



Mexican Reforms: measurable progress

SUMMARY

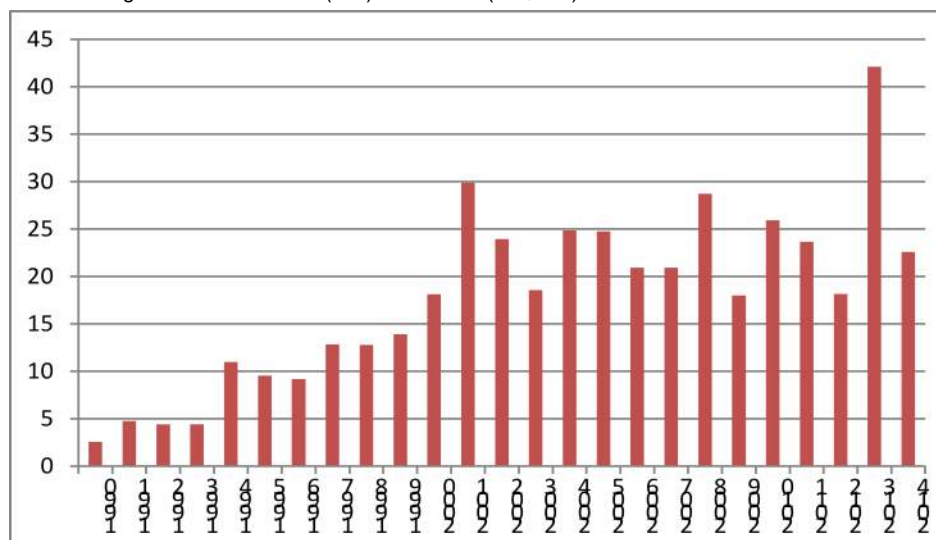
- Since December 2012, there have been more second stage reforms in Mexico than in the 20 years since first stage reforms were approved. They also distinguish Mexico from the other 33 countries in the OECD.
- According to the OECD, fully implemented, the reforms will increase annual GDP growth by 1% after 5 years.
- Reforms with most measurable advances are in energy, the financial system and telecommunications. Judicial, labor, educational and fiscal reforms could have an important effect but are more long term and less easy to measure.
- Energy reform has produced structural change, with estimated additional future investment of US\$62.5 bn., and lower electricity and gas costs.
- Financial reform has increased savings and finance, at lower cost.
- Telecommunications reform has produced structural change, with estimated additional future investment of US\$14 bn., and a reduction in costs.
- The reforms have possibly had some effect on Mexican GDP growth in the first quarter of 2015, and perception of Mexican country risk in financial markets.

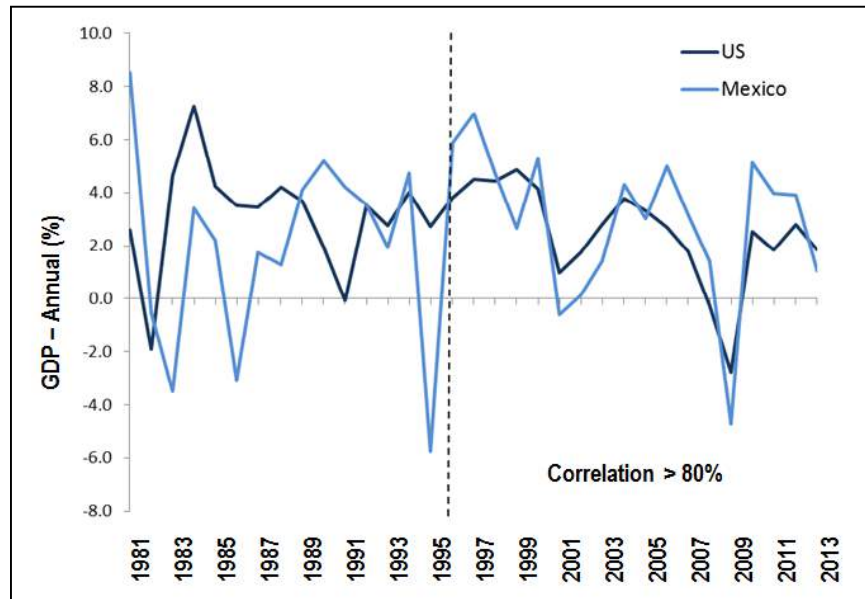
“It’s too soon to tell” - Zhou Enlai (1972), on the impact of the French Revolution (1789)

First stage reforms

After the fall of the Berlin Wall in November 1989, which sealed the failure of the socialist economic model, there were radical changes in Eastern Europe, Latin America and Asia. These so-called “first stage” reforms involved a reconceptualization of the main elements of an economy: private property and trade. In Mexico, the first reforms were passed during the *sexenio* of Carlos Salinas (1988-1994), with major privatizations, symbolized by the reprivatization of the banking system between 1991-2, and trade liberalization, symbolized by NAFTA, which entered into effect in 1994. The reforms were successful in terms of more foreign direct investment (Figure 1) and greater integration with the US economy (Figure 2).

Figure1. Mexico: Foreign Direct Investment (FDI) 1990-2014 (US\$ bn.). Source: World Bank





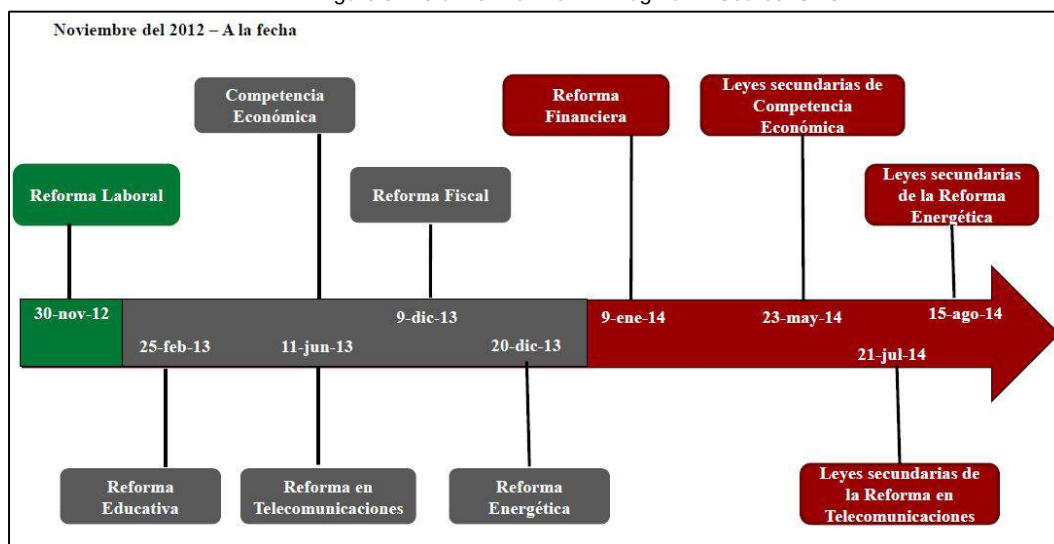
Second stage reforms

To consolidate the success of the first stage reforms it was necessary to introduce second stage, or “structural” reforms. But in spite of political change in 2000, when Vicente Fox was elected as the first non-PRI President since 1929, the reform process stalled. Furthermore, in spite of the increase in FDI and the greater linkage with the US economy, the rate of economic growth did not increase.

“Without the development of new regulatory agencies, tax reform initiatives, adjustments to trade policies, and enhancements in education, labor, and telecommunications, the prospects for economic growth engendered during the first-stage reforms might not be realized¹.”

It was 20 years before second stage reforms were passed, ironically, with the return of the PRI to Los Pinos in 2012. After the Pact for Mexico was signed in December 2012, President Enrique Peña Nieto achieved the passage of 9 important legislative changes (Figure 3).

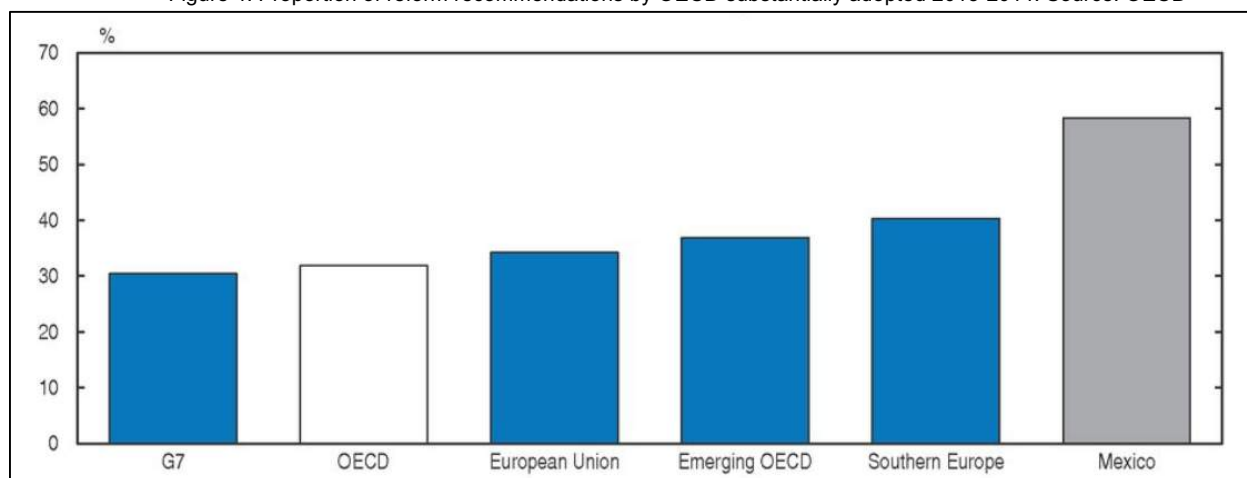
Figure 3. Reforms: Nov 2012 – Aug 2014. Source: SHCP



According to the Organization for Economic Cooperation and Development (OECD), Mexico was the member country which implemented the highest percentage of its recommendations between 2013 and 2014 (Figure 4).

¹ *Economic Policy Reform: the Second Stage*. Ed. Anne Krueger (University of Chicago Press, 2000).

Figure 4. Proportion of reform recommendations by OECD substantially adopted 2013-2014. Source: OECD²



Medium term effects

The OECD estimates the effect of reforms after 5 years (Figure 5).

Figure 5. Reforms: economic effect after 5 years, assuming immediate implementation. Source: OECD

	via productivity growth (%)	via capital deepening (%)	via employment growth (%)	GDP growth (%)
A. Pacto por Mexico Reforms:	0.41	0.51	0.03	1.0
1. Product market regulation				
a) Telecoms	0.06			0.06
b) Electricity & gas	0.32			0.32
c) Petroleum		0.45		0.45
2. Labour market reform				
Employment protection			0.03	0.03
3. Tax structure		0.07		0.07
4. Legal reform	0.03			0.03
B. Additional Reforms:	0.91	0.00	0.10	1.0
5. Judicial reform	0.50			0.50
6. Labour market reform				
a) Pro-formality reforms	0.42			0.42
b) Female participation			0.10	0.10
Total	1.82	0.51	0.13	2.0

These were the main conclusions in relation to Telecommunications, Electricity and Gas, and Petroleum:

- Fully implemented, the Pact for Mexico reforms will increase annual GDP growth 1% after 5 years.
- Over the medium term, the effect on GDP will be threefold: growth in productivity, increased investment, and employment growth.
- The study estimates minimal effects of labor, fiscal, and legal reform after the 5 year period, but that, long term, judicial and labor reforms could increase GDP growth by an additional 1%.
- It is probable that financial and educational reform (not included in the table) will also have significant effects on long term growth³.

² OECD Economic Surveys: Mexico (January, 2015)

³ The IMF differs, as it estimates that, owing to financial reform, GDP grows an additional average annual 0.07-0.16% in the period 2016-2019. IMF Country Report No. 14/319 (November, 2014).

Reforms: progress by March, 2015

In this Commentary, we analyze progress that had been announced (to March, 2015) on reforms (Energy, Finance and Telecommunications). Subsequently, we consider possible effects on the economy and markets.

Energy

The reform has three objectives: a) make the energy industry more efficient and productive, by opening it up to the private sector, b) give more financial and operational independence to Petróleos Mexicanos (Pemex) and Comisión Federal de Electricidad (CFE), openly subjecting them to regulation by independent commissions, and c) assign the surplus generated by the energy industry to a long term fund.

Constitutional change was approved in December 2013 and the secondary laws in August 2014. In March 2015, progress was announced in various areas. Pemex and CFE have been converted to “productive state companies”, through changing 26 regulations and the strengthening of two regulatory Commissions, the Energy Regulation Commission (CRE), and the National Hydrocarbons Commission (CNH). In addition four new agencies were created: the National Agency for Industrial Security and Conservancy for the Hydrocarbons Sector (ASEA), the National Center for Energy Control (CENACE), the National Center for Natural Gas Control (CENAGAS), and the Mexican Oil Fund for Stability and Development. Between 2014 and 2015, bidding rounds Zero and One have been held for hydrocarbon exploration and exploitation.

Figure 6. Estimated investment in hydrocarbons and electricity cogeneration (US\$bn.) 2014-2020. Source: Marcos y Asociados

	2014	2015	2016	2017	2018	2019	2020	Total	AGR
Pemex CAPEX	25	28	31	31	31	31	31	208	3.7
Inversión privada									
Campos maduros (20-25)	1	2	2	2	3	5	6	21	
Aguas profundas (4 bloques)	0	1	2	5	6	8	9	31	
Gas de lutitas (1000 pozos)	0	1	2	3	6	9	12	33	
Modernización de refinerías	0	0	0	2	3	5	6	15	
Procesamiento de gas y fracc. líquidos	0	0	0	1	1	2	2	6	
Ductos gas natural (10,000km)	1	2	2	3	4	5	5	22	
Proyectos cogeneración	0	1	1	1	1	1	1	6	
Proyectos petroquímicos	1	1	1	1	2	3	4	12	
Otros proyectos alm. y dist.	0	1	2	2	3	4	5	16	
Total inversión privada	3	8	12	20	29	40	50	161	
Pemex + inversión privada	28	36	43	51	60	71	81	369	19.2
PIB a precios corrientes (MMM USD)	1,280	1,331	1,391	1,454	1,519	1,587	1,659	12,966	4.4
Pemex CAPEX/PIB	1.95	2.10	2.23	2.13	2.04	1.95	1.87	1.60	
Pemex+IP/PIB	2.20	2.68	3.08	3.51	3.95	4.46	4.87	2.85	

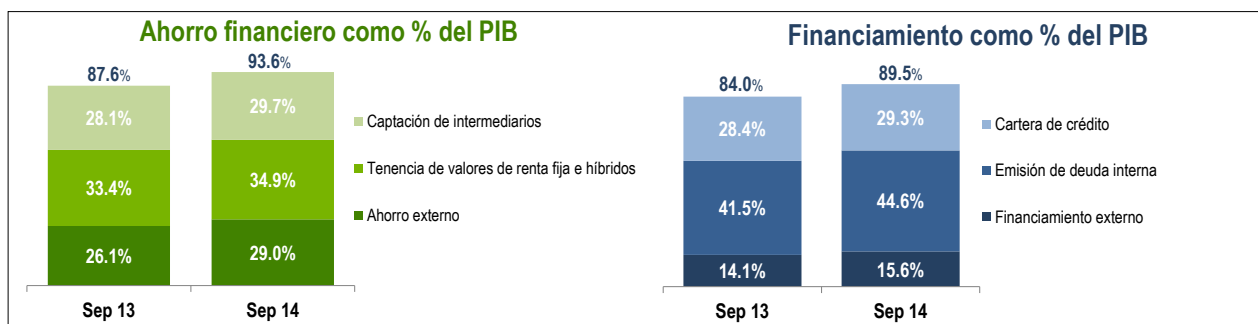
As a result, there will be an estimated investment of approximately US\$62.5 bn. in gas pipelines, Round One investment, and electricity generation and transmission; it is estimated that 212,000 total jobs (direct and indirect) will be created. This estimate is substantially reflected in estimates (Figure 6) from the independent energy consulting firm Marcos y Asociados, which were made after the two Rounds, and the 40% fall in the oil price between June 2014 and May 2015.

In addition, partly as consequence of the fall in energy prices, electricity prices have been reduced by 18-26% for industrial use, 16% for business use, 7.5% for high consumption and 2.5% for domestic consumption. Gas costs have fallen by 4%.

Financial

Financial reform has four objectives: a) increase competition, b) increase financing through the development banking system, c) improve conditions so that private financial institutions can lend more, and d) strengthen the financial system.

Figure 7. Savings and Finance Sep2013-Sep2014. Source: Comisión Nacional Bancaria y de Valores (CNBV)



Since the reform, which was approved in January 2014, savings and finance have increased (Figure 7 – complete data available in September 2014).

- Internal savings increased from 61.5% of GDP in 2013 to 64.6% in 2014.
- Internal financing increased from 69.9% of GDP in 2013 to 73.9% in 2014.

Telecommunications

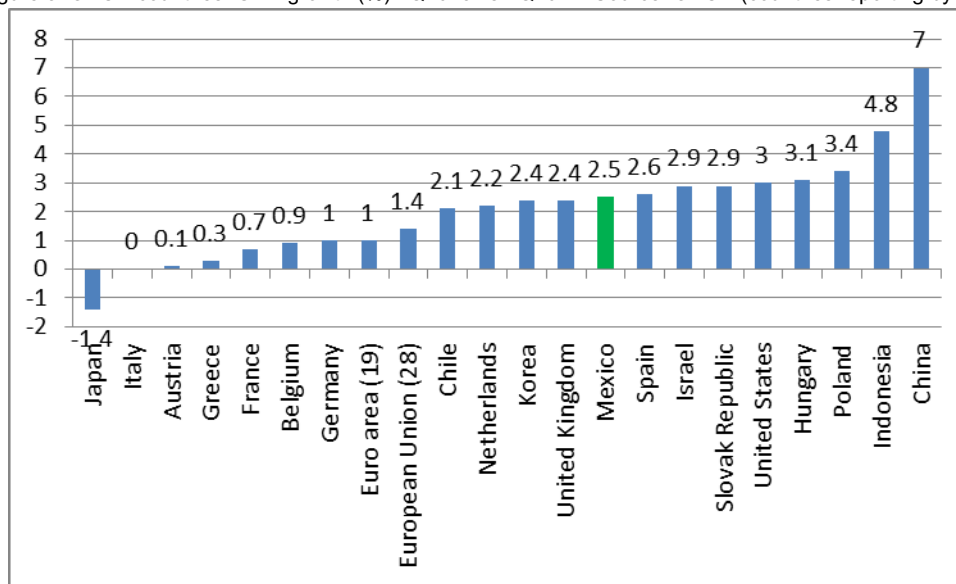
The objectives of the reform are that telecommunications and broadcasting services be provided in conditions of competition, quality, plurality, universal coverage, interconnection, convergence, free access and continuity.

Constitutional reform was approved in June 2013, and secondary legislation in July 2014. There has been progress on several fronts:

- Three regulators (Ministry of Communications and Transport - SCT, Federal Competition Commission – CFC, and Federal Telecommunications Commission - Cofetel), have been reduced to one entity with stronger powers, the Federal Telecommunications Institute - IFT.
- América Móvil has been obliged to reduce its telecoms market share to 50%, a process that has begun with the entry of ATT to Mexico, with an investment of US\$4,375 mn. through the purchase of Iusacell and Nextel.
- New national TV chains were opened for bidding.
- New investment of US\$10 bn. is planned for the project “Red Compartida”.
- National long distance costs were reduced to zero and international long distance costs reduced by 40.7%. Cellphone costs were also reduced.

Possible effect on economy and markets

Figure 8. OECD countries: GDP growth (%) 1Q2015 vs.1Q2014. Source: OECD (countries reporting by May 27, 2015)



It is difficult to attribute to the reforms any immediate effect on the economy. However, the 2.5% growth figure for Mexican GDP in 1Q2015 (vs. 1Q2014), although less than originally estimated at the beginning of 2015, was higher than several other countries in the OECD (Figure 8). The fall in Mexican oil prices and production, the rise of US interest rates, and low global growth, should also be taken into account.

It is possible that the reforms also influenced the markets' view of Mexican country risk, reflected in Mexico's credit rating, the spread on its local 10 year bonds, and the price of 5 year Credit Default Swaps, all of which appear to be correlated with a lower currency depreciation since 2012 than in other countries (Figure 9).

Figure 9. Emerging markets: peso depreciation vs. country risk data Dec2012-April2015. Source: SHCP

País	Cambio desde el 31 de diciembre de 2012 a la fecha		
	Tipo de Cambio (%)	Bono Local a 10 años (pb)	CDS 5 años (pb)
México (A3/BBB+/BBB+)	20.1	44	21
Indonesia (Baa3/BBB-/BB+)	32.3	233	34
Turquía (Baa3/BBB-/BB+)	50.6	216	103
Sudáfrica (Baa2/BBB/BBB-)	43.1	118	71
Brasil (Baa2/BBB/BBB-)	47.8	342	125
Rusia (Ba1/BBB-/BB+)	75.9	239	248
Colombia (Baa3/BBB/BBB)	39.8	126	47

Conclusion

The reforms of this administration are significant. Almost halfway through the *sexenio*, information that has been released on energy, finance and telecommunications reform is positive, and it is possible that this is reflected in GDP growth figures for the first quarter of 2015, as well as country risk indicators comparing Mexico with other emerging markets. As the OECD analysis recognizes, legal/judicial, labor, educational, and fiscal reforms are less measurable in the short term, but of even greater importance over the long term. There is still a way to go for the reforms to be generally accepted and implemented, and evidently this is the major challenge for the administration in the second half of the *sexenio*. It is possible that the mid-term elections scheduled for June 7 will give some indication of the probability of successful implementation during this period.

June 2, 2015
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