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WEEKLY ECONOMIC COMMENTARY

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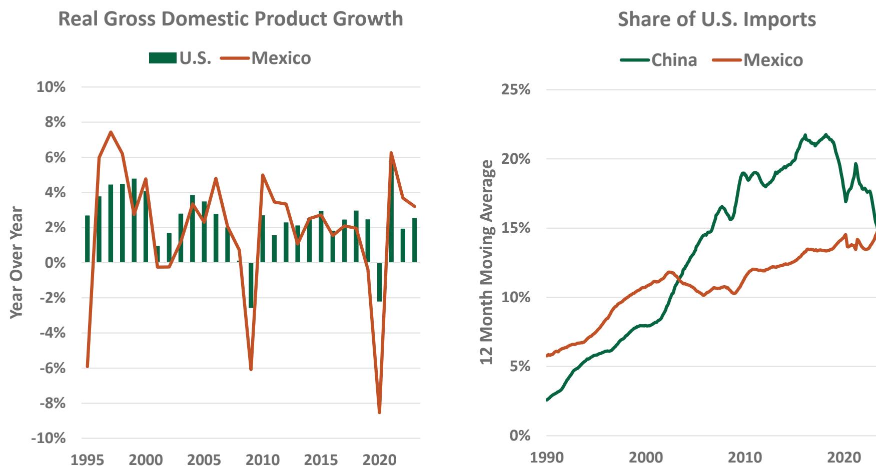
Americans often misunderstand Mexico. Each spring, we look forward to Mexican-themed gatherings for Cinco de Mayo—never mind that Mexican Independence Day actually falls on September 16. The menus of some popular Mexican restaurant chains have items not found anywhere south of the border. And travel to Mexican beach resorts offers wonderful scenery that bears no resemblance to the landscape of most of the nation.

Economically, Mexico does not always command our attention. But that may be changing. This week, Mexico elected its first female president, Claudia Sheinbaum, who will try to carry on the strong performance engineered by her predecessor, Andrés Manuel López Obrador (AMLO). The results of that effort will have important impacts north of the border and beyond.

For decades, Mexico was beset by high inflation and currency instability. Its fortunes were yoked to the economic ups and downs of the U.S., with Mexico experiencing more severe swings than those seen in the States.



Sources: BEA, Census Bureau, Haver Analytics

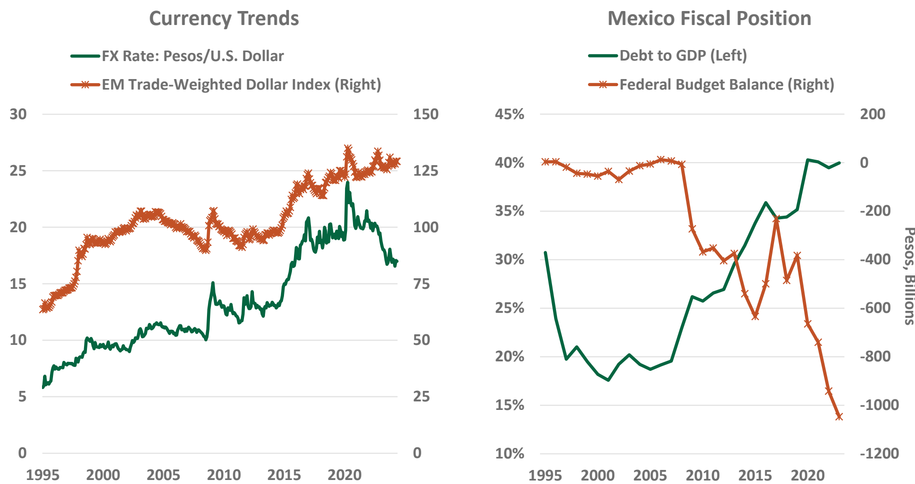
AMLO had success in changing that pattern. He agreed to limited concessions to preserve good trade relations with the United States. The nation's industrial base grew, and in 2023, Mexico overtook China as the U.S.' largest source of imports. The peso, perennially devalued against the U.S. dollar, showed unusual strength in recent years; the currency was also supported by the Banco de Mexico's hard stance against inflation, which raised rates sooner and more quickly than was seen in advanced economies.

AMLO's agenda came at a cost. The federal deficit more than doubled during AMLO's tenure, exceeding one trillion pesos (3.5% of gross domestic product, or GDP). The

nation's ratio of national debt to GDP has doubled since 2005. Unlike the insatiable demand for debt issued by their neighbor to the north, Mexico cannot run such a fiscal imbalance indefinitely. And reforms left some important gaps: Crime remains significant, with violent crime nationwide on the rise, an impairment to foreign investment and tourism.

Incoming president Sheinbaum will be asked to address a series of other economic issues. State-owned energy producer Pemex has been treated as a cash cow by several past administrations, leaving it as the world's most heavily-indebted energy firm. Aside from risk of insolvency, Pemex lacks the capital for exploration and upgrades to cleaner energy production. Reinvestment in the firm will add to the demands on national coffers.

Mexico has great opportunities…but also great challenges.



Sources: Federal Reserve, INEGI, Haver Analytics

Mexico has also been burdened by the increased flow of migrants throughout the western hemisphere. A diminishing share of migrants detained by the U.S. Customs and Border Protection agency are of Mexican origin; most are merely passing through Mexico. The Mexican government has made only limited reforms to curb this traffic. Mexico changed policies to reject migrants arriving by air, but overland transit remains heavy. This will certainly be a point for President Sheinbaum to take up with American leaders.

Mexico's greatest opportunity lies in meeting the moment of de-globalization and reshoring. As U.S. firms reconsider their long-term investments in China, Mexico stands out as a natural destination for manufacturing. Its location and low-cost labor have given the nation an edge in the production of heavy, difficult-to-ship products like vehicles and plumbing supplies. Despite the advantages of a free trade agreement, proximity and overlap in time zones, Mexico has struggled to broaden its northbound exports. Building more productive capacity will require more investment into the nation's infrastructure, especially for roads and energy generation.

Candidate Sheinbaum did not offer a comprehensive plan to support the nation's revenue beyond increasing tax collection and enforcement. Sufficient funding to reduce the deficit and support growth may require higher taxes. As election results came in strongly for Sheinbaum's Morena party, markets reacted negatively. The fear of greater populist intervention is causing jitters; Sheinbaum's commitment to keep AMLO's level-headed finance minister offered some consolation.

Sheinbaum may also raise Mexico's international profile. AMLO speaks only Spanish and did not prioritize diplomacy. Sheinbaum's fluent English may improve the nation's global relations and

hedge Mexico's reliance on U.S. trade, which is a growing risk. A potential second Trump term will be concerning for any nation selling to the U.S.; Trump has promised a 10% tariff on all imports. Even a second Biden term will probably bring a more demanding stance to U.S.-Mexico relations, with greater cooperation required to limit flows of migrants and narcotics.

Mexico's economy is tied to the U.S., for better or worse.

Both parties are watching Chinese investment into Mexican production as a channel to evade U.S. tariffs. The U.S. has renewed its protectionist stance to support its automakers' transition to electric vehicles (EVs). However, as written, the U.S.-Mexico-Canada (USMCA) free trade agreement has no provisions about the ownership of production, and many other foreign automakers have facilities in the nation. China is growing its global EV share; Mexico is an established auto producer; both candidates will halt this backdoor to sell into the U.S.

In the long run, Mexico faces challenges far beyond politics. Its climate varies from desert to tropical, and it is poised to become less hospitable in a warming trend. Fresh water is scarce, especially for the nearly 22 million residents of the Mexico City metro area. The agriculture sector will be especially challenged by these climate risks. Emigration from Mexico fell as the domestic economy offered greater opportunities, but the nation could become a source of climate refugees.

Mexico has enjoyed a prosperous run. Today, it is well-positioned logistically and geopolitically to make further economic advancements. Progress will require disciplined budgeting and tactful diplomacy. If Sheinbaum can achieve this balance, it will be a clear reason for celebration.

First Step

Following the earlier lead of its Canadian and European counterparts (Switzerland and Sweden), the European Central Bank (ECB) clipped its key policy rate this week, ploughing a different furrow from the Federal Reserve.

The widely telegraphed move by the ECB marked its first cut since September 2019. Continued disinflation in the eurozone (from a peak of 10.6% in October 2022 to 2.6% in May 2024) was judged by the ECB as enough to begin easing.

The 450 basis point increase in ECB policy rates between July 2022 and September 2023 helped bring prices under better control. Energy and food disinflation have made large contributions to progress, but core price increases have halved from a peak rate of 5.7% year over year to 2.9% at present. The breadth of inflation is more moderate in the eurozone than elsewhere. About 27% of the items in the euro area's consumer price basket have been rising by more than 4% (annualized) in the past six months, compared to 49% in the neighboring U.K. and 37% in the U.S.

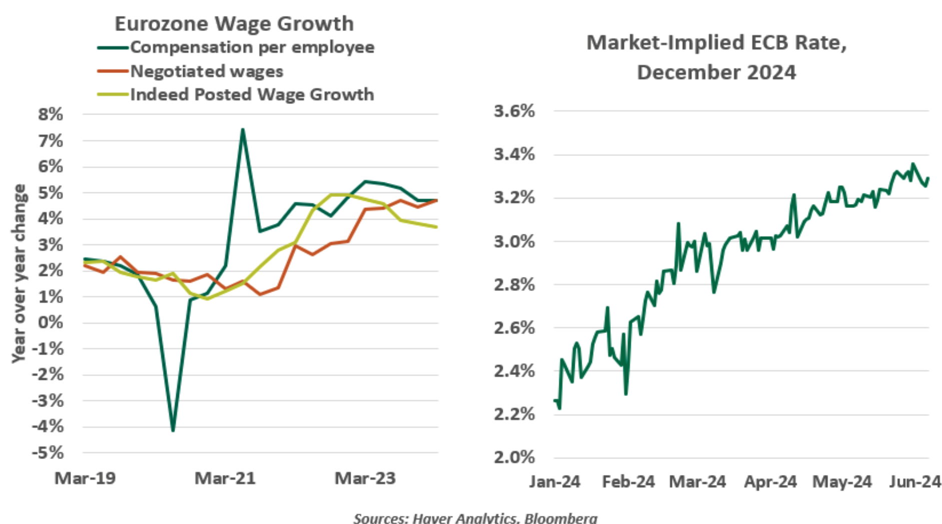
There are lingering concerns over elevated wages and service prices. But forward-looking indicators such as Indeed job postings and the ECB's wage agreement tracker are all pointing towards further moderation in pay gains. Demand in the eurozone remains tepid; economic growth remains sluggish following two years of stagnation. Though activity improved in the first quarter, the divergence in performance among member states persists. A restrictive monetary policy stance is contributing to tight credit standards and weak demand for loans.

In the wake of the decision, the question arises: where will the ECB go from here? At her post-meeting press conference, President Christine Lagarde did not commit to a specific interest rate path, choosing to maintain a "data-dependent and meeting-by-meeting approach."

After three years of high inflation, committing to a specific easing path would have heightened market expectations at a time when economic readings are surprising to the upside. Headline and

core inflation numbers for May came in above consensus expectations, marking the first month-on-month acceleration of 2024. Wage gain measures remained steady or reaccelerated in the first quarter amid still-tight labor market conditions. This has raised the risk that the last mile of disinflation could take longer to run, as has been the case in the U.S. As a result, markets are pricing in only one more cut this year, down from almost six in January.

The ECB maintains it is not "Fed-dependent." However, a growing interest rate differential with the U.S. will likely weaken the euro, tighten financial conditions and trigger capital flows to the U.S. Some ECB rate-setters have warned about diverging too much from the Fed, while others have asserted the need for a regular series of cuts to reach a neutral stance.



Sources: Haver Analytics, Bloomberg

The ECB is confident that inflation is heading towards target, but the last mile may be the longest.

With disinflation in both wages and services to resume, we expect quarterly rate reductions from the ECB to start in September. Monetary policy is still restrictive: model-based estimates of the "neutral" rate of interest in the euro area are around 2.00%. We expect that end point to be reached in late 2025.

While the timing of future easing is anything but clear, the direction of travel is. Given the lingering upside risks to the inflation outlook, it is better to be cautious today than sorry tomorrow.

Taking Stock

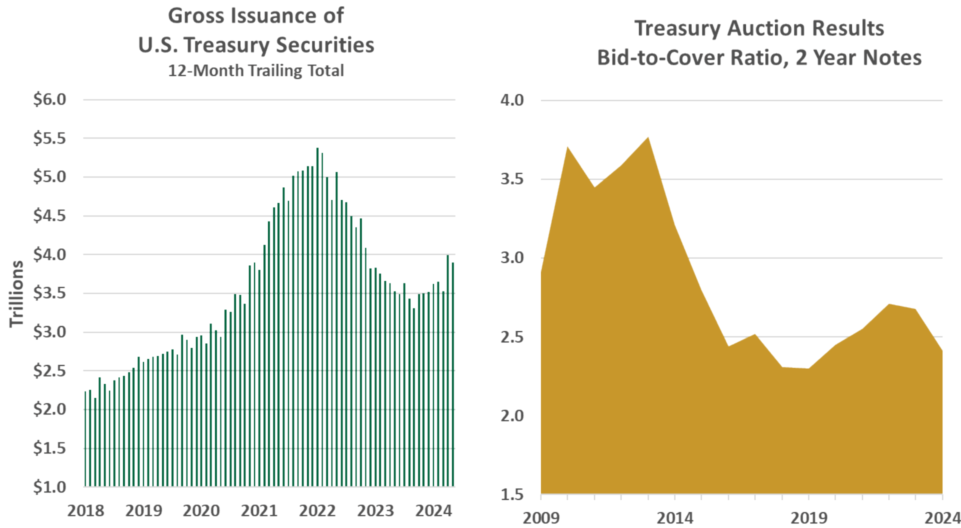
I will never forget the first auction I witnessed. It took place during one of the many summers that I spent on a farm. The auctioneer talked exceedingly quickly, but those in the crowd seemed to understand everything he said. They indicated interest with a nod or a wink; my host cautioned me not to scratch my nose, for fear that I would end up owning a 900-pound steer.

Auctions of Treasury debt are much different affairs. There is no formal gathering; everything is done electronically. Bids are submitted in advance, and bonds are quietly allocated to those willing to pay the most. But despite the relatively low-key format, Treasury auctions are attracting increasing attention.

The United States has been adding to its national debt at a rapid rate. We've written recently about how this happened, and noted that rising interest costs are creating fiscal and political discomfort. Sustaining order requires securing investors for the tens of billions of dollars in debt which are sold every week.

This effort has gotten more challenging over the past two years, as the Federal Reserve has reduced its holdings of government bonds. Finding replacement buyers hasn't been too problematic, but there are increasing signs of strain. The implied "term premium" that the Treasury pays to borrow has been increasing, contributing to higher yields.

Markets are struggling a bit to digest new Treasury debt.



Sources: U.S. Treasury, Haver Analytics, Bloomberg

Recent auctions of debt have occasionally disappointed. The appetite of investors for newly-issued government securities is gauged by several measures. The "bid-to-cover" ratio compares offers to buy with the amount on offer; a lower number indicates weaker demand. This metric has slipped in several recent cases.

In order to ensure that debt auctions are fully subscribed, the U.S. Treasury works with a series of primary dealers. These banks step in to purchase bonds when bids from private investors aren't sufficient; that support has been drawn on more heavily in recent months.

Given the poor state of the American fiscal situation, auctions will likely remain large for the foreseeable future. The risk that markets will push back is rising. No amount of fast talk from politicians will hide the fact that we may be selling a lot of bull.

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