Rabobank

Country update **MEXICO**

Summary

Mexico's economy performed surprisingly well in 2012, as strong trade and remittances links with the US helped the country benefit from the gradual US recovery, while the absence of imbalances at home supported domestic demand. Consequently, Mexico's economy is expected to expand by about 4% in 2012 and 2013. This year's general elections brought the opposition Partido Revolucionario Institucional (PRI) under the leadership of incoming President Enrique Peña Nieto back to power, but the party failed to win an absolute majority in Congress. Therefore, the implementation of Mr Peña Nieto's comprehensive package of structural reforms will crucially depend on the PRI's ability to garner sufficient support in Congress. Meanwhile, the new government will continue its predecessor's conservative macroeconomic policies, which should help Mexico weather a global growth slowdown. Notwithstanding, Mexico remains particularly exposed to the consequences of an insufficiently addressed fiscal cliff in the US, which could reduce next year's economic growth by up to 2%.

Author: **Fabian Briegel**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64053
F.Briegel@rn.rabobank.nl

Mexico

National facts	
Type of government	Federal Republic
Capital	Mexico City
Surface area (thousand sq km)	1,964
Population (millions)	112.5
Main languages	Spanish (93%)
	Indigenous (6%)
Main religions	Roman Catholic (77%)
	Protestant (5%)
Head of State (president)	Felipe Calderón Hinojosa
Head of Government (president)	Felipe Calderón Hinojosa
Monetary unit	Mexican Peso (MXN)

Social and governance indicators	rank / total
Human Development Index (rank)	57 / 187
Ease of doing business (rank)	48 / 185
Economic freedom index (rank)	54 / 179
Corruption perceptions index (rank)	100 / 183
Press freedom index (rank)	149 / 178
Gini index (income distribution)	48.3
Population below $1.25 per day (PPP)	1.15%

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	1154	1.67
Nominal GDP at PPP	1949	2.46
Export value of goods and services	365	1.66
IMF quotum (in mln SDR)	3626	1.67
Economic structure	*2011*	*5-year av.*
Real GDP growth	3.9	1.8
Agriculture (% of GDP)	4	4
Industry (% of GDP)	35	34
Services (% of GDP)	62	63
Standards of living	*USD*	*% world av.*
Nominal GDP per head	10138	94
Nominal GDP per head at PPP	17123	138
Real GDP per head	8446	103

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
US	80	US	48
Canada	4	China	15
China	1	Japan	5
Colombia	1	Korea	4
Main export products (%)			
Manufactured goods			80
Oil			16
Agricultural products			3
Mining products			1
Main import products (%)			
Intermediate goods			75
Consumer goods			15
Capital goods			10
Openness of the economy			
Export value of G&S (% of GDP)			32
Import value of G&S (% of GDP)			33
Inward FDI (% of GDP)			1.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

Mexico's economy surprised to the upside in recent quarters, as strengthening exports and solid domestic demand benefitting from the absence of major economic imbalances kept growth up amid a challenging external environment. Notwithstanding, reflecting close ties with the US economy, Mexico's economic growth slowed gradually from 4.9% yoy in the first quarter to 4.4% and 3.3% in the second and third quarter, respectively. As growth still reaches acceptable levels and recent temporary food price hikes drove inflation above the target band, interest rate cuts to stimulate growth are rather unlikely in the coming months. Additional fiscal stimulus is similarly unlikely, as Mexico's politics are dominated by the transition of power from the center-right Partido Acción Nacional (PAN) to the newly elected centrist Partido Revolucionario Institucional (PRI) following the latter's success at the July 1st general elections. While the PRI's candidate Enrique Peña Nieto, a former governor of Mexico state, managed to win the presidency, his party, together with its ally Partido Verde Ecologista de México (PVEM), failed to win an absolute majority in neither of the two houses of Congress. Consequently, the implementation of Mr Peña Nieto's promising structural reform agenda will depend on his ability to reach across the aisle. In this regard, the strengthening of incoming president Peña Nieto's democratic legitimation through the Federal Election Institute's rejection of claims of fraud by second-placed left-wing presidential candidate Andrés Manuel López Obrador is certainly helpful. Notwithstanding, given that several of the incoming president's reform bills will likely conflict with vested interests, long and protracted negotiations can be expected.

A promising reform agenda that could boost Mexico's growth potential

After several years of sluggish progress on important structural reforms due to congressional gridlock, the election of incoming President Enrique Peña Nieto has raised hopes that major advances can be achieved in the coming six years. During the PRI's election campaign, Mr Peña Nieto and his US-trained economists had announced that they were planning to embark on an ambitious comprehensive structural reform agenda right from the start of the next legislative term. Mexico currently has a promising window of opportunity for a major structural overhaul, as most political parties and the citizens agree on the need for reforms to boost Mexico's growth potential and thereby address rising social challenges. Although the PRI failed to win an absolute majority in Congress, general agreement with the now-opposition PAN on the need for swift reforms could help incoming President Peña Nieto in garnering sufficient congressional support, even if this will likely come at the cost of protracted negotiations (see next chapter for more details). Possibly reflecting the incoming president's awareness of these challenges, he has decided to pursue a front-loaded approach that foresees the passing of most of the individual reforms in the first years of his six-year presidential term, which begins on December 1st 2012.

In essence, Mr Peña Nieto's reform agenda comprises six major reforms that build upon the recently debated liberalization of the labor market, which had been proposed by outgoing President Calderón. Mr Peña Nieto intends to start off with a fiscal reform early next year that should broaden Mexico's currently very narrow non-oil tax base and thereby reduce oil revenue dependency. The tax overhaul will likely be based on the closing of various tax loopholes, including the taxation of currently exempt personal and corporate income, as well as a broadening of the VAT tax base by also including food and medicines. Given still widespread poverty, the latter will only be introduced gradually, as it will have to be combined with a social security reform. The fiscal reform can be seen as a crucial part of the reform agenda, as it has to generate additional revenues that are needed to implement subsequent reforms. Since opposition to the reform will most likely be limited to the left-wing PRD and possibly conservative groups within the PRI, it constitutes one of the less controversial parts of the reform agenda, which enhances its chances for swift congressional approval.

This does not hold, however, for Mr Peña Nieto's repeatedly announced intention to open the national oil sector to private investors, which is currently forbidden by Mexico's constitution. In particular, Mr Peña Nieto plans to halt recent years' decline in state-owned oil company Petróleos de México (PEMEX)'s output by means of attracting foreign capital and skills, whereby the opening of the Brazilian state-owned oil company PetroBras could serve as an example. A successful energy reform could shore up government oil revenues over the medium-term and boost Mexican exports, but it will likely face considerable public opposition against foreign involvement. Also, depending on the scope of the reform, a change of the constitution requiring the support of two-third of Congress could be needed. This seems elusive, however, as the left-wing PRD and parts of Mr Peña Nieto's own PRI with close links to the Mexican oil workers' trade union will most likely oppose meaningful reform.

Given only gradual progress in Mexico's fight against drug cartels, the incoming president promised to adjust the current strategy that heavily relies on the use of the country's armed forces. Still, given limited financial resources and US concerns about too strong a shift in strategy, the scope of the proposed public security reform is limited. Besides strengthening the Federal Police, the creation of a national gendarmerie made up of currently deployed soldiers is anticipated, while the

country's more than 1,600 different police forces should be unified and judiciary processes be streamlined. Notwithstanding, the army will stay on the streets where needed. While we remain cautious about the short-term impact of these reforms, a gradual reduction in drug-related violence could lift Mexico's growth potential by boosting domestic investment by smaller companies, improving tourist arrivals and increasing investor confidence in the stability of the country.

Following the passing of the above-mentioned reforms, Mr Peña Nieto and his team seem to be interested in a general overhaul of Mexico's currently weak social welfare state. The planned reform should extend social security benefits, including 'universal' health care and temporary unemployment insurance, to all citizens, while shifting the financing from contributions to taxes. We note, however, that the scope of this reform will crucially depend on the successful broadening of the non-oil tax base and a stabilization of the government's oil revenues on the back of the preceding fiscal and energy reforms. Once implemented, in combination with the currently debated labour bill, the social security reform could bring about a major decline in informal employment that had risen markedly in recent years. The consequent expansion of the formal economy could further boost Mexico's potential growth and generate additional tax revenues.

Other reforms that have been considered refer to a further improvement of competition policy and limited changes to Mexico's political institutions. In the field of competition policy, the opening of various domestic sectors that are currently dominated by national monopolists might occur, which could attract additional foreign direct investment (FDI) and thereby boost productivity. Political reforms might lead to a downsizing of the 500-seat lower house of Congress or increased possibilities for citizens to directly vote on particular pieces of legislation.

If implemented, the proposed reforms could boost Mexico's annual trend growth from the current 3.5% to 4.5% - 5.5% and thereby spur Mexico's convergence with other OECD economies. Furthermore, reduced dependence of government finances on oil revenues on the back of a broadened non-oil tax base and a smaller informal sector could free funds for urgently needed infrastructure investments and improved public services provision. In combination with the possible opening of currently closed sectors like the oil sector, this could lead to a major improvement in Mexico's attractiveness for FDI inflows.

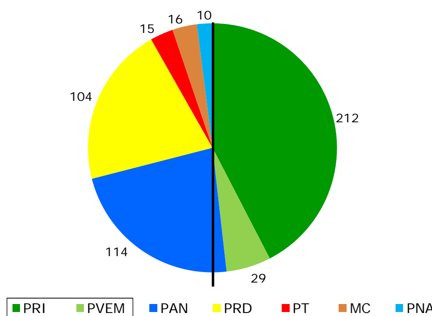
Amid concerns that an unresolved US fiscal cliff could cost Mexico up to 2% of economic growth next year, the front-loading of structural reforms might come at a crucial moment. Provided swift progress can be booked, investor confidence in Mexico's ability to cope with a seriously deteriorated external environment might be strengthened. In case negotiations in Congress end up in gridlock once more, the negative consequences for investor confidence should be limited, however, as Mexico's confidence-enhancing prudent fiscal and monetary policies remain unaffected.

The PRI's past and a lacking absolute majority in Congress create some challenges
Mr Peña Nieto's grand ambitions could be thwarted, however, by the PRI/PVEM's lacking majority in both houses of Congress and lingering fears among opposition parties and civil society groups that the PRI's return to power could lead to rising clientilism and corruption that had characterized the party's quasi-autocratic rule from 1929 till 2000. These concerns primarily center around the party's old guard – oftentimes referred to as 'dinosaurs' by critics – that might still exert considerable influence over Mr Peña Nieto. Also, the PRI's ongoing close ties with the country's opaque trade unions that date back to its uninterrupted 71-year domination of Mexican politics, are

considered to be a relic of the past by the opposition parties that should no longer play a role in contemporary Mexican politics. One month ahead of Mr Peña Nieto's inauguration on December 1st, these concerns have culminated in the formation of a six-year alliance between the center-right business-minded PAN, the leftist PRD, and the center-left Movimiento Ciudadano (MC). The decision to form this rather disparate alliance came as the PRI-faction in the newly elected Congress initially refused to approve some clauses to improve union transparency in a recently debated labour reform bill, as it tried to protect its traditional support base. While stressing that the alliance is not directed against Mr Peña Nieto and his reform program, its leaders note that it is intended to serve as a safeguard against the re-emergence of authoritarian tendencies and corrupt practices reminiscent of the PRI's past.

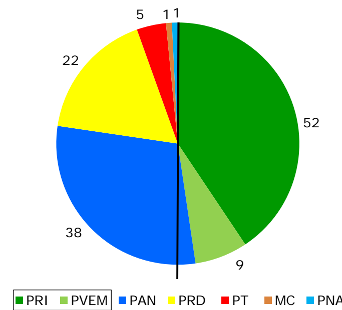
Since the scope of the alliance is unlikely to be extended beyond the commitment to protect Mexico's democratic standards, it should not directly affect cross-party co-operation in promoting structural reforms, provided these reforms are not perceived as serving the PRI's old guard and corporatist vested interests. The fact that both the PRI and the PAN eventually supported the recently debated labor bill, which included several of the trade union clauses that had been reinserted by the Senate, illustrates this point. Still, given that some of the above-mentioned reforms will most likely come to the disadvantage of vested interests, notably energy sector reform, inner-party opposition may increase at a time when heightened opposition scrutiny limits Mr Peña Nieto's leeway to negotiate compromises with the PRI's traditional support-base.

Figure 1: Composition of Congress
Number of seats (out of 500)



Source: IFE

Figure 2: Composition of the Senate
Number of seats (out of 128)



Source: IFE

The recent successful PRI-PAN co-operation on the labor bill suggests that both parties will continue to collaborate in the coming years. Both the PAN and the reform wing of the PRI share very similar views on macroeconomic policy and the need to swiftly implement structural reforms. In spite of the expected close collaboration, increased PAN scrutiny regarding the influence of the PRI's corporatist support base will remain and the PAN will try to dismantle many of the corporatist remains of the PRI's 71-year domination of Mexican politics, notably the close ties between the party and the country's opaque trade unions. In this respect, the formation of the above-mentioned opposition alliance could provide the PAN with the comfort needed to commit to ongoing co-operation with the PRI, as the threat of a united opposition could serve as a disciplining device for the more conservative groupings within the PRI that might prefer to shy away from alienating its traditional support base.

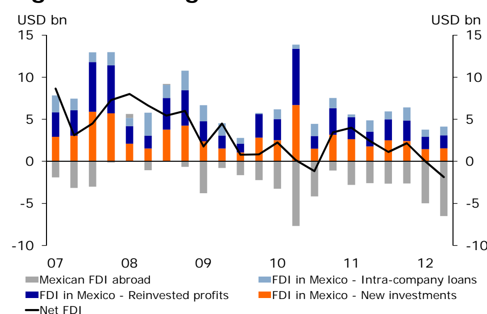
Notwithstanding, Peña Nieto's reform agenda faces a rocky road ahead. Meaningful progress will crucially depend on the incoming president's ability to reconcile various stakeholders' concerns and interests, which will likely result in difficult and protracted negotiations with the opposition and the

party's corporatist allies. Provided this process is managed carefully, progress is certainly possible, but major delays to Mr Peña Nieto's ambitious reform agenda are likely.

Meaningful structural reforms could attract more net FDI, which has turned negative

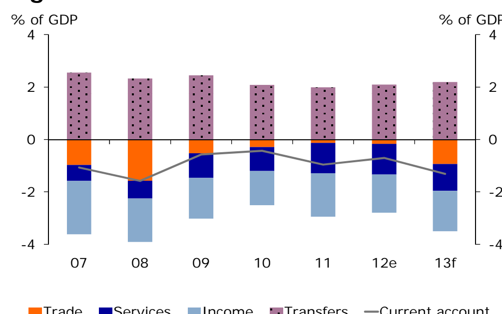
While Mexico's incoming government embarks on its structural reform program that could boost the country's attractiveness to foreign investors, FDI inflows have weakened in recent quarters. Given a major improvement of Mexico's ranking on the World Bank's Ease of Doing Business index, the current global economic slowdown is likely to blame for the softening FDI inflows. On an annual basis, FDI inflows declined by almost a fifth in the first half of 2012, which was mainly driven by declining new investments.

Figure 3: Foreign direct investments



Source: Banxico

Figure 4: Current account



Source: EIU

Meanwhile, FDI by Mexican companies abroad increased strongly in the same period, reflecting rising Mexican presence in e.g. the Netherlands and particularly the US, where Mexican companies benefit from the presence of a large emigrant community and preferential market access under the North American Free Trade Agreement (NAFTA). Consequently, Mexico's net FDI inflows turned negative for the first time since 2010 in the second quarter of this year. Still, we expect that net FDI will recover soon and continue to finance Mexico's small current account deficit, as the global growth slowdown will also reduce investment opportunities for Mexican companies abroad.

Net FDI inflows constitute a major source of non-debt creating financing of Mexico's current account deficit. As such, the recent weak net FDI figures illustrate that a further improvement of Mexico's investment climate by means of structural reforms is certainly welcome. Since the recent deterioration of the net FDI balance mainly results from rising investments by Mexican companies abroad, stronger FDI inflows would enable Mexico's economy to both protect this solid form of current account financing and expand its external asset stock by means of rising outbound investment.

Mexico

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.2	1.2	-6.0	5.6	3.9	3.9	3.7
Consumer prices (average % change pa)	4.0	5.1	5.3	4.2	3.4	4.1	4.0
Current account balance (% of GDP)	-1.1	-1.6	-0.6	-0.4	-1.0	-0.7	-1.3
Total foreign exchange reserves (m USD)	87109	95126	99589	120265	143991	173840	207480
Economic growth							
GDP (% real change pa)	3.2	1.2	-6.0	5.6	3.9	3.9	3.7
Gross fixed investment (% real change pa)	6.9	5.5	-11.7	6.2	8.9	7.0	7.2
Private consumption (real % change pa)	4.0	1.7	-7.3	5.0	4.5	3.8	3.6
Government consumption (% real change pa)	3.1	1.1	3.2	2.4	0.6	2.1	1.8
Exports of G&S (% real change pa)	5.7	0.6	-13.6	21.7	6.8	6.3	6.5
Imports of G&S (% real change pa)	7.0	2.9	-18.5	20.7	6.8	7.6	8.7
Economic policy							
Budget balance (% of GDP)	0.0	-0.1	-2.3	-2.9	-2.5	-2.4	-1.4
Public debt (% of GDP)	31	36	37	37	35	35	35
Money market interest rate (%)	7.7	8.3	5.9	4.9	4.8	4.8	5.0
M2 growth (% change pa)	8	16	6	8	12	16	14
Consumer prices (average % change pa)	4.0	5.1	5.3	4.2	3.4	4.1	4.0
Exchange rate LCU to USD (average)	10.9	11.1	13.5	12.6	12.4	13.3	12.9
Recorded unemployment (%)	3.7	4.0	5.5	5.4	5.2	4.5	4.6
Balance of payments (m USD)							
Current account balance	-11069	-17334	-5064	-4456	-11073	-8360	-17410
Trade balance	-10074	-17261	-4681	-3009	-1468	-1960	-12460
Export value of goods	271875	291343	229704	298473	349375	377400	402340
Import value of goods	281949	308603	234385	301482	350843	379350	414800
Services balance	-6314	-7360	-8283	-9455	-13450	-13920	-13570
Income balance	-21086	-18182	-13693	-13529	-19129	-17270	-20470
Transfer balance	26405	25469	21593	21537	22974	24780	29090
Net direct investment flows	23235	25984	9101	7139	10607	900	10500
Net portfolio investment flows	-4665	4135	-12792	16343	51631	16380	19740
Net debt flows	10559	11892	8875	29449	10441	6910	10330
Other capital flows (negative is flight)	-7196	-16569	4438	-27789	-32810	-23220	-30000
Change in international reserves	10865	8108	4557	20685	23726	29849	33640
External position (m USD)							
Total foreign debt	178611	187137	171485	200081	210901	217720	227860
Short-term debt	27362	28405	27590	39013	45702	47130	51140
Total debt service due, incl. short-term debt	62372	59674	59157	58806	88610	93270	95800
Total foreign exchange reserves	87109	95126	99589	120265	143991	173840	207480
International investment position	-371923	-325278	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	283000	278482	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	654923	603760	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.0	-1.6	-0.5	-0.3	-0.1	-0.2	-0.9
Current account balance (% of GDP)	-1.1	-1.6	-0.6	-0.4	-1.0	-0.7	-1.3
Inward FDI (% of GDP)	3.0	2.5	1.8	2.0	1.7	1.6	1.8
Foreign debt (% of GDP)	17	17	19	19	18	18	17
Foreign debt (% of XGSIT)	55	54	63	58	53	51	50
International investment position (% of GDP)	-35.9	-29.7	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	19	17	22	17	22	22	21
Interest service ratio incl. arrears (% of XGSIT)	4	3	3	3	4	3	3
FX-reserves import cover (months)	3.4	3.4	4.6	4.4	4.5	5.1	5.6
FX-reserves debt service cover (%)	140	159	168	205	162	186	217
Liquidity ratio	113	114	121	128	122	126	128

Source: EIU, IIF

Disclaimer
This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.