Economic Analysis

The oil trade balance will remain negative, but its lowest point has been left behind

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- **The economic authorities have cut programmable public spending, and plan to continue doing so, and have also increased the monetary policy rate as measures to counteract the effects of lower oil revenues and the consequently increased current account deficit**
- **The global oil supply glut was probably underestimated by OPEC when it decided to increase its market share in November 2014**
- **This supply glut could continue throughout 2017 despite OPEC members complying with production cuts of the preliminary agreement of September 27 and Russia ending up cooperating**
- **Forecasts for a narrow definition of the oil trade balance show that it will not be positive until 2019**
- **However, as this estimate of the oil trade balance does not include natural gas or petrochemicals, it underestimates the value of oil-related imports**
- **Therefore, it is more likely that the oil trade balance will remain negative in the following years and, all other things being equal, the country will have to deal with the challenge of financing a higher current account deficit**

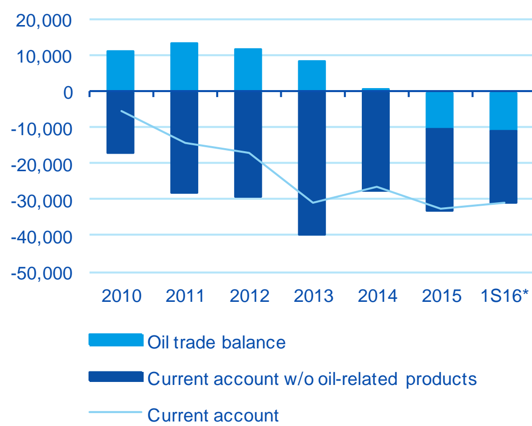
Programmable public spending cuts and increases in the monetary policy rate have been implemented to counter the effects of lower oil revenues on the public finances and the current account

The drop in oil prices of about 50% from levels seen in October 2014, along with the gradual decline in the oil production platform, has adversely affected the Mexican economy through two channels: i) public finances, which today have less income from oil revenues; ii) the balance of payments, which currently shows a further deterioration in the current account deficit (Figure 1). Since greater persistence is anticipated for the continuation of both relative low prices and lower levels of oil production for at least the next four years, both effects could be more structural than cyclical.

Without underestimating the impact of the short-term uncertainty that other global political-economic phenomena (the US presidential election, the trajectory of movements in the Federal Reserve's benchmark rate, etc.) may be generating, the two structural problems mentioned above seem to be already reflected in the behavior of some macroeconomic variables, such as exchange rates and investment flows. In response to this, the monetary authorities have increased the monetary policy rate by 150 basis points during this year. Meanwhile, the tax authorities have been forced to announce significant cuts to programmable public spending equivalent to 0.9% and 1.2% of GDP for 2016 and 2017, respectively.

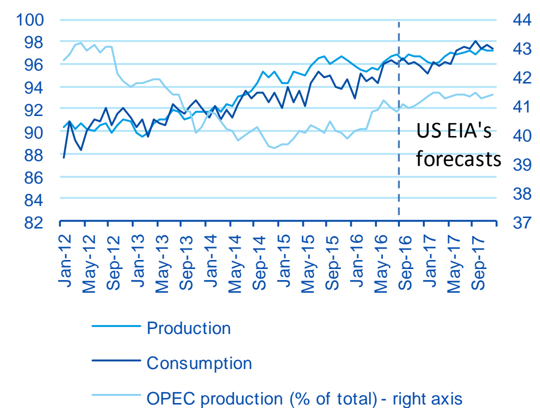
The current lower international oil prices can be traced back to November 2014. At that time, in a context in which the production of shale oil had increased significantly in the US, OPEC defined a new strategy that gave priority to increasing its market share rather than looking for the traditional stabilisation of prices (Figure 2). The intention was to regain the market share lost to new international competitors, particularly shale oil producers established in the US.

Figure 1
Oil trade balance and the current account (US$ million)



*/Data from the first half of 2016 were annualised for comparative purposes
Source: BBVA Research with INEGI data

Figure 2
Global production and consumption of oil and other liquids (millions of barrels/day)



Source: BBVA Research with US EIA data

The global oil supply glut was very likely underestimated by OPEC when it decided to increase its market share in November 2014

The surprise decision by OPEC to increase its market share led to a global oversupply of oil, perhaps much higher than what was expected initially by the cartel itself. In particular, the production of this hydrocarbon in the US took many months to respond to these lower price levels due mainly to two factors: 1) the price of oil continued for a while to be above the variable costs of many producers of this unconventional oil; and 2) some of these producers made themselves more technologically and operationally efficient, thus reducing the break-even price needed to match revenues and costs.

While oil prices may show a faster recovery in the coming months due to the materialization of last week's preliminary agreement between OPEC members, estimates from some brokerage houses and industry experts point to an increase in oil prices that would range between US$5 and US$10.

For the entire expected increase in oil prices to materialize in the coming months, each of the OPEC members would have to comply fully with the agreed production cuts in order to reduce the cartel's oil production to a level of between 32.5 and 33 million barrels per day by November (this would mean that OPEC would cut production by between 200,000 and 700,000 barrels per day from current levels).

The global oil supply glut could continue throughout 2017 despite OPEC members complying with production cuts and Russia cooperating

Even if all OPEC member countries comply with the agreement to reduce oil production and that Russia were to cooperate, the desired balance between the global supply and demand for oil could be at risk of not occurring in 2017. This is a consequence of the fact that shale oil production could increase in response to higher prices driven up by the full implementation of the aforementioned agreement.

Anticipating a base scenario in which relative low prices and lower oil production levels should continue over the next four years, it is very likely that the balance of Mexico's oil account will remain negative. To gain an understanding of the future behavior of that balance, an estimate was made using only oil exports and imports of gasoline and diesel until 2020.

Estimates of the value of oil exports in the subsequent years assume that both prices and quantities exported should stabilize in 2017

To estimate the value of oil exports, we used the federal government assumptions regarding the price of the Mexican crude oil mix and the export platform that are contained in the General Criteria for Economic Policy for 2017 (Figures 3 and 4). As can be seen from both graphs, both the price and oil exports will stabilize in 2017. It is also important to mention that the expected prices for the Mexican crude oil mix are even slightly higher than those which would be signalled by a typical 20% discount on WTI future prices.

Regarding forecasts for imports of gasoline and diesel, the trajectories taken were those disclosed in the Outlook on Crude Oil and Petroleum Products 2015-2029 (Figure 5). These trajectories show that imports of both products will be marked by a negative trend in the following years, which in our opinion might not happen. Finally, prices of gasoline and diesel were obtained from price projections made by the US Energy Information Administration (US EIA) and futures prices from the Bloomberg channel, respectively.

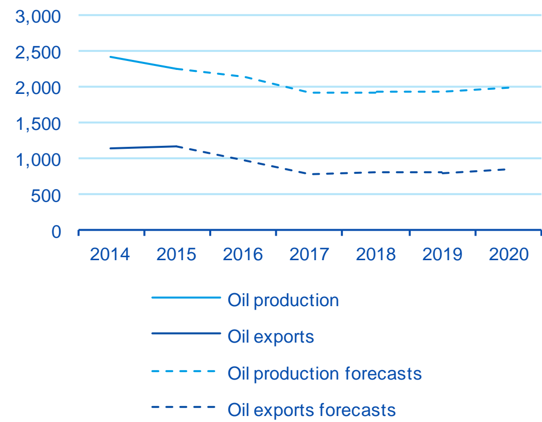
The country will have to finance a higher current account deficit in the coming years due to the negative balance on the oil account

Forecasts for the oil trade balance show that it will not be positive until 2019 (Figure 6). It is noteworthy that this estimate tends to understate the value of oil-related imports because it does not include natural gas or petrochemicals. Therefore, it is highly likely that the balance on the oil account remains negative, although to a lesser extent, beyond 2019.

Figure 3
Price of the Mexican crude oil mix (USD per barrel)

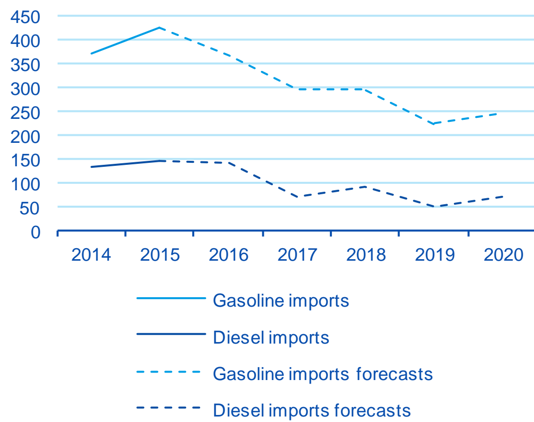
Source: BBVA Research with SHCP data

Figure 4
Oil production and exports (thousands of barrels per day)



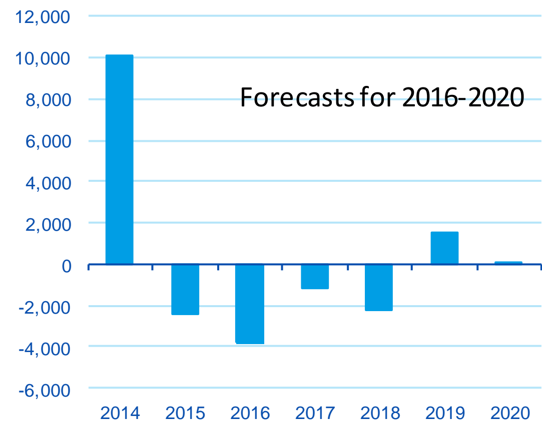
Source: BBVA Research with SHCP data

Figure 5
Imports of gasoline and diesel (thousands of barrels per day)



Source: BBVA Research with SENER data

Figure 6
Oil trade balance* (US$ million)



*/The oil trade balance only includes oil exports and imports of gasoline and diesel
Source: BBVA Research with SHCP, SENER, EIA and Bloomberg data

Conclusions

This paper shows that there has been a structural change in the oil trade balance, which fell into negative territory, but which has risen from its lowest point. This largely explains the exchange rate depreciation observed since late 2014, but also allows us to forecast a higher exchange rate in the coming years (without reaching the levels observed when the oil trade balance was positive). Given the high probability that such balance remains negative for the whole period 2016-2020, the current account deficit will not be mitigated by the foreign trade in petroleum products as in previous years. Consequently, all other things being equal, the country will have to fund a relatively larger amount of current account deficit in the coming years. This probably means a higher equilibrium exchange rate in the long term and, at the same time the imposition of greater restrictions on the management of the country's public finances.

References

Criterios Generales de Política Económica para 2017. SHCP.

Prospectiva de Petróleo Crudo y Petrolíferos 2015-2029. SENER.

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