

# The Mexican economy after the oil price decline

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**Gabriel Casillas**

Chief Economist and Head of Research  
gabriel.casillas@banorte.com

**Delia Paredes**

Executive Director of Economic Analysis  
delia.paredes@banorte.com

**Alejandro Cervantes**

Senior Economist, Mexico  
alejandro.cervantes@banorte.com

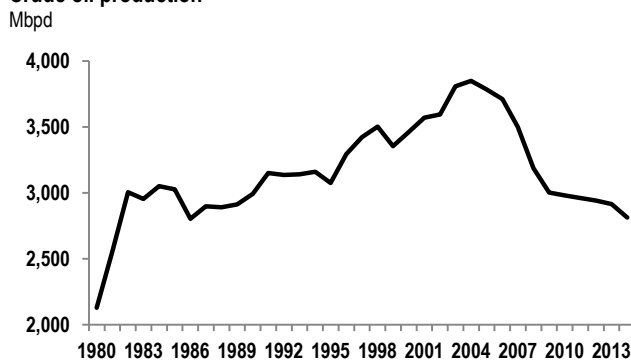
- The recent energy reform marked a real turning point in Mexico’s history
- Nonetheless, we believe that persistently low levels of oil prices will delay an important part of the expected benefits of the reform
- In this context, we revised down our GDP growth forecast for 2016-2020 to a 3.5% average, from 5% previously

**Energy Reform: A real turning point in Mexico’s economic history.** In August 11<sup>th</sup>, 2014, it seemed that the course of the Mexican economic history was finally stirred to a path of higher growth: the laws for a deep change in the energy sector were enacted. This was an ambitious reform that many did not expect to see in a lifetime. It included the opening of the energy sector, including gas, oil, and electricity to private investment, after years of been trapped in a quasi-communist paradigm, where the government had the exclusive right to invest in the sector. Even though Mexico underwent an important structural change in the late eighties, which entailed an important privatization program, the signing of free trade agreements (in which the *North American Free Trade Agreement* was the most important one), the energy sector was always excluded from these liberalization efforts. It seemed the sector was doomed to live in a different logic from that of the rest of the economy.

**Lower levels of output...** Years passed and technological advance seemed not to matter, nor did the boom in oil prices in the mid-first decade of the century, which led them to levels above US\$100 per barrel level (dpb). Crude oil and other products from the value chain of the sector remained in government hands. During this period, crude oil production increased from 2.8 million barrels per day (mbpd) on average in the 1980s, to a record-high of 3.9mbpd in 2004, and back to levels of 2.8mbpd last year, as shown in the chart below on the left.

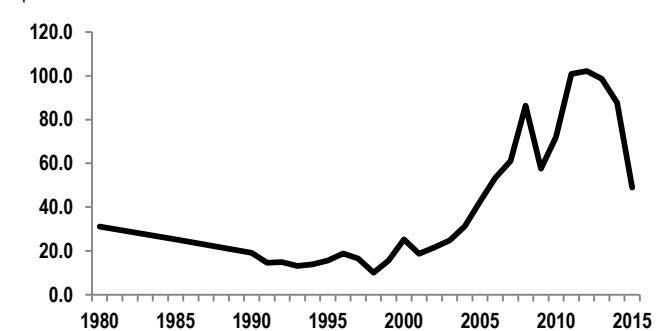
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**Crude oil production**



Source: EIA

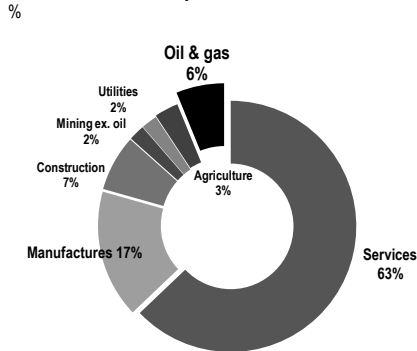
**Oil prices**



Source: Ministry of Energy and Pemex

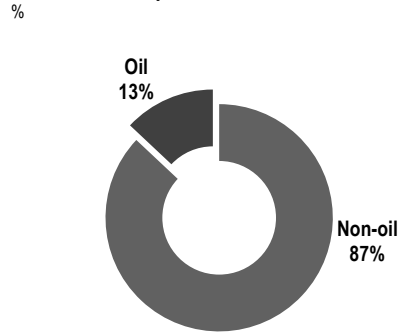
**...and lower prices.** In contrast with popular belief, the Mexican economy has a relatively low dependency on oil. In terms of GDP, it accounts for less than 6%, while oil exports represent only 13% of total as shown in the charts below. Nevertheless, the sector becomes relevant in terms of government revenues (33% of total revenues). It is worth noting that up until 2014, government revenues had not resented the fall in production levels –except for 2009, when prices also came down 26.1%yoy-, on the back of higher prices. Since June 2014, oil prices have fallen 40.3%, as a result of both global supply and demand conditions, along with geopolitical risks that lead us to believe that “low” oil prices will remain around the current levels for a long period of time. Thus, the Mexican economy has to deal now with a scenario with both, lower production and low prices.

**Share of main components of GDP**



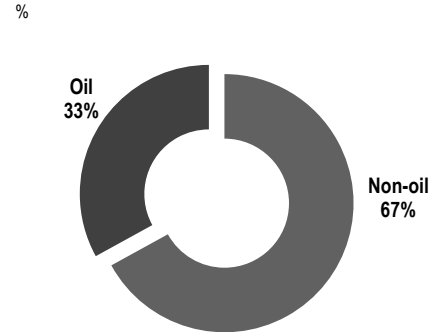
Source: INEGI

**Oil & non-oil exports**



Source: INEGI

**Government revenues**



Source: MoF

**Energy reform amid persistently low levels of oil prices.** Persistently low levels of oil prices will have a significant impact on expected benefits derived from the energy reform. In our opinion, there are three key factors to evaluate the delayed impact: (1) Different production costs among different type of fields; (2) the type of company that participates in each field; and (3) the impact that each type of field has on economic activity.

**(1) Different production costs among different fields.** According to experts, production costs of a barrel of shale oil is about US\$50-US\$60 per barrel on average, well above the costs associated with extraction in shallow water or onshore conventional fields (US\$6-US\$20dpb).

**(2) The type of company that participates in each field.** Shale oil producers are not as large as BP, Exxon, Chevron or Shell that are focused on conventional, on shore fields as well as oil in deep-sea waters. In fact, companies exploiting shale oil fields are usually much smaller and are not vertically integrated. As a result, these companies only extraction profit from oil and not from other parts of the supply chain.

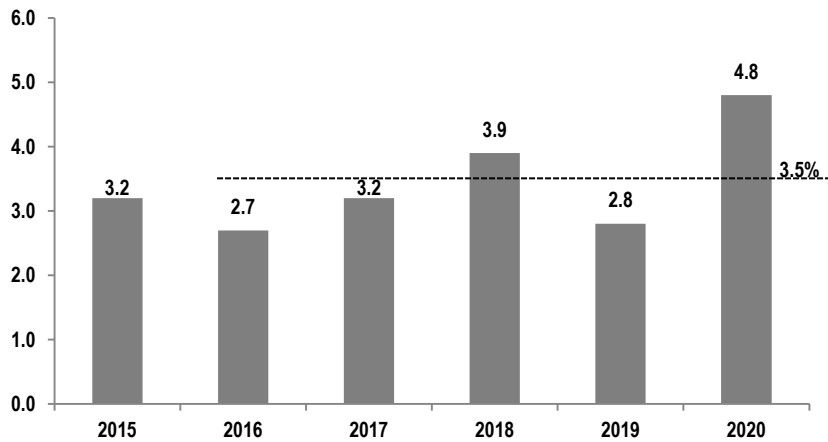
**(3) The impact that each type of field has on economic activity.** We believe that the economic benefits that would derive from the exploitation of shale fields are much higher than that of conventional, on-shore, shallow or deep sea drilling fields. Taking the case of *Eagle Ford* in Texas, U.S., the development of shale oil fields led to the construction of roads, pipelines, hotels and restaurants throughout the 14 counties that form this particular basin. In fact, studies conclude that in 2012, the additional GDP that was generated in this region was close to US\$60bn, equivalent to five points of Mexico's GDP. So it is not difficult to think that Mexico could have grown at 5% in the coming years. Nevertheless, in the case of conventional onshore wells, we believe that the value added is lower than in the case of shale oil because there is already a lot of infrastructure around them (there are even "artificial" cities created around such fields, as it is the case of "Ciudad Pemex" in the Southeastern state of Tabasco). In the case of shallow and deep-sea water fields, the added value is concentrated in the output that can be extracted, because the remoteness of the platforms with respect to the coast does not generate many incentives for opening new businesses such as hotels, restaurants, etc. In addition, we anticipate that in the case of deep-sea drilling platforms are imported from other countries.

**Investment in conventional, shallow waters and deep-sea water fields, but not in shale oil fields.** In sum, we believe that the bulk of the investment will be in conventional, on-shore and shallow-water fields –given low extraction costs-, while we do not anticipate investments in shale fields (*e.g.* Burgos and Sabinas basins) on the back of the persistence of low oil prices. In the case of deep-sea water fields, we expect significant investments despite high production costs, because there are larger and more vertically integrated companies who could participate in these fields. Along with this, the investment horizon –often of more than ten years-, also paints an encouraging picture for investment in this particular area. Nevertheless, as discussed in the preceding paragraph, economic benefits from shale fields are relatively higher than the ones from other fields, so the overall added value expected from energy reform will be limited.

**The Mexican economy will reach an average potential GDP of about 3.5% over the next five years.** In our view, persistently low levels of oil prices probably for a long time, imply that investments to be detonated in the energy sector reform will be significantly lower than we had previously anticipated when prices were above 100dpb. In this context, we expect now the Mexican economy to achieve a 3.5% potential GDP growth over the next five years, from the 5% that we initially anticipated (please see chart below). We highlight that the Mexican economy has averaged a 2.5% growth in the last 25 years, so our new 3.5% estimate now contemplates the initial benefits of the first wave of structural reforms already approved by the federal government. Moreover, the government has a "*golden opportunity*" to reform of the justice system and strengthen the institutional framework to enforce the rule of law. Such a reform would significantly boost the implementation of the adopted structural reforms and speed up its positive impact on potential growth.

**Long-term growth forecasts**

% yoy



Source: Banorte-Ixe

**Optimism limited by low levels of oil prices.** We remain constructive about the future of the Mexican economy, mainly as a result of the far-reaching structural reforms already approved. The impact of many of these reforms will take some time to be seen due to their own nature. Nevertheless, in the case of energy reform, we believe that the sharp decline in oil prices, which we did not anticipate, is not likely to generate the investment levels or the value added to the economy that we estimated when oil prices were above 100dpb.

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**GRUPO FINANCIERO BANORTE S.A.B. de C.V.**
**Research and Strategy**

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

**Economic Analysis**

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Rey Saúl Torres Olivares	Analyst	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

**Fixed income and FX Strategy**

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

**Equity Strategy**

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1746
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto parts	valentin.mendoza@banorte.com	(55) 1670 - 2250
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 1670 - 2251

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 1670 - 2248

**Wholesale Banking**

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Transactional Banking	vrolan@ixe.com.mx	(55) 5004 - 1454