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ECONOMIC RESEARCH AND STRATEGY

A visit to Juarez brings the truth about trade deal Trump made with Mexico

I recently went to the Mexican cities of Chihuahua (capital of the state by the same name) and Ciudad Juarez (economic capital and state largest city with 1.3 million inhabitants). Juarez, from where you can actually see the "wall" (rather a couple of high tech barriers), is located just south of El Paso, its American twin city of 700,000 people.

Both cities are still considered unsafe by the Canadian and American governments. Yet, I visited the region in spite of the travel advisory, Denis Villeneuve's 2015 movie Sicario about the region's drug cartels and reading about the violence in Juarez in a very graphic 2009 Harper's magazine article.

On the other hand, a few years ago, I had attended a positive territorial review of the region. A case had been made that the situation was already improving. And the recent political clean up in the state (César Duarte Jáquez, currently under investigation for corruption and allegedly in hiding, was replaced by Javier Corral Jurado as state governor in October 2016) was likely to have helped further. However, I was still curious about the evolution of the situation since and how the proposed new trade agreement with the U.S. was going to affect the regional economy going forward.

On September 4th, the day before I flew to Chihuahua, outgoing Mexican president, Enrique Peña Nieto gave his last state of the union address in Mexico City. He talked about his economic accomplishments but downplayed inequalities, corruption and rising violence in Mexico, the main reasons why the leftist Andrés Manuel López Obrador, or AMLO, as is more commonly known, was elected president this summer.

This changing of the guard at the national level is relevant because it explains, in part, President Trump's recent rush to close a trade deal with Mexico and get it approved by Congress before December 1st when AMLO will be inaugurated. There were some fears that the president-elect could be less accommodative once in power. However, he has already signaled that he would not disavow the proposed agreement. This may explain why negotiations with Canada could drag on beyond the October 1st deadline as per the 60 day notice needed for the current Congress to approve the final text of a new trade deal.

The real deadline on the NAFTA negotiations is thus likely to be around early November. Members of the next U.S. Congress will be elected on November 6th but won't be sworn in before early January 2019. Negotiations with Canada could thus potentially drag on until the end of the U.S. mid-term campaign or 60 days before the new Congress takes over. This would provide a timely "win" for President Trump but also constitutes a risky strategy in a politically charged environment.

Notwithstanding the need to repeat the process with a new Congress (new final draft with the prescribed delays), potentially pushing a new agreement into next Spring, it matters to ink a trade deal before Congress dissolves in early January because, regardless whether Democrats win the House of Representatives in November, as now seems likely, there is no telling what could happen. Some Democrats already oppose free-trade and there is some fear that, post January 2019, Democratic representatives in the House could be more hostile to trade. Moreover, pro-Trump Republicans are increasing anti-free trade and more of them could be elected in November. This is because some pro-free trade Republican incumbents are not seeking re-election and others feel they have to align themselves more closely with the president's protectionist platform if they want to get elected.

Finally, the federal elections in Canada in the fall of 2019 could make the political environment increasingly unreceptive to even the smallest concessions on both sides of the border.

Negotiators are thus focused on promptly renewing NAFTA as pressures are applied from all sides: Trump is threatening to cancel NAFTA and exclude Canada if he does not get what he wants while Congress, invoking the mandate it gave the President's team to negotiate a three party agreement, is saying that it won't approve the trade deal if Canada is not included. For its part, Canada is claiming it won't sign a bad deal.

The tight delays and gridlock are in a way reducing the risk that the NAFTA agreement could be substantially revised. However, if negotiations drag on beyond November, the final text of the revised agreement will have to be submitted to the new U.S. Congress in January, likely requiring a reset of the legal delays and pushing approval to early March at the earliest. In such a scenario, it is certainly possible that negotiations bring more changes to the agreement and economic uncertainty.

While I was in Chihuahua and Juarez, I took the opportunity to talk with local business people about how the proposed new trade agreement between the U.S. and Mexico (negotiated this summer without Canada) would affect them. The deal involves, among other things, raising the North American car content to 75% but, beyond a significant content threshold, forcing Mexican manufacturers to pay workers at least US$16 an hour in order to avoid tariffs. This, in principle, could force car manufacturers in Mexico to raise wages or move some production to Canada and the United States.

The state of Chihuahua depends very much on car part manufacturing, electronics, medical equipment and aerospace. Its recent development, like other northern regions of Mexico, was partly the result of the expansion of its manufacturing industry since NAFTA was enacted in 1994.

For instance, Ford now makes 2000 engines a day in a state which provides 400,000 jobs in manufacturing: 80,000 jobs in the city of Chihuahua and 220,000 in Suarez alone. The region also ships annually for almost US$ 40 billion worth of goods to its northern neighbour.

There are in total 800,000 jobs in the formal economy in Chihuahua, representing 62% of all jobs in this region of almost 4 million people. This is one of the highest percentages of formal jobs in Mexico. For instance, in the southern states of Oaxaca and Chiapas, only 20% of workers held a formal sector job according to the Mexican Secretariat of Labor and Social Welfare.

Chihuahua now has very low unemployment and significant shortages of skilled workers. In this context, one could be forgiven to think that Mexican car manufacturers would raise wages or agree to marginally reduce local production to meet American demands.

However, beyond the fact that such a wage constraint is going to be difficult to monitor and enforce - a fact recognized by U.S. union leaders during the week-end preceding my visit to Northern Mexico - the proposal was deemed to be totally unworkable. Car manufacturers in Mexico will prefer to pay minimal WTO tariffs on cars and car parts exported to the U.S. than move their plants up north or raise wages.

According to Francisco Santini Ramos, a successful Chihuahua entrepreneur selling equipment to manufacturing companies, whereas manufacturing companies usually pay workers at least 140 pesos/day, the minimum daily wage in the state is still 90 pesos/day (about 50 cents/hour). Even entry jobs at Ford only pay 2$/hour, making $16 unattainable any time soon.

Longer term, the increased use of robots in the car industry which raises productivity might offer the prospect of higher wages. However, according to our host, Mexican car plants are already highly mechanised and, except for limited applications, the implementation of the last generation of collaborative robots won't happen in Mexico any time soon. The payback period would be 3 years versus 9 months in countries where wages are higher making it too risky to invest given the speed at which the technology is currently evolving.

If there is anything, the requirement to raise the North-American content in motor vehicles to 75% is likely to benefit Mexico as local manufacturers will have an incentive to attract production from outside NAFTA countries, even if it means paying tariffs on exports to the United States; and that is only if the agreement can be monitored and enforced. American negotiators seem to have carved out a deal which is only politically attractive to the segment of the American public which sees Mexican low wages as a threat but it won't change the reality on the ground in Mexico.

We could only wish that Canada finds a similar solution to induce the American president to promptly conclude current trade talks. Following the Mexicans strategy of letting Trump claim victory, we could all still emerge ahead.

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