ECONOMIC ANALYSIS

The recovery of oil prices in 2017 marginally contributed to improving the fiscal and external balances

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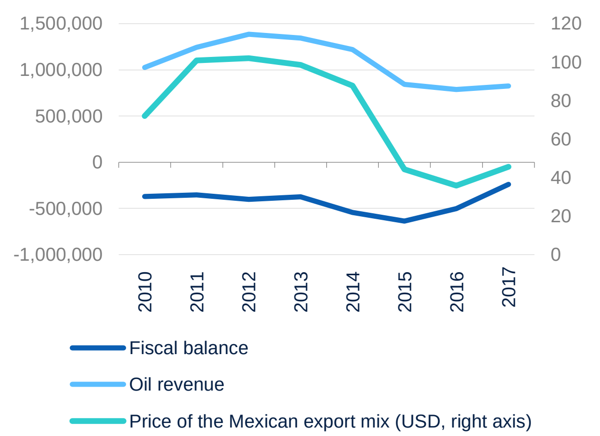
9 February 2018

- **Relatively low crude oil prices in 2015 and 2016 had a negative impact on Mexico's fiscal and trade balances in those two years**
- **Although crude oil prices recovered in 2017, the improvement in the public deficit last year was mainly due to the yearly reduction in public sector spending, and to a lesser extent, the favorable performance of both oil and non-oil revenues (including the Banxico's operational remnant)**
- **Even though this recovery had a positive impact on the value of crude oil exports in 2017, the improvement in the trade balance last year mainly followed the much smaller trade deficit in the manufacturing industry**
- **Despite the yearly increase in the value of crude oil exports in 2017, the trade balance of the oil industry as a whole increased its deficit in relation to 2016**
- **This is mainly explained by the increase in the trade deficit of refined products resulting from higher gasoline and diesel imports**
- **Although we predict that crude oil prices will continue to recover this year and beyond, their contribution to the fiscal and trade balances will be marginal**
- **Consequently, a substantial improvement in these balances will only be achievable in the medium term if the following factors continue in place: i) strong performance of tax revenues; ii) strict discipline over public spending; and iii) the impulse derived from the manufacturing export sector**

The sharp fall in international crude oil prices, and as a consequence, in the Mexican export mix, from average levels of 88 dollars per barrel in 2014 to 36 dollars in 2016, had a negative impact on the country's fiscal balance in 2015 and 2016 (Figure 1). The relatively low oil prices in 2015 and 2016 resulted in a negative year-over-year variation in the public sector oil revenues of 378,000 million pesos and 54,000 million pesos, respectively.

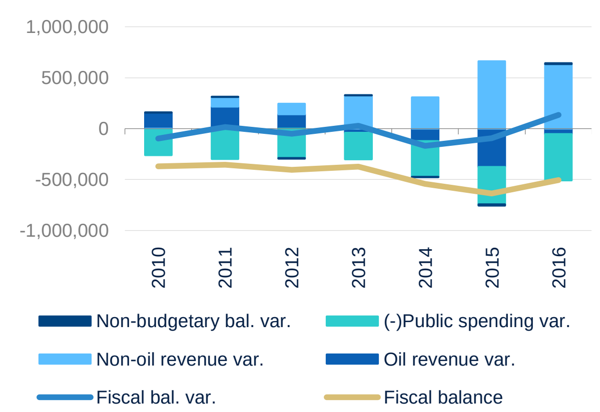
As the bulk of the reduction in these revenues occurred in 2015, the public deficit increased by 95,000 million pesos that year despite the substantial increase of 662,000 million pesos in non-oil revenues driven by the tax reform, without which the fiscal deterioration would have been significantly worse. However, the public deficit improved in 2016 due to the ongoing relatively good performance of non-oil revenues combined with the aforementioned lower annual reduction of oil revenues (Figure 2).

Figure 1. Fiscal balance and oil revenue (Millions of Mexican pesos)



Source: BBVA Research with SHCP and Bloomberg data

Figure 2. Fiscal balance and its main components* (Millions of Mexican pesos)



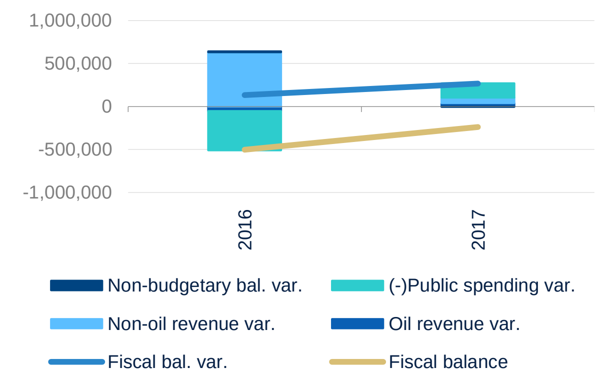
*/ The abbreviation var. represents annual variations
Source: BBVA Research with SHCP data

How has the recovery in crude oil prices in 2017 affected the fiscal balance? The cumulative flow data for January-December 2017 shows that the reduction in the public deficit is mainly due to the yearly reduction in public sector spending, and, to a lesser extent, the favorable performance of both oil and non-oil revenues (including the the Banxico's operational remnant) (Figure 3).

The significantly lower oil prices in 2015 and 2016 also had a negative impact on Mexico's trade balance. In those two years, the value of the country's crude oil exports was around 38% lower than in 2014 (Figure 4).

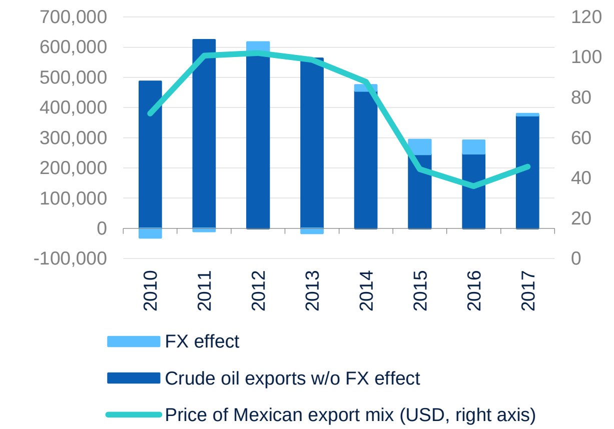
Although the recovery of oil prices in 2017 had a positive impact on the value of crude oil exports, the improvement in the trade balance last year mainly followed the much smaller trade deficit of the manufacturing industry. This deficit went from 6.848 billion dollars in 2016 to 0.989 billion dollars according to cumulative flows for the period January-November 2017 (Figure 5).

Figure 3. Fiscal balance and its main components
(Millions of Mexican pesos)



*/ The abbreviation var. represents annual variations
Source: BBVA Research with SHCP data

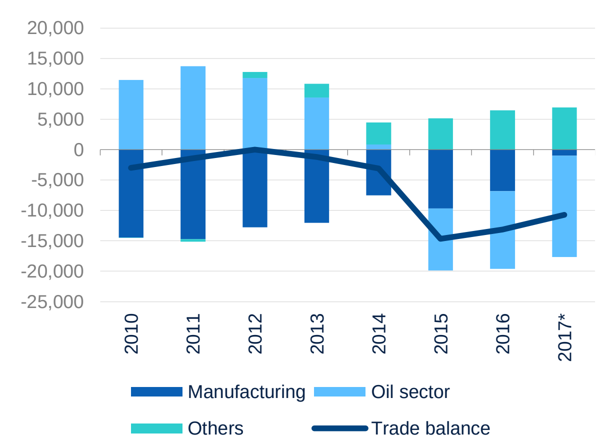
Figure 4. Crude oil exports
(Millions of Mexican pesos)



Source: BBVA Research with SHCP, Banxico and Bloomberg data

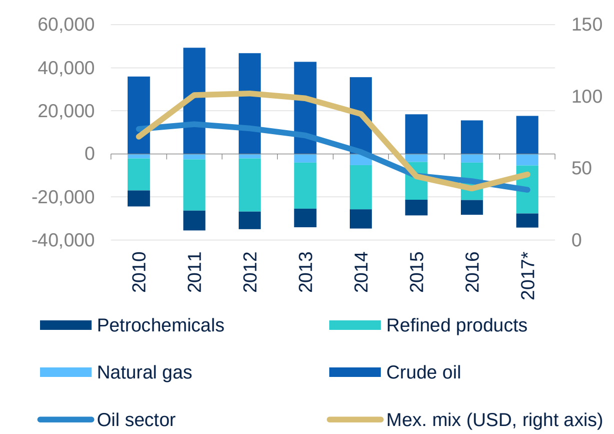
It is worth noting that the trade balance of crude oil, natural gas and refined products has shown a deficit since 2015 (historically, this balance had exhibited a surplus). Despite the yearly increase in crude oil exports in 2017, the trade balance of the oil industry as a whole increased its deficit in relation to 2016. This is mainly explained by the increase in the trade deficit of refined products resulting from higher gasoline and diesel imports (Figure 6).

Figure 5. Trade balance and its main components
(US$ million)



*/ Cumulative flows January-November 2017
Source: BBVA Research with INEGI data

Figure 6. Trade balance in the oil industry
(US$ million)



*/ Cumulative flows January-November 2017
Source: BBVA Research with INEGI data

Going forward, we predict that the gradual recovery in crude oil prices will continue as long as global supply and demand for this energy input continue to rebalance. This will end up having a positive although marginal impact on the country's fiscal and external balances. Therefore, substantial improvements in these balances this year and beyond will only be achievable if the following factors continue to be in place: i) strong performance of tax revenues; ii) strict discipline over public spending; and iii) the impulse derived from the manufacturing export sector.