BRITISH EMBASSY
Mexico City

Economic Overview: March 2014

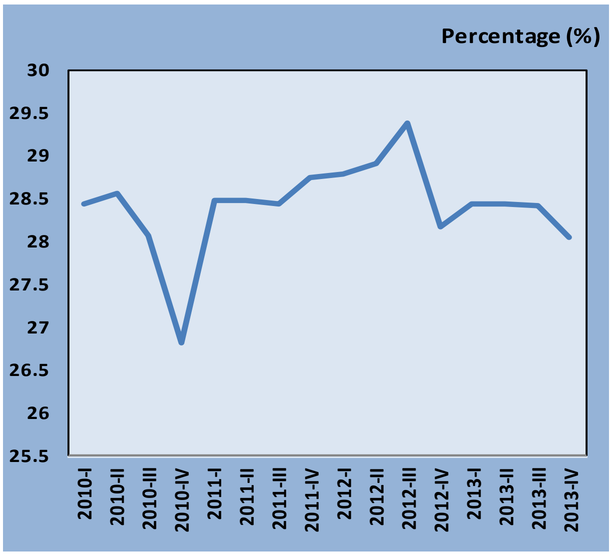
Summary

- Negotiation of secondary legislation for a number of key economic reforms underway in advance of recess on 30 April. Government hopes to pass competition and telecoms reform during this session so that legislation can be implemented during 2014. Congress has agreed to an extraordinary session after 30 April to discuss the secondary energy legislation, although Pemex has already published its proposal for the fields it hopes to exploit over the coming years. All still very much to play for across the reform agenda, with Government and opposition submitting contrasting proposals for each legislation.
- Ministry of Finance successfully launched £1bn (MX$21b) sale of 100-year sterling sovereign debt bonds, at a fixed rate of 5.75%. The London launch exceeded expectations, with demand 2.5 times available supply. Finance Minister declared this a visible display of confidence within international markets and attributed to the recent approval of the energy reform.
- On March 19 the Lower House approved the Law of Universal Pensions for the elderly, along with the creation of unemployment insurance for all workers in the formal sector. But analysts believe that the universal pension will have a limited impact on real poverty figures, as the allowance is below the poverty line established by the Mexican Government. The unemployment insurance has also attracted criticism as it will be financed from workers' savings which would otherwise have been ring-fenced for housing needs.

Following up the economic reforms in the short term

1. Congress' agenda remains full due to the ongoing negotiation of secondary legislation for key economic reforms - namely competition and energy. The lower house has already approved the secondary legislation for the competition reform, although this has been watered down from the initial proposal, including a reduction in the powers of jurisdiction of the new Commission on Economic Competition. But this has not stopped the commission already issuing rulings against monopolistic practices. Whilst the impact of education and energy reforms on growth will only be visible in the medium-long term, the increase in international investors' confidence resulting from the energy reforms is already apparent in increased capital inflows and debt ratings (Moody's upgrade of Mexican debt from BBB to A).

Chart 1: Percentage of labour force working in the informal sector



Source: National Institute of Statistics and Geography (INEGI)

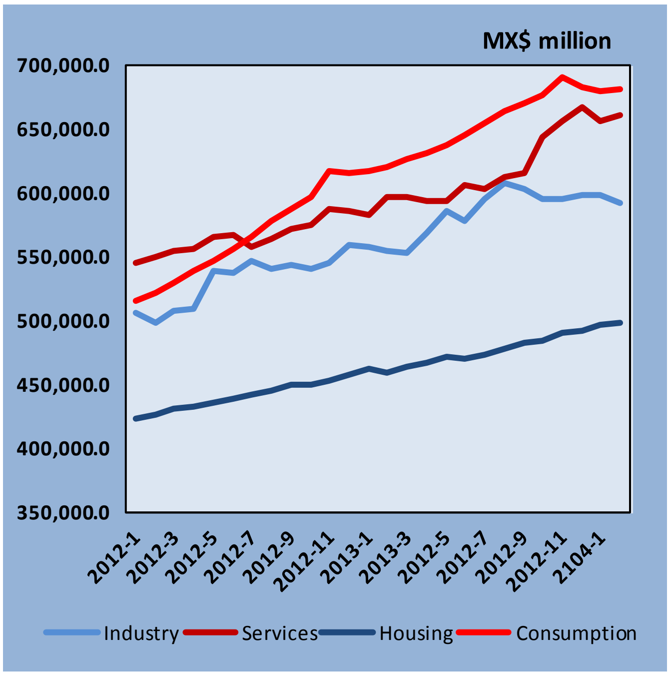
2. The labour reform, one of the final acts of the Calderon Presidency, came into force in late 2012. The purpose of the reform was to reduce red tape in labour markets increasing demand for labour, thus increasing employment

and real wages. However, there has not been an increase in employment for labour since the reform, with unemployment figures continuing to fluctuate between 4.5% and 5.5%. The percentage of the labour force working in the informal sector has also remained the same since 4Q2012, around 28%. Finally, the average real wages of workers in the formal sector has also remained constant, which means the overall productivity of labour has stagnated. Whilst this has been disappointing, the Government has said that other measures, such as an increase in foreign investment and further competition policy, will help to increase employment in the long term.

3. On a more positive note, the effects of the fiscal reform have started to impact positively on federal Government tax revenues, with income for January and February 2014 increasing 8.1% from 2013. For the same period, the Government obtained more revenues from three different federal taxes: income tax, value added tax (VAT) and production and services taxes. The three increased by 14.5%, 12.4% and 6.8% respectively. Even when oil revenues from the same period decreased 1% and inflation was close to 4%, the growth rate of public sector real revenues for this period was 3.1%. But the reform is likely to reduce consumer confidence, as the majority of new taxes will have an impact on household consumption. Positive spill over effects could compensate for the short term effects if the Government uses these new revenues to provide better infrastructure and public services. It is too early in the year to evaluate the quality of public expenditure.

4. The original aim of the financial reform was to increase the availability of credit for economic activity by reducing interest rates, giving positive incentives to financial institutions to lend, and reducing their risks in cases of defaults on loans. Although it is too soon to see the full effects of the reform, implemented in November last year, credit from commercial banks during the first months of 2014 was sluggish, with credit to the private sector during January 2014 decreasing from December 2013. Consumption credits, as a share of the total credits of commercial banks for the private sector, have increased their share (27%).

Chart 2: Commercial banks' credit to private sector



Source: Bank of Mexico

5. Secondary legislation for the competition reform was approved by the Lower Chamber on 25 March, and is currently being discussed in the Senate. Laws for telecoms and energy will be discussed during April, the latter in an extraordinary session as a result of the busy legislative agenda. The Government's proposal for the telecoms secondary legislation is controversial, with opposition congressmen claiming that the reform now protects Televisa by setting restrictions and entry barriers to the sector.

6. The secondary legislation for the energy reform will be heard last, although PEMEX has already launched its proposal for "round zero" (the initial stage of a process to allocate oil fields for public as well as private firms). This proposal names the oil fields PEMEX hopes to exploit during the next 15 years (which amount to 83% of proven reserves). The National Commission for Hydrocarbons and the Ministry of Energy will now determine if PEMEX has the technical capabilities to exploit efficiently the selected fields.

7. Last but not least, the education reform has not been fully implemented nationwide, due to the lack of reliable information necessary to implement a comprehensive strategy. The National Institute for Statistics and Geography did a census of teachers and schools in late 2013. It found that around 39,000 teachers registered on the Federal Government's payroll did not exist. The Ministry of Education will now enforce sanctions against 'teachers' who participate in this type of labour fraud. The same census measured educational infrastructure,

finding that seven of every ten schools didn't have internet access. Whilst the education reform doesn't cover infrastructure needs, savings in the wage bill from these non-existent teachers can be redirected to increase the resources available for infrastructure projects. The reform should also go some way towards tackling corruption within the teacher's union, one of the main underlying causes of falsified statistics exposed by the census.

Policy in focus 1: Century sterling pound bonds

8. On 12 March 2014, Finance Minister Videgaray announced the release (that day) of £1bn (MX$21b) worth of 100-year sterling sovereign debt bonds on the London market, at a fixed interest rate of 5.75%. The bond, which is graded at A3, was seen as an indicator of the level of confidence in the Mexican economy over the longer-term. The sale, which was orchestrated by Barclays and Goldman Sachs was a success, with the demand for bonds 2.5 larger than the amount offered, and 163 investors participating in the sale.

9. This was not the first time that the Mexican Government had issued a sovereign bond in a foreign currency. In 2010, Mexico issued a 100-year dollar bond with a yield of 6.1%, raising US$1b. In issuing their sterling bond Mexico might have taken inspiration from Electricite de France SA, a French firm partially owned by the French Government, who issued a bond in sterling this January. The fact that Mexico's sterling bonds have an interest rate 0.4 percentage points lower that the dollar bond sale shows a higher degree of confidence in the Mexican Government in the long term. Mexico is the only country in the world with two 100-year bonds issued in a foreign currency.

10. The success of the sale, according to the Government at least, was a result of an increase of confidence in international markets caused by the approval of the energy reform, in a context of financial volatility in emerging markets. The Mexican Government could increase the amount of bonds offered if growth figures improve throughout 2014, and if Mexico remains shielded against financial volatility.

Policy in focus 2: the social security reform

11. On March 19 2014, the Lower House approved the Law of Universal Pensions and the creation of unemployment insurance for all within the formal sector. These reforms were presented last year along with the fiscal reform, which was justified as necessary in order to obtain sufficient resources to finance these schemes. However, critics of the reform and the new schemes point out that in reality only 2% of the new revenue raised will be directed towards these social safety nets.

Table 1. Poverty and social deprivation for people older than 65 years old (2012)

	% of population	Million
Poverty	45.8	4
Extreme poverty	9.7	0.8
Moderate poverty	36.1	3.1
Without access to health services	15.7	1.4
Without access to social security	26.5	2.3

Source: CONEVAL, 2013

12. Although there is a broad consensus on the need for a better security net for the poorest, and unemployment insurance the opposition have criticised the resultant legislation. For example, the Law of Universal Pension creates a monthly cash transfer of MX$580 for elderly people, to be upgraded every year according to inflation, and eventually reaching the amount of MX$1092 in 15 years. The beneficiaries will be those over 65 who have been living within the country for more than 25 years. The pension will cover people without social security and people with monthly pensions below MX$1092. The only condition to staying in the programme is that one undergoes free monthly health checks.

13. Whilst this might seem a positive move (and in many ways it is), if the amount of the pension is compared against the most basic needs of the elderly, the amount of the pension is insufficient. According to latest figures on poverty published in January 2014 by the National Council for the Evaluation of Social Policy (CONEVAL), a basic food basket costs MX$868 pp in rural areas and MX$1,227 pp in urban areas. The cost of a basket of basic goods (food, education, health, transport, housing and clothing) is MX$1,622 pp in rural areas and MX$2,542 pp in urban areas. This means the impact of this reform in isolation will not be significant, as the monthly amount by itself is not enough to lift elderly people out of extreme poverty. Besides, people with a current income higher than the maximum amount allowed by the Law (MX $1092, $135 under the extreme poverty line for urban areas) will not be part of the programme, which means that the programme will not be focused to reduce the numbers of those in moderate poverty, which is MX$2,542 for urban areas.

14. The unemployment insurance is aimed at helping workers who have been unemployed for more than 45 days, and have no other source of income. The maximum duration of the insurance is six months. The reform was controversial as it will be financed by the monthly savings of the worker allocated to their housing fund. The employee will decide the amount of resources saved for housing to be used in the insurance. The main criticism is that the Government doesn't fund the insurance with general taxes, which is a common practice in most developed countries. This means that the provision of the right to receive the insurance is received at the expense of the right to acquire a house. Paired with that, the reduction of savings will affect the demand for housing services, affecting the already depressed construction sector.

Monthly Economic Monitor

15. In terms of growth, the survey for March registered again a downgrade in expectations, with the expected growth rate for 2014 falling 0.14 percentage points as a result. The reasons behind this lower rate are the stagnation of aggregate demand. GDP grew only 0.8% during 1Q2014. Whilst the survey for February had a 3.23% and 3.91% forecast for 2014 and 2015, in February the forecast for 2014 fell to 3.09% and for 2015 it increase to 3.92%.

16. The inflation forecast for 2014 decreased to 3.92%, and expected inflation for 2015 fell to 3.57%, returning to Banxico's benchmark. The reason behind this adjustment was the one-off increase in prices caused by new taxes being enforced at the beginning of the year. This information confirms the forecast for inflation reported in January and February economic reports. In March, the Bank of Mexico decided to maintain their target interest rate unchanged, given the gloomy forecast for Mexican GDP. Lower expected inflation and limited negative effects from FED's QE could help Banxico maintain a more expansive monetary policy during 1H2014.

17. Expectations for the Mexican peso (MXN) reflect a limited effect of QE and a solid financial situation. The expected exchange rate marginally increased, with the MXN expected to end 2014 at $13.01 per US dollar (just 8 cents higher than the previous survey). The probability of the exchange rate overshooting remains low.

Consensus Forecast (Jan 2014)	2014	Vs. Dec 2013	2015	Vs. Dec 2013
GDP (growth)	3.09%	⇩	3.92%	⇧
Inflation	3.92%	⇩	3.57%	⇩
Exchange Rate (year-end)	13.01	⇧	12.95	⇧
Source: Bank of Mexico survey on private sector expectations				