COFACE ECONOMIC PUBLICATIONS

FEBRUARY-MARCH 2018

FOCUS

By Patricia Krause
Coface Economist
based in São Paulo, Brazil

Mexico Automotive Industry: Headwinds coming from the North

The Mexican automotive industry has experienced strong growth since the signing of the North American Free Trade Agreement (NAFTA) in 1993. The sector representativeness rose, from 1.5% of GDP and 8.5% of the manufacturing output in 1993, to 3% of GDP and 18% of manufacturing output in 2015[1]. It is currently the world's seventh-largest vehicle manufacturer and the largest in Latin America (after overtaking Brazil in 2014). However, the industry's bright performance is not perceived positively by all. Since the beginning of his election campaign in 2016, United States President Donald Trump has continually attacked the NAFTA. He has blamed the agreement for the deep trade deficit that the US holds with Mexico (USD 71.1 billion in 2017[2]) and for destroying US jobs. The automotive industry is one of his favourite targets, and not by chance: transportation and related equipment represents roughly 13.9% of total US exports to Mexico and 33.7% of total US imports from Mexico[3]. Overall, it is the sector with the greatest trade imbalance within the United States.

Coface downgraded its assessment for the Mexican automotive industry from "medium risk" to "high risk" in December 2017[4], following the US Presidential Elections, in part due to the sector's exposure to potential NAFTA changes[5].

NAFTA renegotiations began in August 2017, and have since been extended until at least the end of the first quarter of 2018. The agreement currently requires finished vehicles to contain 62.5% of their parts from partner nations if they are to take advantage of duty-free imports across the continent. US negotiators wish to raise this ratio to 85%, with 50% guaranteed to US producers. The proposal has been categorically rejected by the Canadian and Mexican governments, as well as by vehicle manufacturers in each of the three countries, who argue that an 85% ratio is not feasible.

The final outcome of negotiations may be postponed to 2019, especially taking into account the electoral calendar in Mexico and in the United States this year. The main short-term consequence is on investments, which are currently on hold. Coface believes that the most likely scenario remains the one where a trade deal that largely preserves cross-border trade and investment links between the three members is reached.

Even if the NAFTA was dissolved, there are still some factors (like Mexico's free floating exchange rate and the high integration between the two countries' industries) that would cushion the negative impact on the Mexican automotive industry. Moreover, if the United States withdraws from the agreement, trade between the two countries would be governed by the World Trade Organization's Most Favoured Nations (MFN) rules that were in force until 1994. Mexican exports to the United States would then pay, on average, an applied tariff of 3.5%, while US exports would face an average Mexican tariff of 7.1%. Mexico's policymakers should start to look beyond the NAFTA, and should also focus on the internal issues that reduce the country's investment attractiveness (such as weak rule of law, high corruption, and rising criminality).

1 - Source: Federal Government Agency ProMexico 2 - Source: US Census 3 - Sources: Census Bureau and JP Morgan 4 - Coface's assessment has remained at "high risk" since then
5 - Every quarter, Coface reviews and publishes a Barometer, including assessments for 13 sectors within 24 countries across 6 major regions of the world

MEXICO AUTOMOTIVE INDUSTRY IN FIGURES

Represents **3%** of GDP and **18%** of manufacturing output

1.7 million jobs (directly and indirectly)

World's **7th** largest producer of vehicles

Production mainly directed to the US: **62%** of total output in 2017

16 major light vehicle assemblies and another **12** plants for heavy vehicle

World's **12th** largest domestic market

68% of domestic sales were made through credit in 2017

Six out of ten cars produced in Mexico are exported to the US

The Mexican automotive industry has considerably increased since the signing of the NAFTA. It is currently home to sixteen major light vehicle manufacturing plants, and another twelve plants for heavy vehicles. All producers are foreign brands, such as General Motors, Ford, Volkswagen, Fiat Chrysler, Nissan, and Kia. **CHART 1** shows the evolution of vehicles production, exports, and domestic sales over the last 24 years. Vehicle production has more than tripled in this period, reaching an annual production of 3.77 million units in 2017. In volume terms, exports have increased at a much faster pace (+547% between 1994 and 2017) than domestic sales (+258% in the same period). The industry is currently highly-oriented to the export market. For example, 82% of its output was directed to the foreign market in 2017.

Despite the threats that the Mexican automotive industry faces, production reached record levels in 2017 (+8.9% year-on-year), driven once again by the export market. Output directed to the United States increased by 9.4%, thanks to the country's strong activity and job market.

CHART 1
Mexico Vehicle Production

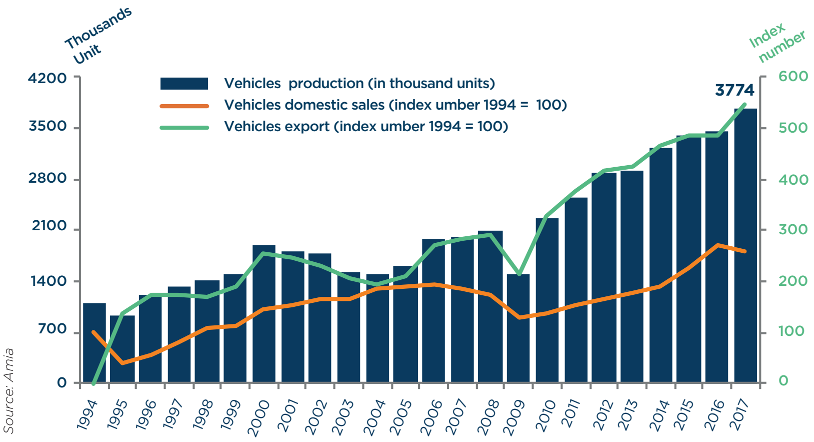
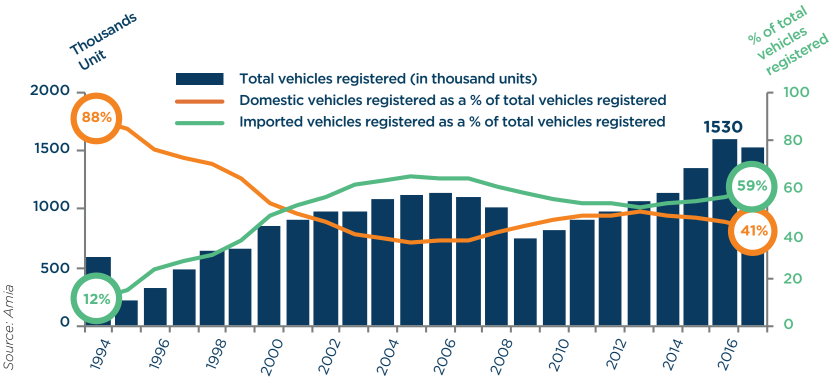


CHART 2
Mexico Vehicle Registration



More importantly, Mexico was able to marginally reduce its dependence on sales to the US. The representativeness of the US to Mexico's total auto exports dropped from 77% in 2016 to 75.3% in 2017. Exports to markets other than the US rose by 20.9% in 2017. Canada (+8.5%), Germany (+22.2%) and Italy (+388%) were the main contributors.

Over the last 24 years, Mexico's domestic market has become increasingly fuelled by imported vehicles, which come mainly from Asia (59% of total imports in 2017). **CHART 2** shows how the ratio of imported vehicles to total registration has evolved, going from 12% in 1994 to 59% in 2017. It also reveals that total car registration expanded by 247% over the same period. Part of these imports corresponds to used cars (17% of total imports in 2016). According to the Economist Intelligence Unit, the passenger-car ownership rate climbed to 236 vehicles per 1000 people in 2017, up from less than 200 in 2012. The ratio is high compared to other large developing markets, but remains considerably below the OECD average.

Contrary to production (largely driven by export prospects), automotive registration numbers have been weak. In 2017, vehicle registration shrunk by 4.6% year-on-year, driven by the weakening of macroeconomic fundamentals. The inflation rose to 6.8% at the year end of 2017 (a sixteen-year record high) and the benchmark interest rate was lifted by 450 basis points since December 2015 (reaching 7.5% a year in February 2018). According to the Mexican Association of Automotive Distributors (AMDA), the number of automotive sales made through financing declined by 2.6% in 2017: a fall equivalent to 27,721 vehicles. Moreover, the uncertainties related to Mexico's presidential elections (scheduled for 1st July 2018) and to NAFTA's renegotiation are likely to have influenced household consumption decisions.

Breaking down sales per car origin, registration of imported cars in 2017 rose by 2.2%, while registration of locally-produced vehicles shrunk by 12% in the same period. To try to help local producers, in late December 2017 Mexico announced the extension of rules that impose restrictions on the importation of used vehicles, with the aim of boosting domestic sales. The rules, which cover environmental and price requirements, have been extended to March 2019. The restrictions are also justified by the need to control high gas emissions. According to EIU the country's average fleet age is 17.2 years, and 120,000 units are more than twenty years old.

Trump's rhetoric has yet to damage the sector, but the NAFTA renegotiation risk is increased by the electoral agenda

United States President Donald Trump has raised concerns regarding new investments in the Mexican automotive industry. During his election campaign, President Trump threatened major global automakers with a 35% import tariff if they continued to produce vehicles in Mexico for sale to the US market. At that time, some global vehicle manufacturers cancelled investment plans in Mexico, and announced new investments in the United States – although none of them declared their decisions to be a result of President Trump's threats.

Since then, however, President Trump has reduced his rhetoric against Mexico's automotive industry, and appears to have abandoned the 35% tariff. Despite this, in August 2017, Toyota announced that it will delay the opening of a new plant in Mexico from 2019 to 2020. Ford decided to cancel part of its planned investments in the country (including a new USD 1.6 billion plant in San Luis Potosí), and declared in June 2017 that it will import most of its next-generation Focus cars from China instead of Mexico. However, Ford also declared later in the same year that that it would move the production of its hybrid- and fully-electric SUVs[6] from Michigan to Mexico. In addition, BMW plans to open a new plant in Mexico in 2019. According to the National Statistical Institute of Mexico (Inegi), gross fixed investments dropped by 4.1% in the first eleven months of 2017 year-on-year.

The conclusion of NAFTA renegotiations was postponed from the end of 2017 to the first quarter of 2018, and could even be extended to 2019. The sixth round of NAFTA talks took place in Montreal at the end of January 2018. Some progress was made, though thornier subjects – such as the rule of origin and the sunset clause – were not resolved.

United States representatives have proposed raising the North American content requirement for vehicles from the current 62.5% to 85%, with a minimum required US content of 50%. This proposal was met with strong resistance, not only from Mexico and Canada, but also from several US companies, who argued that a regional rate of 85% is not feasible.

Regarding the sunset clause, the United States has continued to defend a provision under which the NAFTA would automatically expire after every five years, unless all three parties agreed to its extension. This could hurt the automotive industry, as it would inflict a scenario of uncertainty to NAFTA's future, making it difficult for businesses to make long-term, cross-border plans. In recent negotiation rounds, both Mexico and Canada have made counterproposals that would allow for periodic reviews of NAFTA, but reject the idea of an automatic expiration.

Despite the United States' anti-free trade rhetoric and the postponement of NAFTA renegotiations, the most likely scenario remains the one where a trade deal that largely preserves cross-border trade links between the three countries is reached. President Trump has proven to be highly unpredictable, but has recently assumed a more conciliatory stance, and has even declared that making a reasonable deal is possible. He also mentioned in mid-January 2018 that there is no rush to conclude renegotiations, citing the pending Mexican presidential elections (to be held on the 1st July 2018). In addition, the US mid-term elections will take place in November 2018.

The depth of the US-Mexico trade relationship also increases the odds of our base scenario. If the United States decides to leave the NAFTA agreement, the US government would experience strong opposition from both industry and individual US states. The total annual sum of trade between the two economies grew from USD 81.5 billion in 1993 to USD 557 billion in 2017. In 2017, Mexico was the destination of 10.6% of total US exports, which represents 1.3% of the 2017 estimated GDP. Regarding total imports, 10.8% came from Mexico (1.6% of GDP). According to a study by Atlantic Council, a United States think tank[7], the US states most integrated with Mexico are New Mexico, Arizona, Texas, and Michigan. Moreover, it is estimated that 40% of the value of US imports from Mexico comes from materials and parts produced in the United States. This means that 40% of every dollar that the United States spends on Mexican goods actually supports US firms.

The automotive industry has become one of the most integrated sectors in North America. Very few vehicles are currently made in a single place, and assembly plants have reoriented to take advantage of economies of scale. This phenomenon is not unique to the automotive sector as governed by the NAFTA agreement: Coface's 2014 panorama on world trade[8] explored how globalization has, in effect, transformed the way in which goods and services are produced and sold. There is less and less fragmentation across countries and industries, and more and more vertical fragmentation within the production lines of the same product by different companies, and potentially in different countries. These are called "value chains", to the extent that at each stage a certain amount of value is added. According to the study, transport equipment is the industry which holds the most globally-integrated value chain (i.e. higher than textiles, machinery, electrical, and optical equipment).

If, against all odds, the agreement was dissolved, certain factors would need to be taken into account. According to Article 2205 of the NAFTA, a member can withdraw from the agreement six months after providing written notice of withdrawal to other parties. This way, if President Trump decides to leave NAFTA, what happens next might be subject to legal interpretation: some law experts argue that the president does not have the authority to exit a trade deal without Congressional approval. In terms of legislative power, President Trump would probably experience resistance from not only Democratic, but also Republican legislators representing states and/or sectors with high exposure to the NAFTA.

Although higher border tariffs could reduce sales volumes and would generally reduce profitability within the Mexican automotive sector, various factors would undermine their impact. If the United States withdraws from NAFTA, trade between the two countries would be governed by the World Trade Organization's Most Favoured Nations (MFN) rules, which were in force up until 1994 (the year of NAFTA's implementation). Mexican exports to the US would then pay, on average, an applied tariff of 3.5%, while US exports would face an average Mexican tariff of 7.1%. Therefore, the rate applicable to Mexican exports would not be very high. Furthermore, as Mexico holds a free-floating exchange rate, part of the negative shock would be cushioned by the depreciation of its currency, which would raise the attractiveness of its exports for potential new foreign clients.

An S&P Global ratings report[9] also stressed that several reasons would force US manufacturers to continue to import components, especially for small cars. The report states that, capacity utilisation in this segment in the US exceeds 90% – thus, there is limited available capacity to reallocate production from Mexico to the US. Also, vehicle parts that are currently sourced in Mexico comply with safety, technical, and technological standards for specific vehicles – fully replacing these would not be an immediate process. In addition these dampers, a second S&P report[10] estimates that, if the agreement is cancelled and MFN tariffs are applied, the exchange rate would average 20.9 Mexican pesos per US dollar between 2018 and 2020. This would represent a depreciation of roughly 9% compared to the current rate. S&P also believes that in this scenario Mexico's GDP growth rate would average 1.8% in the same period (0.6 percentage point lower than in the scenario where NAFTA is maintained with no significant changes).

■ ■ ■

6 - Sports-Utility Vehicles
7 - "What if NAFTA ended?" – Atlantic Council, October 2017
8 - "World trade: a sluggish spell?" – Coface, October 2014
9 - A downfall of NAFTA could pinch the Mexican corporate sector's credit quality but won't impair it - S&P Global ratings, November 2017
10 - How an end to NAFTA could affect Mexico's economy – S&P Global Ratings, November 2017

The growth gap is explained by the fact that a failure in renegotiations would represent a confidence shock to domestic demand, impacting negatively on fixed investments. Furthermore, the currency depreciation would also place upward pressure on inflation, which would likely lead the central bank to further raise interest rates.

It is also worth noting that some recent developments in the United States may also jeopardize the prospects of the Mexican automotive industry. One concern relates to the recent approval of US tax reforms. Among several changes, the reform includes slashing corporate taxes from 35% to 21%. The Mexican corporate tax rate currently stands at 30%, so some companies might be motivated to migrate across the border. Mexico policymakers have already admitted that they will evaluate whether to make fiscal changes in response to the US tax overhaul. Moreover, the US tax reform also eliminates the tax paid by companies on profits obtained abroad.

Presidential election in Mexico: another risk factor?

There is a risk that NAFTA renegotiation will overlap with Mexico's presidential election on the 1st July 2018. A change in government could represent a shift from the current pro-business economic direction, and consequently a shift in Mexico's position towards the agreement negotiations. Mexican president Enrique Peña Nieto's popularity is at only 28%: less than half of the support he enjoyed in 2011[11]. This weak outcome represents the dissatisfaction of the population, with rising criminality (2017 was the most violent year in two decades) and corruption in the country. The last three years has seen corruption investigations against ten state governors, eight of whom are affiliated to the ruling PRI party[12].

This general dissatisfaction has created an anti-establishment environment in the country and has strengthened the chances of the populist candidate winning the presidential race. André Lopez Obrador, also known as AMLO, from the left-wing Morena party, represents the main opposition to the PRI government. AMLO is a two-time presidential candidate and former mayor of Mexico City. He pledges to curb corruption and to restore security. Furthermore, AMLO promises to boost social welfare spending, and had positioned himself against private investments in industries traditionally run by the state (he was a critic of the energy oil reform that took place at the end of 2013). With that said, he has recently softened his rhetoric: in an interview in early February 2018, Gabriela Marquez, a Harvard-educated economist who would manage the NAFTA renegotiations if AMLO wins the race, admitted that the agreement represents a significant part of the country's economy and that she would not try to restart negotiations from zero. She also added that AMLO and his party support the continuation of the deal.

AMLO is currently leading the one-round leadership race[13]. According to the average results of the five polls conducted between December 2017 and February 2018, AMLO holds 30.6% of the voting intention. The current second-place candidate is Ricardo Anaya (PAN party) with 23.1%, followed by the ruling PRI party's candidate José Antonio Meade, with 17% (re-election is forbidden in Mexico). Either of the latter two candidates would probably represent more of the same in terms of external politics. Mr Meade is the former finance minister of Mr Penã Nieto's government (before his resignation at the end of November 2017) and is the "investor's candidate". He is an economist with a doctorate from Yale University, and is seen as a capable technocrat with a wide range of experience. Mr Meade's share of voting intention could increase in the upcoming months, as he becomes more known by the population. Despite his association with PRI, he is seen as honest and has not been implicated in any corruption scandals. Moreover, Mr Meade is not a "career politician", having spent most of his career in the private financial sector, which could weigh in his favour.

MEXICO SHOULD THINK BEYOND ITS US TRADE RELATIONSHIP

Mexico already has a network of ten foreign trade agreements with 45 countries. It also appears to be seeking new ones and updating others. For instance, the country is currently reviewing its 21-year trade deal with the European Union. Mexican officials recently said that talks with EU counterparts could be concluded within one month. The updated version of the agreement is expected to add agricultural products, additional services, investment and government procurement, and provisions on labour standards and environmental protection. The key challenge concerns the extent to which each party should open its market to foods and drink.

Moreover, one year after President Trump decided to withdraw the United States from the Trans-Pacific Partnership (TPP) trade deal, Mexico and the ten other remaining countries are about to sign the new Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). The final deal is expected to be reached in March 2018 and to be ratified by 2019. The other economies involved are Australia, Brunei, Canada, Chile, Japan, Malaysia, New Zealand, Peru, Singapore, and Vietnam. The total combined GDP of the CPTPP would be of roughly USD 13.5 trillion, or 13.4% of global GDP.

An eventual Plan B should not solely focus on prospecting new foreign trade partners – the main target should instead be strengthening its business climate. The aforementioned increase in violence and the weak rule of law hampers investments in the country. According to the 2017-2018 Rule of Law Index of The World Justice Project (WJP), Mexico stands at position 92 out of the 113 assessed countries. More precisely, from the 30 Latin America economies analysed, the country is only ahead of Guatemala, Nicaragua, Honduras, Bolivia, and Venezuela.

The index takes into account eight factors: constraints on government powers, absence of corruption, open government, fundamental rights, order and security, regulatory enforcement, civil justice, and criminal justice. Mexico is particularly weakly positioned in criminal justice (105/113), absence of corruption (102/113), and civil justice (100/113).

11 - Source: Pew research centre
12 - The PRI ruled the country for seven decades until 2000, when the centre-right PAN party won the electoral race. The latter party held power for twelve years, until Peña Nieto's took office in 2012
13 - Mexico's electoral system is based one round only. This way, a candidate can be elected with only a few votes

DISCLAIMER

COFACE SA
1, place Costes et Bellonte
92270 Bois-Colombes
France

www.coface.com

FOR TRADE