

Mexico... failing to keep up with the Joneses

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A recent trip to Mexico leaves this visitor with the disappointing feeling that the country is standing still, whilst its Latin neighbours pass it by. With the notable exceptions of Argentina and Venezuela, the rest of the region has made strides forward in macroeconomic stability, reform and capital market accessibility. Progress has been reflected in upward trending sovereign ratings from the major agencies – Brazil and Peru attained investment grade in 2008; Colombia is on track to regain investment grade in 2010. Yet Mexico is threatened with ratings downgrades.

Once again the country's political elite find themselves having to debate a fiscal reform, having spent years dodging the issue or enacting weak reform. The problem is twofold. First, Mexico's tax take is a paltry 9% of GDP. The government argues that consumption and property taxes are very low by OECD standards, but a figure of 9% suggests that few bother to pay. Second, the government gets 40% of its budget from taxation of state oil company PEMEX, which is facing declines in output after decades of over taxation and underinvestment. The government coffers are under pressure. In Mexico's worst recession for decades (GDP could fall 8% in 2009) the government is having to cut fiscal spending, despite the global fashion for fiscal pump-priming. Fiscal problems are already evident at the state level, with the states lacking the crutch of PEMEX and reliant on transfers from central government.

Last week, finance minister Carstens delivered a sobering budget preview for 2010. He stated that GDP in 2010 will be below that of 2008, implying lower non-oil tax revenues. Oil output will fall 23% between 2006 and 2010 as PEMEX's fields age rapidly. In 2004, PEMEX oil production was 3.4m barrels per day - it is now 2.6m and likely to continue falling. Furthermore, the minister commented that 60% of Mexico's stabilisation funds will be used this year. Mexico's fiscal deficit is heading towards 2.5% to 3%, by no means out of control, but high by historical standards and the law mandates a balanced budget. So either Mexico runs a deficit into 2010/2011 or it cuts spending and raises taxation... in a very weak economy.

The minister's comments are aimed at both houses of congress, pushing them to enact much needed fiscal reform. Yet the record here is not promising – we are already hearing the same strategy that has proved too politically difficult in the past, namely to introduce VAT on food and medicine. Surely somebody in the ministry of finance could show a little more imagination! Now that the lower house is controlled by the opposition, watch for some fiery negotiations and we are not optimistic on the outcome. Long term, these budgetary constraints restrict investment in economically productive projects (such as infrastructure and education), reducing the economy's overall potential growth rate.

Mexico is also failing to keep up with the neighbours in the development of its equity capital market. Few new companies list on the equity market. The market capitalisation of Mexico's equity market relative to the country's GDP is a mere 23%. According to recent figures from Deutsche Bank, the average emerging markets market cap to GDP ratio is 60% (Brazil is at 51% and Chile is 69%). Perhaps more tellingly, in 2002 Brazil and Mexico had similar ratios of 15% and 11% respectively. Brazil's gain relative to Mexico reflects the recent vibrancy of its capital market – in that seven year time period Mexico saw just \$5.8bn raised on its equity market compared to \$66.5bn in Brazil. A few large firms dominate the main sectors in the Mexican economy and this concentration likely stifles the growth of small business development and entrepreneurial culture. However, the structure of capital markets and their participants is also a hindrance.



Mexico's pension funds (Afores) hold very low equity holdings in their overall asset allocation (11%), yet the demographic profile of their clients is very young. They are not permitted to own individual stocks for their investors, instead having to buy a market index tracker, yet they can buy private equity?! Something looks wrong to this author. Can the rapidly growing pool of domestic savings be effectively channelled into listed equity capital for businesses under these constraints? Hardly likely. The development of an equity ownership culture has been a long and winding path. Perhaps PEMEX's plan to offer "citizen bonds", a part fixed-coupon bond, part coupon linked to PEMEX profits, can be a positive step in broadening ownership across society.

These issues are not insurmountable and in the context of the meltdown in fiscal ratios in developed countries, should not be overplayed. But, it feels like a country rich in oil, with 120m people, most of them young, connected to the world's largest economy by a border and a free trade agreement, should be making more of its opportunities. We await reform with optimism... but low expectations.