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Mexico Announces Budget Cuts in Response to Global Oil Slump

Carlos Navarro

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by Carlos Navarro
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A few weeks ago, Finance Secretary Luis Videgaray confidently indicated that Mexico could weather the recent downturn in oil prices because President Enrique Peña Nieto's administration had created some flexibility in the 2015 budget (SourceMex, Nov. 19, 2014). That "flexibility" apparently was not enough to prevent the administration from having to reduce spending in 2015, including indefinitely postponing the high-speed rail between Mexico City and the industrial hub of Querétaro. On Jan. 30, Videgaray announced that the administration would reduce spending by 124.3 billion pesos (US$8.4 billion) in 2015. That reduction is the equivalent of 0.7% of Mexico's projected GDP for the year, said the finance secretary.

Energy, transportation expenditures reduced

A large share of the cuts will come from planned expenditures in energy and transportation, including the budgets for the state-run oil company PEMEX and the federal electrical utility (Comisión Federal de Electricidad, CFE). Videgaray said PEMEX would have to reduce expenditures by about 62 billion pesos (US$4.2 billion), while the CFE would have to cut spending by about 10 billion pesos (US$682 million).

Videgaray also announced that the administration had put the Mexico City-Querétaro high-speed rail on indefinite hiatus. The project had already been suspended at the end of the year because of concerns about irregularities in the original bidding process (SourceMex, Nov. 12, 2014, and Dec. 3, 2014). However, the administration had planned to reopen the bidding process sometime in 2015.

The project had been estimated to cost about US$3.75 billion, but private developers were going to pick up a large share of the tab. Still, the federal government would have picked up infrastructure costs in 2015, 2016, and 2017, and expenditures on the rail line had been anticipated for each of those years.

Because of the impact of a weak global oil market on Mexico's budget, some business organizations had already recommended that the administration scrap its ambitious plan to build new passenger rail lines in Mexico, including proposals for trains connecting Mexico City to Toluca in México state and a route that would span the Yucatán Peninsula (SourceMex, Dec. 12, 2012). In the eyes of the Centro de Estudios Económicos del Sector Privado (CEESP), the three rail lines are not considered critical infrastructure. "Perhaps the train to Querétaro should not be given the priority it has received," said CEESP director Luis Foncerrada. "That project and other similar projects should be canceled."

In a recent report, the Secretaría de Hacienda y Crédito Público (SHCP) said the global oil market was expected to remain weak until at least the middle of 2015, recovering modestly in the second half of the year. Analysts at Grupo Financiero Banamex project the average price of Mexican crude oil for all of 2015 at US$53 per barrel, compared with an average price at the end of January of $39.70. In contrast, the 2015 budget Peña Nieto's administration presented in September 2014 was based on

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an expected average oil price of US$82 per barrel for Mexican crude. Congress eventually approved a budget that estimated an average price of US$81 per barrel.

The impact of a weak global oil market on Mexico should be limited in the near term because the SHCP put money into an oil-stabilization fund intended to soften the blow of a sharp drop in prices. Analysts at Grupo Financiero Banamex say resources in the Fondo de Estabilización de los Ingresos Presupuestarios (FEIP) could cover the Mexican budget if prices drop as low as US$14.70 per barrel (SourceMex, Nov. 19, 2014).

When will oil prices rebound?

Still, private analysts are concerned that global prices might not recover significantly the rest of the year, which might require the Mexican government to make a further round of budget cuts. The sharp downturn in global oil prices has hit oil-exporting countries particularly hard. While Mexico appears to have weathered the storm, at least for the next few months, the reality is that the country relies on oil exports for one-third of its budget.

"Lower oil production in 2015 is an important risk for GDP growth and for public finances," Carlos Capistrán, chief economist for Mexico at Bank of America Corp., told Bloomberg news service. "They don't have a hedge for 2016, so if oil prices remain low, they'll have to do an adjustment for 2016. One possible scenario is they decide to start doing part of that adjustment now to spread out the pain."

Videgaray remains confident that the weak global oil market will have only marginal impact on Mexico's GDP growth in 2015, which he still projects in a range of 3.2% to 3.4%. The International Monetary Fund (IMF) recently reduced its forecast for Mexico's GDP growth to 3.2% from a previous estimate of 3.5%.

Some market observers suggest Mexico's economy is diversified enough to allow the country to absorb the impact of low oil prices. "Overall, we expect increased manufacturing exports to more than compensate for lower oil exports; exports are also set to benefit from improved US growth prospects," Mauro Leos, a vice president at Moody's economic research company, told the Spanish news service EFE.

Videgaray noted that the recent budget reductions involved current spending rather than future expenditures, which should also limit the impact on the economy. "The impact will be marginal because the cuts were preventative in nature," said the finance secretary. "Furthermore, they will contribute to the possibility of lower interest rates, reduced inflation, and economic growth."

In addition to reductions to PEMEX, the CFE, and transportation, the administration will also cut expenditures on some direct subsidies and on social communication.

Opposition parties had a mixed reaction to the SHCP's announcement. Senators from the center-left Partido de la Revolución Democrática (PRD) said the move to cut current spending was correct, but they also questioned the need to cut much-needed investments in PEMEX and the CFE. Additionally, PRD Sen. Dolores Padierna suggested there is room for the Peña Nieto government to make further cuts, which could be achieved by greatly reducing the salaries of high-level officials in the administration.

Senators from the conservative Partido Acción Nacional (PAN) also urged cuts in the budgets of the Senate and Chamber of Deputies and called for states to impose a moratorium on incurring

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new debt. "We all have to tighten our belt," said Sen Ricardo Anaya Cortés, PAN floor leader in the upper house.

There is some concern that the weak global market and the reduction in PEMEX expenditures could discourage private investment in Mexico's energy sector. However, Sen. David Penchyna Grub, who chairs the Senate energy committee (Comisión de Energía), offered reassurances that the reductions would not affect the ongoing energy reforms significantly. "I trust the companies' human capital is going to be enough for the process of implementing reform, which is going very well, not to suffer accidents. I trust the budget cuts will be performed with rationality and prudence," said Penchyna Grub, a member of the governing Partido Revolucionario Institucional (PRI).

Some observers noted that, despite the decline in oil prices, PEMEX remains one of the world's most profitable companies because of low costs of production, estimated at about US$10 per barrel in some of its fields. "This figure allows PEMEX to maintain itself as one of the most profitable and competitive oil companies, even when Mexico's oil-export price dropped to about US$38 per barrel last Friday," the daily newspaper Excélsior said on Jan. 26. "This represents a decline in price of 63% relative to the highest price reached last year, at US$102.41 per barrel in June."

PEMEX contractors feeling the pinch

While the impact of the oil crisis on the public sector might be minimal for now, the depressed market is beginning to have a direct and indirect impact on the private sector. Many companies that provide services to PEMEX on a contract basis were seeing a reduced workload from the company. During the first week of January, oil service companies were forced to furlough more than 10,000 employees, and more layoffs were anticipated.

"We're embarked on a strategy to lower our costs," PEMEX chief executive officer Emilio Lozoya said in an interview with Reuters in late December. "This basically means renegotiating terms for a lot of service contracts that were awarded when the prices were very high."

A large number of these companies are in Ciudad del Carmen, Campeche state, a city that relies heavily on PEMEX for much of its economic life. By some estimates, the city could eventually lose as many as 50,000 jobs. "The city is in shock," Stuart Hill, managing director of Xperto Offshore in Ciudad del Carmen, told Bloomberg news service. We were told it was based on PEMEX's budget reductions."

The companies headquartered in Ciudad del Carmen include Oceanografía, a controversial firm involved in a massive fraud scheme. The federal government assumed control of the company in order to save the jobs of many of the workers, but those positions are no longer safe (SourceMex, March 19, 2014, July 16, 2014, and Oct. 22, 2014). Despite the government's decision to keep the company afloat, PEMEX did not send much business to Oceanografía after the takeover, effectively dooming the company.

Oceanografía operated 48 vessels before the slump in oil prices, but all but two of those ships are currently idle because of the lack of business from PEMEX. As a result, the number of employees has dropped to 1,500 from 11,000 previously, a source with access to the company's records said in an interview with Bloomberg news service.

The takeover initially provided some hope that Oceanografía's creditors would receive at least some of the payments they were owed. Some creditors—particularly those who had claims on one of the

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company’s top assets, the vessel OSA Goliath—had hoped to recover some of their investments in the aftermath of the fraud scandal and the government takeover of the company. This is because the ship was valued at about US$245 million, or 53% of what they were owed.

"Now, the collapse in oil prices has all but dashed their prospects of getting repaid in full," Bloomberg news service said in late January. "Producers around the world are cutting drilling budgets, and the lack of demand for service ships is fueling speculation the Goliath’s value has dropped. The ship-backed bonds have sunk to just 71 cents on the dollar after reaching as high as 115 cents." [Peso-dollar conversions in this article are based on the Interbank rate in effect on Feb. 3, 2015, reported at 14.67 pesos per US$1.00.]

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