Economic Analysis

2019 fiscal budget: the government approves its first big test

Macro Unit Mexico

- **The fiscal package is sound in macroeconomic terms but introduces some microeconomic distortions**
- **It is built on reasonable and market-aligned economic assumptions**
- **Revenue and spending projections are conservative**
- **As we expected, market reaction was slightly positive**

The public budget for 2019 eases concerns on Mexico as the federal government shows commitment to fiscal discipline with a 1.0% of GDP primary surplus target based on sensible projections for public revenue and spending on top of reasonable macroeconomic assumptions. Macroeconomic forecasts are as follows: 2.0% GDP growth (BBVA Research: 2.0% with a downward bias), headline inflation of 3.4% (BBVA Research: 3.6%), foreign exchange rate at 20 pesos per USD and the Mexican oil mix at USD 55 per barrel on average (it is now trading at around USD 52). The government forecasts that total public revenue will decrease 0.5% in real annual terms in relation to its own estimations of public income for 2018. Regarding total public expenditure, the government projects a real annual drop of 0.2% when compared to its own public spending estimate for 2018.

The projections for public revenue assume that tax revenue (62.3% of total public revenue) will increase 3.8% in real annual terms or 1.4% without the gasoline and diesel tax revenue (5.8% of total tax revenue). Consequently, next year such fuel tax revenue should go up by around 42% in real annual terms to make it possible for tax revenue to have such projected increment. Freezing local gasoline and diesel real prices for next year in conjunction with stable or lower international prices of these fuels would help to increase the fuel tax revenue but uncertainty remains as to whether such target will be reached.

The federal government is also providing fiscal stimuli to municipalities in Mexico that are along the border with the US. The value added and marginal corporate income taxes were lowered to 8% and 20% from 16% and 30%, respectively. According to the government, such new measures will reduce next year's fiscal intake by 40,000 million pesos. In our opinion, this estimated reduction in public revenue looks fairly optimistic as these measures are also distortionary and could incentivize corporations located somewhere else to change their fiscal address along the northern border of Mexico.

The government mentions that the public spending plan for 2019 was designed around austerity and savings policies to channel more public resources to social needs and infrastructure spending. Despite knowing that a primary surplus is always economically contractionary, allocating more resources to infrastructure projects could spur economic growth. Nevertheless, investment projects like the Mayan train and the new refinery would not necessarily help improve growth as they could mean capital misallocations if they make losses instead of profits as seems likely.

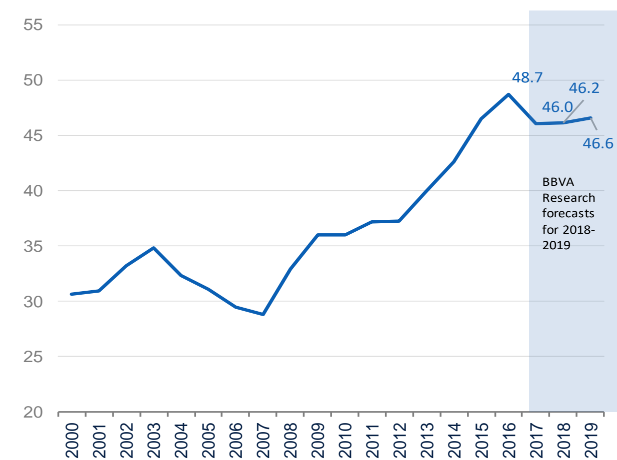
Pemex stands out as one of the few beneficiaries of the new public budget as more capital will be allocated to its upstream and downstream lines of business. The government's injection of new capital (125,000 million pesos of which

50,000 will go to the new refinery) will keep Pemex from significantly increasing its debt in the short term and thus reduces the probability of a rating downgrade. Nevertheless, looking ahead, providing the government goes ahead with its plans of strengthening the downstream business at the expense of exploration and production of crude oil, agencies could downgrade Pemex's credit rating as lower crude oil production would translate into heavier losses, more financing needs and currency mismatch problems since around 85% of Pemex debt is denominated in US dollars.

The public spending plan for 2019 allocates fewer resources to autonomous institutions like the Energy Regulation Commission and Hydrocarbon National Commission. These institutions will see their appropriations drop by 31% and 30%, respectively. In our opinion, these expenditure cuts are not surprising in light of the federal government doubts about the effectiveness of the energy reform to keep crude oil production from declining and lower fuel prices.

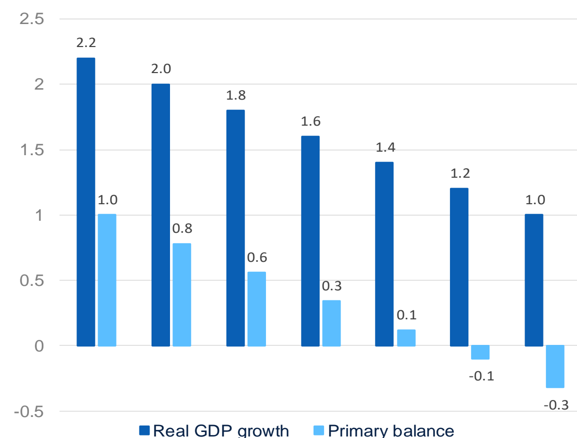
The stabilization of public debt as a share of GDP is one of the federal government goals. Our own forecasts indicate that, *ceteris paribus*, the historical balance of public sector borrowing requirements (as a share of GDP) could remain stable at a level around 46.6% of GDP by 2019 year-end with a primary surplus of at least 0.2% of GDP (Figure 1). Given that the federal government has set a target of 1.0% of GDP for the primary surplus, it is very likely that this wide definition of public debt will remain stable in 2019. Nevertheless, economic growth below 2.0% (not driven by public underspending) and/or a foreign exchange rate above 20 pesos per USD could require a higher minimum primary surplus to achieve such stability. Moreover, lower economic growth than anticipated could translate into a lower primary surplus if the federal government does not adjust its spending plan (Figure 2).

Figure 1. Historical balance of public sector borrowing requirements (% of GDP)



Source: BBVA Research with data from SHCP

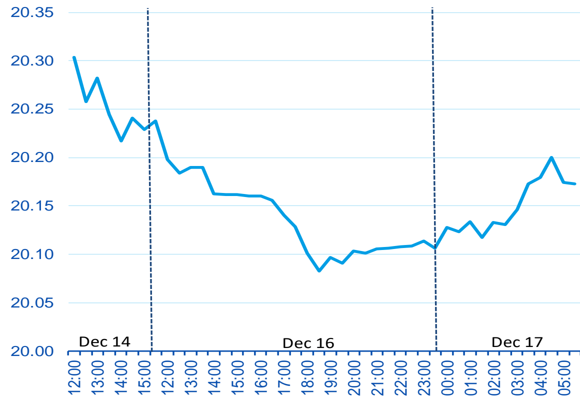
Figure 2. Economic growth and primary balance (YoY % change and % of GDP)



Source: BBVA Research with data from SHCP

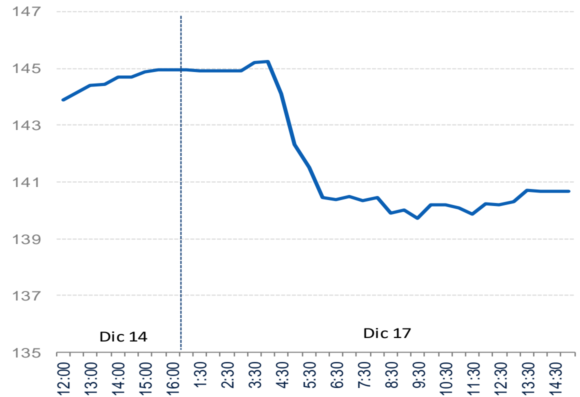
As we expected, market reaction was slightly positive, as this fiscally responsible public budget was not enough to reduce uncertainty on the future public policy decision-making process. Yet, it is a good sign that this fiscal package did not add concerns on the macroeconomic front. As shown in the graphs, financial variables had a small recovery.

Figure 3. USDMXN intraday, Dec 14-Dec17
(Pesos per USD)



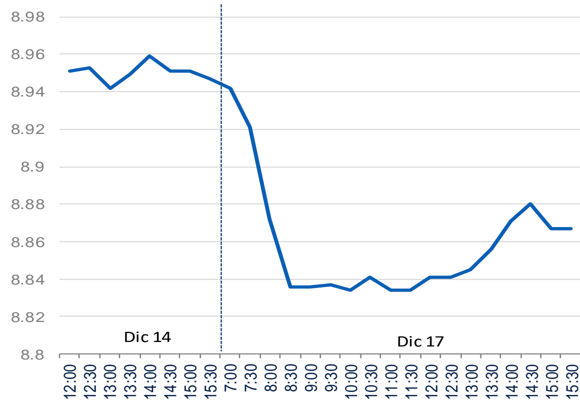
Source: BBVA Research with data from Bloomberg

Figure 4. 5Y CDS spread intraday, Dec 14 – Dec 17
(Basis points)



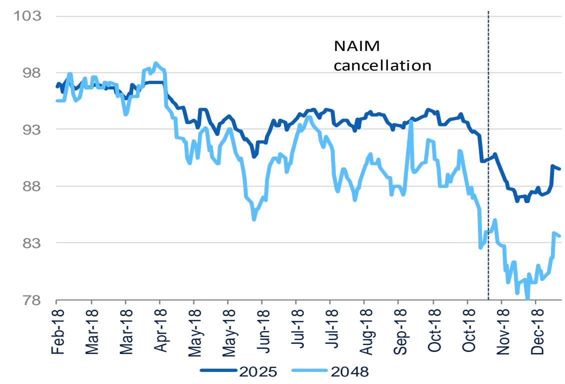
Source: BBVA Research with data from Bloomberg

Figure 5. YTM Mbono 10yr, Dec 14-Dec17
(%)



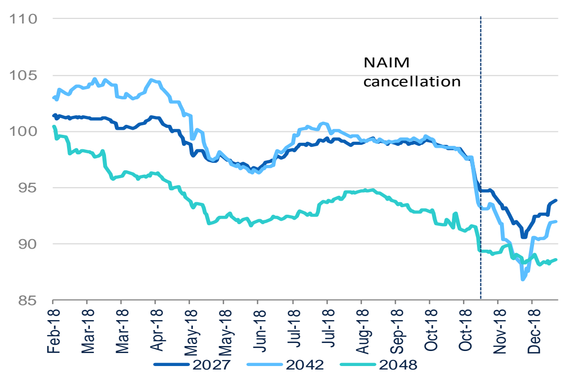
Source: BBVA Research with data from Bloomberg

Figure 6. PEMEX bond prices
(USD)



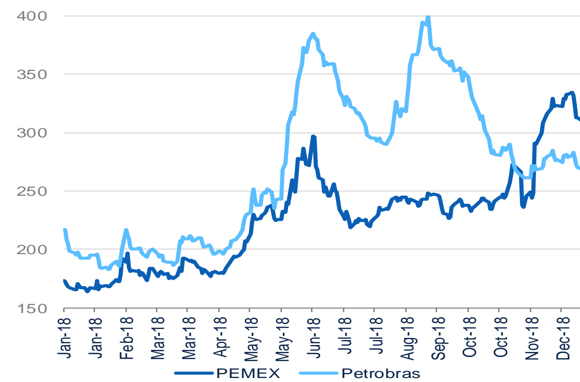
Source: BBVA Research with data from Bloomberg

Figure 7. CFE bond prices
(USD)



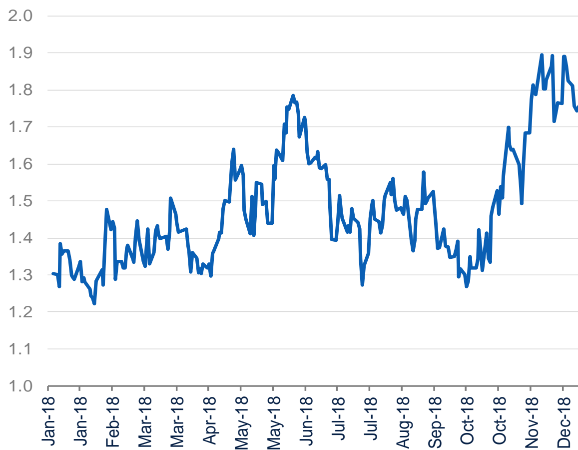
Source: BBVA Research with data from Bloomberg

Figure 8. 5Y CDS spread oil companies
(Basis points)



Source: BBVA Research with data from Bloomberg

Figure 9. UMS 10Y – T10 yield spread
(%, USD denominated)



Source: BBVA Research with data from Bloomberg

Bottom line

The public budget for 2019 is based on within reach macro forecasts and reasonable projections for incomes and expenditures. Yet, there are still doubts on what the government would do if for some reason the fiscal targets were unlikely to be met –i.e., whether they would choose to miss the fiscal targets or reduce promised spending if needed.

The increase in spending on social programs and infrastructure projects is financed with savings coming from austerity, the elimination of around half of the current 156 social programs, and a steep reduction in the discretional allocation of resources to the states (*Ramo* 23). The latter is positive since it significantly reduces politically driven discretionary spending.

The promised reduction in taxes along the border is included in the budget and the estimate of a decline of around 40,000 million pesos seems optimistic to us. The 3.8% real annual increase in tax revenue seems challenging as a sizable rise in fuel tax revenue would be needed. All in all, total income projection seems reasonable considering that it would have increased 5% in real terms during 2018 if there had not been a windfall from Banxico in 2017. No significant windfall is expected this time around, as this year-end foreign exchange rate would be similar to 2017 year-end corresponding figure.

On the negative side, the reduction in taxes along the border constitutes a major policy mistake, as it will result in lower fiscal revenues and significant distortions. Moreover, the significant reduction in resources to autonomous institutions is a cause for concern.

The budget does not contemplate the use of fiscal resources for the cancellation of the airport. Bondholders are unlikely to accept the enhanced buyback offer and the government announced that there would not be another. Thus, we should assume that the cost of repurchasing the bonds (except for USD 1.8 billion sitting in the airport trust) would be incurred by either the federal government or development banks. In either case, this would represent a contingent fiscal liability.

Disclaimer

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