Initial Thoughts on Mexico's Budget

- **Budget targets a sensible 1.0% of GDP, in line with expectations.**
- **Economic assumptions appear ambitious and will make it challenging for the administration to meet its fiscal objective. Execution risk is high, and markets are unlikely to give the administration much breathing room if results fall short of plan.**

At first glance, the newly submitted Mexican budget looks prudent, and probably would have enjoyed a "benefit of the doubt" from global investors before the month of November hit confidence in the new administration hard. However, we fear that following the airport cancelation, the initial rejected MEXCAT bond offer, the referendums, and the signals that the government will move forward with all its spending pledges from the Presidential Campaign—the government has dented the confidence markets had in it, and our sense is this budget did not do enough to restore that dented credibility. In particular, we think that assumptions that could have been given the benefit of the doubt back in October, may face deeper scrutiny now.

Overall, we don't think the budget will fully restore market confidence in the administration as we think the targets of a 1.0% of GDP primary surplus could be missed by 25bps–75bps of GDP, and PSBR of 2.5% of GDP are likely to be missed by 50bps–120bps of GDP. These misses on their own, may not trigger credit rating downgrades for the sovereign—but in conjunction with what market sees as "waste of resources", building what is seen as a financially unviable Mayan train, the Tabasco (and later on potentially Campeche) refinery, as well as other decisions such as canceling the Texcoco airport, could tip the balance for the start of a credit rating downgrade spiral. Also not helping, are likely to be the more uncertain business environments that a number of proposals by the Morena faction in Congress have made—and are likely to continue to do—alongside the policy management and ideas of the more radical members of the Cabinet. Even if this is indeed the case, we would be surprised to see downgrades take place before late–2019, or early 2020. Our take is the following assumptions are part of what we see as risks in this initial read of the budget:

- Growth for 2019 is assumed at 2.0% (a range of 1.5% to 2.5%). Our sense is this assumption is where consensus comes from, but with investor and corporate confidence shaken materially by a number of questionable decisions in the past 6 weeks. Our sense is that 2.0% is now "where we come from", rather than where expectations are going. We expect investment by the private sector, and new employment will be severely dented by the decisions and policy proposals of the past few weeks, which is gradually being reflected on private sector forecasts. It was always tough for a new government to kick off with a 1.0%–1.5% growth forecast, especially one that promised broad based prosperity, but at this point markets need reassurance that the new administration will be prudent, so a lower forecast would have been better on the confidence front.

CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

- Inflation is expected at 3.4% for 2019, which we are highly skeptical of. The argument is that this is the last forecast we got from Banxico (true), but given the uncertainty, and the volatility we've seen in MXN, we expect inflation will be higher than this. Related to inflation, the government is also assuming cetes rates at 8.3% (both average and end of period), which we are skeptical of. We would not be surprised if given the turn in Banxico's rhetoric, and rising FX volatility, we sit at 8.5% by next summer. If the new administration fails to restore government confidence, we could see 9.0% rates by the end of next year (or even higher).

- The price of the Mexican oil basket is assumed at US$55/bl, which is reasonable.

- The financing costs of the government are only seen rising from 2.8% of GDP in 2018, to 3.0% in 2019, which seems optimistic. The government will need to roll-over and issue about US$100bn of debt (roughly 1/6 of the total), and the peso curve has widened over 200bps, and could move more. Also, a continued weakening of MXN could hurt on dollar debt costs—although a weaker MXN also helps through oil-related revenues.

- On the public finance front, tax revenues are assumed to grow 7.0% y/y in real terms, which we think may not materialize due to: 1) growth may be weaker than the new government assumes, 2) the new administration's strategy to rely on citizen good will to collect taxes on SMEs may undermine tax collection, 3) the loss of experienced middle management in the government risks undermining the effectiveness of the government, including on tax collection.

Here is how much we think the above questions could cause in deviations from the proposed budget results:

Variable	Potential deviation in the assumption	Potential cost
Growth assumption	We believe growth could come in 50bps–150bps below the government's assumption	This would imply a hit to the budget of 6bps–18bps of GDP in the fiscal results
Interest rates	We fear the yield curve could end up trading 200bps–300bps wider than the government assumes	This would imply a hit to the fiscal results of 26bps–39bps of GDP
Tax collection undershooting	We think that a number of changes in the tax collection strategy, such as the border region tax incentives, and relying on the good will of SMEs to voluntarily pay taxes could result in lower tax revenues	Undershooting tax collection objectives could cost between 20bps and 60bps of GDP for the fiscal results

We would argue the more moderate members of the cabinet have their work cut out, trying to offset the headwinds caused by their more radical party / cabinet members. The bottom line, is we think the government will miss its budget targets by 50bps–120bps of GDP, assuming a form of inertial scenario, where confidence is dented—but not destroyed, and one in which the external environment remains supportive.

Besides the results on the fiscal accounts per-se, it will be important to monitor the evolution of the AMLO government's new programs. Some that we think should be watched closely include: 1) AMLO's youth employment program should be monitored to determine whether the youths are indeed employed by formal private sector employers (this program was allocated MXN44.3bn in 2019), 2) the impact on pledges to double elderly pensions on long run pension calculations is worth watching (for 2019, the program was budgeted MXN100.0bn). We did not yet see where the cost of the new refinery will fall.

We don't expect any credit rating downgrades. If we get to that stage, the task to stabilize public finances becomes materially more difficult. Taking into account the experience of emerging markets that have allowed fiscal slippage to kick in, it's possible to go from BBB / BBB+ to junk rated in 1.5–2.5 years. Thankfully, besides a reasonable fiscal stance, the new administration also inherited large positions in the oil stabilization funds which have about 1.5 points of GDP to absorb shocks. Hence, a loss of investment grade at this point looks quite remote.