Rabobank

Country update **MEXICO**

Summary

Mexico's economy faced increasing headwinds this year, as economic growth in the US, its main trading partner, slowed down markedly. While domestic demand proved relatively resilient so far, we neither expect this trend to continue nor that it could replace weakening export demand. Consequently, Mexico's economic growth forecasts for this and the next year have been cut to about 3%. Being confronted with a deteriorating external backdrop, Mexico's government has opted for a sensible macro-economic policy approach that tries to balance fiscal prudence with limited stimulus. An interest rate cut might also be in the cards in the coming months. Since the implemented stimulus policies largely focus on the supply side of the economy in spite of a still negative output gap, we doubt the effectiveness of these measures if demand were to weaken further. We consequently expect that the Mexico's exposure to external shocks remains considerable, but its relatively ample foreign exchange reserves should provide some buffer.

Things to watch:

- US economic recovery
- Presidential elections in 2012
- Fight against drug cartels

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)	1,943
Population (millions)	111.2
Main languages	Spanish
Main religions	Roman Catholic (76%)
	Protestant (6%)
	None (3%)
Head of State (president)	Felipe Calderón
Head of Government (president)	Felipe Calderón
Monetary unit	Mexican peso (MXN)

Social and governance indicators	rank / total
Human Development Index (rank)	57 / 187
Ease of doing business (rank)	53 / 183
Economic freedom index (rank)	48 / 179
Corruption perceptions index (rank)	98 / 178
Press freedom index (rank)	136 / 178
Gini index (income distribution)	51.7
Population below $1.25 per day (PPP)	3.40%

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	1034	1.66
Nominal GDP at PPP	1834	2.45
Export value of goods and services	314	1.69
IMF quotum (in mln SDR)	3153	1.45
Economic structure	*2010*	*5-year av.*
Real GDP growth	5.4	1.3
Agriculture (% of GDP)	4	4
Industry (% of GDP)	33	33
Services (% of GDP)	64	63
Standards of living	*USD*	*% world av.*
Nominal GDP per head	9196	93
Nominal GDP per head at PPP	16305	138
Real GDP per head	8198	103

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	71	US	60
Canada	7	China	7
Germany	1	Japan	4
Spain	1	South Korea	3

Main export products (%)	
Manufactured goods	82
Oil	14
Agricultural products	3
Mining products	1
Main import products (%)	
Intermediate goods	76
Consumer goods	14
Capital goods	10
Openness of the economy	
Export value of G&S (% of GDP)	30
Import value of G&S (% of GDP)	32
Inward FDI (% of GDP)	1.8

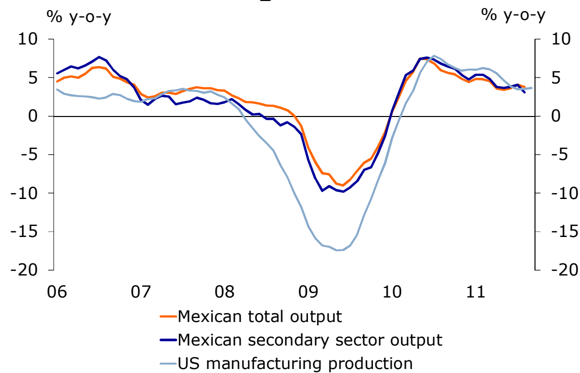
Source: EIU, CIA Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

After having gone through the deepest recession of all Latin American countries in 2009, Mexico's economy embarked on a strong recovery last year as substantial US fiscal and monetary stimulus pulled the US economy out of recession. Benefitting from the integration of its manufacturing sector into US supply chains and a rebound in workers' remittances from Mexicans living north of the Rio Grande, Mexico's economy posted 5.4% growth last year, far above its pre-crisis average. Bearing witness to a moderation of the speed of the global recovery on the back of a gradual reduction of fiscal stimulus, Mexican economic growth for this year was expected to cool down slightly to come in at 4.5% (see previous report), but this estimate proved too optimistic. Owing to the marked downward revision of US economic growth earlier this year and a general slowdown of global economic growth, Mexico's growth projections for 2011 have been cut to 3.4%, mainly on the back of weaker exports. However, the deterioration of Mexico's external environment this year had not been limited to sluggish growth in its main export market, the US. Rising global risk aversion on the back of the deteriorating sovereign debt crisis in the euro area led to a flight to safety, largely into US treasuries, during the third quarter, bringing about an almost 20% depreciation of the Mexican peso and the Brazilian real. Concurrently, Latin American CDS spreads climbed, but this movement was muted compared to the development of CDS spreads for certain euro area sovereigns. While Mexico's open economy proved relatively resilient to the deterioration of its external environment so far, the Mexican peso appreciated slightly and the CDS spread returned to its 2010 level, a further deterioration of global economic conditions in the coming year

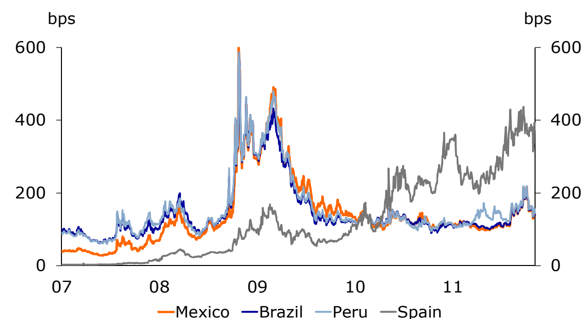
cannot be excluded. Consequently, this update will take a closer look at the resilience of Mexico's economy if external economic conditions were to worsen further in the months ahead.

Chart 1: Economic growth



Source: INEGI, Federal Reserve

Chart 2: CDS spread development



Source: Bloomberg

Mexico's lines of defence

On the fiscal front, the 2012 budget proposal opts for a delicate balance between ongoing fiscal stimulus amid lower expected economic growth, while limiting budget deficits in order to reduce deviations from Mexico's balanced budget rule and demonstrate fiscal prudence. Consequently, a budget deficit of 0.2% of GDP (2.2% including investments into state-owned oil company PEMEX) is proposed. However, it should be noted that some underlying economic assumptions will likely prove to be too optimistic if Mexico's external environment were to worsen, with a double-dip recession in the US presenting a particular risk. This would certainly hold for the 2012 economic growth assumption of 3.5% and the projected volumes of oil sales by PEMEX, Mexico's state-owned oil company that acts as the government's cash cow. Since the 2012 budget still leans heavily on oil revenues, the projected budget balance is also exposed to a worsened economic situation through lower oil sales.

Still, the relatively small projected budget deficit should leave some room for a possible temporary deterioration of government finances that should not immediately lead to a marked worsening of Mexico's relatively low public debt ratio.

The government's economic stimulus efforts largely focus on the provision of guarantees to boost credit provision. Given that the output gap has not been closed yet and is unlikely to do so soon amid lower economic growth, we doubt the effectiveness of this approach. Recent estimates put the remaining negative output gap at about 1% of GDP, reflecting considerable slack in the economy. Therefore, measures aimed at increasing credit supply will likely fail to stimulate growth, if credit demand remains depressed given still unused production capacities.

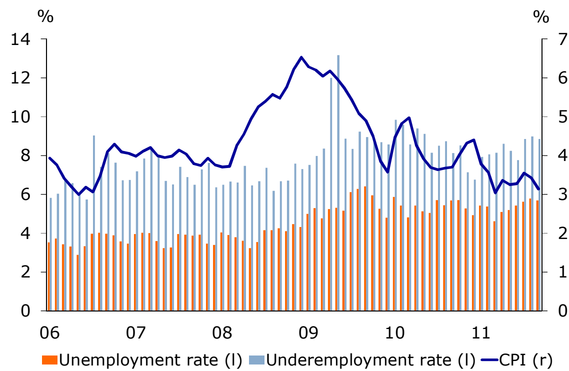
Direct government stimulus of the demand side of the economy remains rather limited.

On the monetary front, Mexico's central bank (Banxico) could cut interest rates if the external backdrop continues to worsen. While Banxico, which has the sole mandate of maintaining price stability, kept its policy rate at its current level of 4.5% during its most recent meeting, it hinted at a possible rate cut if the risks of a marked economic downturn were to increase. So far, the depreciation of the freely floating Mexican peso has already provided some stimulus, while inflation rates remained relatively stable on the back of a limited pass-through. Also, the still large output gap and the related relatively high un- and underemployment rates contain core inflation.

Therefore, depending on the speed of inflation pass-through and the level of the exchange rate of the Mexican peso, Banxico should have some room to cut interest rates without sparking a pronounced rise in core inflation that could undermine the price competitiveness of Mexico's export

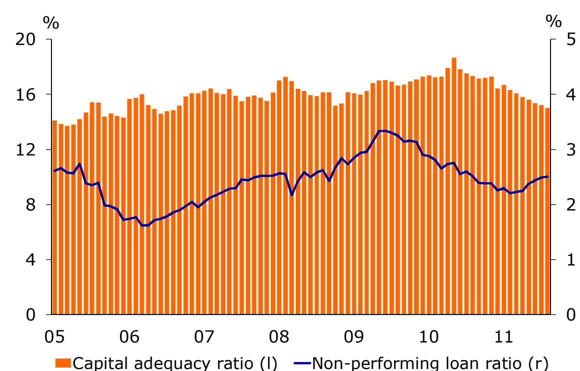
sector. While Banxico' s relatively late rate cuts during the 2009 recession make an earlier move during the current downturn more likely, its effect on stimulating domestic demand could be tempered given Mexico's low degree of bank penetration. Therefore, an interest rate cut will most likely stimulate external demand through a nominal exchange rate depreciation on the back of a lower interest rate differential with respect to the USD. However, it should be noted that the Federal Reserve could resort to additional quantitative easing if the growth outlook for the US economy were to deteriorate further. Given a still positive interest rate gap between the US and Mexico, resulting inflows could thereby nullify the impact of a Mexican rate cut on the nominal exchange rate.

Chart 3: Unemployment and inflation



Source: Banxico, INEGI

Chart 4: Banking sector performance

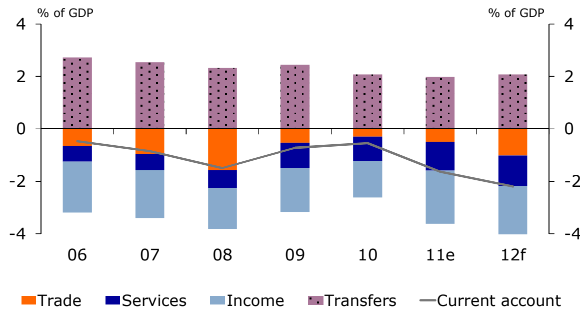


Source: Banxico

Mexico's tightly regulated banking sector remains well-capitalized and non-performing loans hover around a manageable 2.5% of total loans. While direct exposures to European sovereign and private debt are negligible, credit growth could suffer in case of a further deterioration of the sovereign debt crisis in the euro area. The sector is largely foreign-owned and parent banks of Mexican subsidiaries, especially those from weaker euro area countries, could be forced to reduce their asset base in order to boost capitalization ratios. The decision to boost euro area banks' Tier 1-ratio to 9% will likely bring about a similar effect.

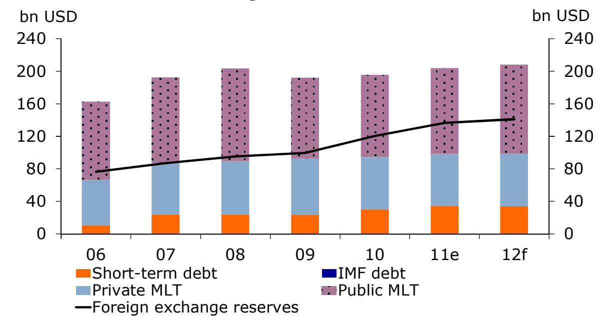
Given the above-mentioned limitations to the effectiveness of Mexico's fiscal and monetary stimulus measures, the country's relatively large foreign exchange reserves in combination with the absence of major economic imbalances in our view represent Mexico's major line of defence against a worsening global backdrop. Thanks to a deliberate policy of accelerated foreign exchange reserve accumulation since the 2009 recession, Mexico's foreign reserves amounted to USD 140bn in October 2011, covering the country's entire foreign short-term debt, as well as its entire private external medium- and long-term debt. Even though Mexico's current account deficit is expected to worsen from 0.5% to a moderate level of 1.6% and 2.2% of GDP in 2011 and 2012, respectively on the back of rising trade and income balance deficits, we expect that about 80% of the current account deficits in the coming years will be financed by foreign direct investment inflows.

Chart 5: Current account balance



Source: EIU

Chart 6: External position



Source: EIU

Major reforms needed to strengthen Mexico's resilience

Given the short time span since the deep 2009 recession and the current paralysis of federal politics ahead of the July 2012 presidential elections, Mexico's prudent fiscal and monetary policy stance in our view represents a sound preparation amid a deteriorating external environment. Still, we want to stress that more needs to be done if the country wants to strengthen its resilience to external shocks. Major reforms are needed to boost Mexico's domestic demand, starting with a major broadening of the country's tax base in order to reduce government finance's dependence on oil revenues and to make funds available to improve Mexico's underperforming educational system. In combination with labor market and anti-trust reforms, a better-performing educational system could spur Mexico's sluggish labor productivity growth, which would make more substantial real wage increases possible without harming Mexico's price competitiveness position. However, despite general awareness of Mexico's structural problems, we do not expect any significant progress on the reform front, even after the July 2012 presidential elections. While Enrique Peña Nieto and his center-left opposition Partido Revolucionario Institucional (PRI) will likely win the July 2012 presidential elections, we do not expect that he will also win an absolute majority in Congress. Consequently, the PRI will depend on alliances with Partido Acción Nacional (PAN) of incumbent president Felipe Calderón and the Partido de la Revolucion Democrático (PRD). Yet, given a still developing political culture after 71 years of PRI rule, reaching across the aisle proves to be difficult in Mexican politics. We therefore believe that Mexico's current presidential system constitutes a major impediment to reform, as incumbent governments tend to lack a majority in Congress. Furthermore, the constant flow of state elections creates a difficult environment for the federal government to impose possibly painful reforms. Unless these issues are addressed first, progress on important structural reforms is unlikely to gain speed in the future, and consequently, Mexico's exposure to external shocks remains considerable.

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Mexico

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.2	3.2	1.2	-6.2	5.4	3.4	3.1
Consumer prices (average % change pa)	3.6	4.0	5.1	5.3	4.2	3.5	3.9
Current account balance (% of GDP)	-0.5	-0.9	-1.5	-0.7	-0.5	-1.6	-2.2
Total foreign exchange reserves (mln USD)	76271	87109	95126	99589	120264	136650	141050
Economic growth							
GDP (% real change pa)	5.2	3.2	1.2	-6.2	5.4	3.4	3.1
Gross fixed investment (% real change pa)	0.0	6.9	5.9	-11.9	2.3	4.8	4.3
Private consumption (real % change pa)	0.0	4.0	1.7	-7.2	5.0	3.7	3.5
Government consumption (% real change pa)	0.0	3.1	1.1	3.8	2.8	1.8	2.5
Exports of G&S (% real change pa)	0.0	5.7	0.5	-13.9	25.7	6.9	3.8
Imports of G&S (% real change pa)	0.0	7.1	3.0	-18.8	23.5	9.2	5.3
Economic policy							
Budget balance (% of GDP)	0.1	0.0	-0.1	-2.3	-2.9	-2.5	-1.0
Public debt (% of GDP)	32	31	36	37	37	38	36
Money market interest rate (%)	7.5	7.7	8.3	5.9	4.9	4.8	4.8
M2 growth (% change pa)	14	8	16	6	8	9	12
Consumer prices (average % change pa)	3.6	4.0	5.1	5.3	4.2	3.5	3.9
Exchange rate LCU to USD (average)	10.9	10.9	11.1	13.5	12.6	12.0	12.5
Recorded unemployment (%)	3.6	3.7	4.0	5.5	5.4	5.1	5.0
Balance of payments (mln USD)							
Current account balance	-4487	-8851	-16339	-6352	-5626	-19020	-26730
Trade balance	-6133	-10074	-17261	-4681	-3009	-5660	-12400
Export value of goods	249925	271875	291343	229704	298473	336280	373370
Import value of goods	256058	281949	308603	234385	301482	341940	385770
Services balance	-5736	-6305	-7379	-8405	-9611	-12760	-14010
Income balance	-18567	-18868	-17162	-14797	-14511	-23610	-25580
Transfer balance	25949	26396	25462	21531	21504	23000	25260
Net direct investment flows	14293	21477	25137	8314	4335	16460	20000
Net portfolio investment flows	1258	3888	-3549	11644	47137	22100	12800
Net debt flows	90	23368	14256	4421	3421	8150	4260
Other capital flows (negative is flight)	-8929	-29018	-11396	-13470	-28582	-11230	-5920
Change in international reserves	2225	10865	8108	4557	20684	16460	4400
External position (mln USD)							
Total foreign debt	162497	192689	203579	192008	195586	204040	208300
Short-term debt	10237	23848	24027	23335	29592	34520	34340
Total debt service due, incl. short-term debt	53674	49801	64466	63980	73830	78050	81950
Total foreign exchange reserves	76271	87109	95126	99589	120264	136650	141050
International investment position	-309204	-350297	-361834	-352651	-362731	n.a.	n.a.
Total assets	188518	228862	245392	245626	303092	n.a.	n.a.
Total liabilities	497722	579159	607226	598277	665823	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-0.6	-1.0	-1.6	-0.5	-0.3	-0.5	-1.0
Current account balance (% of GDP)	-0.5	-0.9	-1.5	-0.7	-0.5	-1.6	-2.2
Inward FDI (% of GDP)	2.1	2.9	2.4	1.7	1.8	2.0	2.1
Foreign debt (% of GDP)	17	19	19	22	19	18	17
Foreign debt (% of XGSIT)	54	60	59	71	57	54	50
International investment position (% of GDP)	-32.5	-33.8	-33.1	-40.1	-35.1	n.a.	n.a.
Debt service ratio (% of XGSIT)	18	15	19	24	22	21	19
Interest service ratio incl. arrears (% of XGSIT)	4	4	3	4	4	4	3
FX-reserves import cover (months)	3.3	3.4	3.4	4.6	4.4	4.4	4.1
FX-reserves debt service cover (%)	142	175	148	156	163	175	172
Liquidity ratio	117	120	117	123	128	128	123

Source: EIU

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