# BTMU LATIN AMERICA TOPICS

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MEXICO: FOLLOWING PASSAGE OF KEY REFORMS, ANOTHER IMPORTANT YEAR IS AHEAD

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### Reform progress backs promising investment and growth outlook

Looking ahead at Mexico's 2014, we see a cyclical growth rebound and the importance of delivering on 2013's reform progress via the passage of secondary laws and their effective implementation.

The Mexican economy is positioned for a cyclical rebound in 2014 on the back of stronger growth in the US and higher government spending. Real GDP growth is expected to rise to 3.5% in 2014, from an estimated 1.3% last year, per the market consensus. (Figure 1.)

On a structural level, the government's decisive advancements to its reform agenda in 2013 underpin the fresh prospects for sustained higher economic growth in the medium term. During the busy year, the government approved measures to increase competition in the telecom sector; improve the quality of education; increase the flexibility of fiscal revenues; and, open the energy sector to private investment. Moreover, the financial and political reforms are still being worked on.

The approval of these key reforms backs a promising outlook for higher structural economic growth through increased investment and productivity, especially in the energy sector. The government expects potential GDP growth to accelerate from 3.5% to 5.3% by 2018, the last year of President EPN's term. Our view is for a notable albeit more gradual growth pick up towards 4.5% over the next four years, with the initial impulse to be determined by two pending factors: 1) the scope of secondary legislation, and 2) the implementation of the reforms. Both developments will be crucial in assessing the likelihood and timing of new investment flows and subsequent output growth.

At the same time that the outlook for investment and productivity gains should raise GDP growth prospects, fiscal accounts will have some improved flexibility.

### Fiscal reform increases non-oil revenue and widens public deficit

The fiscal reform was less ambitious than expected but marks needed progress in increasing non-oil revenue. Its main elements include new taxes, as well as new spending and a wider deficit to support the rebound of GDP growth. On the revenue side, steps are taken to—effective January 1st— standardize the value-added tax at 16% (from 11%) in border states; raise the personal tax for those earning more than Ps750,000; introduce a 10% capital gains tax on securities and derivatives; and, place excise taxes on junk food and artificially-sweetened beverages.

The reform also approved a widening of the public deficit to stimulate the economy; the primary deficit increased to 0.4% of GDP in 2013 (from 0%) and will increase to 1.5% of GDP in 2014.

### Energy reform opens hydrocarbons and electricity sectors to private investment

The landmark energy bill opens the state-controlled oil, natural gas, and electricity sectors to private investment. It backs the prospects of higher investment and oil output, as well as lower energy costs. The bill—modifying Articles 25, 27, and 28 of the Constitution—was passed in December by Congress. It has since been ratified by the states and been published into law.

Underground resources remain property of the state, but the reform permits the state to contract with PEMEX and the private sector, and for PEMEX to contract with the private sector. Four contract types are allowed: services, production sharing, profit sharing, and licenses. Companies with exploration and production contracts will be able to book reserves as assets. Moreover, PEMEX will become a productive enterprise with budgetary independence. The National Oil Fund, a sovereign wealth fund to be managed by the Central Bank, is set up to detach Pemex from fiscal accounts.

In the electricity sector, the state's control over generation is eliminated, permitting private participation. The state retains control over transmission and distribution.

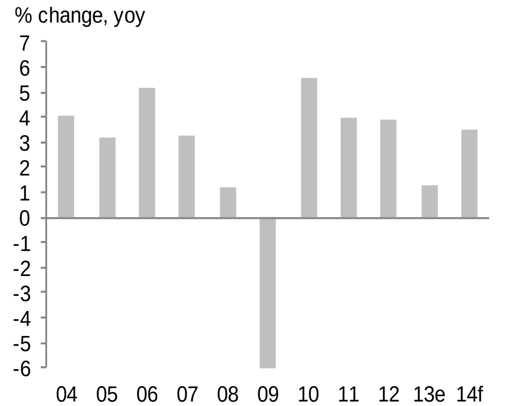
Forthcoming secondary laws will detail key aspects of contract terms, governance, and regulation.

### Pending tasks: Secondary laws and implementation

For the reforms to materialize into larger investment flows and higher growth, another year of important work is ahead. The details governing the reforms need to be specified in the supporting secondary laws, and the reforms' success will ultimately rely on the extent to which they are effectively implemented. Congress returns on February 1st and it is likely to prioritize the energy reform's secondary laws, which must be approved within 120 days of the bill's December passage.

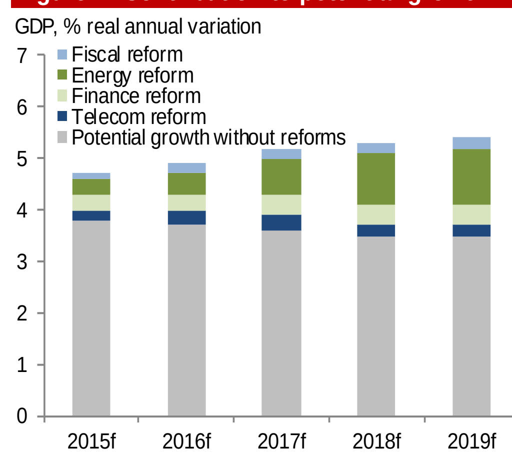
After establishing secondary laws in 1H14, it will take the rest of the year to prepare for implementation. So, it could be at least one year before large investments start to come in and a few years before production growth increases. In the base case, foreign direct investment would record a sizeable rise starting in 2015, which would serve to diversify the composition of capital inflows to Mexico. (Figure 3.)

**Figure 1: Real GDP growth**



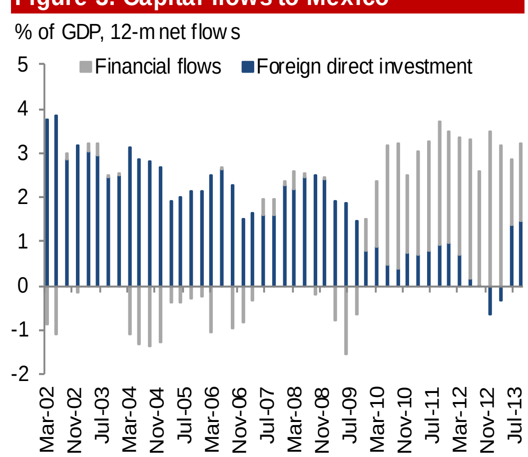

Source: INEGI; Market consensus; BTMU Economic Research.

**Figure 2: Contribution to potential growth**




Source: Ministry of Finance.

**Figure 3: Capital flows to Mexico**




Source: Central Bank; BTMU Economic Research.

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