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Central Intelligence Agency

Washington. D.C. 20505

DIRECTORATE OF INTELLIGENCE

14 November 1984

MEXICO: IMPACT OF LOWER OIL REVENUES

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Summary

Mexico's economy could contract again if current oil revenue losses are not reversed soon, according to our econometric forecast. In the absence of a Mexican policy response, a 10 percent fall in oil revenues would reduce projected economic growth from 2.0 percent to -1.5 percent next year; the economy would contract another 5.3 percentage points in the unlikely event oil revenues plummeted 25 percent. In either case, revenue shortfalls would further constrain depressed government spending, ability to pay for imports, consumer demand, and private investment. Rather than accept economic contraction, however, we believe Mexico City would lobby hard for more lenient IMF targets on government deficit levels. This would allow the government to increase its spending, thus limiting the dropoff in economic growth. Even before the latest weakening of the oil market, we believe that Mexico City was planning to ask the Fund for spending relief. In addition to higher spending, our econometric model suggests reserve drawdowns, lower imports and currency devaluations would be necessary to offset most of the economic losses caused by a sustained drop in oil revenues. Even with

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This memorandum was requested by the Deputy Secretary of the Treasury. It was prepared by [25X1] of the Middle America-Caribbean Division, Office of African and Latin American Analysis. It was coordinated with the Office of Global Issues. Information as of 5 November 1984 was used in preparation of this paper. Comments and questions are welcome and should be addressed to the Chief, Middle America-Caribbean Division, [25X1]

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such policy moves, prolonged difficulties in the petroleum sector could prompt a new debt crisis.

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Background

On 29 October, OPEC announced a 10 percent reduction in the organization's production quotas in an attempt to defend its light crude price. Shortly thereafter, Mexican officials publicly stated that effective 1 November Mexico would reduce its oil exports between 7 and 10 percent even though Mexico is not a member of OPEC. Mexico could avoid real revenue losses if it bases the announced cutback in oil exports on their average sales of 1984 or 1983. We estimate that sales have already been reduced 10 percent in the last six weeks by slack demand and seasonally poor weather.

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Regardless of what Mexico ends up doing, it is clear that the government is concerned about the potential impact of falling oil prices. Indeed, in strategy sessions preceding recent OPEC meetings, Mexico played a prominent role. For example, Secretary of Energy, Mines and Parastatal Industries Francisco Labastida joined Saudi Oil Minister Yamani and his Venezuelan counterpart on an unsuccessful visit to Lagos to request that Nigeria reinstate the OPEC price.

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This increasing coordination with OPEC is prompted by the high financial stakes Mexico City has riding on a stable world oil market. The government, for example, is currently negotiating a $48.5 billion debt rescheduling package with more than 500 banks that is based on assumption of steady oil revenues. Moreover, the sharper the fall in oil revenues--either due to export cutbacks or price decreases--the more difficult it will be for Mexico City to meet debt obligations, maintain growth, and adhere to IMF targets. Finally, such a revenue crunch would be magnified by the ongoing reduction in foreign investment that has resulted primarily from the trend toward greater state control over industry.

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Methodology

In order to assess the potential impact that lower oil revenues might have, we explored the quantitative ramifications of these alternative oil revenue paths in our Mexican econometric model. Specifically, we simulated 1985 crude oil revenues remaining constant (Baseline Case), declining by 10 percent (Case II), and falling by 25 percent (Case III). The baseline case

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assumes the IMF would allow Mexico some leniency in meeting the 1985 targets set two years ago. This scenario posits a 5 percent increase in government spending, no change in international reserves, and oil exports at their former ceiling of 1.5 million barrels per day (bpd) at $27.00 per barrel.* Moreover, we assume relief of $500 million in interest obligations caused by an expected one half percent drop in LIBOR (London InterBank Offered Rate). 25X1

Cases II and III are derived from the baseline but reflect their respective declines in export revenues. In the first running of the simulation, both cases assume no Mexican policy response to offset the declines in order to demonstrate the full potential impact of such contractions. Finally, another simulation incorporates policy shifts (affecting government spending, exchange rates, investment incentives, etc.) Mexico is likely to implement in response to the declines in economic activity forecast in Cases II and III. In these latter cases, somewhat greater relief in interest rates could occur if OPEC and Mexico were to reduce prices rather than volumes. By lowering world energy prices such an action would reduce the component of interest rates that reflect expected inflation. 25X1

Baseline Case: Oil Revenues Remain Constant

Mexico would be unable to expand its economy much next year, even if nominal oil revenues remained constant. Reduced foreign borrowing and tight IMF financial targets will continue to hold down government consumption and investment, while financial problems and weak business confidence will keep private investment depressed. 25X1

As things now stand, we expect Mexico City to press the IMF to loosen strictures on reflating the economy, even if oil revenues do not decline next year. After three full years of falling consumption, Mexico City is under strong pressure to ease austerity and stimulate the economy. Indeed, with national elections approaching next July, the government may adopt even more reflationary policies than the ones we posited. According to US Embassy reports, officials of the ruling party are worried that the recession generally has significantly eroded its voter appeal. 25X1
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* This is an average price for light and heavy grades of crude oil. 25X1

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Without any relaxation, our analysis projects a modest economic decline in 1985. By boosting spending several percentage points to 5 percent, however, the model indicates that real GDP could grow. We believe Mexico City would have difficulty selling reflation to the IMF without also adjusting imports and the exchange rate. Increased government spending, depressed imports, and boosting daily depreciation of the peso to a 50 percent annual rate would keep inflation high. Taking all of these policy adjustments into account, our model suggests that the Mexican economy could expand by about 2 percent next year.

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Case II: Moderate Decline in Oil Revenues

Lower revenues next year caused by a 10 percent drop in oil export volume (equivalent to either a price fall of about $2.70 per barrel or 150,000 b/d sales reduction) would have a substantial impact on the economy. Assuming all other policy variables were held constant, such a drop would cause an economic contraction of 1.5 percent--3.5 percentage points below the baseline.

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Only by adopting dramatic, multifaceted policies would the government offset the impact of lower oil revenues. Such a response would almost surely require additional revisions in IMF targets, including higher spending, drawdowns in international reserves, further cuts in imports, and an increase in the daily depreciation of the peso. Model results indicate, for example, that just to maintain baseline economic activity, Mexico City would have to raise spending another 3 percentage points, reduce international reserves by $1 billion, and increase the annual depreciation of the peso to 60 percent. The cumulative effect of these actions would reduce imports 8 percent and boost inflation substantially.

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Case III: Oil Revenues Plummet

Our econometric analysis indicates that a 25 percent drop in oil revenues next year (equivalent to either a $6.75 per barrel price cut or nearly 400,000 b/d sales reduction) would have a devastating effect on the Mexican economy. In the absence of offsetting policy responses, this unlikely scenario would cause GDP to decline 7 percent and would drive private consumption and investment down dramatically.

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In these circumstances, measures needed to prevent economic decline would require fundamental changes in economic policy. Mexico would virtually have to abandon its IMF-sponsored austerity program, for example, although our model suggests that a substantial drawdown in reserves could temporarily delay any unilateral actions to increase debt relief. Only when the growth of government spending in the baseline case is more than doubled, international reserves reduced by $2.5 billion and the annual depreciation of the peso increased to 80 percent, does the model simulate positive GDP. On the other hand, we estimate that these measures would cut imports by 20 percent and push inflation back toward triple-digit levels. 25X1

Outlook

Depressed oil revenues beyond next year would not only torpedo the economic adjustment program, but also probably prevent Mexico from meeting rescheduled debt obligations. The intensifying liquidity crisis would probably drive Mexican economic decisionmaking toward more statist policies, rather than inducing the government to lift its many restrictions on private investment. Mexico City might again blame the economic decline on the private sector and the US-led world economic system. Such conditions also might encourage Mexico to reinstate a moratorium on debt service. These actions would greatly increase the already strong resistance of bankers to new loans for Mexico and trigger another strong surge in capital flight. 25X1

Lower oil revenues, disinvestment, and the cutoff of international capital could plunge the economy into a stagflation trap. Efforts to reinvigorate the economy would increase government spending sharply to support consumption, unleashing an inflationary explosion that would further cut real wages and crowd out private investment. Rapid increases in the cost of living and unemployment would sharply erode living standards and prompt new highs in social tensions and illegal migration to the United States. 25X1

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MEXICO: IMPACT OF REDUCED OIL EXPORT VOLUMES

	1984	1985				
			10 PERCENT DECREASE *		25 PERCENT DECREASE *	
	PROJECTED	BASELINE	NO POLICY ADJUSTMENT	WITH POLICY ADJUSTMENT	NO POLICY ADJUSTMENT	WITH POLICY ADJUSTMENT
	PERCENT CHANGE FROM PREVIOUS YEAR					
GDP	0.97	2.02	-1.52	1.70	-6.76	0.23
GDP DEFLATOR	65.50	60.78	61.67	64.37	62.99	71.75
PRIVATE CONSUMPTION	1.87	3.56	0.04	2.24	-5.19	-0.85
PRIVATE INVESTMENT	-4.78	3.43	-2.92	1.53	-12.33	-4.06
GOVERNMENT CONSUMPTION	1.00	5.00	5.00	8.00	5.00	12.00
GOVERNMENT INVESTMENT	2.00	5.00	5.00	8.00	5.00	12.00
	BILLION US DOLLARS					
FOREIGN EXCHANGE INCOME	30.84	32.80	31.30	31.28	29.06	29.00
PETROLEUM EXPORTS	14.92	14.78	13.30	13.30	11.09	11.09
OTHER MERCHANDISE EXPORTS	7.83	8.79	8.79	8.88	8.80	9.05
OTHER **	8.10	9.23	9.21	9.10	9.18	8.87
FOREIGN EXCHANGE OUTLAYS	31.29	32.67	32.01	33.00	31.02	32.05
DEBT SERVICE	17.06	17.08	17.08	17.08	17.08	17.08
MERCHANDISE IMPORTS	9.02	9.99	9.63	9.23	9.08	8.01
OTHER ***	5.20	5.60	5.30	6.69	4.86	6.96
FOREIGN EXCHANGE BALANCE	-0.44	0.13	-0.71	-1.72	-1.96	-3.05
CHANGE IN RESERVES	1.99	0.00	0.00	-1.00	0.00	-2.50
FOREIGN BORROWING REQUIREMENT	2.43	-0.13	0.71	0.72	1.96	0.55
MEMORANDUM ITEMS						
TRADE BALANCE ****	15.33	15.26	14.14	14.64	12.48	13.80
CURRENT ACCOUNT BALANCE	4.52	5.12	4.32	4.83	3.12	4.60

* ASSUMES OIL GRADE MIXES ARE CONSTANT

** INCLUDES SERVICE INFLOWS, IN-BOND PLANTS, AND DIRECT FOREIGN INVESTMENT

*** INCLUDES OUTFLOWS FROM SERVICES AND CAPITAL FLIGHT

**** TRADE BALANCE = EXPORTS OF GOODS, IN-BOND INDUSTRIES AND TRANSPORTATION - IMPORTS OF GOODS

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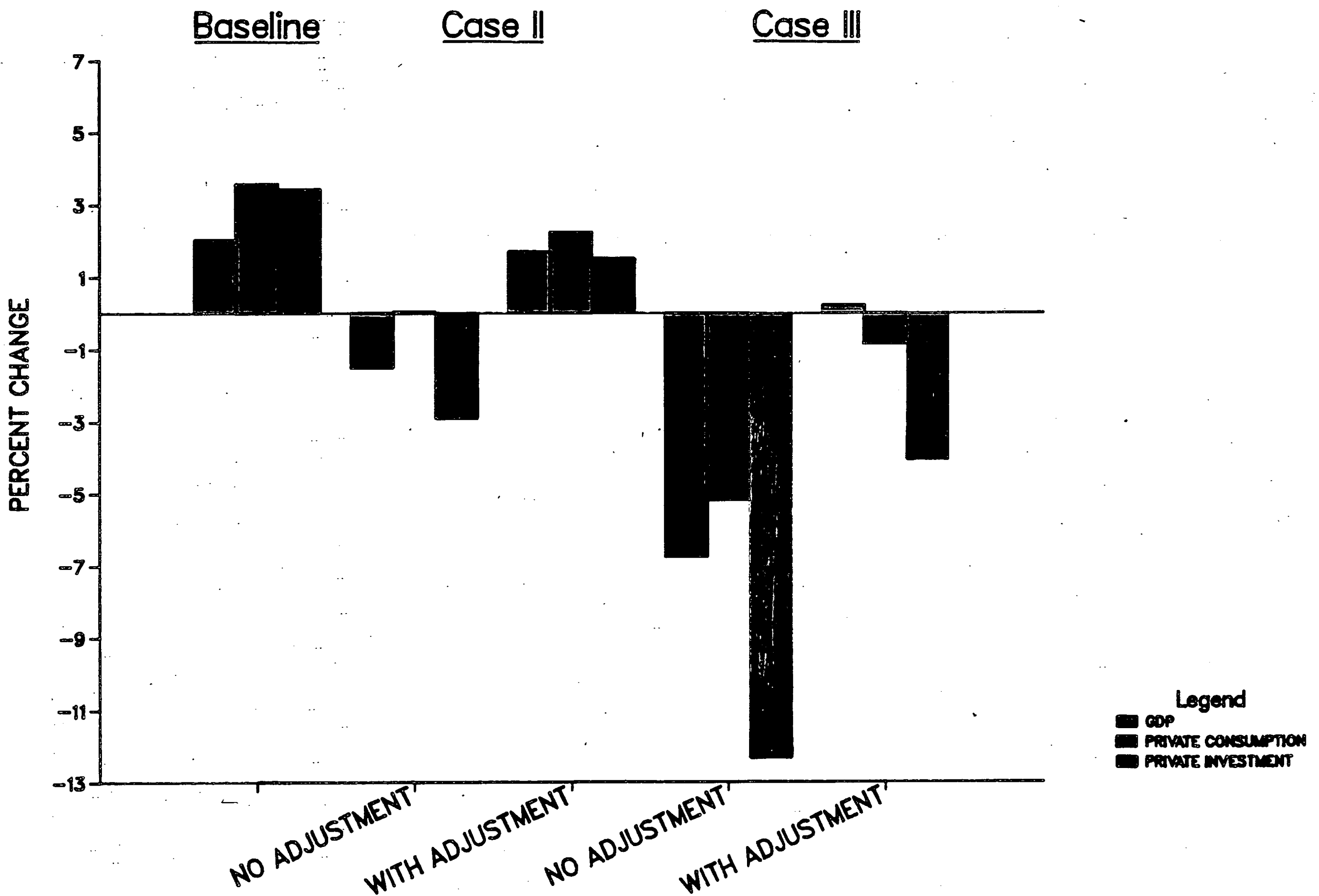

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