Making sense of government's fiscal assumptions for 2016

- **The government unveiled yesterday the details of its 2016 Economic Package**
- **The budget proposal was devised taking into consideration three important challenges:**
  - **(1) Restrain debt growth and reduce debt to GDP levels, through the reduction of fiscal deficit;**
  - **(2) The reduction of oil platform and prices; and**
  - **(3) Face an adverse external backdrop**
- **Taking these into consideration, the government is proposing a 0.5% fiscal deficit for 2016**
- **There will be no new taxes, but some modifications to current fiscal framework**
- **Spending cuts are expected to be around MXN101.4bn**
- **In order to finance the 0.5% of GDP deficit, the government is asking for a net domestic indebtedness of MXN535bn**
- **In addition, the government is asking for another US$6bn in external indebtedness**

The government unveiled yesterday the details of its 2016 Economic Package. As mentioned in our note published yesterday (*"2016 Budget proposal – The government keeps its deficit-reduction promise*" [here]), our first reaction to the government's budget proposal is that it sends a strong signal to market participants of fiscal responsibility that has characterized the Mexican government since the early nineties especially as this fiscal effort is carried out in an adverse environment of lower oil prices and probable interest rate hikes. We also believe that the assumptions expressed in the proposal (see table below) are realistic, despite we have a slightly more challenging scenario for GDP growth for 2016 (2.7%), but still within the MoF's estimated interval (2.6%-3.6%). In this note, we deep a little bit further into the 2016 fiscal policy for next year, by examining in detail each of the assumptions made by the government.

General Economic Policy Criteria (CGPE) 2016

	CGPE	Consensus*
GDP (% yoy)	2.6 – 3.6	3.0
Inflation	3.0	3.0
USD/MXN (average)	15.90	15.98
Public balance (% GDP)	-3.0	- -
Ex. Pemex investments (% GDP)	-0.5	- -
Mexican mix of oil (dpb)	50	- -

*Banamex's survey.
Source: SHCP, Banxico and Banorte-Ixe

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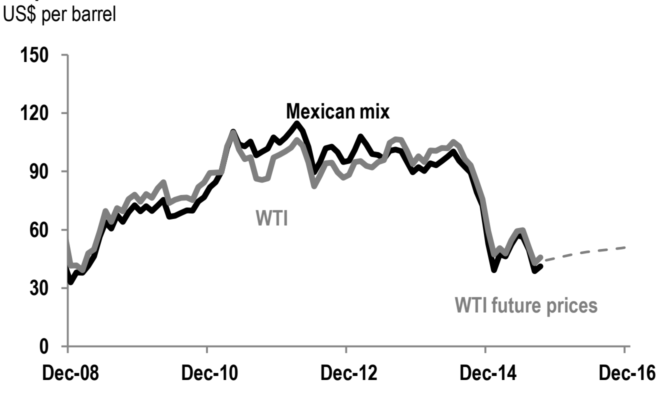
Economic expansion still below potential. The MoF expects an economic expansion in the area of 2.6%-3.6%, in line with consensus according to last Banamex survey. This forecast rests on three assumptions: (1) An economic expansion in the U.S. of 2.7%yoy; (2) a reduction in the drag coming from oil production (from 0.4% in 2015 to only 0.04% next year), as the government expects output to stabilize in 2016 (see next section); (3) a more dynamic domestic demand, as a result of higher levels of employment and the implementation of economic reforms. Downside risks to this scenario include a more moderate rate of growth globally, an in the U.S. in particular along with persistent levels of volatility in international financial markets and other risks associated with oil production.

Coping with falling oil prices… One of the main challenges facing Mexico's government is an adverse scenario in terms of the energy sector. The government assumes an average price for the Mexican mix of oil in the area of US$50 per barrel. This number comes as a result of the application of the pricing formula contemplated in the *Budget and Fiscal Responsibility Law* (LFPRH), which include assumptions such as the recent and future performance of oil prices, both for the Mexican mix of oil, as well as for the WTI reference (see chart below). It is worth mentioning that the government already announced that it hedged its oil revenues for 2016 through the acquisition of put options at an average exercise price of US$49 per barrel. In addition, the government has an *Oil Stabilization Fund (FEIP)*, which currency has a balance of MXN44,219mn (~US$2.6bn). On top of this, there is the infrastructure stabilization fund and the fund for federal entities, which sum to a total of MXN124.5bn.

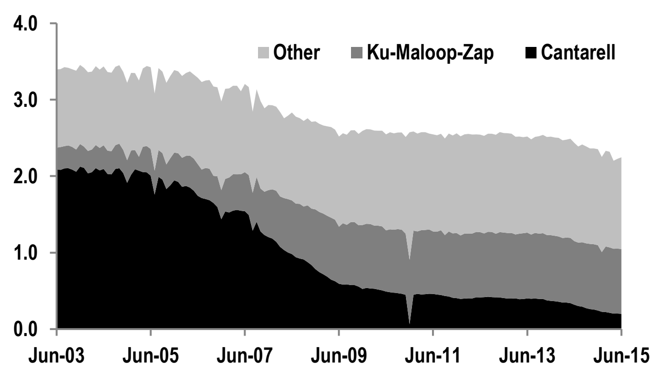
…And a lower oil production platform. A more significant challenge for the Mexican government in the energy sector comes in terms of oil output. The budget proposal for 2016 estimates that oil output will remain relatively stable at 2.3 million barrels per day (mbd), assuming that new fields will start producing next year and will compensate for the decline in other mature fields, as it is the case of Cantarell (see chart below on the right). Nevertheless, the government considers that production levels will recover in the medium term as the energy reform continues to be implemented.

Oil prices
US$ per barrel



Source: Bloomberg

Oil production by region
mbd

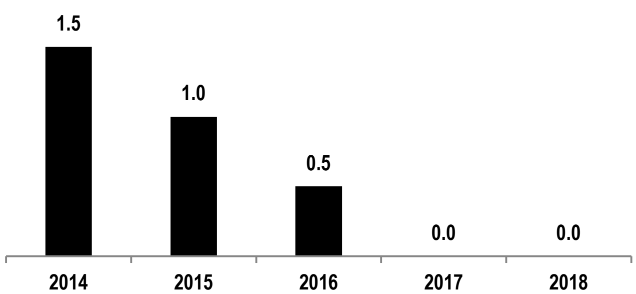


Source: SENER

Fiscal policy in 2016. The budget proposal was devised taking into consideration three important challenges: (1) Restrain debt growth and reduce debt to GDP levels, through the reduction of fiscal deficit; (2) the reduction of oil platform and prices, already mentioned; and (3) an adverse external backdrop.

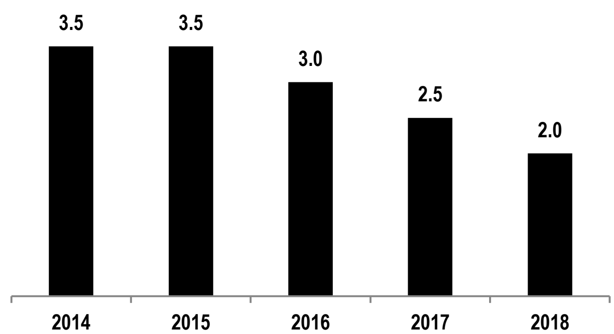
Reduction of fiscal deficit to 0.5% of GDP. This reduction is in line with Mr. Peña-Nieto's administration commitment with sound fiscal accounts. In this context, the government intends to reduce fiscal deficit from 1% in 2015 to 0.5%, next year, and will get to a balanced budget by 2017, as shown in the chart below. It is worth noting that this figure excludes the so called *high impact* investments (*i.e.* mainly done by state-owned Pemex and CFE), which represent about 2.5% of GDP. Including such investments, fiscal deficit would amount to 3% next year, coming down to 2% by the end of this administration (see chart on the right).

Fiscal deficit ex. high impact investments
% GDP



Source: MoF

Fiscal deficit including high impact investments
% GDP



Source: MoF

Lower deficit amid lower levels of income and higher non-programmable spending…In this context, even though oil revenues are expected to decline 30% vs. 2015 budget, while non-programmable spending will be higher on the back of higher transfers to Federal States –given larger levels expected of tax collection-, and higher financial costs, the government is not proposing any new taxes nor the increase of existing ones. Nevertheless, they are making some modifications to current tax framework, which intend to promote savings and investment in the short-term. Such modifications include the elimination of income tax deductions in pension contributions; investment deductions for small and medium companies along with measures to promote reinvestment, and formality, and summarized in the table below.

Modifications to tax framework

Measures to promote savings

- Changes in income tax retentions on interest paid by the financial system, linking them to real interest received by taxpayers and consistent with the evolution of financial markets
- Tax deductions on pension fund contributions
- Fiscal measures to facilitate repatriation of resources abroad

Measures to promote investment

- Immediate deduction of investments for small and medium companies and in strategic sectors (energy, transport infrastructure among others)
- Profit reinvestment incentives

Other measures

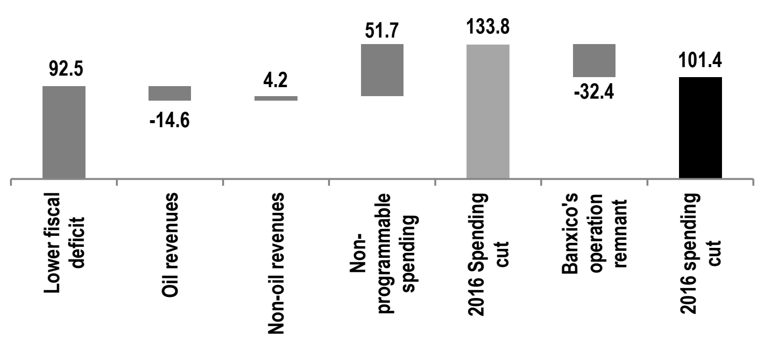
- Simplification of tax collection
- Enhancement of fiscal compliance
- Incentives for investment in power generation and in renewable energies
- Other measures to promote formality

Source: MoF

…And a multi-annual fiscal consolidation strategy. With lower oil revenues, the modifications proposed in the tax framework and higher non-programmable spending, the fiscal deficit target will be met by adopting a multi-annual fiscal consolidation approach, which includes: (1) A reduction in programmable spending; (2) savings coming from Banxico's operation remnant; and (3) the reengineering of the spending budget (the so called *zero based budget*). In the first case, programmable spending excluding high-impact investments (which include Pemex and CFE's investments) will come down in around MXN101.4bn (~US$6.4bn), lower than the MXN133.8bn (~US$8.4bn) originally announced, taking into account the cuts already made to 2015 spending (MXN124.3bn), as well as the savings coming from Banxico's operation remnant (MXN31.4bn in 2016 pesos or US$1.97bn), which was deposited in the *Investment Program and Infrastructure Projects Fund* (FIPPI) and will be available next year. In the case of the spending budget, the LFPRH restricts structural spending (spending ex. financial costs, federal participations, cost of fuels used for power generation, public sector pension payments, and public investments) to expand more than 2% in real terms in any given year. For 2016, the government expects structural spending in the area of MXN147.5bn (~US$9.3bn) below the maximum range established by the law (MXN2,236.2bn or US$140.6bn).

Spending cuts in 2016

MXNbn, difference vs. 2015 estimated budget

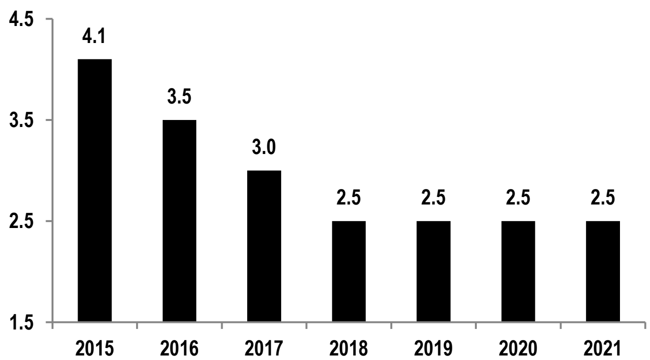


Source: MoF

Other fiscal responsibility measures. Along with the multi-annual fiscal consolidation strategy and the modifications to the current tax framework, the government is proposing two measures aiming to reassure its commitment to fiscal responsibility. The first one has to do with reinforcing Banxico's autonomy by establishing a mechanism through which the monetary authority's operation remnant would be allocated to reduce public debt. The second one intends to bring forward the liberalization of retail gasoline prices, which was originally contemplated for 2018. Gasoline prices will now fluctuate with international prices but within a band, which will be determined by the end of the year, according to the levels observed in the market. The upper limit of the band will protect consumers from sudden increases in prices, while the lower limit guarantees Pemex costs of production and distribution. Additionally, it intends to adopt a system of *fixed tax* on fuels, which will not be tied to Pemex operational costs.

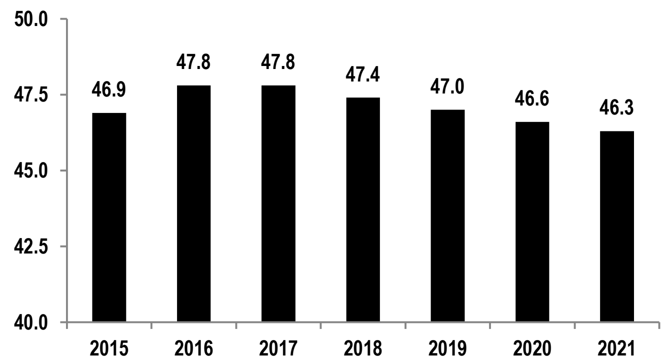
Public sector borrowing requirements and fiscal risks. With the abovementioned measures, public sector borrowing requirements (PSBR) will come down from 4.1% to 3.5% of GDP in 2016. In the medium term, PSBR will continue coming down to 2.5% of GDP by 2018 (see chart on the left). Nevertheless, these figures imply that the historical requirements (PSHBR) increase in the next two year and come down just marginally as a percentage of GDP in the long term (see chart on the right). The MoF mentions that these levels are consistent with other economies with the same credit rating and with the country's economic stability. Regarding fiscal risks, the MoF identifies five risks to its 2016 budget: (1) Lower than expected growth; (2) lower oil prices; (3) exchange rate volatility; (4) lower levels of oil production; and (5) higher interest rates. The effect on the government's numbers is shown in the table below.

Public sector borrowing requirements
% GDP



Source: MoF

Public sector historical borrowing requirements
% GDP



Source: MoF

2016 Budget sensitivity to risks

Risk	MXNbn	%GDP
Half percentage point of real growth	10,921.1	0.57
One additional US$ dollar in oil prices	3,699.8	0.19
10 cent appreciation of the Mexican peso (average)	-519.0	-0.03
Oil revenues	-1,499.2	-0.08
Financial costs	980.2	0.05
50mbd of crude oil production	12,559.5	0.65
100bps increase in interest rates	15,199.0	0.79

Source: MoF

Public debt policy in 2016. In order to finance the 0.5% of GDP deficit, the government is asking for a net domestic indebtedness of MXN535bn. In addition, the government is asking for another US$6bn in external indebtedness. These levels are MXN60bn (~US$3.8bn) lower than what was approved for the current year and reflects government financing needs. In the meantime, Pemex is asking for a net external indebtedness of US$2bn, while the CFE intends to increase domestic debt from MXN8bn to MXN12.5bn, both basically aiming to satisfy investment needs. In terms of domestic debt, the government aims to: (1) promote efficiency of domestic markets; (2) enhance liquidity and operational efficiency as well as the price setting process for government's instruments; and (3) develop real-rates domestic markets. In the external front, the government wants to broaden and diversify the base of investors as well as to develop bond references in the different markets where they already have issuances in order to improve terms and conditions of external debt.

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