Economic update

After the Federal Reserves latest announcement this week, the peso made some gains on the dollar and closed yesterday at 15.57 down from a peak of 15.73 reached on March 10th. The Fed´s slightly less optimistic outlook on the American economy from a range of 2.7-3.0 to 2.7-2.3 presumably signals that it will maintain a more flexible if not gradual approach to future rises in rates, which in turn eased pressure on the Mexican currency.

On a separate note, the Federal Institute of Telecommunications –the sector´s regulator- issued a preliminary ruling declaring Televisa as a dominant player in the cable TV market, given that it found that the company account for 75.2 per cent of subscribers.

The move echoes the regulator´s ruling last year in which it declared the Televisa as dominant in open TV market as well and is a consequence of the Telecommunications reform passed under President Enrique Peña Nieto, which aimed to increase competition in the sector. Televisa now has 20 days to challenge the ruling.

If the ruling was to stand, the Federal Institute of Telecomunications will be able to impose asymmetric regulation in the sector as it now does in the open TV market.

Another structural reform that was highlighted this week was the financial reform. During Mexico´s National Banking Convention, leading figures from the public and private sector lauded the new legislation for decreasing the cost of capital in the country. Financing to the private sector has increased from 25.7 per cent of GDP in 2012 to 29.2 per cent in 2014. However, it should be noted that this expansion also coincides with a much looser monetary policy from Mexico´s Central Bank, which started in 2013.

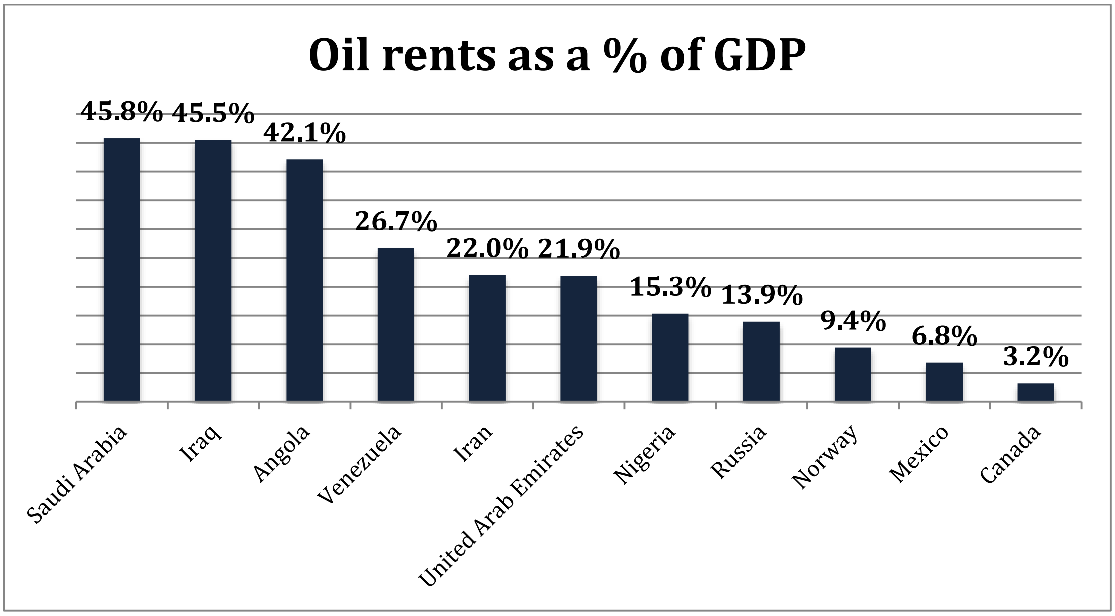
Impact of low oil prices on Mexico: not good, but could be worse

The recent plunge of the oil price came at a particularly bad time for Mexico. The unwelcome surprise hit just as the first phase of the country´s Round One of bidding for oil blocks kicked-off and bridled domestic and international enthusiasm regarding its historic energy reform, which opened the sector to private investment for the first time in 75 years.

Notwithstanding that on an intuitive basis this event has an obvious negative impact on the country; it is also worth noticing the nuances of how lower oil prices affect Mexico as a whole.

If the oil rout were to have happened 30 years earlier, they would´ve had a much more devastating effect than they would now. Back then, oil and minerals accounted for 65 per cent of Mexican exports, whereas manufacturing accounted for 26 per cent. Today manufacturing accounts for the lion´s share of the country´s exports, at 83 per cent, whereas oil and minerals account for slightly over 11 per cent of Mexico´s export sector.

As Mexico´s economy has become more diversified, oil rents weight within the country´s GDP has also shrunk and now only amounts to close to 7 per cent of the latter. In fact out of the top eleven net oil exporters, Mexico´s economy has the second lowest dependency of oil, in terms of its share of GDP.



Source: World Bank´s World Development Indicators

Despite the fact that Mexico´s current account is no longer as dependant on oil as it used to be, the same cannot be said for the Mexican government´s budget, a third of which depends on oil. This is most likely to be the channel through which the fall in the price of oil is likely to hit Mexico. Even though Mexico´s government hedges it oil revenues, it made an adjustment to the budget in the order of 0.7 per cent.

Furthermore, the Secretary of Finance, Luis Videgaray, stated this week that low oil prices are likely to be the case for the medium term and that the true negative impact of this will affect Mexico in 2016, given the 2015 hedge.

This puts the government in a tight spot both domestically and internationally. In regards to the former, the fiscal reform of 2013, which increased VAT by 15.2 per cent and the tax on production on services by 51.7 per cent proved to be (unsurprisingly) highly unpopular and also played a significant role in depressing consumption, which has only recently showed timid signs of recovery. In the aftermath of the reform, Secretary Videgaray pledged to not raise taxes again and has said that any further fall in the price of oil would be met by spending cuts.

To complicate matters even further, Pemex´s has yet to show signs of arresting the fall in oil production. It recently revised downwards its estimates for production in 2015 from 2.4mbd to 2.2mbd in light of the $4 billion USD cut it due to the budget adjustment.

In regards to pressures from abroad, the Mexican government now faces tougher negotiating conditions with private companies looking to partake in the on-going bidding round. In fact one of the most repeated phrases by IOC´s throughout a series of recent conferences focused on Mexico´s energy sector in London was that the Mexican government should offer “internationally competitive” contract terms.

The Mexican government has so far maintained an open if not collaborative disposition to international investors’ concerns regarding the energy reform and in fact modified contract terms recently.

However, there are also growing calls for it to not be excessively generous, in order to hasten the visible effects of the energy reform. The high quality of Mexico’s offering in Round One, in addition to the facts that it has a lower risk profile and expected cost structures than other oil producing countries and that investment decisions in the oil industry are based on long-term prices also provide the government with arguments to stick to its guns. Yet this will undoubtedly prove to be a very difficult balancing act.