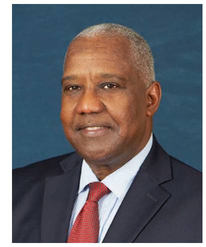
Major Country Risk Developments
June 2019



By Byron Shoulton

Global Overview

The global economy dodged a big bullet with the U.S. government's decision to refrain from imposing threatened tariffs on all Mexican exports to the U.S. effective June 7, 2019. While the White House described its decision as an "indefinite suspension" of recently announced plans to impose the tariffs, U.S. companies, importers, banks and exporters to Mexico all breathed a bit easier. With 80% of Mexican exports going to the U.S. and trade between both countries registering $800 billion in 2018, Mexico is America's largest trading partner, surpassing China, Canada and other countries. A tax on trade between both countries would carry numerous downside risks, not the least of which included the potential of higher consumer prices, job losses in both countries, recession in Mexico, tariff retaliation by Mexico against U.S. exports, boycotting each other's products, disruption of supply chains, bottlenecks, slowdown in trade flows; and the likelihood of more, not less illegal immigration.

Above all, tariffs on Mexican exports to the U.S. would have marked a dramatic escalation in the trade war, causing significant economic damage to Mexico, a traditional U.S. ally. Of note, the economic damage to both countries would have resulted for reasons completely unrelated to trade. While the Mexican side would have taken the bigger hit, American businesses and consumers would pay a high price and the ability for the U.S. to get cooperation from Mexico on a host of issues would be severely damaged if the tariffs were imposed. For example, the pending ratification of the revised Nafta trade agreement known as the U.S., Mexico, Canada Agreement [USMCA] would have faced even greater opposition in all three countries, hurting any chance of its ratification. Economists and informed politicians warned of the likely pain from the threatened tariffs and Mexico's likely retaliatory measures would have been acute for both countries, with potentially global spillover. Both countries deserve credit for moving expeditiously to tamp down recent bilateral tensions, finding common ground and backing away from a confrontation that had no clear winners.

The rationale given by the Trump Administration for considering tariffs on U.S. imports of Mexican goods is that Mexico needed to do more to stop the flow of thousands of Central American migrants passing through Mexico on their way to the U.S. As a result, Mexico and the U.S. hammered out a deal in which Mexico agreed to bolster security on its southern border and expand its policy of taking back migrants. Mexico has promised to send 6,000 newly trained National Guards to its southern border with Guatemala to stem the tide of people passing over illegally enroute to the U.S. The relief caused by the agreement was palpable in the Mexican border city of Tijuana, where President Lopez Obrador led a rally attended by several thousand people to celebrate the deal. However, Lopez Obrador also warned that it was not enough for Mexico to tighten its borders, saying Washington also needed to invest in economic development in Central America to stem the exodus from the region.

Mexico has promised to send 6,000 newly trained National Guards to its southern border with Guatemala to stem the tide of people passing over illegally enroute to the U.S.

Prior efforts by Mexico in this regard clearly fell short of the desired goal. In 2007, 54,000 Central Americans from the "Northern Triangle" (Guatemala, Honduras and El Salvador) were apprehended at the U.S. border. That number swelled to 226,000 in 2018.

Central American migration to the U.S. via Mexico has continued to rise despite recent attempts by Mexico to control it. One estimate is that 1% of the combined population of Guatemala, Honduras and El Salvador have left their home countries just since January 2019. U.S. Customs and Border Protection reported that more than 144,000 people were taken into custody during May 2019, a 32% jump over the previous month.

In December 2018, the U.S. committed $5.8 billion through public and private investment in Guatemala, Honduras and El Salvador as a part of the proposed plan and $4.8 billion to strengthen security and fortify the economy of southern Mexico. Only a small portion of the funds committed represent new investments. The U.S. State Department said it plans to allocate $180 million to Central America in the 2019 fiscal year and could invest and mobilize private-sector loans for $2.5 billion if commercially viable projects are identified. The rest of the money was already in the pipeline. On March 31, 2019 President Trump announced that the U.S. was cutting aid to the Northern Triangle countries. The move was the culmination of increasing alarm over the rising numbers of migrant caravans setting off for the U.S. from Central America. The U.S. State Department had cancelled funding for the three countries for the 2017-2018 fiscal years.

Finding viable solutions to the flow of migrants is an important core issue for the U.S., the region and Mexico. Since January, The U.S. has been returning migrants to border cities, including Tijuana, Mexico and El Paso, Texas, under the Migrant Protection Protocols program agreed to by both countries. Immigration advocates have argued that Mexico isn't a safe destination for Central American asylum seekers, and some have been targeted there by kidnapping rings. Honduras, Guatemala, El Salvador and Nicaragua have been independent nations for two centuries, which is plenty of time for them to have developed the necessary institutions and policies to be successful countries. Instead, a series of corrupt and incompetent rulers have kept these economies underdeveloped and struggling. A generational crisis exists in the Northern Triangle where corrupt governance, impoverished communities, climate catastrophes and terrifying criminal violence all drive migrants north.

Below we look at the economies of some of the countries engaged in this exodus of people traveling thousands of miles across national borders, fleeing poverty, gang violence, drug related warfare, government corruption and economic stagnation in search of work, opportunities and a more secure way of life.

Mexico

The World Bank has lowered Mexico's economic growth forecast down to 1.7% for 2019, compared to an expansion of 2% predicted at the beginning of the year. The delay of the ratification of the new U.S. Mexico and Canada Agreement [USMCA] and uncertainty over the country's energy policy are having a negative impact on Mexico's GDP growth. The growth outlook for 2020 was also adjusted downwards to 2% instead of the previous projection of 2.4%. The World Bank notes that the Mexican government maintains low levels of public investments and underlined that Mexico should tackle its high rate of informal workers and the inequality between states in the north and south of the country.

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The damage that U.S. tariffs would do to the Mexican economy would have been considerable. Both nations remain so deeply economically intertwined that tariffs would cause serious harm especially to the North American auto sector. They would also hit other Mexican manufacturing exports, farmers, food processors, crude exports, mining and drilling exports and trigger huge loss of employment in Mexico.

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Given Mexico's large trade surplus with the U.S. ($128 billion in 2018), and its dependence on the U.S. market, the country has more to lose from a trade war with the U.S. even if it were to impose retaliatory tariffs of its own. U.S. tariffs would weigh on investment in Mexico as well as export performance; and would have raised the risk of a technical recession in Mexico (real GDP contracted in the first quarter of 2019). According to one forecast, a 5% tariff on Mexican goods would cost the U.S. economy $41 billion and 400,000 jobs. The specter of these losses made the Administration's tariff proposals widely unpopular with U.S. business leaders and lawmakers, and their resulting pushback likely contributed to the signing of the joint deal, including plans to deploy 6,000 troops on Mexico's southern border with Guatemala.

In a previous attempt to stem the flow of illegal migrants to the U.S. border, the former Mexican president, Enrique Pena Nieto Pena, changed his government's focus on law enforcement and deterrence, and extended a program that permitted undocumented Central American migrants in the southern Mexican states of Chiapas and Oaxaca, the possibility of regularizing their stay in Mexico by giving them temporary residence status. The program was quite generous, allowing migrants medical access, the right to education for children, the right to apply for work and a monthly stipend of $120. The scheme successfully kept around half of the Central American migrants in Mexico to remain in that country. Most of the other migrants decided to continue to the U.S. border.

When President Lopez Obrador took office in December 2018, he seemed at first to be continuing his predecessor's migration policies and may have been even more lenient, permitting the issuing of 1-year humanitarian visas. This decision and Mr. Obrador's more tolerant attitude, led to around 300,000 Central Americans entering Mexico since January of this year.

To address the problem more fully, rather than just facilitate migration, Mr. Lopez Obrador lobbied the Trump Administration to contribute funds to the development of Central America's Northern Triangle, the countries from which most migrants emigrate, in order to prevent the outflow of migrants in the first place. These plans were included in a $30 billion "Marshal Plan" program that would have created jobs in the region.

Mr. Lopez Obrador expressed the view that the U.S., Canada and Mexico should look beyond free-trade agreements as one way to promote the economic and social development of Central America. Although this plan had the potential to help stem the migrant flow, the U.S. has not been receptive to these overtures, instead it cut aid to the three Northern Triangle countries in early April, and pushed for Mexico to do more than it has done so far to prevent the flow of migrants to the U.S.

Looking ahead, although the proposed plan is ambitious, it is yet to receive appropriate funding and agreement from each of the governments. The implementation of the recommendations would require significant political will that has been lacking in recent years. For example, in 2015 Mexico, Guatemala and Honduras signed an agreement to build a gas corridor at a cost of $800 million that never came to fruition. U.S. funding will be crucial and is not likely to be forthcoming given that U.S. aid to the Northern Triangle countries has consistently fallen since 2017.

Another option would be for Mexico to accept the migrants. Mexican population growth has slowed considerably in recent years, owing to earlier outmigration and a fertility rate of 2.2 births per woman (just slightly above the replacement rate). The migrants could therefore add to overall population growth and help to shore up the effects of an aging population. However, Mexico is still a developing economy with a large pool of unskilled labor, and the southern Mexican border states where Central American migrants tend to go to are already among the country's poorest. Therefore, this plan does not seem viable on the scale of current migration trends from Central America.

Migration out of Central America is unlikely to abate given the several domestic challenges in the region. With the U.S. 2020 presidential election approaching, a confrontation with Mexico over migration was inevitable. President Obrador has been careful to avoid antagonizing the Trump Administration, which explains the quick response from the Mexican government to the threat by the U.S. to impose tariffs. Economists had warned of the potential pain of the proposed tariffs – that was set to start at 5% and rise incrementally to 25% by October – and Mexico's likely retaliatory measures would have been acute for both countries.

As part of the deal, Mexico also agreed to the rapid expansion of a policy to return Central American asylum seekers to Mexico while they wait for U.S. immigration court hearings.

Moving ahead, Mexico is likely to continue working to appease the U.S. Many citizens say they're content with Lopez Obrador's approach to President Trump. President Obrador responded to the threat of tariffs by calling for continued friendship, dialogue and collaboration between the U.S. and Mexico "for the good of our people". His approval ratings went up by four points between the day of President Trump's announcement of potential tariffs, and the announced agreement reached ten days later.

As part of the deal, Mexico also agreed to the rapid expansion of a policy to return Central American asylum seekers to Mexico while they wait for U.S. immigration court hearings. Mexican specialists have noted that the best kind of relationship between neighbors: is one where both countries tackle problems together, as compared to a relationship where there is deep resentment and only a grudging cooperation based on pressure or force upon one by the other. Few in Mexico see the latest agreement with the U.S. as the end of U.S. demands centering on border security. Both countries are expected to check in at the end of July (45 days from the date of the agreement) to see how measures agreed to are playing out. However, uncertainty around what the U.S. Administration will deem a success already has some bracing for another round of economic threats from the U.S. This is because it remains unclear what quantity of migrants Mexico is expected to stop in order to satisfy the U.S.

Meanwhile, the IMF have urged PEMEX (Petroleos Mexicanos) to present a business plan that would generate renewed creditor and investor trust to help reverse the negative and deteriorating credit profile of Mexico's national oil company. The IMF has stressed the need and urgency for Pemex to increase productivity and efficiencies against a background of a mounting debt load and high financing costs. The Mexican government is contemplating providing Pemex with long-term financial support from its stabilization fund. The government has underlined this will be a "one-time" undertaking. Pemex plans to increase oil production thanks to the development of 20 new oil fields over 2019, which will include 116 wells. Of these fields, 16 are located offshore, especially in the Gulf of Mexico, and four onshore. Pemex had not developed any new field since 2015. Creditors have shied away from extending credit to PEMEX citing high foreign currency denominated debt and growing evidence of an inability to meet maturing obligations.

Guatemala

Volcanic eruptions that destroy homes, coffee and other agricultural production are just one of the additional economic strains forcing thousands of Guatemalan citizens to brave the torturous route through mountains, deserts and rugged terrain, in attempts to reach the U.S.-Mexican border. There is little work for a growing population and opportunities to survive have become increasingly harder in recent years and months. Reports of families fleeing drought, famine, violence, persecution or worse, proliferate. The Mexico-Guatemalan border is highly porous. Mexico has struggled historically to combat organized crime groups dedicated to people smuggling - but no financial commitment has been announced to strengthen Mexican or Central American governments' capacity to stop migration. Furthermore, the Mexican National Guard has not been fully created and a redeployment of troops to the Guatemalan border (the Mexican military is overstretched in its fight against drug cartels) will likely leave other parts of the country vulnerable to organized crime groups.

GDP growth is forecast at 3.3% in 2019 (up from 3.1% in 2018) and is projected to reach 3.5% in 2020.

The Guatemalan President Jimmy Morales speaking recently at the Summit of Heads of State and Governments of Central American Integration System (SICA) stressed the importance of a regional plan for attention to migration, to alleviate the recent caravans that have become a politically charged symbol in the U.S. The plan detailed by Mr. Morales, contains sociological and economic studies outlining the root causes and consequences that irregular migration has caused to Central American countries. He asked Central American countries to "regain the objective of regional integration" in order to move towards an economic and social community with priority for peace, development, freedom, and democracy. Unfortunately, President Morales' popularity has weakened considerably which has hurt his right-wing party's chances of regaining the presidency.

Some Guatemalans complain that agricultural output has contracted dramatically in recent years and cite this as one reason parents encourage their children to travel north to the U.S. to find work and pursue other opportunities. Drought and unprecedented winds have destroyed successive corn crops, leaving families destitute, children dying and forcing Guatemalans to abandon their homeland for work in Mexico or ultimately in the U.S. As Guatemalans see their own crops wither due to lack of rainfall, they also observe luckier households build new homes or buy motorcycles because of money sent back by a relative working in the U.S. Some of these new homes have American flags painted on them. There are other factors as well. The despair also reflects the marginalization of Mayan communities that goes back hundreds of years, presided over in the country's capital by an incompetent political kleptocracy. Mayans are indigenous people who rarely migrated before, but drought and famine has hit their farming communities hard, triggering a dramatic change in attitudes and even conviction by some that climate change is devastating their way of life.

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At the same time, Guatemalans understand the peril of trying to make the illegal journey to reach the U.S. In one small village, six people died recently while travelling to the U.S. But the risk is preferable to remaining in a desiccating land that seems without a future. People complain of not having water in their communities. They then ask grimly "what is there here to look forward to?". Some families reportedly have children living in the U.S., "working 12 hours a day, seven days a week, and sending money home". Twenty students from one small school left this year to migrate to the U.S. Last year, only one student had gone. Before that, teachers report they never saw a student leave. Remaining in Guatemala as crops fail and children suffer is not an option for a growing number of families. "There is no rain, and no way to grow crops. One can't live here" one father explains. Migrants aren't listening to messages from the U.S. or from their governments, meant to discourage them from attempting to take the risk of travelling without legal documentation. People are hearing directly from folks they know who have made the journey – and who remain in the U.S., reinforcing their decision to emigrate.

The country holds presidential elections in June 2019 with the possibility of a run-off in August – if no candidate wins an outright majority in the first round. With the disqualification of two leading candidates the presidential race was drastically altered. The consensus is that the wife of a former president, Sandra Torres of the Unidad National de la Esperanza (UNE) will emerge the winner given her name recognition and the strength of the UNE. The UNE party maintains a strong base of support in the populous regions of San Marcos, Huehuetenango and Alta Verapaz. Torres has consistently led in polling, but her popularity has been clouded by allegations of unlawful campaign financing during her 2015 presidential run. Torres would represent just the second left-leaning administration in Guatemala since 1954 and if elected is expected to pursue an agenda aimed at increasing public spending on education and healthcare for the poor. It is expected that Torres' center-left agenda will likely face significant resistance in the congress which is dominated by center-right parties.

Foreign exchange reserves are currently at $14 billion, equivalent to eight months worth of import cover, a more than adequate cushion. FX reserves have improved steadily since 2015 when reserves were at $7.8 billion.

Honduras

The President of Honduras, Juan Orlando Hernandez is responding to a national strike by the nation's teachers and doctors, and a chain of protest marches they have held since May, demanding the repeal of two decrees related to the health and education systems. The president stated that the decrees have already been repealed by the government, but protesters seem intent on pushing further demands. Some of the protests have ended in violence with clashes between police and demonstrators, while separately there has been other violent incidents such as the burning of dozens of vehicles and containers belonging to a banana producing multinational company and a company linked to the state electricity company, among others. On May 31st, 2019 Honduran protesters tried to burn down the entrance of the U.S. embassy in Tegucigalpa.

The country's president stressed that "we will not allow violent acts to intimidate our people. They entrusted us to recover the peace and tranquility of the country and we have bet everything. We are going to move forward", he said.

The removal of President Manuel Zelaya in June 2009 is a fundamental antecedent to understand the current exodus of Hondurans, as it represents a watershed in the human rights crisis in that country. Many ascribe the designation: coup d'état to the removal of Zelaya and blame the U.S. government of the day for supporting the coup. In the ten years since, Honduras has become for environmentalists and human rights activists, one of the most dangerous countries in the world.

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Some claim that with the election of President Hernandez in 2014, a link was created with drug trafficking and certain sections of the Honduran government. There are also claims that the policies of the sitting government have undermined the medical and health systems, leaving 65% of the population in poverty or close to being in poverty. Hence the ongoing protests by those opposed to the Hernandez regime.

The country's main business lobby group has expressed deep concern for the ongoing crisis and has called on the government and demonstrators to bring a swift conclusion to the conflict by engaging in a dialogue. The doctors and teachers (who are now considered unemployed) said their group [Platform for Defense of Health and Education] have conditioned any dialogue on the government's compliance with a set of demands. The group is insisting on open and transparent negotiations with government representatives who are decision makers and who are prepared to find solutions. Without that assurance they say they won't go back to work.

Honduras will see its fiscal deficit narrow as strong revenue growth continues to outpace modest spending increases. More specifically, the fiscal deficit is set to shrink slightly from 2.1% of GDP in 2018 to 2% in 2019. Furthermore, higher real GDP growth would likely boost revenues and an IMF Standby program will contain expenditure growth. Since Honduras entered an IMF program in 2013, it has narrowed its deficit from 8% of GDP to 2.2% and it is expected this trend will continue given the Fiscal Responsibility Law (FRL)'s support from the ruling Partido Nacional (PN) and the opposition Partido Liberal (PL). The forecast is for 2019 revenue growth of 5.3% - as solid economic activity increases income and sales tax receipts. GDP growth in 2019 of 3.9% was projected prior to the recent protests [as U.S. economic activity remains steady]. The U.S. received 40% of Honduran exports, and remittance inflows from the U.S. made up 19.8% of Honduran GDP in 2018.

Fiscal consolidation efforts will be further supported by Honduras's new IMF program. After completing an IMF program in 2017 that helped the country shrink persistent fiscal deficits (which averaged 5.8% of GDP from 2009 to 2013), Honduras has entered a two-year Standby Agreement of $311 million with the IMF. The program's purpose is to allow the Honduran government to restructure the finances of the state-owned National Electric Power Company (ENEE), whose projected operating deficit in 2019 is equivalent to 1.2% of GDP, while still pursuing fiscal consolidation. Moreover, the program aims to provide Honduras flexibility to continue investing in infrastructure and spending on social programs, thereby mitigating any potential political backlash against fiscal consolidation.

Some U.S. suppliers selling to companies in Honduras have been reporting recently that they have encountered various problems, including payment delays, reports by importers that they were unable to access foreign exchange in a timely manner, etc. The strikes and protests further highlight conflicts that could lead to deteriorating country conditions. Unless these are addressed and resolved speedily, it will make it more difficult to continue extending dollar-denominated credit to Honduran entities.

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El Salvador

The Salvadoran economy began 2019 with a contraction in its growth. An adverse business climate, low levels of investment and little generation of formal employment are some of the factors that contributed to the result. According to El Salvador's Foundation for Economic and Social Development, the economic activity index was at 2.6% in February 2019, below the 3.1% registered the previous year. Retail activity fell 7 points during the first quarter 2019. GDP growth in 2018 was 2.5% compared to 2.3% in 2017. Growth continues to be weak with only small quantities of new jobs being created.

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Formal employment created between 2014 to 2018 barely reached 49,000. Annual employment demand requires filling a minimum of 55,000 positions each year. Estimates show that approximately 200,000 people remained in the informal sector as a result. Foreign Direct Investment (FDI) registered $839 million in 2018, the lowest in Central America. Reversing this trend is a major challenge for the new government, which took office on June 1, 2019. According to independent analyses El Salvador needs to attract $1.8 billion annually if it is to achieve sustained growth and create quality jobs. The new government says it will seek to attract $2 billion in FDI annually over the next few years.

The incoming President Nayib Bukele is likely to pursue a more business-friendly agenda than was initially anticipated. The new administration is expected to ease regulations on businesses and will move to improve the business environment by establishing an anti-corruption body while changing the government's approach to reducing crime. However, Bukele's more ambitious proposals will likely face congressional gridlock, as the incoming president lacks support in the legislature and faces a poor fiscal outlook.

In public appearances since his election on February 3rd this year, Bukele has emphasized supporting free enterprise and limiting government; and has detailed plans to cut red tape for obtaining business permits, etc. Moreover, Bukele will seek closer relations with the U.S. Despite the Trump Administration's decision to cut aid to the Northern Triangle countries, the incoming Salvadoran president has noted that fostering closer relations with the U.S. will be a foreign policy priority. To that end, Bukele is seeking to win favor with the Trump Administration by reconsidering El Salvador's diplomatic ties with China after the previous FMLN-led government cut ties with Taiwan in 2018. The new government has named as its foreign minister Alexandra Hill Tinoco, who worked on combatting drug-trafficking for the UN and the Organization of American States. Hill's appointment will likely be viewed favorably by the U.S. given the Trump administration's focus on stopping drug-trafficking across the U.S.-Mexico border.

Bukele says he will also prioritize efforts to reduce corruption and violent crime. Building on his campaign's anti-corruption rhetoric, he has outlined two major policy initiatives: First he'll attempt to create an independent, multilateral anti-corruption body similar to the UN-backed Commission Against Impunity and Corruption in Guatemala (CICIG). That's because El Salvador suffers from pervasive corruption, ranking 105th of 180 markets in Transparency International's Corruption Perception Index and well below the Latin American average in Fitch's short-term Political Risk Index. Second, Bukele will shift away from his predecessor's emphasis on aggressive policing of gangs in favor of investment in education and youth employment for El Salvador's growing youth population. This suggests that the new administration will represent a major shift in El Salvador's policy direction after years of leftist rule. El Salvador's Congress has been largely gridlocked since the March 2018 election delivered the majority to the opposition Alianza Republicana (ARENA) and Partido de Concertacion (PNC) parties. Bukele's GANA party has only 10 of 84 seats in the National Assembly and even when combined with occasional coalition partner the FMLN, falls well short of a majority. However, Bukele's shift to a more business-friendly agenda opens the possibility for an alliance with the right-wing ARENA party.

El Salvador's poor fiscal outlook will constrain some of Bukele's spending priorities. His plans for investing in education and youth unemployment will be constrained by the country's wide fiscal deficit and mounting debt load. The projected fiscal deficit is 3.2% of GDP in 2019, while the debt-to -GDP ratio stood at 72.8% in 2018 – and will likely remain at 71.2% by the end of 2020. Its important to note that ARENA's fierce opposition to spending increases means that the new government's ambitious reforms will likely face little prospect of advancement unless GANA wins more congressional support in the 2021 congressional elections.GANA wins more congressional support in the 2021 congressional elections.

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FCIA's Deals Of the Month

Single Buyer Non-Cancelable Limit Policy: $10 milllion limit for short term import financing in Mexico in the packaging industry.

Multi-Buyer Policy: Domestic Whole Turnover non-cancelable limits with a $7 million policy limit in the IT services sector.

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