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Mexico Prepares to Cut Spending as Oil-Price Drop Hits Revenue

By Reducing Spending, Government Signals It Aims to Continue Lowering Deficit

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MEXICO CITY—The Mexican government plans to make spending cuts to offset a drop in revenue from falling oil prices and prevent its budget gap from widening further, according to people familiar with the plan.

Finance Minister Luis Videgaray is expected to disclose the extent and magnitude of the adjustments in public spending for this year as early as Friday, said one of the people. The minister has scheduled a news conference Friday morning to discuss the state of the country´s economy.

Despite two decades of macroeconomic stability and strong exports, some economists have grown concerned about an increase in government borrowing since the global financial crisis.

By cutting spending, the government would be signaling that it intends to stick to its plan of gradually reducing deficits over coming years. That could allay economists' concerns that Mexico could be relaxing fiscal discipline ahead of midterm elections in July, one person said.

A senior Finance Ministry official confirmed there are plans to cut federal spending this year, and to adjust spending plans for 2016 in an effort to counter volatility in global markets. The official said two-thirds of total cuts planned for this year would concentrate on current spending, which typically excludes investment projects.

Government ministries will be required to lower operating and administrative expenses as part of the austerity drive, which could be relaxed if oil prices recover, said the person familiar with the government´s plans.

Faced with economic growth of just 1.4% in 2013, the government of President Enrique Peña Nieto widened the fiscal deficit to an estimated 4.2% of gross domestic product last year to boost growth through public spending. The wider deficit was coupled with a tax overhaul that increased non-oil tax revenue, but also slowed down economic growth.

The 4.7 trillion peso ($322 billion) budget approved by Congress for 2015 represented a 1.6% increase over 2014, and calls for a fiscal deficit of around 4% of GDP.

“Fiscal discipline was abandoned in Mexico a few years ago, and this has become more acute at present,” said Oscar Vera, a Mexican economist and consultant. “The pace at which the budget gap has widened is worrisome.”

Critics also say that relaxing fiscal discipline amid persistent violence and allegations of conflicts of interest among senior government officials could affect perceptions of Mexico’s riskiness and increase funding costs.

The federal government, which relies on oil and related taxes for around 30% of its revenue, budgeted for oil at $79 a barrel this year, and hedged about 60% of planned exports at $76.40 a barrel, intending to use money from an oil stabilization fund to cover the difference.

The problem is that the government is facing cash-flow shortages before income from hedged oil sales comes in toward the end of the year, according to one person with knowledge of the plan. The price for Mexico’s exported crude averaged $52.37 a barrel in December, and has moved below $40 a barrel in January.

Major infrastructure plans such as a high-speed rail in central Mexico and a new airport for Mexico City won’t be affected, this person added.

As part of the austerity push, state-owned oil company Petróleos Mexicanos and electricity utility Comisión Federal de Electricidad will also implement spending cuts. Energy minister Pedro Joaquín Coldwell said this week that spending cuts were being analyzed at both companies.

Part of the increased spending in the past two years has been funded with high oil prices, and some through increased borrowing, which Mr. Videgaray has defended as necessary to raise long-term economic growth.

The higher spending has had no impact so far on the government’s ability to issue debt. The government this month sold $4 billion in 10-year and 30-year global bonds, securing record-low yields, while yields on 10-year peso bonds recently touched 18-month lows, supported by demand among foreign investors.

“You don´t see widespread concerns abroad over Mexico’s fiscal discipline because other regional peers, such as Brazil, are doing much worse,” said Carlos Elizondo, an economist at Mexico’s CIDE university. “But fiscal discipline has clearly deteriorated over the past three years.”

Mr. Peña Nieto’s economic overhauls, which included historic changes in energy laws that opened the oil industry to private investment, prompted the three main ratings firms to upgrade Mexico’s sovereign-credit ratings further into investment grade since May 2103.

“In Mexico there is greater pessimism than abroad,” said Víctor Herrera, managing director in Mexico at Standard & Poor’s. “Foreign analysts and investors are less worried. When you compare Mexico to other countries such as Russia and Brazil, it’s not that bad,”.

Mr. Herrera said Mexican governments have set a precedent for belt-tightening when needed in the past. “We’ve had budget cuts before, and it wasn’t such a big deal. Growth was slowed a little,” he said.

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