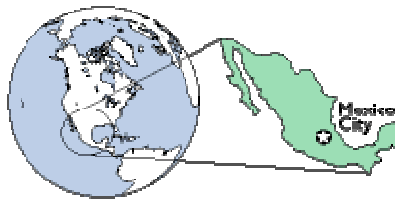


COUNTRY REVIEW

Mexico Update



14 August 2009

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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.

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MEXICO: UPDATE**Economic stability**

The economy is in severe recession with Q2 2009 real GDP growth expected to have contracted by more than 10% yr/yr (8.2% yr/yr Q1). Lower interest rates, the easing credit squeeze, signs of US recovery, stable/rising oil prices and leaving behind the worst effects of swine flu, should allow some improvement in H2 and growth of 2-2.5% in 2010, after contraction of 7% or so in 2009 as a whole.

Inflation is on a downward trend from the 6.5% yr/yr December 2008 peak and should converge with the target range (3% +/-1%) before year-end, notwithstanding the sharp depreciation of the exchange rate (more than 50% between September 2008 and early April 2009) that worked against a more rapid fall in the early months of 2009. The more stable (and somewhat stronger) exchange rate in recent months and lower inflation expectations allowed the central bank to cut the policy interest rate from 8.25% to 4.5% since early 2009 and there could be scope for a further cut before rates stabilise.

The fiscal balance is the main concern, as oil prices have fallen and production is declining. (Oil accounts for around 40% of government revenues). In H1 2009 there was a public sector deficit (traditional balance) of around 1.7% of GDP, against a small surplus in H1 2008. To counter the revenue shortfall—from recession as well as below budget oil prices—expenditure cuts have been made or announced and stabilisation funds accumulated during earlier periods of high oil prices along with profits from hedging oil revenues will also be used to provide some cushion. Nonetheless, the deficit is likely to rise in 2009 from 2.1% in 2008. Public debt-GDP ratios are manageable at current levels (39% and 24% on a net basis), but it will be necessary for the government to implement further measures to address the issue of declining oil revenues. The lack of a government majority in congress is clearly a potential constraint.

The current account deficit should remain around 1.5% of GDP in 2009 and 2010. Both exports and imports fell sharply in H1 2009 and growth of both should pick up moderately in H2 and into 2010, but imports are unlikely to outstrip exports significantly in the expected relatively low growth environment. Workers remittances were down almost 12% in H1 but these should start to recover as the US emerges from recession, while continued low interest rates will contain interest payments and profits and dividend outflows are likely to remain subdued. FDI fell by 55% in Q1 2009 compared with a year earlier, but assuming a similar pace is maintained for the whole of 2009 net FDI would still cover 75-80% of the current account deficit in 2009-10 (net FDI more than fully covered the deficit in 2001-08). FX reserves fell from USD95bn at end-December 2008 to USD81.2bn (IMF definition) at end-June 2009 as the central bank intervened to prevent the sharp depreciation of the exchange rate, but as the exchange rate should be more stable (though tending to depreciate) in the next 6-12 months pressure on the FX reserves should abate. Importantly in this context, Mexico has arranged precautionary access to the IMF's flexible credit facility (FCL) worth USD47bn. Not only does this facility provide a cash cushion as it is only available to economies with sound policy records and sustainable debt positions and is without conditionality, it helps underpin market confidence. An earlier USD30bn swap line provided by the US Fed has similar effects. In any event, FX reserves at current levels (excluding the back-up facilities) cover almost 4 months of imports, 170% of external debt falling due in 2009 and more than fully covers the combined total of the current account deficit, principal falling due and ST debt outstanding in 2009, all positive indicators. External debt ratios are low to moderate. External debt (ED)-GDP is 24%, ED-exports of goods and services (XGS) is 82% and interest payments are 5.5% of XGS. The debt service ratio is 17.5%

Political stability

Political stability has become a bit more fragile as recession intensifies, given regional and income differences and security issues. President Calderon's position has also weakened following the PAN's losses in July's mid-term elections, which gave the opposition PRI a majority in congress. Nonetheless, while pressures on systemic stability are rising, the institutional framework should hold in the near-term and the systemic political risk remains P2-, which is consistent with a BB grade.

Structural Business Environment

The Structural Business Environment is generally sound.

Summary

Although the deterioration in the fiscal accounts poses some problems in the medium-term and the depth of the recession, along with the continued fragility of the global financial environment, has implications for potential corporate stress and insolvencies, the key risk indicators remain consistent with a grade BB. A wider balance of payments crisis should be avoided provided the sound policy framework is maintained, given likely access to international support.

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