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 TO THE COUNTRY

SHORT-TERM TRANSACTIONS: SEK 93 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 1287 MILLION

DATE

12/2/2015

Economy heading in right direction – but institutional reforms still needed

Mexico has been characterised by political consensus on stable and responsible economic policies for many years. In spite of this, political deadlock has got in the way of long-term structural reforms. It was against this background that a cross-party agreement called the "Pact for Mexico", which was launched by sitting president Peña Nieto in 2012, attracted much attention with an extensive reform programme. The reforms have continued to progress over the past year with parliamentary decisions in strategic and historically protectionist sectors such as energy and telecom. Several steps have thus been taken to open the door for investments and greater competition in order to bring up Mexico's modest growth. These changes have not yet had an impact on the economy, but government stimulus and an economic recovery in the US are expected to lead to strong growth for 2015 and a couple years ahead. However, the Mexican population's focus has been turned toward drug-related violence and the widespread corruption throughout society. The recent violent incidents and political scandals clearly demonstrate that economic reforms alone are not enough for Mexico to boost its potential growth. Institutional development and a mature judiciary are required, but this is normally a slow and difficult process. In spite of these deficiencies, it is estimated that growth is heading in the right direction.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- History of economic stability and confidence-building economic policies.
- Broad political consensus on sweeping structural reforms.
- Stable international reserves and low debt level.
- The export sector is benefiting from the economic recovery in the US.

Weaknesses

- Complicated security situation.
- Extensive corruption and major deficiencies in the judiciary.
- Relatively high dependence of the public finances on revenue from the oil sector.

EKN'S POLICY

Unchanged risk categorisation

EKN has had Mexico in country risk category 3 since 2009 – an assessment made in collaboration with the other OECD countries. EKN has the country in this category for both short-term and long-term credit guarantees. Regardless of the buyer category or the duration of the credit period, EKN has no specific, general restrictions. Instead, each transaction is assessed on its own merits.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- The successful implementation of the reforms initiated resulting in increased diversification of the economy and long-term higher growth.
- Sustainable institutional development with substantially lower levels of corruption and crime.

The policy may be made more restrictive in the event of

- The loss of political consensus on disciplined fiscal and monetary policies.
- A substantial decline in macroeconomic stability.
- The security situation getting even worse.

EKN'S EXPOSURE AND EXPERIENCE

Decreasing exposure

EKN's outstanding exposure for transactions in Mexico totalled SEK 1.9 billion at the end of 2014, which is a little over 1 billion less than the year prior. The volume of guarantees was SEK 1.4 billion, with the remaining share consisting of offers. The sectors dominating EKN's exposure are primarily telecom, transport and the paper industry. EKN's experience of transactions in Mexico is generally good. The judiciary is however deficient, which makes unambiguous contracts very important.

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DISCLAIMER

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POLITICS

High reform pace, but the discontent is increasing

The ambitious reform agenda President Peña Nieto managed to negotiate across party lines upon taking office in 2012 has continued on through 2014. Under the agreement, the "Pact for Mexico", the governing party, PRI, decided on an extensive reform package together with the two dominant opposition parties. The pact was thus intended to eliminate several years of political deadlock that had blocked economic growth in Mexico. The pact covers structural reforms in several strategic areas such as energy, telecom, finance the, labour market and education in order to increase growth and competitiveness. Peña Nieto's ability to get these changes adopted has been impressive. The rate of decision-making has been rapid, as all reforms have essentially been approved during the first two years. However, the cross-party pact has not got off without a hitch. The new energy reform in particular has led to conflicts. The reform brings to an end the 75-year state monopoly in the oil industry and opens the door for private investments. This caused left-wing opposition party PRD to leave the pact and protest strongly against this proposal. Nevertheless, the energy reform was able to pass the congress in full, but both the rate of decision-making and the rate of implementation have slowed down since PRD jumped ship.

In spite of the president's successes in implementing promised changes, his popularity has recently fallen sharply. One reason is because the economic effects of his reforms have not yet been seen, but above all the president has failed to manage the severe security situation. Drug-related violence and widespread corruption continue to be a major problem in spite of Nieto's promises to allocate greater resources to improve the security situation. The violence is distributed to all parts of the country. Politicians are murdered and a corrupt police force is contributing to the problems. The discontent over the security situation escalated in late 2014 as around 40 students disappeared and were then murdered after a demonstration. Popular protests sharply increased throughout Mexico after this event, as it was revealed that police officers, highly ranked local politicians and criminal gangs were responsible for the abduction. In addition, dubious procurement processes and a bribery scandal with links to Nieto's wife have further undermined confidence in the president in popular opinion. It is becoming increasingly clear that Mexico's growth does not only involve economic reforms, as institutional maturity is at least equally important. There is thus huge pressure on Nieto to produce a credible strategy to seriously neutralise the deficient security situation and the widespread political corruption.

These political scandals, increased partisan conflicts and imminent parliamentary elections in July 2015 make it probable that the rate of reform will be shifted into a lower gear. There is uncertainty as to whether the actual implementation phase will be able to stay on its original schedule. However, there is little risk of the reform efforts being reversed. In spite of disagreements between the dominant parties, there is still a political majority that is prepared to support continuing economic change.

ECONOMY

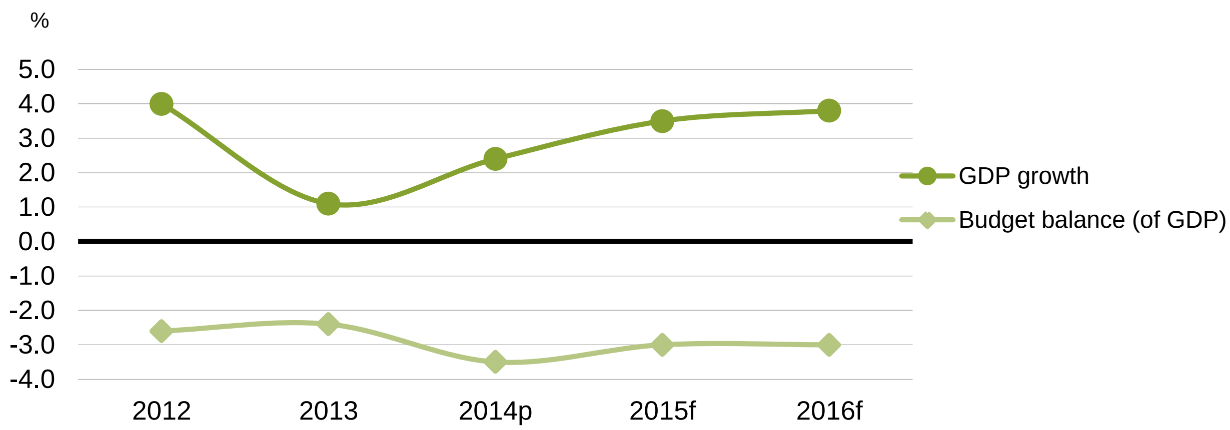
Growth expected to take off in 2015

As opposed to many other countries in the region, Mexico's dependence on commodities is relatively limited. Exports of commodities amount to at least 40% of total exports for most countries in Latin America, while the corresponding share of exports for Mexico is lower than

15%. Mexico has thus not benefited from China's increased demand for commodities to the same extent. On the contrary, Mexico has had to compete in the same segment, at a disadvantage. The competitive situation for the Mexican manufacturing industry has improved in recent years, due to a favourable trend for the Mexican peso and rising wage costs in China. "Maquiladoras" are a prominent feature of the Mexican manufacturing industry. Maquiladoras are assembly plants that manufacture textiles and clothing, electronics and automotive components. Mexico's membership in NAFTA and its deep economic integration with the US are also important features of its economy. Nearly 80% of all Mexican exports go to the US, and the US plays an important role for the Mexican tourism sector. Emigrant remittances from the US are also a very important source of income for the Mexican economy.

High energy costs, lack of competition and a stale labour market with a large informal sector have stalled increasing productivity and growth for several decades. The recently adopted reforms aim to resolve several of these structural weaknesses and will likely raise the country's long-term growth potential. Growth has not increased yet though, which is mainly due to the short-term effects of the reform package having been overestimated, along with a slower recovery in the US. Increasing positive signals from the US in the latter half of 2014 indicate that the Mexican economy will also take off in 2015. Strong exports to the US, along with domestic expansionary fiscal policies and an increase in public investment and private consumption are expected to serve as short-term growth drivers. Open and effective implementation of the reforms adopted is a necessity for the rate of investment and for the country's growth potential to increase.

ECONOMIC GROWTH AND BUDGET BALANCE



Source: WEO 2014, IMF

Mexico has a long history of well-managed public finances with low deficits and low debt levels. The country's responsible economic policies have been maintained across parties and the fiscal framework and its budget regulations have been respected even in periods of economic decline. The country has also shown discipline in its monetary policies for several years with stable prices and continuity in the actions of the central bank. These policies have granted Mexico high confidence on the capital market, which has resulted in lower funding cost and access to longer maturities. However, there are weaknesses on the revenue side, the share of tax collected in Mexico is the lowest in the entire OECD at only 12% of GDP. Instead, oil revenues account for one-third of the national budget, which makes the government sensitive to volatile energy prices and fluctuating production. The risks of lower oil price are limited in the short term, as the government has insured its sales at a certain price via put options and the budget law imposes lower spending when the oil price falls. In the long term, the tax reform of 2013 is also expected to generate higher and more diversified tax revenue. This is expected to lead to a reduction in government dependence on oil revenue, which is crucial in light of a lower oil price.

BALANCE OF PAYMENTS AND DEBT ISSUES

Stable external balance

Mexico's external balance is stable and its external debt of 35% of GDP is to be considered low. The country has accumulated satisfactory international reserves and has secured financial support from the IMF via a line of credit that can be used when needed. Support from the IMF and the high confidence in the Mexican economy from international financial markets are key factors of strength for Mexico.

The country's current account deficit is also low, although the trend is slightly negative. The reform package is expected to increase the deficit to a certain extent in the short term, driven by imports and investments, but the deficit is expected to be reduced in the long term thanks to increased export revenues. The current account deficit is considered sustainable and Mexico is far from the acute balance of payment crises the country suffered in the 1990s. The current account deficit is largely financed with foreign direct investments (FDI), but FDI has fallen since the financial crisis. Instead, portfolio inflows from international investors have been very high over the past years on both a historical and regional level. Portfolio investments tend to be volatile and pose a risk when global liquidity falls. But in consideration of Mexico's good economic conditions, a floating exchange rate and considerable international reserves, the country has a strong capacity to manage a financial crisis.

CURRENCY POLICY

High degree of convertibility

Ever since an inflation target was adopted as the fixture of the country's monetary policy following the 1994-95 financial crisis, confidence in the Mexican central bank has steadily increased. The government simultaneously introduced a floating exchange rate regime, which is managed by a currency commission composed of representatives from the ministry of finance and central bank. The currency commission can intervene on the market when needed. The currency has strengthened since the mid-1990s and has demonstrated stability, even during periods of turbulence on the international financial market. There is underlying confidence in the peso, although there were substantial fluctuations during the 2008-2009 global financial crisis. The peso also depreciated sharply in 2013 following signals from the Fed that its liquidity injections would soon be reduced. But the currency markets functioned well and the currency stabilised quickly, without intervention. The currency has a high degree of convertibility and can be considered by EKN in transactions financed in local currency.

FINANCIAL SECTOR

Strong banking sector with solid reserves

Mexico's financial sector is currently financially strong and relatively highly consolidated, as the seven largest banks together hold 80% of the banking sector's total assets. The banks are generally profitable and well-capitalised, with solid liquidity and controlled lending growth. The asset portfolio of the banking sector is diversified in both client segments and industries, even though corporate loans dominate. Future lending growth is expected to be concentrated to segments that are high-yield but also risky, such as SMEs. The proportion of bad loans is thus at risk of increasing, but the strong profits and ample provisions of the banks give them scope to absorb greater losses. Mexican banks are considered well-equipped to manage a situation where stimulus from developed economies is reduced. Deposits are extensive and stable, and even though there is substantial short-term borrowing, it is mostly in peso, which reduces the refinancing risk. The strong balance sheets and good financial provisions of the banks play a part in alleviating the effects of declining global liquidity.

The Mexican banking regulatory environment has recently been modernised. Mexican banks have applied Basel III framework since 2013. However, the limited penetration of the financial sector is a lingering weakness in the system. The total lending of the banking sector is equal to just over 30% of GDP, which is significantly lower than in equivalent countries and is insufficient especially when it comes to SMEs. The banks are also relatively sluggish and bureaucratic from a regional perspective. The ongoing financial reforms are taking aim at these deficiencies by providing incentives to increase competition in certain client segments. New legislation is also aiming to increase credit growth via improved transparency in connection with lending and orderly legal proceedings for matters such as foreclosure.

Mexico opened the door for foreign ownership in the financial sector in the late 1990s. As a result, over 70% of total bank assets are controlled by foreign interests, especially large Spanish and American banks. Foreign ownership is considered long-term and stable, and support from the respective parent company is considered likely. In addition, the willingness and ability of the government to provide support when needed is considered very high. Mexico has a long history of supporting banks. In light of the limited size of the banking sector in proportion to the country's economy, the country's capacity to support the banks is also considered to be strong.

BUSINESS ENVIRONMENT

Weak business environment but positive trend

The business environment has generally improved in Mexico over the past few years, thanks to reforms that facilitated startups and reduced the regulatory burden. The recently approved reforms in the telecom and energy sectors are also expected to improve the prospects for investments. Access to financial information is generally good in Mexico. In addition, the country's openness to foreign investment and free trade is relatively high, which facilitates international transactions. This is reflected in the World Bank's Doing Business Index, in which Mexico is ranked 39th globally out of 189 countries, which is four places better than the year prior and third place in the region. The largest problems are related to slowness with respect to the registration of property, a very complicated tax system and widespread corruption. Corruption, especially in the judiciary, is considered higher than in many countries in the region, which creates uncertainty and increases transaction costs. Mexico is ranked the 103rd most corrupt country out of 177 countries according to Transparency International. Mexico's high crime rate and drug-related violence have had an impact on business opportunities, especially on the local level. In addition, there can be substantial differences between Mexico's states in terms of the efficiency and credibility of the judiciary and the ability to enforce contracts.

EKN'S EXPOSURE

Telecom sector dominant

EKN's exposure to Mexico has varied greatly over time, in part because funding alternatives via the capital markets are periodically good for large companies. EKN's exposure has fallen sharply after guarantees for some major transactions were redeemed before maturity. EKN's exposure as at 31 December 2014 was SEK 1.9 billion, with guarantees accounting for 1.4 billion and the rest comprised of offers. EKN is still seeing a large inflow of small transactions. EKN issued around 50 guarantees in 2014. The majority of the portfolio is comprised of guarantees in telecom, transport and paper production. Imports on open credit are common, while letters of credit are relatively rare.

FALLING EXPOSURE - OFFERS AND GUARANTEES (SEK)

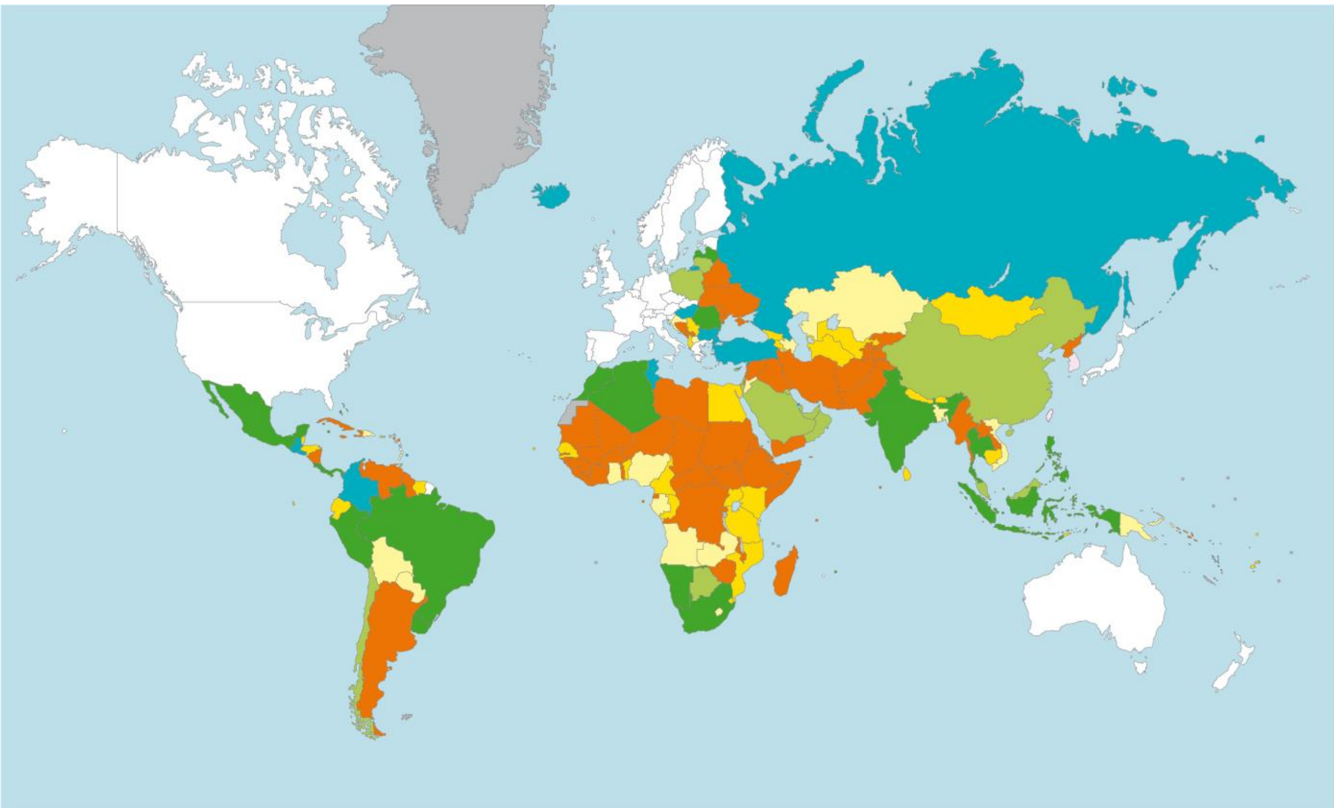
PAYMENT EXPERIENCE

Overall good experience, but unambiguous contracts important

EKN's experiences in terms of transactions with the public sector have been relatively good. Some payments suffer from bureaucracy and slowness in transactions with public sector companies. However, the government's finances are strong and no payment problems are expected. The government's willingness to pay is considered strong and it has managed its debt in an exemplary manner. On its own initiative, Mexico repaid all its obligations to the Paris Club and the Brady Bond loans in advance, which the country took out in the late 1980s. However, EKN has less experience of transactions with regions and municipalities.

EKN's experiences have generally been good in transactions with the private sector. However, there is occasionally a lack of respect for contracts entered into and it is crucial for Swedish exporters to ensure that they draft sound and unambiguous contracts. The legal system has improved but is still deficient, particularly with regard to credit and property rights. There can also be major regional differences with respect to how legal proceedings are conducted, the degree of corruption and the risk of violence. Legislation concerning the reorganisation of companies is also unclear. The reorganisation process can continue for a very long time regardless of the circumstances. Other export credit agencies have reported fraud in export transactions with private buyers in Mexico.

COUNTRY DATA	CREDIT RATING (COUNTRY CEILING/SOVEREIGN RISK)
Area: 1,964,375 km² (3.4 times Sweden) **Population:** 120 million (2014) **GDP:** USD 1,327 billion in 2013 (Sweden USD 552 billion in 2013) **GDP/capita:** USD 15,600 in 2013 (Sweden USD 40,900 in 2013)	**Moody's:** A1/A3 **S&P:** A+/BBB+ **Fitch:** A/BBB+



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

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management.
Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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