit opinion poll leads, and with new media regulations heavily favoring his candidacy, **Enrique Peña Nieto** (PRI) has cemented his position as **prohibitive front-runner** in the first six weeks of official campaigning for the Presidency. His opponents, Josefina Vázquez Mota and Andrés Manuel López Obrador, are locked in a battle for second place, with little sign of forward momentum.

The latest polling suggests that the PRI-PVEM alliance will comfortably secure more than the 42% vote share necessary to ensure a Congressional majority. This raises the **prospect of unified government in Mexico for the first time since 1997**, and potential for a new President to deliver on a reform agenda, should they wish.

Recent Presidential election cycles in Mexico have typically coincided with periods of social unrest and economic instability, most notably the Tequila crisis which erupted upon the accession of President Zedillo to office in December 1994.

While unexpected, **market-moving developments** (such as high-profile assassinations) cannot be entirely discounted, and while one may draw a parallel between 1994 and 2012, insofar as there is both a Presidential election and internal security threats which could conceivably induce volatility in Mexican financial assets, the key difference in 2012 is that Mexican macroeconomic fundamentals are now much stronger:

- The central bank is headed by the highly credible Agustin Carstens, backed by significant reserves, and without an unsustainable currency peg to defend.
- There is no significant macro imbalances, credit or asset bubbles in the Mexican economy. Bank credit remains subdued.
- Mexico has access to a $72bn IMF Precautionary Credit Line in case of need.

Internal security issues are unlikely to pose any direct threat to the election process, profit-maximizing drug cartels preferring to adopt a wait-and-see approach in the expectation that a PRI President would not adopt a more robust stance than his predecessor against organized crime interests. There is much speculation as to the extent of drug cartel financing of political campaigns, particularly at local & regional level.

Escalating drug wars have claimed some 50,000 victims in recent years as President Calderon has adopted a robust, military led posture to combat organized crime. While this strategy has had some success in taking down senior drug cartel leaders, it has led to an escalation in violence in some areas. There is also some question as to whether this strategy has targeted cartels in a symmetric manner.

It is unlikely that Peña Nieto would choose to step up his predecessor's counter-narcotic military strategy. Moreover, his pledge to shift responsibility from the military to a newly resourced police force, traditionally riven with corruption, is not deliverable in the short term.

More likely is an uncomfortable détente, which could in turn complicate bilateral relations with the US. Expect **no major changes in security policy through 2013**. Turf wars between cartels are as – if not more – important a source of violence as government action. It is not likely that government policy can mitigate this.

Any significant escalation in drug-related violence, including its geographic scope and a widening in the nature of targets, poses risks to foreign and, particularly, local investors.

After the economy and internal security, interrelated **fiscal & energy reforms are key electoral issues**. While Peña Nieto has courted global financial press with suggestions that he will introduce significant private sector involvement into the oil & gas sector, he has been far more circumspect domestically in relation to what remains a highly sensitive & salient national issue. Recent manifestations of Latin American resource nationalism will not improve the immediate scope for reform leading to shared ownership of hydrocarbon assets on Mexican territory.

Measures to increase private sector involvement in the energy sector could be adopted quickly, as soon as early 2013, within the current constitutional framework, however. For instance, **'incentive-based service contracts' could be made more attractive**. Although the uptake has been limited to date, these contracts, conceived as part of the 2008 energy reforms, allow private sector operators like Halliburton and Schlumberger to engage in upstream hydrocarbon extraction on a cost recovery plus fixed fee per barrel basis. More **comprehensive, constitutional reform is extremely unlikely in the short term**.

A two thirds congressional super-majority, and a majority of the state legislatures, is required to amend Article 27 of Mexico's 1917 constitution, which affords PEMEX its monopoly position by banning private ownership or part-ownership of hydrocarbons. This would necessitate, at a minimum, a PRI-PAN political rapprochement. Such an alignment must be viewed as unlikely to be brokered in the aftermath of the 2012 elections, rendering unlikely any short-to-medium term evolution towards shared asset ownership, or similar, arrangements.

Oil prices are currently in a 'sweet spot', high enough to drive government revenues without inducing a demand sapping double dip recession in the US. **Extreme movements in the oil price** could thus threaten US growth – and hence Mexican exports – to the upside, and Mexican fiscal balance to the downside.

Mexico’s Latin American competitors and **trading partners are becoming increasingly protectionist**, flexing their muscles through trade rules and currency manipulation, to varying degrees. Brazil recently succeeded, for instance, in introducing a voluntary export agreement limiting Mexico’s bilateral auto exports.

The Mexican **peso is among the most flexible in the region**, under the tutelage of Agustin Carstens, Central Bank Governor. While a regional escalation in mercantilist impulses poses risks to Mexico’s trading economy, the fact that 80% of its exports go to the US serves to limit the downside here. This does pose **risks at the margin for Mexico based manufacturers exporting to the LAC region**.

Medium-term (2-5 years)

While progress has at times been painfully slow, the trajectory of reform in Mexico has been reasonably constant since the mid-1990s. Mexico’s institutions have survived intact both the end of PRI’s stranglehold on the Presidency in 2000 and the controversy over the result of the 2006 election.

The big political question facing Mexico over the medium term is whether PRI’s return to ascendancy signals a return of the *ancien régime*, or normal regime change in a consolidating democracy. While a PRI majority in Congress and unified government yields opportunity to transcend legislative grid-lock and deliver on reform, it also potentially gives PRI the political opportunity to return to ways of old. With mid-term elections in 2015, and the new President’s political honeymoon likely to end much earlier, the **window of opportunity for unified government to deliver on reforms may be limited.**

The meta-structure of Mexican politics has been in flux since the 1980s, only culminating in PRI losing the Presidency in 2000. Momentum for reform and democratic norms was deep-rooted by then, this momentum in fact facilitating regime change. While rule of law cannot yet be said to be fully entrenched, broader social and cultural trends render implausible any significant backsliding towards ‘perfect dictatorship’. **A return to unified PRI government is likely to put Mexican democracy to the test, but it is a test it will most likely pass.**

While a certain degree of distribution of patronage must be expected from the new President, warning bells would certainly be sounded if Peña Nieto and his coterie of advisers were to use the opportunity of unified government to row back on electoral reforms or to attempt to undermine separation of powers, such as Supreme Court or Central Bank autonomy. Moreover, achieving a Congressional super-majority in support of such an agenda would prove impossible.

No significant policy change is expected with respect to economic openness and bilateral US relations, although the former could be complicated in respect of the LAC region if neighboring countries escalate protectionism while the latter may be complicated if a more permissive stance is adopted by the new President vis-à-vis organized crime.

Finance will be a critical constraint on government action across a range of areas, likely to become binding without significant revenue-generating reforms. One third of government revenues derive from PEMEX, whose production of oil has been in decline in recent years due to lack of investment and technical know-how. Production has stabilized at just under 2.6m bpd. **Eventually, comprehensive energy reforms are inevitable**, if ever-harder-to-access conventional and non-conventional resources are to be tapped, and fiscal sustainability assured.

Persistently high oil prices reduce incentives for immediate reform in this area. A steep and sustained fall in prices, however, would reassert the imperative over the medium term. Even at current prices and production levels, Mexico could become a net oil exporter by the end of the decade, limiting the extent to which comprehensive reform can be delayed.

Ultimately, while the timing of energy reform may be dictated by prevailing oil prices, maintaining fiscal balance will come down to a choice between two politically unpalatable alternatives: revenue raising tax reform or energy reform. Moreover, energy reform itself would necessitate tax reform in the short-term if government revenues are to be maintained.

The **biggest downside risk over the medium term is an escalation of drug related violence**, its spread out of largely localized geographic areas at present and / or further increased scope of targets to cover foreign owned economic assets as targets for extortion and kidnapping. It is impossible to forecast the trajectory of intra-cartel turf wars, while economic assets will be targeted only insofar as the benefits of doing so outweigh the costs. Foreign capital has the advantage of mobility in this regard, particularly where the parent firm is geographically diversified.

It is possible that a new President could adopt a less robust posture vis-à-vis organized crime, thereby alleviating the security situation somewhat. While this may mitigate potential downside risks in the short-term, reducing the likelihood of capital flight and improving the investment environment, such a **Faustian pact is unlikely to facilitate consolidation of the rule of law** or long-term economic development.

It is unlikely that this internal security situation will be comprehensively resolved over a 5 year time horizon but, while the threat of collateral damage and political instability will remain, and could become more acute, the **direct threat to foreign assets should remain relatively limited** unless there is a qualitative shift in strategy by organized crime syndicates.

At present, the largely foreign owned banking sector is highly profitable in Mexico. Credit as a proportion of GDP is persistently low compared to peer countries, suggesting room for future growth. As property rights become better protected, facilitating more collateral-based lending, the **banking sector should prove a profitable play over the medium-to-long term**. The forthcoming IPO of a minority stake in Santander Mexico, the country's third largest by assets, may provide an interesting entry opportunity over the coming year.

Long-term (15-25 years)

On its current trajectory, it can be expected that democratic norms will become further entrenched, and rule of law consolidated. Mexico has long been the sleeping economic giant of

Latin America. Recent reforms have not as yet fed through to catch-up economic growth, but a sustained period of political and economic stability opens up the prospect of Mexico building enough momentum to escape the 'middle income trap'. **Colombia provides a model of how economic growth can take off once internal security and organized crime challenges have been overcome.** Short-term pain can provide a platform for long-term gain, but such an outcome is unlikely should Government enter into any myopic, tacit arrangement whereby drug-violence is reduced and turf wars settled in return for government acquiescence.

At an estimated 683 trillion cubic feet, Mexico has the fourth largest shale gas reserves on the planet, leaving it **well placed to profit from the shale gas revolution**. Presently, private ownership of hydrocarbon assets is constitutionally prohibited, and private sector involvement in their extraction confined to as yet unattractive service contract arrangements.

PEMEX does not have the technical know-how or investment capacity even to maintain the current rate of extraction of conventional oil reserves, never mind exploration and extraction of unconventional oil & gas. They can be expected to attempt this on a small-scale through public-private partnership, but this is ultimately unlikely to prove a sustainable model.

Despite recent campaign promises to open up the sector to private investment, and an emerging public consensus that this is both necessary and inevitable, there appears at this point to be **insufficient political incentives** domestically – coupled with significant obstacles, including the powerful PRI-aligned oil workers' trade union, the need for simultaneous tax reform, and necessity for a post-election PAN-PRI Congressional alliance – to push for the necessary **constitutional reforms**.

In the short-term, therefore, it can be expected that the terms of service contracts will be made more attractive to improve their uptake. In the medium-to-long term, comprehensive energy reform is inevitable, as fiscal pressure intensifies, with the precise timing potentially dependent on the trajectory of global oil prices. From 2020, if not before, fiscal pressures are likely to become irresistible, and constitutional reform unavoidable. Investment in **Mexican shale gas will likely prove therefore to be a profitable play over the next quarter century**.

In the event of constitutional reform, and private sector acquisition of Mexican oil & gas assets, the possibility cannot be entirely discounted that state expropriation will remain a risk, even in the face of the consolidation of rule of law, and property rights in particular. Resource nationalism is not expected to diminish in Mexico, or in the wider LatAm region, as a salient political issue and one which can be utilized by populist politicians.

A Comparative Case: Mexico v China

Mexico's peer group includes Latin American powerhouse Brazil and Argentina which, like Mexico, has massive shale gas reserves with significant state involvement in the extraction sector.

The most appropriate benchmark over the medium term, however, is arguably China, which has posed the **greatest threat to Mexico's emergence as pre-eminent exporter of manufactures**, particularly to the US market.

While Mexico has the advantage of proximity to the US, China has had the edge in terms of labor costs. **With Chinese wages rising rapidly, however, the balance is beginning to swing back in Mexico's favor**.

For a US manufacturer facing a choice between locating a plant in either of the two countries, there may soon not be much to separate the two. So what about the politics?

In the past decade, nascent liberal democracy, with appropriate institutional checks and balances, has become increasingly entrenched in Mexico. 2012 should see the 2nd democratic regime change of the millennium, without sustained destabilizing unrest.

While unified PRI government may arouse fears in some quarters as to prospects for the continuing development of democracy and the rule of law in Mexico, it appears unlikely at this point that any serious deviation from its current political trajectory is in prospect.

Having liberalized its economy in the 1980s, joining NAFTA in 1994, **Mexico has already undergone economic transition**, facing and passing the inherent tests to social and political stability.

China shows no sign of political transition, but the coming economic transition will pose risks to social and political stability. Indeed, there is evidence of late of high-level tensions in the Chinese apparatus of governance between reformers and hardliners, spilling into the public domain in one notable high-profile case.

Although Mexico's internal security challenges are well documented, they so far remain largely localized; they are not political in nature; and have not led to the targeting of international investors' assets to any significant degree. While an escalation of organized crime-related violence cannot be discounted, i**t is not expected that profit-maximizing drug cartels would directly target international investors' assets**, as it is not in their interests to do so.

Although largely undocumented in the Western press, China faces periodic bouts of localized social unrest and separatist agitation. There is no evidence of late that these are in significant danger of spilling over into more broad-based unrest which might threaten the prevailing political equilibrium. Botched economic transition would put this to the test.

Explicit or implicit expropriations remain a prospect in both Mexico and China, although it should be judged that, because they have less global clout and more to lose, Mexico would be less inclined to systemically target US assets in this manner.

Geopolitical tensions are inevitable over a medium-to-long term horizon between China and the US, but negligible between Mexico and the US, with the overall risk of resulting expropriation thereby judged far higher in China.