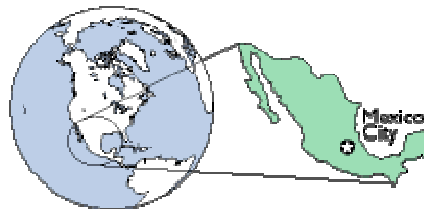


COUNTRY REVIEW

Mexico



September 2010

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EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Emergence of a more pluralistic democratic framework with a clear succession process.
- Established track record of prudent fiscal and monetary policies (including, a fiscal responsibility law, inflation targeting and a floating exchange rate).
- Modest current account deficit.
- Adequate overall external liquidity position.
- Moderate external debt and proven access to international markets.
- Strong links with US and strong policy track record ensure international financial support if necessary.

Weaknesses

- Lack of government majority constrains structural reform progress.
- Wide differences in income distribution, geographically as well among socio-economic groups.
- Highly dependent on US economic cycle (e.g. 85% of Mexican exports go to the US and Canada and workers remittances account for 8% of total current account earnings or the equivalent of 2.7% of GDP).
- Moderate long-term growth record.
- Low tax base and high dependence on oil for fiscal revenues.

Country Risk Assessment

Ratings	Mexico		Median Grade BB	Chile	Peers	
	Latest	Previous			Peru	S. Korea
Systemic Political Risk:	P2-	P2+	P2+	P2+	P2-	P2+
Systemic Economic Risk:	E3	E3	E3	E2	E3	E3
ME rating:	ME3	ME3	ME3	ME2	ME3	ME3
<i>Structure</i>	2.8	2.3	4.0	4.0	4.0	3.3
<i>Policy</i>	4.2	4.0	4.3	2.2	3.6	4.2
<i>Solvency</i>	2.0	1.9	1.3	2.8	1.7	1.3
<i>External Liquidity</i>	1.7	3.6	1.0	2.8	1.0	2.2
SBE rating:	SBE3	SBE3	SBE2	SBE2	SBE3	SBE2
COUNTRY GRADE:	BB	BB	BB	A	BB	BB

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Mexico City
Population:	109.61 mn (2009)
GDP:	USD 874935 mn (2009)
Currency:	Peso (MXN)
Form of state:	Federal republic
Head of government:	President Felipe Calderon
Next elections:	July 2012 Presidential & Legislative

Major Industries (% of GDP 2008)	Global Assumptions	2010	2011
Agriculture 3.8%	Real GDP grth (% yr/yr) *	3.3	2.9
Industry 37.1%	Inflation (% av) *	1.2	1.4
Mining 18.8%	Dated Brent (USD/b)	75	70
Services 59.1%	* World		

Main Exports (% of total, 2009)	Main Imports (% of total, 2009)
Oil 13.5%	Consumer goods 14.0%
Non-oil 86.5%	Intermediate goods 72.9%
Agricultural 3.4%	Capital goods 13.1%
Mining 0.6%	
Manufacturing 82.6%	

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	1,023,385	1,088,101	874,935	1,014,729	1,078,100
Population (mn)	107.49	108.56	109.61	110.66	111.71
GDP per capita (USD)	9,521	10,023	7,982	9,170	9,651
Real GDP growth (% yr/yr)	3.3	1.4	-6.6	4.7	3.3
Inflation (% eop)	3.8	6.5	3.6	4.5	4.0
Fiscal balance (% of GDP)	0.0	-0.1	-2.3	-2.5	-2.3
Current account balance (% of GDP)	-0.9	-1.6	-0.5	-0.6	-1.4
External debt/GDP (%)	19	19	22	20	20
External debt/Exports of goods & services (%)	61	60	72	63	61
Interest payments/Exports of goods & services (%)	4	3	4	4	3
Foreign exchange reserves (USD mn)	84,000	95,126	99,589	105,599	106,000
Import cover (months)	3.3	3.2	4.6	4.1	3.7
Exchange rate assumption: USD/MXN	10.95	11.13	13.51	12.70	12.85
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Presidential elections in July 2000, won by Vicente Fox of the PAN (Partido Accion Nacional) ended 71 years of uninterrupted executive power by the PRI (Partido Revolucionario Institucional) and marked the first peaceful transfer of executive power to the opposition. This was the crucial step in the evolution from flawed one-party democracy to a more transparent, pluralistic system. Presidential elections in July 2006 proved a major test of systemic stability as the result was extremely close and contested, but there was no institutional breakdown. The winner, President Felipe Calderon of the centre-right PAN, has continued the basic policy approach of his immediate predecessors, built around prudent fiscal and monetary policy accompanied by market-oriented structural reforms to boost growth potential.

Although President Calderon has been more successful in dealing with congress than his predecessor—with some progress on pension, fiscal and energy reform, albeit significantly diluted by strong opposition—after mid-term elections in 2009 the PAN was left without a majority in congress and reforms have largely stalled. Nonetheless, the PRI may support some measures, as they will not want to be seen as too obstructive. The president's popularity has also been eroded by the government's inability to control drugs related violence in some key northern states, despite a high profile military-led offensive. As a result, the PRI appears to be in a good position ahead of the next presidential elections due in 2012. However, In July 2010 although the PRI won nine of the twelve governorships at stake in regional elections—the same number as the party held already—it also lost three of its traditional strongholds. A key reason was the alliance between the PAN and the PRD (Partido de la Revolucion Democratica), ideological opposites (right and left, respectively) but with the objective and potential to block the PRI. The results suggest that, while the PRI probably still has the momentum, its support may not be overwhelming. It remains to be seen if a PAN/PRD alliance for the presidency could be feasible, but in 2011 elections for governor will be held in Mexico State, which will be an important indicator for all parties. President Calderon is not permitted to stand for a second term in 2012.

In the medium-term the administration also needs to tackle the problem of the geographic divide between the wealthier north (PAN dominated) and poorer south (PRD dominated) that could fan the fires of opposition in some regions and encourage guerrilla activity, as well as the security threat from the narcotics trade. Overall, pressures on systemic stability are rising, but the institutional framework should hold in the near-term.

International relations will continue to focus on the US, with security and immigration issues to the fore. Mexico is a member of the North American Free Trade Association (NAFTA) along with the US and Canada. Strong links with the US and a strong policy track record ensure international financial support if it were to become necessary.

Economic Stability

Economic liberalisation—including entry into NAFTA—has brought substantial structural change. Exports are more diversified—petroleum accounted for 12% of the total in 2009 compared with 31% in 1987—and exports of goods and services increased from 20% of GDP in 1987 to 28% in 2008 (World Bank). The energy sector is smaller as a proportion of GDP than in other oil exporting economies and vulnerability to falling oil prices has been much reduced, though petroleum is still important for fiscal revenues (36% of total revenue). As NAFTA partners—the US and Canada—account for 85% of exports—the economy is closely tied to the US economic cycle. Annual average growth of real GDP per capita during the past ten years was a modest 0.8%. A key issue in the medium-term is to arrest the decline in oil output, which will probably need further liberalisation of the sector to encourage adequate investment, but will continue to meet with strong political resistance, and other reforms need to be implemented to accelerate potential growth.

Real GDP increased by an annual average 3.7% in 2004-07, but slowed to 1.4% in 2008 and contracted by 6.6% in 2009, under the combined impact of the global recession and swine flu. Real GDP returned to growth in H2 2009 and was 7.3% yr/yr in Q2 2010 after 4.3% in Q1. Prospects for growth depend heavily on the course of the US economy, but a slower pace may be expected in H2 2010 and 2011, with annual growth of 4.7% and 3.3% respectively.

In 2009 the overall fiscal deficit widened to 2.7% of GDP, after some counter-cyclical measures against the recession and should be just over 3% of GDP in 2010. The traditional deficit (a closely observed, slightly narrower definition, but targeted measure) in 2010 is expected to be around 2.5% of

GDP. Budget projections presented to congress envisage lowering both the overall and traditional deficits to 2.7%, and 2.3% respectively. These targets should be met as long as oil prices remain around current levels (the budget assumes slightly lower prices in 2011). In the medium-term further measures to raise the tax base will be necessary to offset the perceived vulnerability to oil revenues. Gross public debt was a relatively comfortable 34% of GDP at end-2009, though it is expected to rise to 36.8% of GDP by end-2010.

Monetary policy is based on inflation targeting and a floating exchange rate. The target band is 2-4%, though the aim is the mid-point 3%. Inflation dropped from 6.5% yr/yr at end-2008 to 3.5% at end-2009, though it was still above the mid-point target as a sharp depreciation of the exchange rate (more than 50% between September 2008 and early April 2009) partially offset the impact of spare capacity. Inflation picked up somewhat in Q1 2010 but had eased to 3.6% yr/yr in July. The fall in inflation in 2009 enable the central bank to cut interest rates in H1 and the policy rate has been held steady since then. With inflation expected to be around 4.5% at end-2010 and 4% at end-2011, interest rates will probably begin to rise, though continued spare capacity should contain inflation expectations.

The latest IMF article IV review in early 2010 noted that the core financial system came through the global financial crisis reasonably well. A key reason was that although there is considerable foreign ownership of the banking system, the bulk of funding comes from domestic retail sources. NPLs (3% of total loans at end-2009) however are increasing.

The annual average current account deficit in 2003-07 was less than 1% of GDP, widening to 1.6% in 2008. In 2009 the deficit narrowed to 0.5% as GDP, as both exports and imports fell sharply. Both have increased in H1 2010, but the current account deficit in 2010 as a whole will be of a similar magnitude (-0.6%) before widening to -1.4% in 2011, as import growth outstrips that of exports. FDI fell sharply in 2009 and though still fall short of previous levels should cover 70% of the current account deficit in 2011. FX reserves, which fell during the height of the global financial crisis had recovered to USD99.6bn at end-2009 and stood at USD105.6bn in mid-2010. At this level FX reserves provide 3.7mo import cover and are around 200% of external debt due in 2011 and 150% of the sum of the current account deficit, MT debt principal repayments and ST debt outstanding. External debt ratios are moderate. The external debt-GDP ratio at end-2009 was 22% and the external debt-exports of goods and services ratio 72%, while interest payments due were around 4% of exports of goods and services. We expect these ratios to fall to 20%, 61% and 3% respectively in 2011.

The exchange rate remains vulnerable to sharp swings in capital flows as confidence ebbs and flows in the global recovery and GDP growth is highly sensitive to developments in the US economy. Nonetheless, overall the economy should continue to demonstrate resilience to shocks and avoid wider balance of payments and public debt crises in view of the sound policy framework and access to international financial support if necessary. Importantly, in 2009 Mexico was able to arrange precautionary access to the IMF's flexible credit facility (FCL) worth USD47bn, which not only provided a cash cushion at a critical juncture but also underpinned market confidence as this facility is only available to economies with sound policy records and sustainable debt positions and is without conditionality. The FCL was renewed for another 12 months in March this year. An earlier USD30bn swap line provided by the US Fed had similar effects.

Structural Business Environment

The Structural Business Environment is above average in our assessment, but falls short of the strongest ratings overall. Based on data and definitions from the World Bank's 2010 Doing Business Survey, Employing Workers, Registering Property and Paying Taxes were weaker areas, ranking below average, none were particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality and Control of Corruption above and Rule of Law just below average for the Latin American Region with a similar pattern for the upper middle income group of countries, though Rule of Law was well below average. Transparency International's Corruption Perception Index, 2009, assigns Mexico a score of 3.3—on a scale of 1 (bad) to 10 (good)—and a ranking of 89= out of 180 (the same as Malawi, Moldova, Morocco and Rwanda). As a broad measure of the pro-business environment The Heritage Foundation's 2010 Index of Economic Freedom ranks Mexico 41 out of 179.

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Charts

