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FEATURE

Mexico

Economic slowdown likely to continue in 2020

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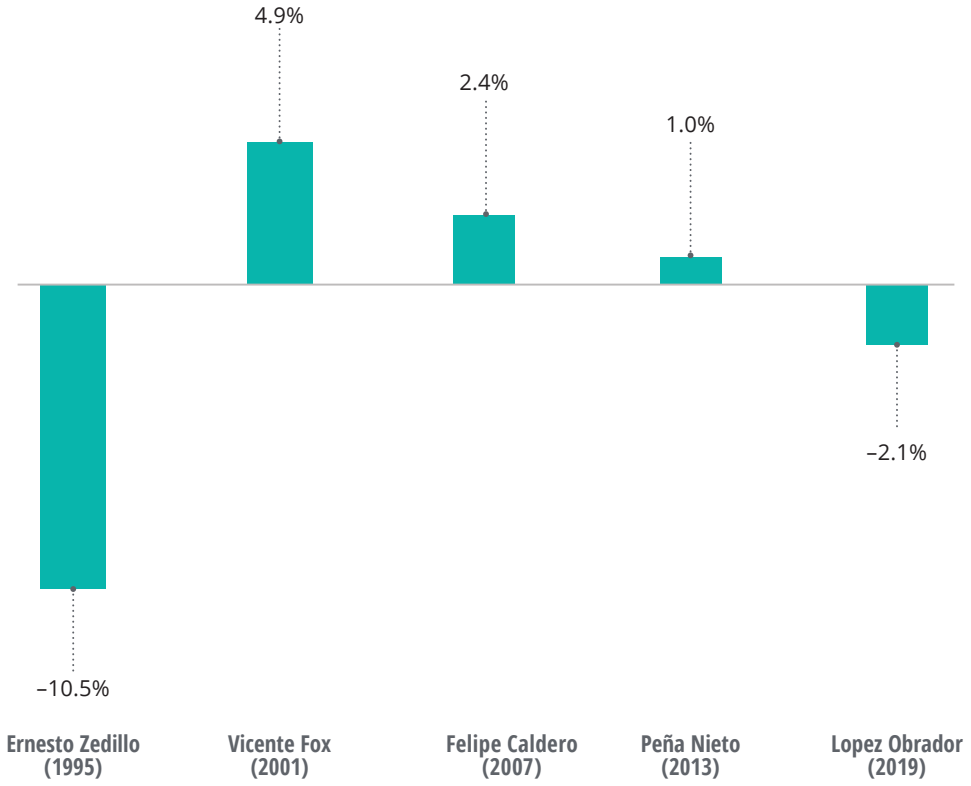
The Mexican economy will likely end the year in stagnation, mainly due to the decline in industrial activity. A smaller carry-over effect and the contraction of public expenditure, along with a partial recovery of investment, will weigh on Mexico's growth in 2020.

ONE OF THE key campaign tenets of Mexican president Andrés Manuel López Obrador (AMLO) was to reduce unnecessary expenditure and expand social programs without compromising the fiscal position of the country. To accomplish these objectives, the federal administration has imposed large cutbacks on public outlays in a move known as "republican austerity." As a result, the reduction in expenditure has been larger than what was anticipated in the

FIGURE 1

Austerity behavior of the current Mexican administration as compared to past ones

Real annual percentage variation in public expenditure, accumulated January to September of every year



Source: Deloitte analysis of ministry of finance and public credit data.

2019 budget. In the first nine months of the year, government expenditure contracted 2.1 percent annually in real terms—the biggest cut implemented by a president since 1995 when Ernesto Zedillo (figure 1) had received a country at the onset of the 1994 economic crisis. This situation reflects fiscal discipline; however, the downside is the impact on economic growth.

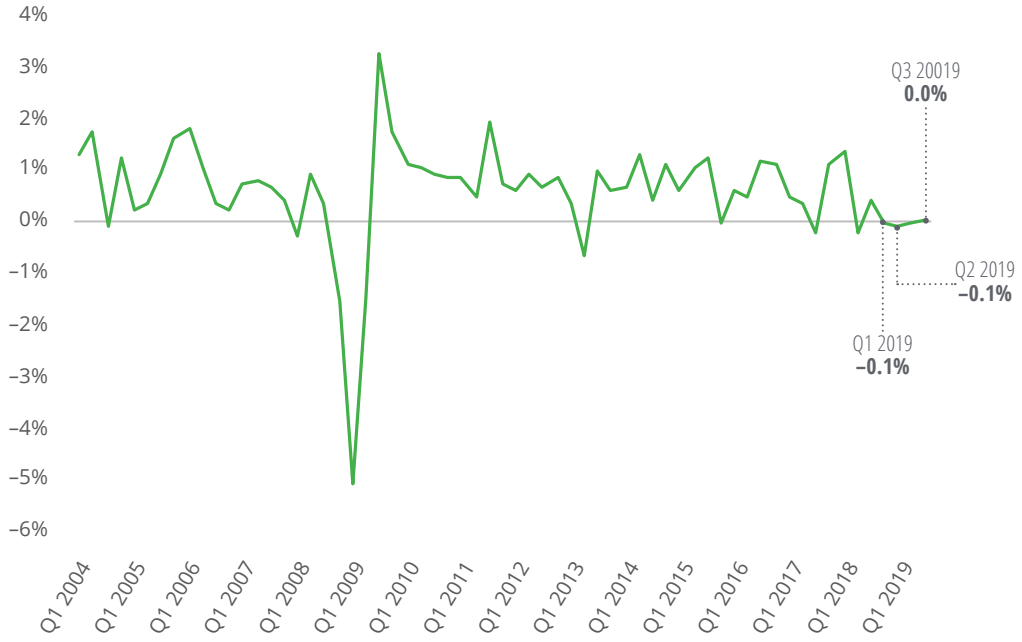
In addition to the slowdown in public expenditure, Mexico also experienced multiple transitory shocks at the beginning of 2019 that affected investment and, therefore, overall economic activity: gasoline shortages as a result of addressing fuel theft;[1] strikes in manufacturing plants in Tamaulipas by workers demanding higher minimum wages;[2] railway blockades by a teachers' union in Michoacan;[3] and the suspension of oil rounds, among others. In the course of this year, new factors emerged, such as the conflict between the Federal Electricity Commission (CFE) and pipeline operators.[4] Although they reached an agreement, the episode raised some concerns in the private sector.

The combination of these events, along with the general global economic slowdown, had a negative impact on various industrial and services activities. The situation caused a 0.1 percent contraction in the first and the second quarter GDP, on quarterly basis (quarter on quarter), confirming a technical recession in the national economy (figure 2). For the third quarter, the economy presented a stagnation of 0.0 percent quarter on quarter. In

FIGURE 2

The Mexican economy went into technical recession in the first half of the year

Percentage variation in Mexican GDP, QoQ

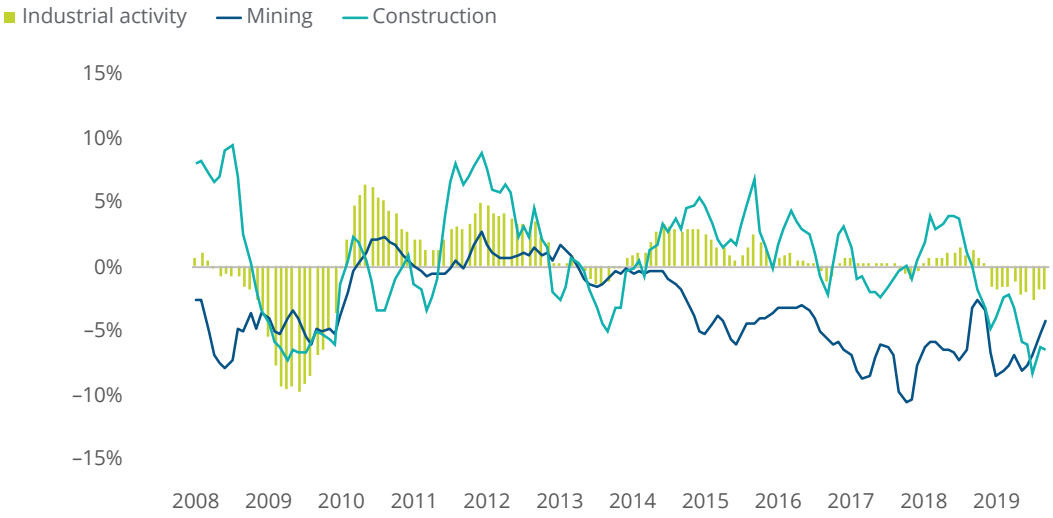


Source: INEGI.

FIGURE 3

Mining and construction activity continue to fall

Three-month moving average of industrial, mining, and construction activity, percentage YoY



Source: INEGI.

overall terms, the GDP fell 0.03 percent in the first nine months of the year, in line with projections of a 0.0 percent annual expansion, and there is even the possibility that the economy will contract in 2019.

Investment, the drag that rules them all

Private investment and business confidence have been witnessing a decline for several years,[5] driven by the fall in oil prices in 2014 and the ongoing United States-Mexico-Canada Agreement (USMCA) renegotiation. But the factors that emerged in 2019 have accentuated this downturn.

The slowdown in investment has been particularly pronounced in capital-intensive sectors such as construction and mining (figure 3). The former has collapsed since the middle of the fourth quarter of 2018, when the construction of the new airport was cancelled.[6] Tougher construction permits and a more stringent inspection process of construction sites in many parts of the country, particularly in Mexico City, have heavily impacted both output and employment in the construction industry in 2019.[7]

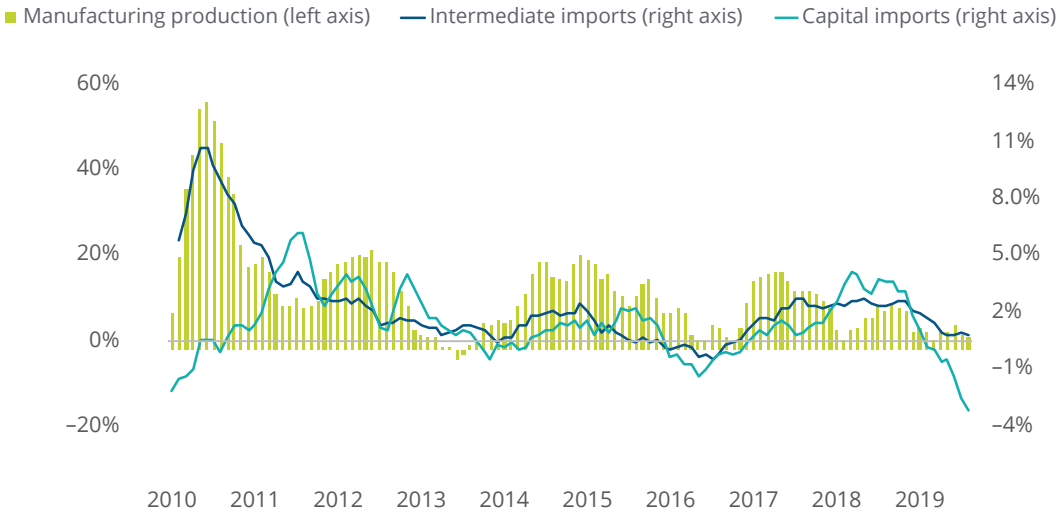
As regards the mining sector, it started to decline since 2014, when international crude prices fell.[8] The financial position of Pemex, the state-owned petroleum company, made it impossible for it to face the price downturn resiliently. Soon after that, its production fell even as its debt increased, placing Pemex in a critical and fragile position.

In the wake of these factors, it's not surprising that private investment has fallen, but the drop this year has been severe, to levels not seen since the financial crisis of 2009. This has also been reflected in a sharp decline in nonoil intermediate imports

FIGURE 4

Manufacturing downshifted as imports dropped

Three-month moving average of imports and manufacturing activity, percentage YoY



Source: INEGI. Imports do not include oil.

and capital imports—strong leading indicators of a weaker manufacturing output (figure 4).

Consumption and exports resilient

In the first nine months of the year, tertiary activities posted a 0.6 percent expansion compared to the same period of 2018, the lowest growth for this period since 2009. While consumption of goods grew 0.8 percent annually in the first eight months of the year, services consumption expanded only 1.0 percent in the same period (figure 5).

Although a slowdown in tertiary activities can be an alarming trend as they represent more than two-thirds of the economy, there are also some positive signs:

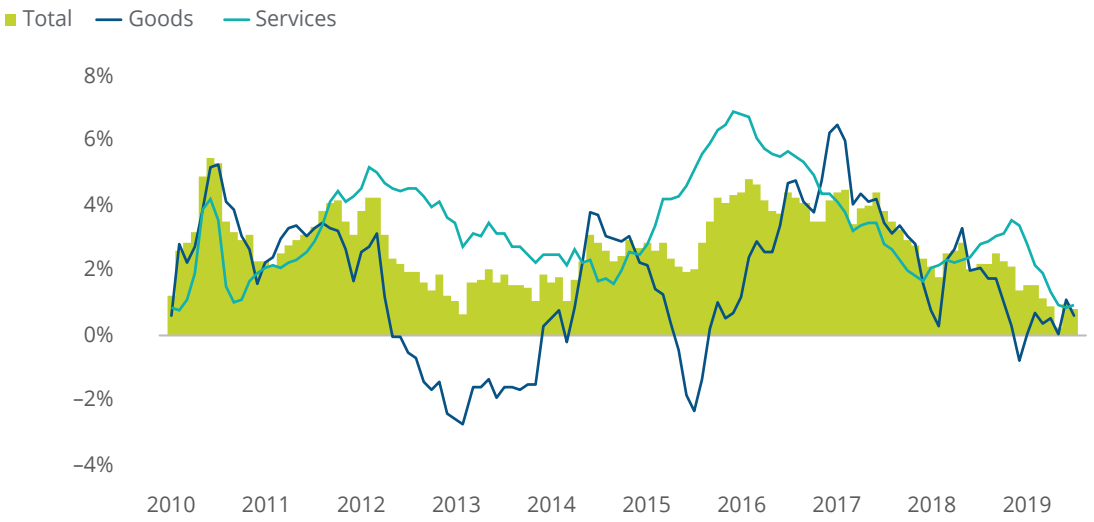
- Growth in real wages: In the first eight months of the year, wages increased 2.5 percent, the largest growth since 2001.
- Record high levels of remittances: In the first eight months of the year, they accumulated a balance of US$ 23.8 million—a historical record.
- Strong consumer confidence: Even though the index has fallen from its maximum level reached in February, it remains at its highest level since 2006.

Another positive sign for the Mexican economy, although with mixed results, is international trade. Mexico remains competitive because the United States, its most important trade partner, has been able to sustain economic expansion despite fears of recession.[9] Mexican exports increased 4.4 percent in the first eight months of the year, with goods

FIGURE 5

There's been moderate expansion of private consumption

Three-month moving average of private consumption, percentage YoY



Source: INEGI.

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exports to the United States increasing 6.1 percent in the same period.

Further, according to the United Nations Conference on Trade and Development (UNCTAD),the US-China trade conflict has benefited Mexico, which brought in US$3.5 billion from additional exports to the US market, mainly in the agroindustry, transportation equipment, and electrical machinery sectors.[10] This benefit to Mexican exports will continue through the rest of 2019, while the United States and China work to reach an agreement.

Despite these positive developments, the US manufacturing sector has registered a slowdown,[11]affecting export of Mexican intermediate goods to the US market. Besides, strikes in some large US automakers have affected the export of Mexican automobiles.[12]In October 2019, Mexican automobile exports registered a contraction of 19.5 percent as compared to the same period last year, the biggest drop since 2009. The trend for exports in 2020 looks less optimistic, given lower expected growth in the United States.

Pemex no longer Mexico government's treasure chest

The weak economic environment was reflected in a downgrade of Mexican sovereign debt to BBB,[13] from BBB+ by Fitch Ratings; Moody's, meanwhile, changed the outlook to negative from stable.[14] In addition, Fitch cut the rating of Pemex bonds to junk bonds due to its weak financial situation.[15]

Pemex is one of the main potential internal risks in Mexico due to its high level of debt and its large contribution to federal public finances. According

to the oil company's latest balance sheet, its debt represents 97 percent of its assets and constitutes about 20 percent of the country's total public debt.

In July, the government announced the Pemex business plan with a view to rescue the company.[16] To balance Pemex's budget, the government plans to gradually reduce the rate of the company's shared utility tax (DUC, in Spanish) from the current level of 65 percent to 58 percent in 2020, and 54 percent in 2021 (the total tax exemption will be US$2.4 billion). The government also plans direct contributions to the company in the range of US$2.6 billion over the next three years.

The goal is for Pemex to reach a balanced budget by 2021 and to increase oil production to 2.7 million barrels per day by 2024, compared to the current production of 1.7 million barrels per day.[17] The target seems quite ambitious considering production has been falling since 2014, and in January, it reached its lowest level since 1990.[18] This underscores the challenges facing a government that vows to pump far more in a few years.

The new business plan limited Pemex's cooperation with private firms. But later, due to the potential challenges of this decision and pressure from the private sector, the government announced the Integrated Exploration and Extraction Services Contracts (CSIEE), which would enable public-private partnerships.[19] It is not yet known how this association will work or which oil fields will be part of it, but it can raise the hope of private investors.

Furthermore, the finance ministry announced that Pemex will receive a new round of recapitalization of US$5 billion as part of the 2020 budget from the government.[20] The company will use these funds to pay down its short-term debt maturing between 2020 and 2023 and will proceed to issue new debt to seven-, 10-, and 30-year tenors with a view to extend the maturity structure of its debt. Pemex

will also launch an exchange offer in the short, intermediate, and long part of the curve to lengthen out its amortization schedule.[21] This recapitalization scheme was received very well by the private sector.

Greater involvement of the federal government in the administration of the state-owned firm will divert resources from other public infrastructure projects, thus dragging down the pace of expansion of construction and other expenditure-dependent sectors. The government has already spent US$4.6 billion on Pemex this year (0.5 percent of the GDP) and is committed to a slightly bigger investment in 2020, which will aggravate the budget and expenditure cuts in the coming year.

2020: Light at the end of the tunnel?

In September 2019, the current administration presented the 2020 Economic Program.[22] Like the 2019 budget, the 2020 plan is consistent with AMLO's campaign promise of fiscal discipline. The new proposal calls for a primary surplus equivalent to 0.7 percent of GDP,[23] which is lower compared to the estimated primary surplus of 1.0 percent of GDP in 2019.

The budget revenues for next year are based on the Ministry of Finance's estimation of a 2.0 percent GDP growth for 2020, a forecast far above the consensus of 1.1 percent. In addition, the ministry estimated that oil production will reach 1,951 million barrels per day by the end of 2020, an increase of 14.4 percent compared to current output—something that hasn't happened since the time data is available (1990).[24] As a result, these figures seem to be overestimated, which could eventually lead to spending cutbacks like in 2019.

There are several factors suggesting that the income and economic growth goals programmed in the 2020 Economic Package will hardly be achieved. Some of them are:

- External risks, especially those related to global trade and the deceleration of various economies, including the United States
- The stagnation of the Mexican economy in 2019, which will barely provide a marginal boost for 2020
- The 5.4 percent cut in public investment expected in the 2020 Economic Program
- Violence and public insecurity, which is one of the main factors hindering business confidence (according to the latest central bank survey)[25]

To conclude, the economy will see stagnation this year and the central bank forecasts a range between -0.2 and 0.2 percent.[26] Next year, the economy is estimated to grow 1.1 percent, mainly driven by some previously postponed durable goods consumption decisions (as strong fundamentals of consumption persist) and the reactivation of some investment projects by both the public and private sectors. While an increase in investment is not expected, we do not estimate a further decline either. Finally, total exports will continue to increase, but at a modest pace, as economic growth in the United States is decelerating.

The authors finished writing this document on November 19. The opinions expressed in this publication are those of the authors. They do not purport to reflect the opinions or views of Deloitte.

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