COUNTRY RISK ANALYSIS

Mexico

CREATING CONFIDENCE IN YOUR EXPORTS

COUNTRY RISK CATEGORY

3/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES IN THE COUNTRY

Short-term transactions: SEK 61.2 million

Medium and long-term transactions: SEK 3,329.6 million

EKN'S POLICY

Sovereign risks: Normal risk assessment

Other public risks: Normal risk assessment

Bank risks: Normal risk assessment

Corporate risks: Normal risk assessment

See “EKN'S POLICY” section

DATE

12/02/2014

Reforms creating opportunities for faster growth

For many years, Mexico has been characterised by consensus and responsible economic policies along with good relations with the international financial markets. Despite this, political obstacles have prevented long-term structural reforms, which has restricted economic growth. It is against this background that the cross-party cooperation under Pacto por México has aroused a lot of attention over this past year with a comprehensive programme of reforms. Several steps have been taken towards strengthening competitiveness and boosting growth, but it is still uncertain how effective these reforms will be. Given the strong dependence on the US, the brighter outlook for the US economy is expected to have a positive effect, although Mexico is affected by lower liquidity in the global financial system. The business environment has been strengthened, but the country has political and institutional challenges in the form of widespread drug-related violence, high levels of corruption and deficiencies in the judiciary.

STRENGTHS

- Reassuring economic policies
- Structural reforms can boost the economy
- Support from the US and the IMF when problems arise

WEAKNESSES

- Troublesome security situation
- Small and relatively underdeveloped financial sector
- High levels of corruption and shortcomings in the judiciary

POLITICS

Reforms characterising the PRI's return to power

The scenario of expectation was fragmented before the former governing party PRI (Partido Revolucionario Institucional) returned to power in December 2012, with Enrique Peña Nieto as president. On the one hand, it was feared there would be a return to the less democratic systems that characterised the party's rule for the majority of the 20th century. While on the other hand, there was hope of a reduction in drug-related violence and a more dynamic economy with a rapidly rising rate of growth. Just over a year after the power shift, the assessment is that both the expectations and the fears were somewhat misplaced.

However, a comprehensive programme of reforms has taken off that is focusing on the structural problems that have been putting limits on economic growth for a long time. During the twelve-year reign of the right-wing PAN in the early 21st century, reforms were prevented by political deadlock and PRI's lack of willingness to implement any change. PRI has since changed its position and in what has been called Pacto por México it is now collaborating with the two opposition parties in order to increase competitiveness, create jobs and accelerate the rate of growth. Through a common objective and a lot of horse-trading, many reforms have now been implemented. The changes include reforms in the energy, telecommunications and financial sectors, the education system and the labour market, which in the long term is expected to lead to a more efficient economy. The long-standing ban on re-election has been relaxed, with the intention of making congressmen and mayors more accountable to the electorate. In addition, the reforms include a number of changes designed to reduce the politicisation of the judiciary and electoral authorities.

However, this cross-party relationship has not always run smoothly. Energy reforms in particular have led to conflicts. Since the oil industry was nationalised in 1938, the nationalistic energy policies, where the constitution severely restricts the presence of foreign companies, has been a source of pride for many Mexicans. Meanwhile, the energy sector has been plagued by low investment and high costs, which has created pressure to implement change. The agreed reform does away with the monopoly, but has led to the leftist PRD withdrawing from the pact and gathering signatures for a referendum on the issue. This will probably not nullify the decision, but may create uncertainty and delay investment. The necessary supplemental legislation is expected to be enacted in cooperation with the conservative PAN party, but the coming years will likely be dogged by partisan considerations prevailing and the pace of reform slowing.

Unclear strategy against violence

No visible progress is being made in combating serious drug-related violence. The violence has spread to various parts of the country and is having an adverse effect on the business climate. Politicians have been murdered and tourist flows to Mexico have been hit as a result of the escalation of violence, even though the violence is at a much lower level than in many neighbouring countries. Serious crime is concentrated to certain cities and regions. The corrupt police force is contributing to the problem, which led the former president, Calderón, to deploy the military in its fight against the drug cartels. However, this led to many accusations of human rights abuses. Calderón has also been criticised for his strategy in challenging drug leaders, which is thought to have escalated the violence. The anticipations of a new strategy from Peña Nieto, who is more focused on law and order than on confrontation, have not yet materialised. Several high-profile arrests have been made during Peña Nieto's first year as president. The plan to establish a gendarmerie as a way of getting a less corrupt police structure in place has been delayed. The murder rate is estimated to have declined slightly, but other serious crime has increased and, at the state level, the problems are acute in many cases. Question marks therefore remain on the strategy and it is highly probable that the situation will continue to be difficult when it comes to security.

Despite the violence and widespread corruption, there is hardly any imminent threat to the country's fundamental political stability. Consensus is relatively strong on economic policy, and even if a comprehensive reform programme is implemented, the course of economic policy is not expected to change. In emergency situations, Mexico can also, in all likelihood, rely on support from its northern neighbour, the United States.

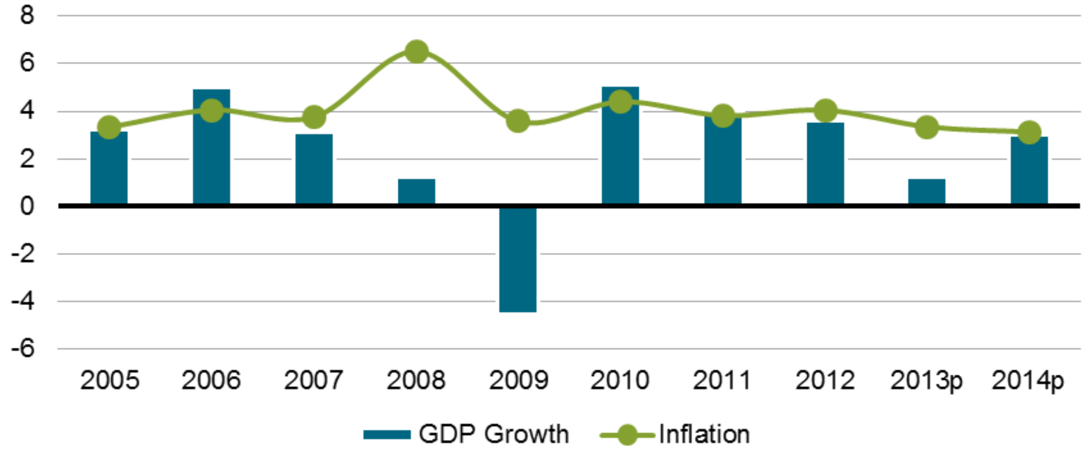
ECONOMY

Reforms can improve the dynamics of the economy

The Mexican economy is dominated today by oil extraction and the manufacturing industry. The manufacturing industry is dominated by “maquiladoras” - assembly plants that manufacture textiles and clothing, electronics and automotive components for export to the United States. Mexico's NAFTA membership and the deep economic integration with the US is an important feature of its economy. Almost 80 per cent of all exports go to the US and the country is vital to the Mexican tourism sector. Emigrant remittances are also a very important source of income for the Mexican economy. Its close link to the US resulted in Mexico getting hit very hard by the global financial crisis of 2008-09, but a strong recovery has subsequently occurred. The competitive position of the Mexican assembly industry has improved, particularly in relation to its main competitor, China. This is linked to a competitively favourable development of the Mexican Peso and a sharp rise in the production costs in China. A brighter economic outlook for the US is expected to benefit the Mexican economy over the coming years.

The growth rate over the past 30 years, however, has been restrained, averaging less than 2.5 per cent per year. With the exception of manufacturing, improvements in productivity and competitiveness are conspicuous by their absence. This is partly due to high energy costs, a lack of competition in many sectors, a rigid labour market with a large informal sector, and insufficient access to finance. Added to this are deficient institutional arrangements and legal frameworks that inhibit economic growth in the longer term. The recently agreed reforms address several of these weaknesses, which we believe can enhance long-term growth. The economy is expected to gradually become more efficient and dynamic, with increased competition, markets that work more efficiently and a greater scope for private investment. Overall, structural reforms are forecast to increase the potential growth rate of just over three to nearly four per cent.

GDP – GROWTH AND INFLATION (%)



Stable inflation levels despite volatile growth rate

The crowning glory was the energy reform resolved in December 2013 that exceeded the expectations of most analysts. From an economic perspective, the reforms have been needed for a long time. The state oil company Pemex has long been drained of capital because of high taxation. The lack of public funds for new investment has resulted in the company lagging behind in technological development which has contributed to its inefficient operation. Similar problems for the utility company CFE have created an inefficient electricity market, where very high electricity prices have restricted the competitiveness of Mexican companies. The reforms are to weaken the companies' monopoly status and to allow private companies to explore for and extract oil as well as generate electricity. An increase in both foreign investment and growth is therefore expected within a few years. A more efficient and dynamic energy sector is also expected to have a positive impact on other sectors of the economy. However, the extent of the impact on investment and growth is difficult to predict and is influenced by additional legislation that is to be passed in 2014.

In the present situation, oil revenues represent a third of the state budget, which has made the state vulnerable to volatile energy prices and declining production for Pemex. In the long term, the reduction in revenue from Pemex is forecast to be offset by revenues from increased production due to the energy reforms. Dependence on oil is expected to continue, but a new oil fund is being created to promote long-term stability. Even a reform on the fiscal side, including increasing the tax base and phasing out fuel subsidies, may strengthen the resilience of public finances and increase the ability to counteract the effect of cyclical fluctuations. The fiscal reforms were less extensive than anticipated and also contains some new expenditure. Additional changes may therefore be necessary to prevent state finances from deteriorating.

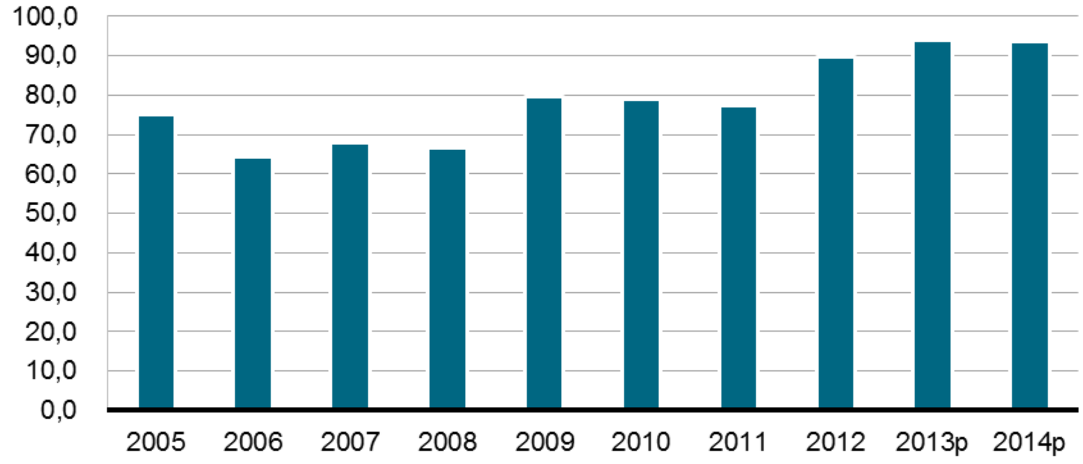
Government finances have previously been well administered and have been characterised by low deficits, giving access to capital markets even during periods of financial turmoil. The responsible economic policies cross party lines. The fiscal framework and its budgetary rules have been respected. This was the case even during the economic downturn caused by the financial crisis, which limited the increase in debt. The state's debt profile has improved with longer maturities and a higher share of loans in local currency. The increased debt levels at the local and state level are a risk factor, but the effects on government finances are expected to be minor.

BALANCE OF PAYMENTS AND DEBT ISSUES

Manageable debt levels

Mexico's external balance is stable, and the debt level at 30 per cent of GDP is considered low. The country has sufficient international reserves and has made sure of its financial support from the US and the IMF via a flexible credit line that can be used when necessary. Knowing that any economic problems in Mexico would immediately spill over to the US means Americans are very inclined to support its neighbour to the south. Backing from the US and the high level of confidence in the Mexican economy from international financial institutions are therefore important strength factors for Mexico.

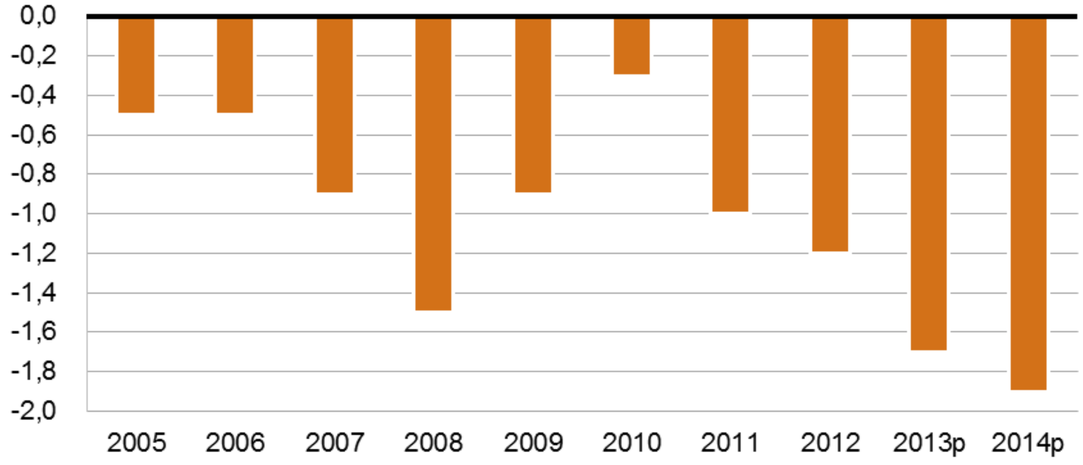
EXTERNAL DEBT (% OF EXPORTS)



Mexican debt is at a moderate level

The country's current account deficit is low too, even though the trend shows that it is increasing. The reform package is expected to bring a continued increase driven by imports and investment in the short term, but then a decrease due to increased export revenue in the longer term. The deficit is assessed to be sustainable and Mexico is a long way from the acute balance of payments crisis that the country faced in the 1990s. The current account deficit is largely financed by foreign direct investments, which have however decreased since the financial crisis. In recent years, the portfolio inflows from abroad have instead been very high from both a historical and a regional perspective. The fact that the proportion of current liabilities has increased also constitutes a risk factor when global liquidity decreases. But taking into account the good macroeconomic foundations and the government's ability to manage the economy, the risk of acute financial crises is very limited.

CURRENT ACCOUNT BALANCE (% OF GDP)



The current account deficit is volatile, but remains at a moderate level

CURRENCY POLICY

High degree of convertibility

Since the inflation target was introduced as an anchor for monetary policy after the 1994-1995 financial crisis, confidence in the Mexican Central Bank has steadily increased. At the same time, the government introduced a floating exchange rate regime, which is managed by a currency commission composed of representatives of the Ministry of Finance and the Central Bank. The currency commission can intervene in the market if necessary, such as in global financial crises. Since the mid-1990s, the currency has strengthened and has demonstrated remarkable stability, even during periods of turbulence on the international financial market. There is an underlying confidence in the Peso, although fluctuations were significant during the 2008-2009 global financial crisis. Admittedly, the Peso depreciated very sharply in the spring of 2013 after the US Federal Reserve indicated that liquidity injections eventually were about to be reduced. But currency markets worked well and the currency stabilised quickly, without any intervention from the currency commission. The currency has a high degree of convertibility and can be assessed by EKN in local currency-financed transactions.

FINANCIAL SECTOR

Stable but limited financial sector

The Mexican banking system today is financially strong and has a modern regulatory system. The system survived the global financial crisis and is relatively well consolidated. The banks are generally profitable and well capitalised, with good liquidity and cautious loan growth. A continuation of the moderate increase in the proportion of bad loans is to be expected, but the provisions are adequate. Financial problems among home construction companies are not assessed to have systemic effects as the banks' exposure to the sector represents a marginal portion of the loan portfolio.

From a regional perspective, Mexican banks are expected to be more than able to handle a situation where the stimulus from developed economies decreases. Customer deposits are extensive and stable, and although there is some significant short-term borrowing, it is primarily in pesos, which reduces the refinancing risk. The banks have strong balance sheets and good financial reserves which will help to alleviate the effects of declining global liquidity.

A large share of the banking system, 65 per cent, is in foreign hands, which makes the system sensitive to changes to the credit ratings of parent banks. Foreign ownership is expected to largely remain intact, but support from parent companies is not something that can be taken for granted. The prospect of state aid is all the more likely. Mexico is assessed as having both the capacity, willingness and a solid history of providing support during periods of financial turbulence. It is reported that no bank has been allowed to fail in the last 30 years.

However, a persistent weakness in the system is the limited scope of the financial sector. Lending is substantially lower than in comparable countries and has deficiencies, not least when it comes to small and medium-sized enterprises. Some improvement has been made in recent years through state bank lending. Mexican banks are also relatively slow and bureaucratic from a regional perspective, and much less developed financially than, for example, Brazilian banks. A recently adopted financial sector reform focuses on some of these deficiencies. Through robust credit disclosures, increased competition and an enhanced legal framework, for example, for the banks’ chances of recovery, loan growth is estimated to increase in the long term among households and small and medium-sized enterprises.

BUSINESS ENVIRONMENT

Improvements in the business environment being hampered by corruption

The business environment has generally improved in Mexico in recent years, thanks to reforms that have facilitated the creation of new enterprises as well as efforts to reduce the regulatory burden. The access to financial information is generally good in Mexico. Additionally, Mexico is relatively strong in terms of openness to foreign investment and free trade, which facilitates international transactions. Mexico appears in 53rd place in the World Bank's “Doing Business Indicators”, putting the country on a level with Spain and in fourth place in the region. The main problems relate to the inertia in terms of registration of property, an extremely complicated taxation system and widespread corruption. Corruption, especially in the judiciary, is estimated to be higher than in many other countries in the region, which is creating uncertainty and increasing transaction costs. High crime rates and drug-related violence have also affected business activities, especially locally. Furthermore, there can be big differences between the various states in areas such as the credibility and effectiveness of the legal system, as well as the ability to invoke agreements.

Many important sectors such as telecom, TV, energy and sections of the food industry are dominated by one or just a few companies. This means that smaller suppliers or other parties may find themselves in a position of dependency. A number of the reforms introduced by Pacto de México are aimed at increasing competition, which could lead to significant regulatory changes over a transition period, but could also open up new business opportunities.

EKN'S EXPOSURE

Transport, telecommunications and consumer trade

EKN's outstanding guarantees for transactions in Mexico were valued at over SEK 3.25 billion at the end of 2013. The outstanding guarantees are for transactions in various sectors, but transport, telecommunications and consumer trade dominate. EKN's exposure has varied greatly over time, particularly as access to financing through the capital markets has been good periodically for larger companies. Exposure has fallen sharply in recent years following guarantees for some major transactions being redeemed prematurely. A large flow of smaller transactions is still evident, particularly in the transport, construction and paper sectors. Imports on open credit are common, while letters of credit are relatively rare. Offers were nearly SEK 0.35 billion.

OFFERS & GUARANTEES AT DECEMBER 31, MSEK

Guarantees are dominated by transactions in transportation, telecommunications and consumer trade

PAYMENT EXPERIENCE

Important to have unambiguous agreements

EKN's experiences in terms of transactions with the public sector have been relatively good. Bureaucracy and slowness in payments have occurred in transactions with public companies. At the same time, state finances are strong and no payment problems are expected. The government's willingness to pay is estimated to be strong and debt management has been exemplary. On its own initiative, Mexico repaid in advance all its obligations to the Paris Club and the Brady Bond loans, which the country took out at the end of the 1980s. However, EKN's experience of transactions with the regions and municipalities is more limited.

In transactions with the private sector, EKN's experience has been mainly positive. However, there is occasionally a lack of respect for agreements entered into and it will be of key importance for Swedish exporters to ensure that sound and unambiguous agreements are available. The legal system has improved but is still inadequate, particularly with regard to credit and property rights. Regional differences can also vary greatly when it comes to how litigation is conducted, the level of corruption and the risk of violence. Legislation concerning the reorganisation of companies is also unclear. The reconstruction process could continue for a very long time regardless of circumstances. Other export credit agencies have reported fraud in export transactions with private buyers in the country.

EKN'S POLICY

Stable classification

Mexico was downgraded to country risk category 3 in 2009, in an assessment undertaken in collaboration with other OECD countries. EKN places the country in this class, both for short and longer credit guarantees. Regardless of the buyer category or credit duration, EKN has no specific, general limitations. Instead, each transaction is assessed on its own merits.

SOURCES FOR THE GRAPHS: IMF, EKN's own assessments

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 1,964,375 km² (4.3 times Sweden)

Population: 117.1 million (2012)

Population growth: 1.1 % (2013)

GDP: USD 1,178 billion in 2012 (Sweden USD 524 billion in 2012)

GDP/capita: USD 10,055 in 2012 (Sweden USD 54,476 in 2012)

CREDIT RATING

	COUNTRY CEILING	SOVEREIGN RISK
Moody's:	A1	A3
S&P:	A+	BBB+
Fitch:	A	BBB+

COUNTRY ANALYST

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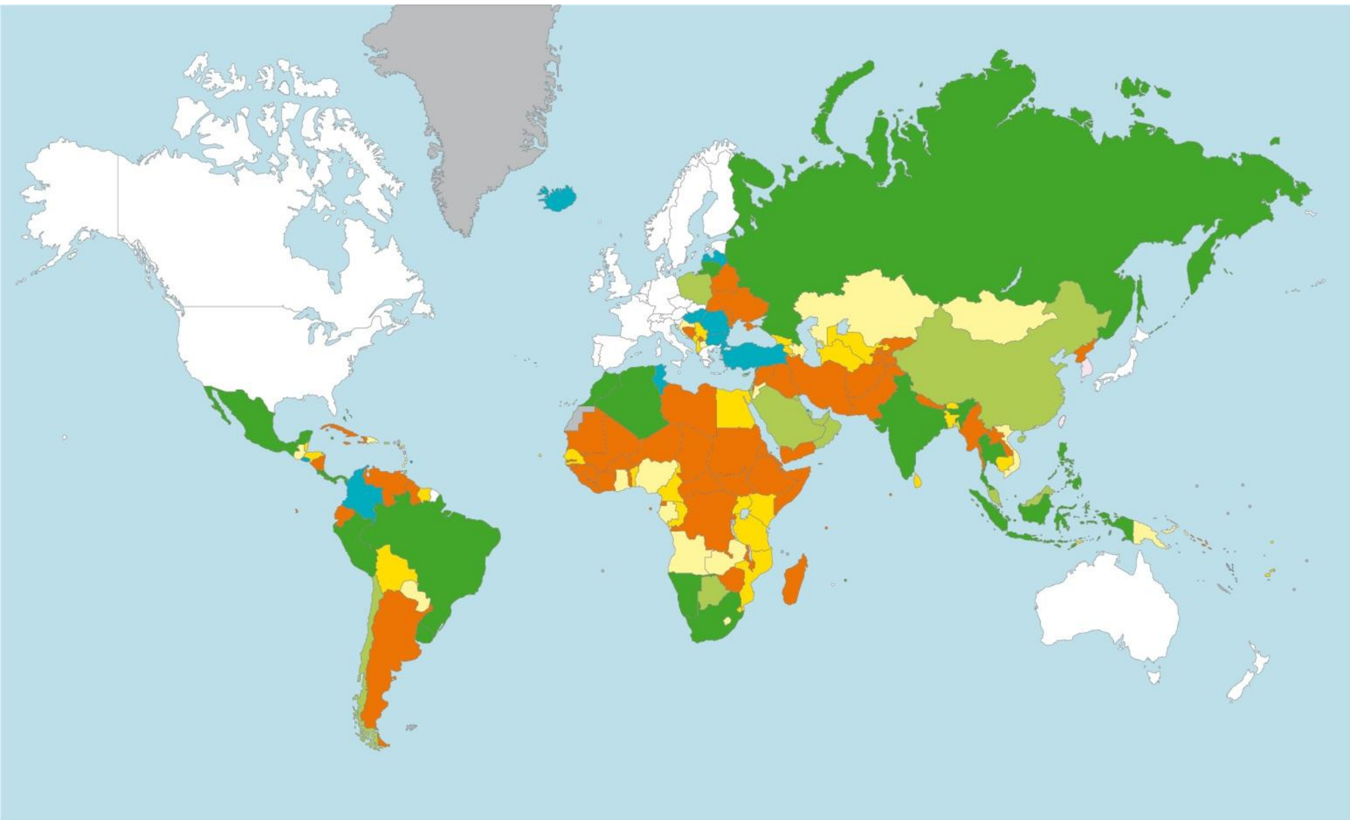
12/02/2014

EKN'S VIEW OF THE WORLD



The country risk categories range from 0 to 7.
The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7 No Policy Fixed

EKN – CREATING CONFIDENCE IN YOUR EXPORTS
EKN is an authority tasked with promoting Swedish exports and the internationalisation of Swedish companies. We do this by offering guarantees of payment and financing, together with advice on business structures and risk management. Our services provide you with greater security, increased competitiveness and more opportunities for successful export transactions.

The Swedish Export Credits Guarantee Board
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