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BRITISH EMBASSY
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Economic Overview: July 2014

Summary

- The National Institute of Statistics and Geography (INEGI) published the results of their Global Indicator of Economic Activity. The economy is recovering from a sluggish first quarter but lacks the dynamism to keep up with expected growth rates. The annualised growth of the economy in May 2014 was 1.4%. However, taking into account seasonal effects, May's figures suggest a weak recovery, since the economy fell 0.12% between April and May this year. The construction sector is still in crisis, affecting growth expectations.

- The Mexican Congress has approved the secondary legislation of the energy reform. The reforms will increase the financial independence of PEMEX, but its tax burden will also need to be reduced to help its competitiveness. Three elements will be key to successful implementation: strong regulators, an independent judiciary and a coherent tax scheme for private investment.

- INEGI published for the first time their official figures on the impact of informality on GDP by sectors and regions. 60% of the informal workforce only produces one quarter of the national production, meaning large differences in productivity between formal and informal workers. If this is not addressed, it will be harder to increase growth rates.

Macroeconomic Overview: data from 2Q suggests slow recovery

1. On 24 July 2014, The National Institute of Statistics and Geography (INEGI) published the results of their GDP proxy (Global Indicator of Economic Activity) for April and May. The year-on-year growth in the economy in May 2014 was 1.4%. However, correcting by seasonal effects, May’s figures suggest a weak recovery, since the economy fell 0.12% between April and May this year. The most dynamic sector is the primary sector, which grew 2.7% year-on-year. However, the share of agriculture in GDP is negligible (3%). Growth in the industrial and services sectors was sluggish during the 1H2014. One of the reasons for this is the lower-than-expected growth of the American economy during this period. This month, the IMF downgraded the 2014 growth prospects for the US.

2. There is an unbalanced growth path within the industrial sector. While the manufacturing sector is starting to recover its dynamic pace, construction and mining still show a declining trend. The construction sector is labour intensive and has been the weakest sub sector during the last couple of years. During the first semester of 2014, the biggest construction firms started to report positive profits (though marginal). With new government urban regulation, the subsidies for social housing will privilege used houses and vertical construction near to urban centres. Firms in the sector are reducing their demand for unskilled labour, which means fewer jobs created in a very labour intensive market.

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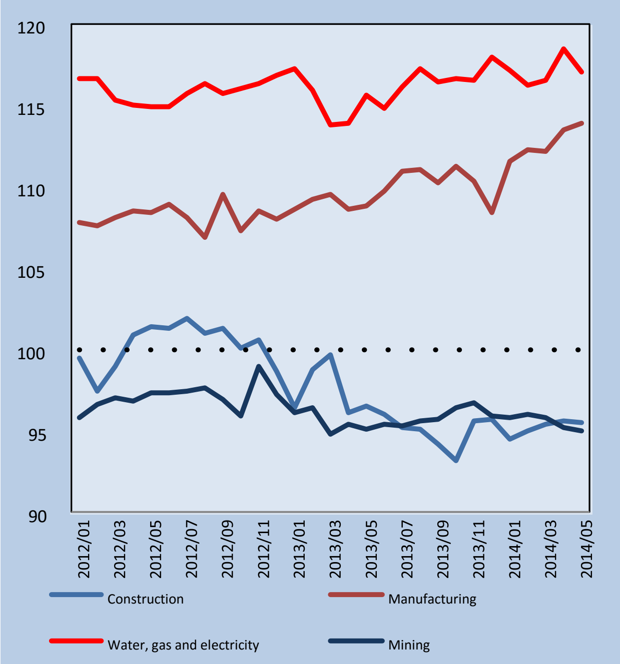
3. The figures on aggregate demand components are positive in April, suggesting higher growth rates for the second half of the year. From March to April, the monthly indicator of domestic private consumption grew 2.17%. For the same period, consumption of both national and imported goods and services increased 1.7% and 3.3%, respectively. In terms of gross fixed investment, the country experienced a heavy decrease in national machinery and equipment purchases in March. Nevertheless, the latest figures for April suggest a recovery in which the index of gross fixed investment grew 1.3%.

4. Even if the economy is showing some signs of recovery during the 2Q2014, the growth rates are still very low compared to the expectations created by talk of the “Mexican Moment” last year. The GDP proxy only grew 1.4% yoy, less than the 1Q2014 growth rate (1.8%). It will be difficult to achieve the goal set by the Ministry of Finance (2.4%) if the economy keeps underperforming during the second half of the year.

Chart 1: Global Economic Indicator for the industry (base 2008=100)

Source: National Institute of Statistics and Geography.
Time series corrected by seasonal effects



Policy in Focus 1: The political economy of the energy reform

5. The Mexican Congress has approved the secondary legislation of the energy reform. In addition to the commercial opportunities that will be available for domestic and foreign investors, there are significant implications for the economic performance of the country as well as for the Government's public revenues.

6. The reform will change the financial rules governing the Mexican state owned electricity (CFE) and oil firms (PEMEX). They will now be able to allocate and administer their own budgets and take investment decisions independent of the Ministry of Finance. CFE and PEMEX's management boards will also have the freedom to construct their own investment plans, create their own labour and HR policies, and access international capital markets without any interference from the Ministry of Finance. Their only constraint will be a one-off set of general guidelines established by the Finance Ministry and Congress. Given the significant pay and benefits structure of both companies, this ability to re-structure their pay and benefits system should, to some extent, allow them to increase profits, at least in the short term.

7. In another effort to help the state owned companies become more competitive, the labour liabilities of both PEMEX and CFE (approximately GBP£55b to be paid in the next 20 to 30 years, approximately 10% of GDP) will be relabelled as public debt, to help them approach the international markets to negotiate new loans. The Government will absorb 30% of the liabilities as debt. The Government has, however, imposed a set of conditions to reduce the burden in the future (increased retirement age, an individualised pension scheme and a reduction of benefits for PEMEX and CFE unions).

8. The goal of these changes is to improve the competitiveness of these State-owned firms vis-a-vis international energy companies, but. PEMEX's tax burden is still the main obstacle to achieving financial sustainability; between 2006 and 2012, the average fiscal burden of PEMEX represented 68% and 90% of its gross and net revenues, respectively. Since between 30% to 35% of the Government budget (now 4.7% of the GDP by law) comes from PEMEX, the Government will be looking to maintain a balance: maintain its main source of non-tax revenues and

allow PEMEX to become a competitive firm. The fiscal reform is effectively capturing new sources of revenue, but they will not be enough to substitute the revenues from PEMEX.

9. The secondary legislation includes a wide range of measures aimed at addressing this and securing additional government revenues – including establishing taxes and quotas for private investors in the hydrocarbon sector. However, their success will be contingent on a number of factors. First, strong regulation is needed to ensure that the conditions of the contracts are not detrimental to the State (i.e. positive conditions that allows the Government to obtain a significant share of the oil rent). The Energy Regulation Commission and the National Commission of Hydrocarbon will need more human resources and expertises to regulate as a suite of new big players enter the sector. Second, independent judges are needed to solve commercial disputes around compensation. Finally, there is a risk that the tax rate for private companies will create perverse incentives and underinvestment. The law establishes a progressive tax rate for private companies: as the project becomes more profitable, the compensation paid will increase as a share of net profits. However, if this rate increases more than the marginal profits of the project, the optimal amount of gross profits of the firms could be less than the optimal amount for the Government.

10. A much discussed point in the secondary legislation is the relationship between the companies exploring or exploiting oil and the original owners of the property. The companies are required to sign a contract with the owners establishing the conditions for the use of land. The firms will have to pay a rent in the form of a fixed amount of money, plus a share of the gross profits which will vary from 0.5% to 3%. Both firms and owners have expressed concerns about this enforced partnership. The energy companies argue that the landowners share in the profits but not the risks. Several rural land owners and workers organisations argue that companies will take advantage of the asymmetric relations of power levels in the negotiations. Companies are also concerned about the negotiations process, as they believe that municipal authorities and local leaders could increase the transaction costs of doing business. This is of significant importance to the development of shale gas in northern Mexico, where US gas prices are still low in comparison.

Contracts with private firms

11. The law establishes three new types of contracts: licences, profit sharing and production sharing agreements. In all cases, the firms will need to compete in an international public tender to win the contract. In the case of licenses, winners should pay a bonus on contract signature. For all the contracts, companies will pay the Government an exploration fee during the first stages of the project. When the project reaches the production stage, the firms will then pay royalties in the form of a fixed percentage of the production value and a compensatory amount. The latter will be based on a share of the operational profit over a given period or as a percentage of the volume of oil extracted. In addition to these fiscal rules, companies will have to pay general taxes such as income tax, value added tax and corporate tax.

12. However, companies will be able to reduce the compensations paid to the Government by outlining their operating costs in the contract, and deducting these. There will be a cap on what operating costs can be deducted as a share of gross profits. Companies will also be allowed to carry losses for ten years which will be deducted from the compensation paid.

Electricity market

13. Finally, the electricity sector will also be liberalised. There will be three different ways to market for suppliers: they can sell their capacity directly to the state owned CFE at a fixed price; they can sell directly to private companies in the form of long terms contracts with an agreed price; or they can sell their capacity on a spot market with prices

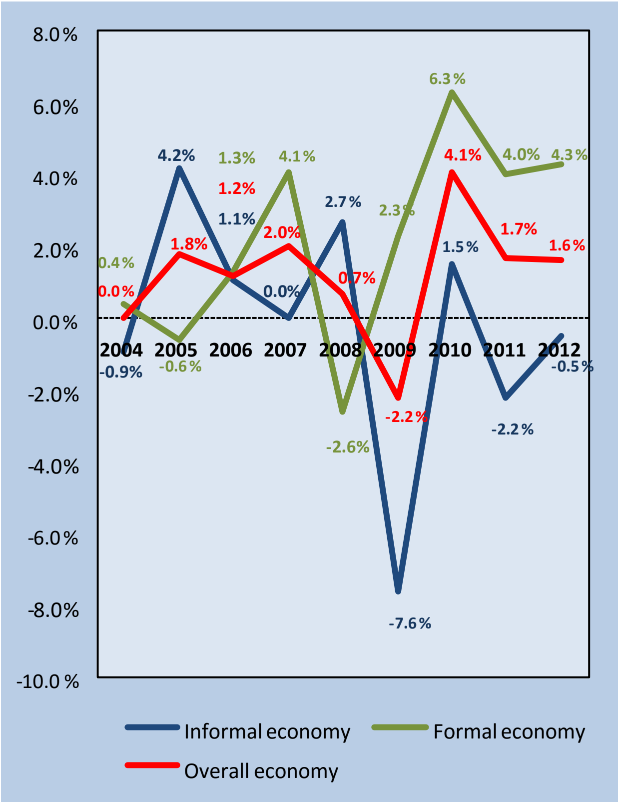
set by the Energy Regulation Commission (CRE). Whilst companies will be able to buy electricity from private suppliers, households will continue to buy their electricity from CFE (at least in the short term).

Policy in Focus 2: Informality in Mexico

14. On 30 July, INEGI published for the first time their official figures on the impact of informality in GDP by sectors and regions. The informal economy is characterised by small production units not registered for tax or social security purposes; often involving the absence of labour contracts, a lack of access to basic benefits or social security, and a blurry distinction between production factors (capital and labour). The definition used by INEGI also includes jobs within formal firms that do not have proper social security, such as subsistence agriculture and domestic work. The definition does not include illegal economic activities.

15. According to INEGI, in 2012, 25% of Mexico's GDP was produced in the informal economy. However, 59.8% of the occupied labour force works under conditions of informality. This explain why Mexico is not growing at higher rates. The fact that 60% of the informal workforce only produces one quarter of the national production implies that the productivity amongst informal workers is almost 2.5 times lower than that of formal workers. Differences in productivity could be caused by the financial restrictions that informal workers face, the lack of incentives to increase the size of their businesses, and differences in levels of education and human capital between the formal and informal workers.

Chart 2: Productivity growth rates between formal and informal sector, 2004-2012



Source: National Institute of Statistics and Geography. The productivity was calculated a the gross added value per job position

16. There are also structural causes behind informality. The scarcity of credit for SMEs in Mexico is one of the most important barriers to increasing the scale of the firms. If firms remain small, they have more incentives to avoid taxes and engage in informal labour contracts as it gives them the flexibility to resist negative shocks. Also, the process of opening and registering a formal business in Mexico is long and bureaucratic compared to other regions of the world. Finally, the social security system in Mexico is linked to the legal status of the worker. Social security is financed by the Government, the employer and the worker on a tripartite basis. In addition, the government has social security programmes for people living in informality, which do not require any quota from employers. This discourages employers from formalising the status of their employees. And can be seen as a tax on social security for formal workers and a subsidy for informality, providing more incentives to shift to, or remain in, the informal sector.

17. Successfully implementation of the financial regulation to make sure that commercial banks are providing the necessary capital to SME should also help as would the health reform, a key element of the government's reform agenda. This has yet to be discussed, but would, if passed, create a universal healthcare system, independent from

working status and financed by general taxes. A coherent social security scheme, such as this, if well implemented, would align the right incentives to increase the demand for labour in the formal sector, therefore reducing informality.

Monthly Economic Monitor

18. Banxico's July survey registered a downgrade in GDP growth expectations, decreasing them from 2.65% to 2.56%. It seems that there is a strong downward trend in the survey which will continue through the end of the year. Whilst the June survey had a 2.65% and 3.87% forecast for 2014 and 2015, in June the forecast for 2014 and 2015 fell to 2.56% and 3.85%, respectively. The forecast took into account the downgrades made by the IMF to Mexico and the US.

19. The yearly inflation forecast for 2014 slightly decreased to 3.78%, and the expected inflation for 2015 marginally decreased to 3.48%, within Banxico's benchmark (3%+/-1). It is worth mentioning that there are no signs of inflationary pressures caused by the decision to cut the interest rate by half a point a couple of months ago.

20. Forecasts for the Mexican peso (MXN) reflect a solid and stable currency and a more optimistic environment during the year for emerging markets. The USD/MXN year-end expected exchange rate for 2014 is 12.95.

Consensus Forecast (June 2014)	2014	Vs. May 2014	2015	Vs. May 2014
GDP (growth)	2.56%	⇩	3.85%	⇩
Inflation	3.78%	⇩	3.48%	⇩
Exchange Rate (year-end)	12.95	=	12.89	⇩
Source: Bank of Mexico survey on private sector expectations				