CGD Note
JUL 2019

Mexico's Financial Risks:

Solving Pemex for a Solvent Mexico

Laura Alfaro, Augusto De La Torre, Guillermo Calvo, Roque Fernandez, Pablo Guidotti, Paulo Leme, Enrique Mendoza, Guillermo Perry, Carmen Reinhart, and Liliana Rojas-Suarez

1. INITIAL CONDITIONS

Mexico's financial risks and the policies being adopted by the new administration cannot be adequately assessed without recognizing key features that characterize the following initial conditions:

- Per-capita income growth performance has been lackluster for many years and current estimates point to further deceleration. Over the past 25 years, Mexico has displayed one of the worst growth performers in Latin America, with negligible total factor productivity growth. Structural factors such as inequality, an inefficient tax and social security system, high levels of corruption and violent crime have been key impediments to growth despite a major strengthening of the macro-financial policy framework and significant international integration. Current data suggests that economic growth has about halved to around 1% in 2019, primarily owing to a sharp decline in investment and a recent slowdown in consumption.

- Since the 1990s, Mexico has made significant progress on a number of fronts. Mexico has adopted a flexible exchange rate regime, consolidated its central bank independence, and developed a deep domestic-currency-denominated debt market. Unlike other emerging market economies, Mexico has been able to consistently maintain a viable current account balance, presently with a deficit at around 1.5% of GDP.

- Mexico is highly internationally integrated in finance and trade. Financial integration makes it potentially exposed to shifts in confidence of foreign investors. Today, the country enjoys one of the most diversified export structures in the region. Since the establishment of NAFTA, Mexico has become especially integrated to the US economy, sharing a more synchronous economic cycle. About 80% of Mexico's exports go to the US, representing 28% of GDP.

Andrés Manuel Lopez Obrador (AMLO)'s rise to power by an overwhelming majority was initially viewed by markets as a potential return to populist policies. His domestic popular support was anchored in an anti-corruption and anti-crime agenda. Atypical of populist experiments, AMLO has pledged adherence to fiscal responsibility without resorting to imminent tax increases. However, his development strategy is centered on boosting the role of government in the energy sector, infrastructure investment, and development finance.

In the next sections we identify some key economic and financial risks and potential actions to mitigate these.

2. EXTERNAL CHALLENGES

Global financial conditions remain generally favorable, but global growth is slowing toward 3% and the balance of risks are skewed to the downside. In the United States, economic activity is slowing from 2.9% in 2018. Consensus forecast for 2019 and 2020 are clustered around 1% to 2%. The trade channel will transmit this cyclical downturn to Mexico, exacerbating the observed contraction in the first half of 2019.

Turning to monetary policy, the US Federal Reserve is anticipated to shift to a modest easing cycle starting in July 2019. The FOMC is expected to cut Federal Fund rates by 25 bps, and US interest rate futures price a total easing cycle of 75 bps. These developments are likely to encourage Banco de Mexico to start cutting interest rates soon. Local markets in Mexico are already pricing an easing cycle amounting to 75 bps. Banco de Mexico (Banxico) has maintained a hawkish stance in monetary policy, raising its policy rate to 8 ¼%. The large interest rate differential in favor of peso-denominated assets has encouraged corporate treasurers and traders to benefit from the generous carry-trade opportunity.

US trade protectionism and migration will be other key external factors impacting the Mexican economy. These issues were central in the 2016 U.S. presidential election. On October 1st, 2018, the United States, Canada and Mexico agreed to a new trade deal, replacing NAFTA with the United States-Mexico-Canada Agreement (USMCA). From the Mexican vantage point, substantial changes to the original agreement included higher wage requirements and content rules for the auto manufacturing industry, and a 6-years sunset clause. The trade deal needs to be ratified through legislation, which could take months. Mexico was the first to respond. On June 19, 2019, the Mexican Senate approved USMCA by an overwhelming majority.

Recently, the US threatened to raise import tariffs on Mexican products unless Mexico helped to contain the flow of immigration from Guatemala, Honduras, and El Salvador to the US through Mexico. Pressing migration issues will continue to pose significant policy challenges for the AMLO administration.

3. MEXICO’S DOMESTIC CHALLENGES

Although NAFTA (1994) generated positive expectations for the country’s development prospects, they have not materialized. Out of an average growth of 2.5% per year since NAFTA, the largest contribution to growth can be attributed to the increase in population, followed by a much lower contribution of investment, and a zero contribution of total factor productivity.

This disappointing growth performance is a puzzle in view of the expansion and diversification of Mexico’s tradable sector, centered around a strong manufacturing base. While this sector has lifted growth in the northern and central areas of Mexico, it has failed to promote growth in the rest of Mexico. This failure is largely due to significant and growing microeconomic distortions that inhibit the efficient allocation of domestic resources and provide incentives for the majority of firms to remain very small in size and mostly family-owned. These incentives rest on a segmented tax and regulatory system that places the bulk of the burden on the larger and more efficient firms, while shielding small firms from taxes and social security contributions but also providing workers with a low provision of social security and health benefits.

An additional impediment to growth stems from chronic deficiencies in the rule of law. On the one hand, contract enforcement impedes the interconnection of firms in product and input markets across all the country. On the other hand, rising levels of corruption and drug-related crime also are directly linked to a weak rule of law, increasing the cost of doing business.

The problems associated with the above distortions are being compounded by the significant cyclical decline that the economy is experiencing. In this context, rather than addressing the microeconomic distortions it appears that the government is responding with a massive reallocation of public expenditure to boost the role of the state in the energy sector, infrastructure, and development finance.

In view of declining oil and non-oil fiscal revenues, AMLO's government has so far relied on wholesale reductions in expenditure. In particular, cuts have affected public-sector employment and wages, and the cancelling of major infrastructure projects (e.g., the Texcoco airport) and a number of social programs such as Prospera, Estancias Infantiles, and in the health sector. These expenditure cuts seem to be intended to create space for new and planned public investment in energy and infrastructure, in particular the construction of a refinery and the funding of Pemex's exploration and extraction investment replacing outstanding contracts with the private sector.

In addition, the government has announced the construction of new airport, a railway in the Yucatan peninsula without proper social return evaluation and feasibility studies. Hence, the ongoing reduction in government expenditure is reducing the overall quality of government expenditure, is making spending decisions more arbitrary, and is exacerbating the downturn in economic activity. This strategy raises concern about its viability and may end up increasing country risk.

The migration crisis is posing further downside fiscal risks. While there are no estimates of the fiscal costs of maintaining the migrants' shelters at the border as well as the deployment of the National Guard, other experiences around the world suggest that the fiscal cost is not negligible and may reach a 0.5% of GDP.

Pemex

Pemex is by far the single most important fiscal problem faced by the AMLO administration. Lack of investments in exploration and extraction have led to a steady reduction in oil production, while the company has issued a large stock of debt in international markets. Investors have become increasingly weary of holding Pemex bonds and, following its credit risk downgrade, the spread differential between Pemex and the sovereign has increased by 100 basis points.

4. CAPITAL MARKETS' ASSESSMENT OF SOVEREIGN AND PEMEX RISKS

Capital markets have so far maintained a favorable assessment of the sovereign. Currently, external and domestic markets are pricing that the AMLO administration will maintain the current macroeconomic framework. Sovereign risk measured by the spreads on 5-year CDS are at an all-time low (110 bps). The local yield curve (TIIE) shifted downward by almost 100 bp across the entire term structure. High domestic real interest rates, strong international reserves position, the FCL credit line with the

IMF, and the US$20 billion Banxico's program of non-deliverable forwards have contributed to exchange rate stability. The Mexican Peso has depreciated by 5% since AMLO took office. Finally, open interest in futures markets remain at normal levels and the Peso is trading at a small forward discount of 8%.

However, there are three financial market signals that tell a different story. First, Mexican equity markets have sold off steadily, reducing the market's P/E ratio to 12.8x, or the same order of magnitude of the P/E ratios for Argentina and Brazil. For Mexico, this represent a sharp decline from a peak of 19.5x in 2016, which was in line with US equity market valuations. The decline in P/E ratios reflects expectations of lower future real GDP growth and higher real interest rates in Mexico.

Second, the spreads of Pemex hard currency debt have decoupled from the sovereign and widened by almost 100 bps, largely reflecting the downgrade of Pemex hard-currency debt by Fitch Ratings to junk bond status (BB+). In the next 4 years, the company faces external maturities by about USD 20 billion.

Third, in June 2019, S&P's and Moody's downgraded the credit outlook for the sovereign to negative; and Fitch Ratings downgraded the sovereign to BBB with negative outlook. Both agencies noted that the strong investment grade rating (BBB+ for S&P) is at risk, and there is reasonable chance for a credit rating downgrade within the year or so. Rating agencies have expressed concerns about how AMLO's administration will respond to the external and domestic challenges discussed earlier.

In relation to public debt sustainability, Mexico's reported gross public debt ratio stands at about 53% to GDP. The public debt ratio has increased in recent years and its risk profile has deteriorated. A significant portion the public debt is denominated in foreign currency and a rising share of domestic-currency debt is held by foreign investors. In addition, there is a significant stock of federal public debt issued for Banxico's open market operations that is not included in the aggregate public debt statistics. Estimates of this debt outstanding were in the order of 25% of GDP in 2016. Including this debt in the gross debt definition may make the debt to GDP ratio inconsistent with the current BBB+ credit risk rating.

Given Mexico's reliance on external financing, a sovereign rating downgrade or an additional deterioration of Pemex financial conditions could severely curtail capital inflows to Mexico. This would widen sovereign and corporate credit spreads and the Mexican Peso could weaken.

5. DOS AND DON'TS TO AVERT A SOVEREIGN CREDIT-RISK DOWNGRADE

In this environment of increased global uncertainty, avoiding policy mistakes carries a high premium. Mexico's challenges are wide ranging. Here we will focus on the most pressing financial risks and offer recommendations to mitigate them.

The Committee believes that the paramount task for the government is to address the critical situation at Pemex. Specifically, Pemex needs a detailed action plan to address its weak financial situation and declining output and exploration. AMLO's reduction of Pemex's tax burden is a good start, but its debt situation remains extremely precarious given large debt amortizations coming due. This calls for a bold corporate restructuring tackling various key issues: i) raise the company's earnings by cutting operational expenditures and eliminating leakages; ii) restructure corporate governance and management; iii) redirect savings to invest in R&D in deep water oil and natural gas exploration; iv) embark in a broad asset and liability management, selling some of its non-core assets to allow for a significant reduction in the debt burden and deleveraging the company.

The Committee believes that the Pemex's corporate restructuring should be complemented by a number of additional actions, such as: i) reinstating the role of the Commission of Hydrocarbons; ii) reconsidering the cancellation of contracts with the private sector; iii) refraining from new poorly-planned, large-scale projects like the Dos Bocas refinery (which could derail the use of scarce funds to less productive uses); and iv) attracting new private funding for investments in exploration and extraction.

The Committee believes that a comprehensive corporate restructuring plan can avert a Pemex's debt crisis. Currently, Pemex is on a collision course that may lead to a debt restructuring. A crisis at Pemex would contaminate the credit rating of Mexico itself, which if moved below investment grade would trigger an immediate divestment from Mexican assets by many large institutional investors such as mutual and pension funds resulting from investment mandates.

The government has met its primary balance goals in the short run by offsetting a sharp fall in revenues with a draconian cut in expenditures. **While rationalization of current expenditures is needed, the Committee believes that the success of the government's plan of using primary surpluses to finance public expenditure projects requires well-developed and substantive feasibility studies.** In this regard, projects such as the Dos Bocas refinery, the Maya Train, the Santa Lucia airport should be scrutinized. Similarly, it is worth reconsidering decisions about canceling projects that are well underway such as the Texcoco airport and the Toluca-Naucalpan highway.

Center for Global Development

Ideas to Action: Independent research for global prosperity

WWW.CGDEV.ORG

The Latin American Committee on Macroeconomic and Financial Issues (CLAAF) gratefully acknowledges financial support by the Center for Global Development, the Banco de la Ciudad de Buenos Aires, the Central Bank of Chile, and FLAR for funding its activities during 2019. The Committee thanks Diego Castrillón for his support in the production of this statement. The Committee is fully independent and autonomous in drafting its statements.