The economic consequences of the new US tariffs

- **Talks between Mexico and the U.S. regarding President Trump's threat to impose tariffs to Mexican imports started today and will continue in the next few days**
- **We expect that the U.S. will impose a 5% tariff on Mexican exports, but will be lifted at the end of the month at the G20 summit**
- **Under this scenario, effects will be absorbed by the exchange rate, with a negligible effect on our outlook for 2019**
- **Nevertheless, we have got a plethora of questions from our clients about the economic consequences if the tariffs are imposed**
- **Under such alternative scenarios, while the FX would continue to be the main shock-absorber, we would expect more negative effects on growth than inflation, and monetary policy stimulus to be postponed**

President Trump's tariffs. Last week the US president, Donald Trump, threatened to impose a 5% overall tariff to all Mexican imports effective on June 10th, scalable to 25% on 5%-pts monthly increases, if Mexico does not act *"to dramatically reduce or eliminate the number of illegal aliens crossing its territory into the US"* (see our note: *Mr. Trump's trade wars – Reopening the Mexican front* <pdf>). In response, a Mexican delegation led by Foreign Relations Minister, Marcelo Ebrard, was sent to Washington, D.C. to meet with Vice-President Michael Pence and Secretary of State, Michael Pompeo. Although some progress was made, talks are likely to keep on going even after June 10th, date on which a 5% tariff on all Mexican imports to the U.S. will start applying.

Low probability of seeing more than a 5% tariff imposed as the president's decisions found only a narrow consensus but subject to President Trump's political agenda. Over the weekend, different public figures in the U.S. have spoken against the decision about imposing tariffs to Mexico. Mr. Trump even faces opposition in Congress, where Senate Republicans said they were contemplating a plan to try to block these tariffs. With this in mind, we believe that it highly possible to observe the imposition of a 5% tariff on June 10th, but that it could be removed by the end of the month, after the president kicks off his reelection campaign on June 18th.

Baseline: 5% short-lived tariffs. Our base-case is that a 5% tariff will be applied but it will be removed by the end of the month in the G20 summit. In our baseline, the main shock absorber will be the exchange rate, with a negligible effect on our GDP, inflation and monetary policy forecasts. Nevertheless, although we do not expect Mr. Trump to follow-on with the whole threat, we have received several questions from our clients asking about other scenarios.

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In our view, under other possible scenarios, which go from a permanent 5% to a 25% tariff by October, the FX would continue to be the main shock-absorber, while implications for growth would be increasingly negative but larger than those expected for inflation. In terms of monetary policy, we believe that an escalation of tariffs will postpone any potential monetary policy stimulus by the central bank, as depicted in the table below.

Scenario analysis of US tariff threats

Scenario	Exchange rate***	GDP forecast		Inflation		Monetary policy rate	
		2019	2020	2019	2020	2019	2020
(1) Baseline*	**19.60**	**1.5**	**2.2**	**3.5**	**3.5**	**8.00**	**7.00**
(2) 5% tariff**	19.80	1.3	2.0	3.5	3.6	8.25	7.50
(3) 10% tariff**	20.40	1.0	1.8	3.5	3.7	8.25	7.50
(4) 15% tariff**	21.10	0.8	1.6	3.5	3.8	8.25	7.00
(5) 20% tariff**	21.70	0.8	1.6	3.8	4.0	8.25	6.75
(6) 25% tariff**	22.30	0.8	1.6	4.0	4.2	8.25	6.50

Source: Grupo Financiero Banorte
*A short-lived 5% tariff is imposed
**Permanent
***From pre-tariff announcement level of 19.10 pesos per US dollar. immediate response.

The scenarios shown above consider the following assumptions:

(1) *The effect of tariffs will be faced mainly by US consumers*. Given the state of the US economy, we believe it could be easier for firms to transfer higher costs to consumers, but this effect will be partially compensated by the appreciation of the US dollar *vis-á-vis* the Mexican peso;

(2) *Mexico is not likely to impose an overall tariff*. In case of retaliatory measures, tariffs would likely be imposed on certain goods that have a low impact on Mexican GDP and CPI. Eventually, this could foster US firms to increase their lobbying activities in DC to lift them; as a result

(3) *Tariffs will not be inflationary in Mexico per se*. The only inflationary factor in Mexico would be the one associated with MXN depreciation, which has been proven to have a very limited pass-through effect in recent years –more so when, psychologically speaking, it has already stood above 21 pesos per dollar in the past–. Moreover, as we believe that the impact would be more on growth rather than on inflation, it would be harder for firms to transfer higher costs to consumers;

(4) *The most significant impact would be on Mexico's business confidence.* This would add to the usual *'new government'* uncertainties that the country is already experiencing, resulting in a potential additional dent to Mexico's GDP in both year 2019 and 2020. Moreover, the higher the tariffs, the higher the chance of a US recession, which adds to the potential negative impact on Mexico's growth; and

(5) *Banxico's actions will be defined by FX and growth dynamics.* Since we expect these tariffs to have a more significant impact on GDP and the exchange rate, rather than on inflation, USD/MXN and activity dynamics would define whether Banxico is able to cut the reference rate or if the Board would have to leave it unchanged. In our view, the final effect would be to postpone any potential monetary stimulus

Keynes' unintended consequences. Just as John M. Keynes' famous *Economic Consequences of the Peace* book predicted that the *Versailles Treaty* would engender the Second World War, instead of peace, by imposing extremely high levies on Germany, it is our take that Trump's tariffs -if imposed-, would attract an even more feverish flow of migrants because it would be impact Mexico's growth. This, in addition to the fact that the US aggressive stance on international trade could trigger the next global recession –diminishing the chances for a Trump reelection–, is why we believe the tariff issue with Mexico will not escalate further than a temporary 5% tariff.

Analyst Certification.

We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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	Reference
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HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
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