

Economic

Sovereign FC MLT Ratings

Moody's: Baa1

S&P: BBB

Fitch: BBB

Nominal GDP (2009)

USD 876 bn

Population (2009):

111 mn

Total Trade / GDP (2009):

53%

Currency:

Mexican Peso (MXP)

Exchange regime:

Independently floating

Merchandise Imports from Canada (2009; 2 sources):

CAD 3.1 billion (Statcan)

Top exports:

Oilseeds

Autos and light motor vehicles

Wheat

Animals (processed)

Oil/gas/mining M&E

Largest Merchandise Export Destination (2009):

United States (73%)

Risks to the Outlook



US recovery is stronger than expected.



Global financial sector turbulence; US manufacturing sector stalls

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Highlights: Mexican GDP is expected to show robust growth in the near term, reflecting in part how significant activity plunged in 2009. The outlook is subject to significant risks surrounding US consumer and manufacturing activity. Even with the growth envisaged, output levels are unlikely to return to pre-crisis levels until sometime in 2012. • Currency and financial markets have stabilized and both S&P and Moodys now assign stable outlooks to their ratings of the Mexican government.

Real economy: Real GDP fell 6.6% in 2009 on the combined impacts of the global financial crisis and plunge in US manufacturing / imports - seen Q3 2008 to Q1 2009. The plunge in activity during this period was considerable, as the 6.6% drop in last year's GDP came despite consistent positive quarter-to-quarter growth since Q2 2009. We expect manufacturing and non-oil exports to continue to be the most significant areas of growth in 2010, spurred on by rising US trade and manufacturing. Domestic sources of growth will be weaker with consumer confidence still fragile, consumer / non-bank financial loan growth flat and remittances still falling. GDP is expected to rise 3.5% in 2010 and 4.0% in 2011.

Fiscal Policy: Fiscal deficits are expected to be modest over the forecast horizon, largely because stimulus was not relied upon to the same extent that it was in other markets. Still we do not expect much of an improvement in 2010 as the government has hedged oil sales at US\$57/brl this year, versus US\$70/brl in 2009. Liquidity and solvency indicators are not concerning at this point but there are persistent structural concerns surrounding government finances that could initiate another round of rating downgrades in coming years (both Fitch and S&P downgraded Mexico in 2009). Of greatest concern is the narrowness of the non-oil tax base, which measures only 10-11% of GDP, and government's reliance on oil revenues (roughly 35% of total revenues). The latter is of particular concern given an outlook of falling oil production.

Monetary Policy: The peso has appreciated considerably since the heights of the global financial crisis and volatility has normalized. Still we expect the peso will weaken slightly over the forecast as bumps in the global recovery emerge (examples: Greece and Dubai World) and the Central Bank implements its new policy designed to increase FX reserves (by buying USD).

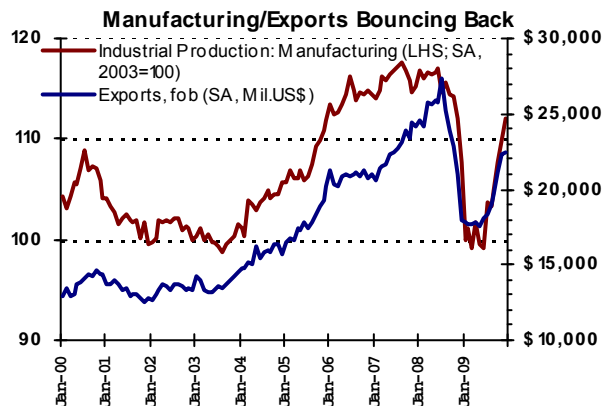
External Sector: Mexico was, and still is, particularly vulnerable to the US given the highly integrated nature of its manufacturing sector to that of the US, related dependency as a destination of exports (roughly 80% of total), and major source of FDI and inbound family remittances. Trade was hit particularly hard in 2009 (-20% in real terms), but it is now the area of the economy that will rise the fastest. Meanwhile, international investors have returned to Mexican stocks and bonds driving considerable improvements for the peso, stock prices and government bond spreads. The restored confidence allowed Mexico to issue a USD1bn bond in January, weather concerns over the expiration of its USD 30 billion swap agreement with the US Fed, and allow the country to seek the end of its USD 47 billion Flexible Credit Line with the IMF. Cognisant that global risk aversion may return (particularly in light of troubles plaguing highly indebted Euro-area nations) the Central Bank is actively seeking to build-up international reserves (akin to strategies employed by Brazil and China) as an insurance policy against future market volatility.

Outlook: Strong links to the US economy will continue to drive Mexico's economic outlook for the foreseeable future. This link should drive fairly rapid growth in 2010-11 as US imports and manufacturing bounce back from terrible declines seen in 2009. Unfortunately, the long term outlook for the US consumer is much weaker than was exhibited during the boom years, limiting growth for Mexican exports of consumer durables. Mexico must therefore become more competitive so as to increase the market share of its exports to the US and to better leverage its expansive network of free trade agreements. Failure to advance the reform agenda could prompt further rating downgrades. Reducing PEMEX's use as a government cash cow and easing restrictions on private sector involvement in the energy sector would help to prevent such an event.

Economic Indicators

	04-08 avg.	2009	2010	2011
GDP (% growth, real)	3.4	-6.9	3.5	4.0
Inflation (%chg, pa avg.)	4.3	5.3	5.7	4.6
Fiscal Balance (% of GDP)	-0.1	-2.9	-2.2	-1.8
Exports (% comp. annual growth)	12.1	-20.9	19.0	16.0
Imports (% comp. annual growth)	12.6	-23.5	22.0	17.0
Current Account (% of GDP)	-0.8	-0.6	-1.3	-2.0
Reserves (months of curr. debits)	3.2	4.1	3.6	3.2
External Debt (% of GDP)	18.7	20.3	18.2	16.9
Debt Service Ratio (due)	16.4	17.1	13.4	11.9
Exchange Rate (to USD; eoy)	11.5	13.3	12.6	13.0

Source: EIU and EDC Economics



Political

Political Structure

Federal Republic

President
Felipe Calderón

Legislative Bodies

- National: Chamber of Deputies (500 seats); Senate (128 seats)
- State: 32 state governors and legislatures

Major Parties (percentage of vote)

- Partido Revolucionario Institucional (PRI) (36.7%)
- Partido Acción Nacional (PAN) (28.0%)
- Partido de la Revolución Democrática (PRD) (12.2%)

Last Elections

- Presidential: July 2006
- Legislative: July 2009
- Governors: varies, but term of six years.

Next Elections

- All levels: July 2012

Press Freedom Survey:

- 2009 Score: 55 – Partly Free

(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:

- 2008 Score: -0.26 (-2.5: Worst; +2.5: Best)

worldbank.org

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General Political Environment:

In July 2006, Felipe Calderón of the Partido Acción Nacional (PAN) won a closely contested presidential election, strengthening Mexico's democratic transition. President Calderón was inaugurated for a 6-year term on December 1, 2006 and has since had an approval rating of about 60%. His election was well-received by local and foreign business interests who favoured policy continuity and solid management of the economy. While a divided Congress and Senate paralyzed his predecessor Vicente Fox, in the first three years of his mandate Calderón was able to implement long-awaited pension, fiscal and electoral reform reforms despite his lack of a majority in either chamber. The former should provide an important boost to government revenues; the latter will reduce the ability of political parties to buy television and radio advertising during election campaigns.

With the PAN's decline and the PRI's resurgence in the July 2009 mid-term congressional elections, Calderón will have to navigate a much-altered political landscape. The PRI had been relegated to the opposition after having ruled Mexico for decades (1929-2000) but claimed 36.7% of the vote in July 2009 election where all 500 congressional seats were contested. With a PRI majority in congress, Calderón faces unprecedented challenges in pursuing his administration's national development plan, which focuses on the rule of law, economic growth, and increased competitiveness, and his goal of addressing monopoly power in Mexico.

Investment Environment:

Although Mexico's business environment remains politicized and without a strong legal framework, it is rapidly changing as a result of the more global focus of the government and the private sector. Access to international arbitration is guaranteed by law and by free trade agreements such as NAFTA. These agreements in turn have strengthened Mexico's position as Latin America's premier recipient of foreign direct investment.

Corruption is a serious problem and continues to negatively impact the business environment despite increasing emphasis on anti-corruption measures. Mexicans' historic suspicion of foreign investment is receding. The country offers a welcoming environment for businesses in almost every sector except in the energy sector, where opportunities for foreign companies are limited. Any decision to significantly open the oil and electricity sectors to foreign investment would be very controversial and nationalist sentiment is likely to prevail over the short term. In late October 2008, Calderón managed to pass some weak reforms for the oil sector that allow for more foreign participation in some areas and that are also symbolically important.

Political Violence:

Strikes and demonstrations are frequent in Mexico and can affect business operations. Kidnapping rates remain high, but it is the growing clash between government and the drug cartels that poses the greatest threat to the country's security. At the beginning of his term Calderón launched a large-scale crackdown on Mexico's notorious drug cartels, and even extradited suspected traffickers to the United States. Since Calderon took office in December 2006, an estimated 17,000 have been killed in drug-related murders. High profile assassinations involving politicians and security officials occur in many states, suggesting strong links between organized crime and corruption within police forces at all levels of government. The government needs to demonstrate that it can contain the spread of narco-violence to re-assert its authority, particularly in parts of cities on trafficking routes near the border with the U.S.

Violent attacks are carried out from time to time by insurgent groups such as the EZLN and the EPR. The EPR claimed responsibility for three separate attacks on PEMEX infrastructure between July and September 2007, but the groups have been relatively quiet in 2009.

Political Outlook

The victory of the PRI in the July 2009 mid-term congressional elections marks a significant shift in Mexican politics. With a PRI-PAN coalition highly improbable, Mexico could face a legislative stalemate. President Calderón could seek rapprochement with the PRI, but appears for now to be sticking to his reform plans and risk severely limiting his capacity to govern until his terms ends in 2012. The momentous challenges Mexico faces on the economic and crime fronts could generate the impetus for PRI and PAN cooperation. The PRI's main concern is to maintain momentum for the 2012 presidential and legislative elections and so its motivation to collaborate with the PAN is low. However, there has been some cooperation this fall and Calderon continues to push policy reform, so he is not a "lame duck" yet.