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The Mexican Congress will face the unenviable task of drafting a 2018 budget that takes into account a reduced dependence on oil-export revenues and incorporates ongoing expenditures linked to recovery efforts for two major earthquakes.

President Enrique Peña Nieto's administration complied with its legal obligation to present the budget blueprint by the deadline set by the budget law (Ley Federal de Presupuesto y Responsabilidad Hacendaria). On Sept. 8, Finance Secretary José Antonio Meade Kuribreña presented a budget that takes into account the first primary surplus since 2008. The budget, which assumes a primary surplus of 0.9 of GDP in 2018, helps Mexico improve its standing in the international debt markets. The budget projects that the total public sector borrowing requirement will fall to 2.5% of GDP in 2018, compared with 2.9% in 2017.

A move to improve Mexico's credit rating

This projection means that the government can reduce the pace of budget cuts in 2018 and still cut spending to contain a deficit that threatened Mexico's credit rating.

"This year, the economic package is restricted by the necessity to demonstrate a control of public finances to the world," said Adriana Berrocal, president of the private-sector organization Instituto Mexicano de Ejecutivos de Finanzas (IMEF).

All three major credit rating agencies downgraded Mexico's outlook from stable to negative in 2016, although two of the three revised it to stable in July. At present, Mexico has a BBB+ credit rating

"This puts into perspective the restrictions involved in crafting a budget, but the consequences of ignoring the restrictions are also clear," Meade said during a recent public appearance in Mexico City. The budget plan foresees no need to create new taxes or raise the current tax rate in 2018, Meade said.

Meade said the Peña Nieto administration has set expenditures for 2018 at 5.2 trillion pesos (US$296 billion), but the total represents a reduction in federal spending of 2.8% in 2018. At the same time, the administration projected economic growth in 2018 at a modest 2.5%.

Some observers lauded the finance secretary for not overestimating projected growth for 2018. "In contrast to his predecessors, Meade dared to put together a budget that is based on a mediocre growth rate," columnist Viridiana Ríos wrote in the daily newspaper Excélsior. "This means that the budget would be based on healthier and predictable finances."

Ríos pointed out, however, that a growth rate of 2.5% is not what Mexico should be seeking. "Mexico needs to grow more, and especially in a more even manner. The small growth rate of recent years has benefitted the rich disproportionately. While Mexico's per capita GDP grows by less than 1%

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annually, the fortune of the 16 richest Mexicans grows fivefold each year, according to Oxfam," she wrote.

Citing statistics from the federal anti-poverty agency (Consejo Nacional de Evaluación de la Política de Desarrollo Social, CONEVAL), Ríos noted that inequality is also evident on a regional basis. "Our small growth rate has primarily benefitted the exporting states in the northern areas, leaving 76.4% of the population that lives in states like Chiapas to subsist in poverty," she said. "In contrast, states like Nuevo León only recorded a poverty rate of 20.4%"

One consequence of the restrictive budget for 2018 is a cap of 2.5% on the amount of money allocated for public infrastructure for the coming year. While this represents a modest increase from 2017 in actual expenditures, they are down 0.3% in terms of GDP. Furthermore, the proposed infrastructure expenditures represent a decline of more than 21% from 2013, the first year of Peña Nieto's term. The budget blueprint allocated 577.8 billion pesos (US$32.5 billion), including purchases of real estate, land, furniture, and equipment, as well as public works investment.

The Nuevo León industry chamber (Cámara de la Industria de Transformación, CAINTRA) raised concerns about the proposal to cut spending on investment, science, innovation, and technology. The chamber noted that infrastructure spending in 2018 would be down 8.5% in real terms from 2017, compared with a 58% increase in funds for political parties.

Cost of disaster coverage uncertain

Still to be quantified is the ongoing cost of recovery from two earthquakes as well as hurricanes in Guerrero and Baja California Sur states.

The first earthquake, measuring 8.2 on the Richter scale, brought major devastation to states in the south on Sept. 7, particularly communities in Chiapas, Oaxaca, and Tabasco states (SourceMex, Sept. 13, 2017). The earthquake claimed at least 96 victims.

The second quake, measuring 7.1 on the Richter scale hit central Mexico on Sept. 19, causing major damage to Mexico City and surrounding states. The disaster resulted in at least 230 deaths in the Mexican capital and several communities in Puebla and Morelos states. As of Sept. 22, authorities were still assessing the damage from the second earthquake.

Because of the disasters, the administration is going to recommend to Congress to boost funding significantly for the federal disaster fund (Fondo de Desastres Naturales, FONDEN).

"When we receive better information about the extent of damage, the executive branch and the Congress will be able to assess the needs and the possibility of making the necessary adjustments to the budget," Meade said in a television interview.

After the Sept. 7 earthquake, Meade raised the possibility of accessing a catastrophe bond issued by the World Bank in August. The bond covers Mexico for as much as US$360 million against losses from tropical cyclones and earthquakes, Meade said in an interview with Bloomberg news service.

Ensuring an oil export price of US$46

On the revenues side, proceeds from oil exports are beginning to play an increasingly smaller role in the federal budget. As part of this trend, the government is beginning to reduce allocations to the

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state-run oil company PEMEX because of recent energy reforms. The 2018 budget sets aside about 392 billion pesos (US$22 billion) for PEMEX, an increase of less than 1% from the allocations in 2017.

Under the energy reforms, PEMEX opened the oil and gas sector to private entities, which are expected to share the cost of exploration and extraction (SourceMex, Dec. 18, 2013, and Aug. 6, 2014). Several contracts have been awarded to private entities since the reforms went into effect (SourceMex, July 22, 2015, Oct. 5, 2016, July 26, 2017).

The opening of the energy sector is intended, in part, to restore Mexico's capacity to produce hydrocarbons, although increased output should not be apparent for some time, because energy related projects take time to develop.

For now, Mexico continues to report reduced production. In a public forum in mid-September, Meade acknowledged that Mexico's output of crude oil in 2017 would amount to less than 2 million barrels per day, the lowest level since 1980. Mexico's oil production peaked during the administration of former President Vicente Fox (2000-2006), with output reaching 3.5 million bpd in 2003.

Even with a reduce reliance on oil-export revenues, the budget still contains an estimate for the average oil price. This estimate was set at US$46 per barrel, compared with US$42 per barrel in 2017.

To guarantee revenues from oil exports, the Mexican government in recent years has made use of a tool in the financial markets known as the hedge. Under the maneuver, which was employed in 2015 and 2016 (SourceMex, Feb. 4, 2015,Feb. 10, 2016, Aug. 31, 2016), Mexico works with a small group of investment funds on Wall Street to ensure a guaranteed price.

The finance ministry (Secretaría de Hacienda y Crédito Público, SHCP) acknowledged that its 2018 budget proposal took into account a hedge strategy to guarantee the average export price of US$46 per barrel of crude through the purchase of financial instruments and a strengthening of the government's special fund to stabilize oil revenues (Fondo de Estabilización de los Ingresos Petroleros, FEIP), which was created in 2000 (SourceMex, Feb. 9, 2000).

"We're far enough advanced so that we're confident in saying that the US$46 coverage and stabilization fund have good support," Meade said in an interview with Bloomberg news service, pointing out that moving to a free-floating price of gasoline "played a role in looking at how much we will cover."

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