Full Rating Report

Mexico

Ratings

Foreign Currency

Long-Term IDR	BBB
Short-Term IDR	F2

Local Currency

Long-Term IDR	BBB+
Country Ceiling	A-

Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

Financial Data

Mexico

	2009
GDP	875.1
GDP per head (USD 000)	8
Population (m)	109.6
International reserves	99.9
Net external debt (% GDP)	-0.5
Central government total debt (% GDP)	35.1
CG foreign-currency debt	48.7
CG domestically issued debt (MXPbn)	3,518.9

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Related Research

Applicable Criteria

- *Sovereign Rating Methodology (August 2010)*

Other Research

- *Global Economic Outlook (December 2010)*
- *Sovereign Review and Outlook (December 2010)*
- *Guide to Sovereign Credit Report (October 2008)*

Rating Rationale

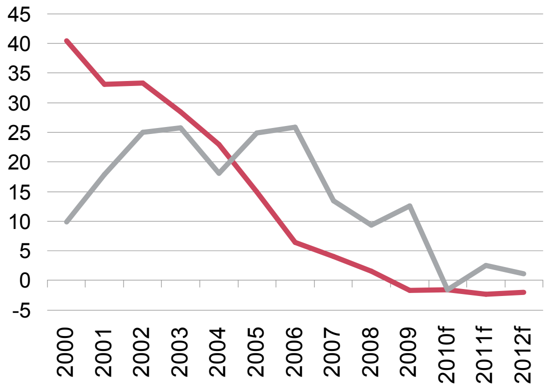
- Fitch Ratings affirmed Mexico's sovereign ratings on 12 January 2011. The country's investment-grade ratings are underpinned by its disciplined macroeconomic policies, a relatively robust banking sector, resilient external accounts, a modest external debt burden, and the sovereign's manageable external amortisation profile. These strengths sufficiently counterbalance the structural weaknesses in Mexico's public finances and the country's modest growth prospects.
- After a steep recession in 2009, Mexico's economy has been recovering, with real GDP growth estimated by Fitch to have reached close to 5% in 2010. However, Mexico's five-year GDP growth average of 1.7% barely exceeds the five-year average population growth of 1%, highlighting the importance of achieving a higher growth trajectory in the medium term.
- Economic recovery in 2010 was aided by the favourable external trade performance. However, despite the supportive economic policies and job creation, domestic demand conditions remain relatively subdued. The rising wave of drug-related violence appears to be dampening confidence, investment and economic activity.
- Fiscal performance continues to be in line with Fitch's expectations and the agency expects the general government debt burden to remain close to 40% of GDP, in line with the peer median. Fiscal performance has been boosted by the economic recovery and the tax reform approved in 2009. Elevated oil prices and a gradual stabilisation in oil output are providing some fiscal flexibility to authorities to consolidate fiscal accounts.
- However, the limited resources in the Mexican government's Oil Stabilization Fund (OSF) leave the country's public finances vulnerable to swings in oil income, which represents over 30% of total public sector revenue. Moreover, the political window to further enhance the non-oil tax base or to pass material structural reforms is narrowing owing to the several state elections in 2011 and the presidential election in 2012.
- Mexico's external accounts are not a source of significant vulnerability as the current account deficit is small and a large proportion of it is covered by foreign direct investment (FDI) flows. Moreover, Mexico continues to have access to the IMF's Flexible Credit Line (FCL) in case the external conditions deteriorate markedly and unexpectedly. More importantly, the Mexican authorities are appropriately exploiting the opportunity provided by increased capital inflows to the country by building international reserves to strengthen their capacity to face future external shocks.

Key Rating Drivers

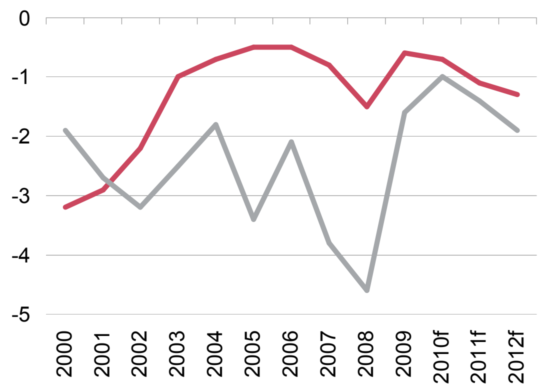
- Sustained high economic growth, greater fiscal flexibility and a significant improvement in the external liquidity ratio, would be positive for creditworthiness. Improvement in the outlook for the oil sector would also be viewed positively.
- Although not Fitch's base case, the agency would view significant fiscal deterioration or renewed economic weakness that undermines public debt dynamics negatively.

Peer Comparison

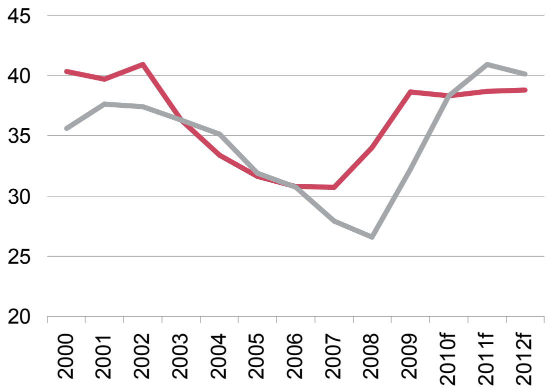
Net External Debt
% of CXR



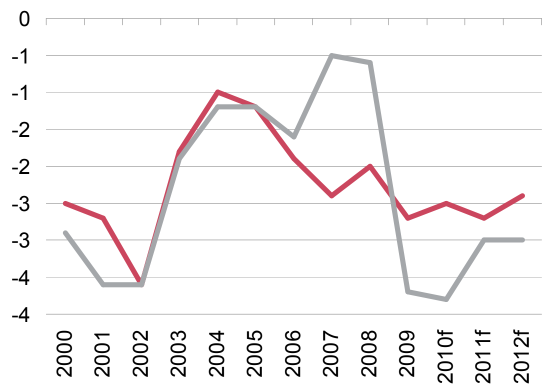
Current Account Balance
% of GDP



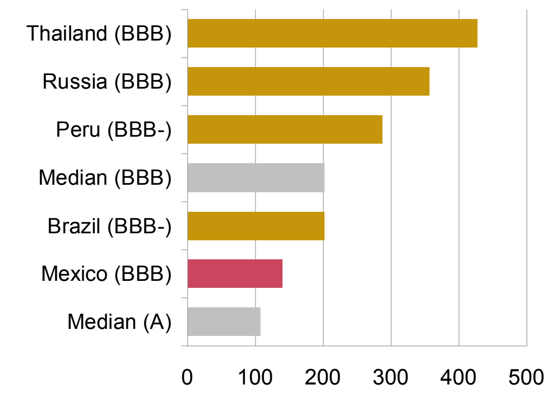
General Government Debt
% of GDP



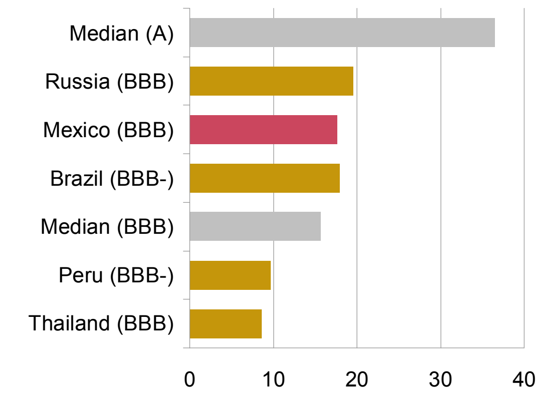
General Government Balance
% of GDP



International Liquidity Ratio, 2009
%



GDP per capita Income, 2009e
At market exchange rates, USA=100



Mexico

Medians

Peer Group

Rating	Country
BBB+	Ireland
	Libya
	South Africa
BBB	**Mexico**
	Aruba
	Lithuania
	Russia
	Thailand
	Tunisia
BBB-	Azerbaijan
	Brazil
	Bulgaria
	Croatia
	Greece
	Hungary
	India
	Kazakhstan
	Morocco
	Namibia
	Panama
	Peru

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
23 Nov 2009	BBB	BBB+
19 Sep 2007	BBB+	A-
07 Dec 2005	BBB	BBB+
15 Jan 2002	BBB-	BBB
03 May 2000	BB+	BBB
15 Sep 1997	BB	BB-

Rating Factors

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Strength	Weakness	Neutral	Neutral
Trend	Stable	Stable	Stable	Stable

Note: Relative to 'BBB' category (sovereigns rated 'BBB+', 'BBB' and 'BBB–')
Source: Fitch

Strengths

- Mexico has a track record of disciplined macroeconomic policies. The flexible exchange rate and inflation-targeting regimes, and the Fiscal Responsibility Law buttress the country's macroeconomic policy framework.
- As a member of the North American-Free Trade Agreement (NAFTA), Mexico has considerable access to the US market, and its industrial sector has become more integrated with that of its northern neighbour. Mexico receives broad support from the US, including the country's access to a USD30bn Fed swap line during the 2008-2009 global financial crisis. Moreover, Mexico has a good relationship with the multilateral lenders, which gives it significant funding flexibility.
- The banking sector remains relatively robust, as reflected by a Banking System Indicator (BSI) indicator of 'C'. The Macro-Prudential Indicator of '1' suggests a low vulnerability to a banking crisis.
- Deft liability management has reduced the foreign-currency share in total federal government debt. Steady development of local capital markets has given the government an important alternative to financing its fiscal deficit.

Weaknesses

- Mexico's public finances remain structurally weak due to its heavy reliance on oil revenue, a low non-oil tax burden, and a lack of significant resources in its OSF. Medium-term prospects for oil production remain uncertain despite the recent stabilisation of the oil platform.
- Mexico's five-year growth performance has been mediocre compared with its rating peers. Although Mexico has favourable trade access to one of the largest and most stable markets in the world, the economy could benefit from greater trade diversification.
- Although there is broad consensus between the two main political parties on the main pillars of macroeconomic stability, prospects for further acceleration of structural reforms in the fiscal, energy and labour sectors in the forecast period remain weak. Progress on structural reforms to address competitiveness challenges is needed to place Mexico's economy on a higher growth trajectory.

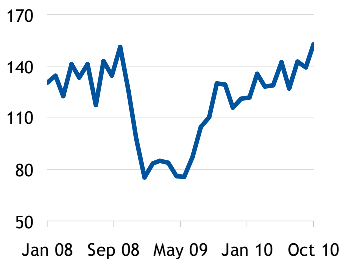
Local Currency Rating

The one-notch uplift in the Local-Currency IDR reflects Mexico's track record of macroeconomic stability, the authorities' ability to tax in local currency, and the steady development of local markets, which provide the authorities with an alternative source of financing. However, structural weaknesses in public finances prevent wider notching between the Foreign-Currency and Local-Currency IDRs.

Country Ceiling

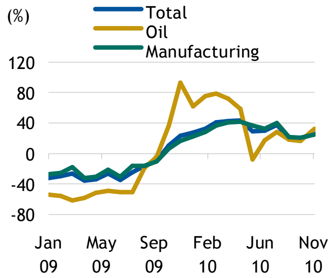
The higher Country Ceiling than the IDRs reflects Mexico's integration with the global economy and more importantly with the US through the NAFTA. Mexico's flexible exchange rate, low financial dollarisation, and high international financial integration (partly reflected by high foreign participation in the banking sector) reduce the risk of the authorities imposing exchange rate and capital controls.

Auto Production
(2003=100)



Source: Banxico

Exports
Year-on-year growth

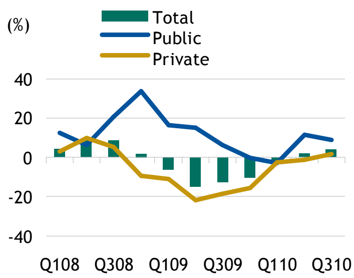


Source: INEGI

Consumer Confidence
(Jan 2003=100)

Source: INEGI

Gross Fixed Investment
Year-on-year growth



Source: INEGI

Outlook and Key Issues

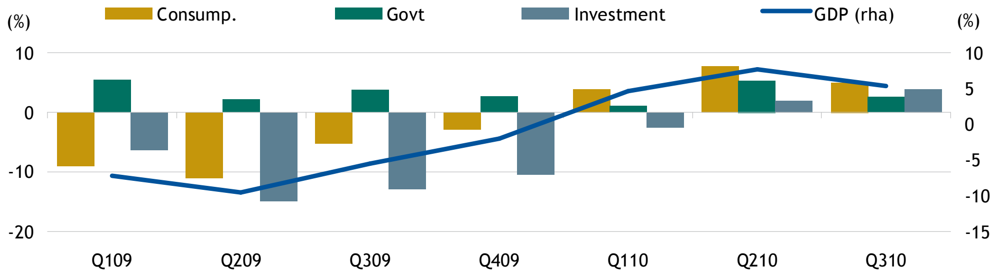
Macroeconomic Outlook

Economic Recovery and Growth Outlook

In 2010 Mexico recovered from its steep recession in 2009. Fitch estimates that growth may have reached close to 5%. The economic recovery was led by the favourable performance of the manufacturing sector, which was boosted by the rebound in external demand. The auto sector in particular has been one of the bright spots in the recovery process, with production increasing by 41.7% in January-November 2010 compared with the same period in 2009. Its performance has been aided by the level of the Mexican peso, the country's geographic advantage, and the restructuring of some US auto companies, which are increasing their production in Mexico. Auto exports increased 57.2% during the same period. More broadly, Mexico has increased the share of its exports in US imports.

However, Mexico's economic recovery has not been broad based. Domestic demand has remained relatively weak, reflecting the underlying weakness in private consumption and investment growth. Private consumption growth continues to be weighed down by the slow recovery in consumer confidence (which remains well below the pre-crisis level), the subdued growth of credit to consumers, and weak growth in the formal sector wage bill. Private investment remained flat for most of 2010, reflecting excess capacity in the economy, uncertain US economic prospects, broader confidence issues, rising violence and continued delays in executing infrastructure projects. The financial woes of some of the non-bank financial institutions have further curtailed the supply of housing credit.

GDP and Its Components
Year-on-year growth rates



Source: INEGI

Fitch forecasts that Mexico's GDP growth will decelerate in 2011 as the economy slows from its above-potential growth performance in 2010 and the base effects wear off. The acceleration in US growth will help Mexico maintain growth close to 4% in 2011. The real exchange depreciation, the greater penetration of the country's exports in the US market, and some diversification in the destination of Mexico's exports would allow the country to benefit from US growth.

In addition, some recovery in domestic demand could occur due to a modest pick-up in credit growth as banks begin to lend following the consolidation of their balance sheets. The still low level of financial intermediation in the country provides scope for further credit expansion, although much will depend on the development of credit demand. Greater capital inflows and planned investments in the auto sector by foreign companies could also provide some "income" boost to domestic demand.

Although Mexico's short-term outlook has benefited from the expected acceleration in US growth in 2011, its medium-term growth prospects remain relatively weak compared with regional peers and by emerging-markets standards. This hinders faster growth in per capita income (with population growth of about 1%) and a faster reduction in the government debt burden.

The IMF has recently lowered its estimate for Mexico's potential GDP growth owing to the expected lower trend growth for the US and the adverse impact of tighter financing conditions on capital accumulation and productivity growth[1]. This highlights the need for Mexico to implement further structural and micro-economic reforms that improve flexibility and competition in some of the input markets (eg the labour and energy sectors), reduce business costs, and decrease the high level of labour informality.

Infrastructure Rank

Chile	40
Lithuania	43
Panama	44
Hungary	51
Brazil	62
Mexico	75
Bulgaria	80
Peru	88

Source: World Economic Forum – Global Competitiveness Report 2010-2011

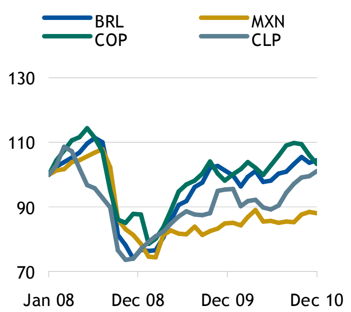
To improve competitiveness and boost growth, the government has attempted to increase infrastructure spending through a national infrastructure programme, establishing a trust fund to attract private investment and liberalising the investment regime for private pension funds. However, execution delays due to capacity constraints, heavy regulatory requirements, and a limited-risk investor appetite following the global credit crisis have continued to hinder greater progress in this sector.

The Calderon administration has also submitted reforms to strengthen the anti-trust agency's capacity to deal with competition-related issues and to increase fines on firms for collusive behaviour. A labour reform that allows for part-time employment and reduces the burden of payroll taxes for such employment is in Congress. A bill that could improve prospects for greater private sector participation in the infrastructure sector is also with Congress. However, it remains unclear whether these reforms would pass or pass undiluted, and to what degree their effects would be felt during the forecast period.

Inflation and Monetary Policy

Moderate growth in 2011, coupled with only a modest increase in international prices, is likely to keep inflation under control in 2011. The central bank forecasts that inflation could reach 3% (the middle point of the 3%+/-1% variability interval) by Q311, although the institution has emphasised the variability interval of +/-1% around this target.

Currencies (Jan'08=100)



Source: Bloomberg, Fitch

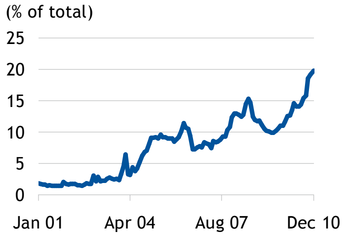
Unlike other central banks in the region, the Bank of Mexico (BOM) has not yet started the tightening cycle owing to the favourable inflation trends, the still relatively weak domestic demand and a tempered credit growth. Monetary and exchange rate management will be challenged by the prospect of higher capital flows to Mexico following the recent decision by the US Fed to implement a second round of quantitative easing (QE2).

The appreciation of the Mexican peso has been less impressive than that of the other regional currencies, perhaps reflecting the weakness of the US dollar, the uncertain US economic outlook and the negative news flow resulting from the drug-related violence. Moreover, Mexico has been able to sustain real exchange rate depreciation as the pass-through to inflation from a weaker currency has been limited by the increased credibility of the central bank and the continued negative output gap.

Although capital inflows continued to increase in 2010, the Mexican authorities appear to be less disposed towards imposing capital controls or increasing taxes on inward portfolio investment. Instead, they have adopted a multi-pronged strategy to prevent sharp and fast-paced currency appreciation. This consists of: accumulating international reserves; implementing modest fiscal consolidation; and allowing some appreciation of the currency. If large capital flows persist and inflation remains under control, a cut in the central bank benchmark rate cannot be ruled out.

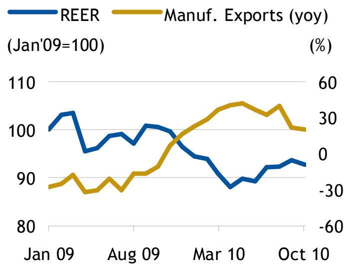
[1] The IMF estimates that Mexico's potential growth may have fallen from 3% in the pre-crisis years to 2%-2.25%.

Non-resident Holdings of Domestic Public Debt



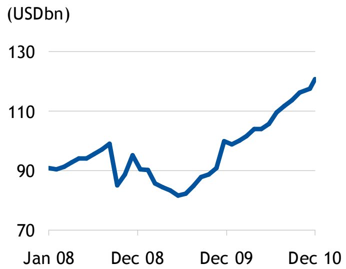
Source: Banxico

REER and Manuf. Exports



Source: Banxico, Fitch

International Reserves



Source: Banxico

External Accounts

In line with Fitch's expectations, external accounts remain stable, with the current account deficit forecast to remain relatively modest at 0.7% of GDP in 2010 and 1.1% in 2011. The export performance in 2010 was aided by the strong growth in manufactured goods underpinned by the recovery in US demand and greater penetration into the northern neighbour's market. However, overseas remittances are still well below pre-crisis levels and were 0.6% lower in January-November 2010 than in the same period a year earlier.

Fitch expects a moderate deterioration of the current account deficit in 2011, but does not foresee any financing issues. The agency forecasts the capital account to remain well supported by FDI and portfolio inflows, and the sovereign's continued external borrowing from multilaterals. Barring a significant increase in risk aversion, the large private sector companies and Pemex should continue to have comfortable access to the international capital markets, reducing external financing pressures.

In line with the return of normality in the currency market, the Mexican authorities have exited from all forms of foreign exchange intervention introduced during the height of the global credit crisis. Instead, to reduce their vulnerability to external shocks, they have begun to accumulate international reserves through two main mechanisms: by keeping (rather than selling to markets) foreign exchange obtained from Pemex's net oil receipts and the sovereign's external borrowings; and by implementing a rule-based mechanism to build the foreign exchange reserve cushion. In 2010, the authorities accumulated USD21bn in international reserves, aided by a higher-than-expected increase in net oil receipts, increased sovereign external borrowing and the foreign-exchange mechanisms.

Although the authorities have not stated any specific target for international reserves, further accumulation is likely in 2011. They continue to evaluate the desired levels of reserves, balancing the need to boost external resilience against the costs related to sterilisation, reduced balance of payments stress, the improved private and public sector amortisation profiles, and their continued commitment to a free-float exchange regime.

Mexico continues to have access to the IMF's FCL, although it has not needed any disbursements from this facility. The Mexican authorities have obtained an approval for a new two-year FCL facility with resources totalling USD73bn. The BOM has repaid the USD3.2bn it received from the US Fed swap line during the global financial crisis.

Public Finances

Mexico's fiscal vulnerabilities stem from its very narrow tax base (about 10% of GDP), the high reliance of public sector revenue on oil revenue (33.0% of total in 2010) and reduced oil output (oil production has fallen by a cumulative 24% from the peak in 2004). Furthermore, Mexico's fiscal buffers are limited. Fitch estimates that resources in the federal government's OSF were equivalent to a mere 0.1% of GDP in 2010 down from nearly 1% in 2008. The agency also estimates that total resources in the various oil saving funds of the federal government, states and Pemex were equivalent to 0.4% of GDP by end-2010 down from 1.7% in 2008.

Amid a steep recession and a declining oil production platform that hit both non-oil and oil income, the government was able to muster support in Congress to pass a revenue-enhancing tax package in 2009. The authorities estimated that the package could yield just over 1% of GDP in additional revenue. The agency expects revenue and overall fiscal performance in 2010 to have been in line with budget projections. Higher-than-budgeted GDP growth has not led to any material "excess non-oil revenue" as part of the income tax payments pertaining to 2010 were made in 2009 to escape higher tax rates (stemming from the tax increase package) in 2010.

Although oil revenue is likely to surpass budgeted levels, this “excess revenue” is unlikely to lead to additional resources in the OSF as these will be used to cover the higher cost of electricity generation and costs related to Hurricane Alex.

The 2011 budget forecasts a slight fiscal consolidation at the non-financial public sector level. The budget assumes a growth rate of 3.9% (broadly in line with Fitch’s forecast), an oil price of USD65.4 for the Mexican mix (slightly lower than Fitch’s 2011 average WTI forecast of USD82)[2] and a 1% reduction in oil production. Congress slightly increased the 2011 target for non-financial public sector deficit (excluding Pemex investment) to 0.5% of GDP from the government’s proposal of 0.3%, in order to provide a continued counter-cyclical boost to the economy while keeping debt dynamics stable.[3]

The authorities expect tax revenue to grow by 7% in real terms (higher than real GDP growth), as the full-calendar-year impact of the 2010 tax package will be felt in 2011. Provided the economy does not decelerate sharply, revenue projections appear broadly realistic. Spending cuts will have to ensue if revenue falls short of expectations in order to comply with the Fiscal Responsibility Law[4]. Fitch does not foresee significant increases in the OSFs in 2011 unless there is a rapid increase in oil prices[5]. Even in such a case, rules related to the use of “excess revenue” provide leeway for the government to accommodate other spending pressures with the windfall before accumulating resources in the OSF.

Continued fiscal consolidation and modest growth is likely to stabilise the general government debt burden at below 40% of GDP, which is in line with the ‘BBB’ median. However, the debt/revenue ratio remains quite high relative to the peer median, highlighting the narrowness of the revenue base. Federal government debt maturities, estimated by Fitch at 6.2% of GDP for 2010, remain in line with the peer median. Although the short-term fiscal outlook appears stable, downside risks could arise if the recent stabilisation in oil output proves short lived or oil prices fall sharply. A faster reduction in government indebtedness and/or larger fiscal buffers would be desirable to create the fiscal space to cope with future shocks.

Oil Production

Oil production in Mexico declined from a peak of 3.4 million barrels per day (b/d) in 2004 to 2.6 million in 2009. After declining by 9% in 2008 and 7% in 2009, oil production is gradually stabilising. The precipitous fall in oil production in recent years has been due to the unexpected and large declines at Cantarell, Mexico’s largest oilfield. The recent stabilisation owes much to the more intensive use of technology in the Cantarell field and increased drilling activities in Chicotepec, another strategic oil field.

The stabilisation of the production platform is positive, although it is too early to decisively discount the possibility of future declines in oil production. Budgetary constraints and capacity issues could still derail the planned stabilisation of oil production. Moreover, with a greater focus on stabilising production in the short term rather than on exploration, Pemex risks undermining the medium-term trajectory of oil production.

The company has contracted private oil companies to conduct research and test new technologies to capitalise on the potential of Chicotepec (a large but fairly fragmented oil field). After considerable delays in getting approval for the incentive-based contracts that will be used to attract private investment in the oil

[2] The Mexican oil mix trades at a discount of about 10% to the WTI benchmark.

[3] Including Pemex investment, the non-financial public sector deficit could reach 2.5% of GDP.

[4] The Mexican government has hedged its net oil export receipts which will make the 2011 oil income immune to any unexpected drop in oil prices to below-budget levels.

[5] Even with stable oil production, the rise in gasoline imports implies that the magnitude of the “oil windfall” from higher oil prices will continue to decline.

sector, Pemex expects to announce the first round of such contracts in Q111. Although the need to engage the private sector is biggest in deep-sea exploration, such contracts are likely to be used initially for attracting investment in mature fields and Chicotepec. It is unclear at present how successful such contracts will be in boosting private investment in the sector.

Political Outlook

Mexico will hold presidential elections in July 2012, although the electoral cycle is likely to begin in earnest in 2011. The country will also hold six state elections in 2011, including in the State of Mexico. The latter could have important implications for the presidential race, as the outgoing governor, Enrique Pena Nieto, is considered the current favourite Institutional Revolutionary Party (PRI) candidate for the presidential elections.

Although it is still too early to determine the trajectory of presidential elections, the PRI appears to be in a strong position to regain the presidency. Although market-related uncertainty may rise leading into the elections, Fitch does not expect the election cycle to have any material impact on Mexico's sovereign creditworthiness. Substantive changes to the existing policy framework are unlikely under a PRI or National Action Party-led government.

In light of the impending election cycle, the window of opportunity for pursuing economic reforms will greatly diminish after H111. Although the PRI may recognise the need for reforms to boost Mexico's potential GDP growth, political dynamics could weigh on the extent of cooperation and lead to the dilution of initiatives that have been submitted to Congress even if they are passed.

Drug-Related Violence

There was an escalation in drug-related violence in 2010. Although the violence is highly concentrated (in about five states) and is largely related to drug cartels, its spread to Monterrey (one of the country's important industrial hubs) has exacerbated the "perception problem" related to this issue.

The surge in drug-related violence has several causes, including a "turf war" among drug cartels, the relatively difficult economic and social conditions, which have made recruiting easier for cartels, the broader institutional problems (including a relatively weak police force and judicial system) at the state and municipal levels, and the more aggressive approach adopted by the Calderon administration to dealing with the drug lords.

Although the federal government police force has grown, it still does not appear sufficiently large to control the violence. Moreover, the intelligence gathering process and capacity require further strengthening in light of the nature and the scale of the problem. Although it is difficult to foresee the trajectory of the escalation of crime-related activities, it appears that the authorities would have to step up their efforts to address the above-mentioned weaknesses to prevent the spread of violence and reduce its intensity. The government spends about 1% of GDP on defence and public security.

The government has focused on disrupting some of the organised crime networks by capturing weapons and some of the leading gang members. It is also making efforts to professionalise the police force and increase its capacity to respond to the surging violence. To improve the efficiency and efficacy of the police force and reduce corruption, the Calderon administration submitted a reform to Congress that would unify state and local police forces and place them under the command of state governors. Continued technical and financial assistance from the US will be critical for Mexico to control the reach of organised crime.

The five states that have been heavily hit by the rising violence produce nearly 20% of GDP. FDI flows to these states have fallen but it is difficult to differentiate the impact of the U.S. recession from that of the rising violence. Anecdotal evidence suggests that the rise in crime rate appears to be affecting confidence levels, and retail, commerce and restaurant related activities, dampening the country's growth momentum. The sluggishness in the overall recovery in investment also points to the adverse impact the rising wave of crime may be having on investment. FDI has also not recovered to the pre-global financial crisis level.

Forecast Summary

	2006	2007	2008	2009	2010f	2011f	2012f
Macroeconomic indicators and policy							
Real GDP growth (%)	5.1	3.3	1.3	-6.0	4.8	3.8	3.6
Consumer prices (annual average % change)	3.6	4.0	5.1	5.3	4.2	4.1	3.7
Short-term interest rate (%)[a]	7.2	7.2	7.7	5.4	4.5	4.5	4.8
General government balance (% of GDP)[b]	-1.9	-2.2	-2.0	-2.6	-2.4	-2.7	-2.4
General government debt (% of GDP)[c]	30.9	30.4	33.8	38.4	38.0	38.4	38.6
MXP per USD (annual average)	10.9	10.9	11.1	13.5	12.7	12.4	12.6
Real effective exchange rate (2000 = 100)	94.5	93.1	90.8	79.6	86.0	86.0	86.0
External finance							
Current account balance (USDbn)	-4.8	-8.7	-16.2	-5.7	-6.5	-12.6	-15.7
Current account balance (% of GDP)	-0.5	-0.8	-1.5	-0.7	-0.6	-1.1	-1.3
Current account balance plus net FDI (% of GDP)	0.9	1.1	0.6	0.1	-0.1	-0.1	-0.4
Net external debt (USDbn)	19.2	12.9	5.4	-4.6	-5.1	-7.5	-6.8
Net external debt (% of GDP)	2.0	1.2	0.5	-0.5	-0.5	-0.7	-0.6
Net external debt (% of CXR)	6.4	4.0	1.6	-1.7	-1.5	-2.1	-1.8
Official international reserves including gold (USDbn)	76.3	87.2	95.3	99.9	120.9	134.3	142.6
Official international reserves (months of CXP cover)	3.0	3.1	3.2	4.3	4.3	4.4	4.3
External interest service (% of CXR)	4.7	4.6	4.2	4.3	4.2	4.8	4.7
Gross external financing requirement (% int. reserves)	32.4	33.1	45.1	37.2	26.2	30.9	30.3
Memo: Global forecast summary							
Real GDP growth (%)							
US	2.7	1.9	0.0	-2.6	2.8	3.2	3.3
Japan	2.0	2.4	-1.2	-6.3	3.2	1.5	1.7
Euro area	3.1	2.7	0.4	-4.1	0.9	1.5	2.0
World	3.8	3.7	1.4	-2.5	3.1	2.9	2.7
Commodities							
Oil (USD/barrel)	65.4	72.7	97.7	64.0	80.0	85.0	85.0

[a] 28-day Cetes rate (annual average).
[b] Refers to federal government plus social security, plus flows related to IPAB (agency responsible for managing the debt derived from the bank bailout after the tequila crisis) and FARAC (a toll road rescue trust fund), and excludes non-recurrent revenue.
[c] Refers to debt of the federal government plus states and IPAB and FARAC.
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

Mexico

	2009						
	Peru 'BBB-'	Mexico 'BBB'	Russia 'BBB'	Thailand 'BBB'	Brazil 'BBB–'	'BBB' median	'A' median
Real GDP (5yr average % change)	6.8	1.4	4.1	3.0	3.6	3.7	3.5
Volatility of GDP (10yr rolling SD)	3.2	3.5	5.0	2.7	2.1	3.5	3.1
Consumer prices (5yr average)	2.8	4.4	11.4	3.2	5.0	4.6	2.8
Volatility of CPI (10yr rolling SD)	1.5	1.7	4.3	1.9	3.1	2.3	1.8
Years since double-digit inflation	13.0	10.0	0.0	28.0	6.0	n.a.	n.a.
Unemployment rate	8.3	5.5	8.4	1.5	8.1	9.0	6.8
Type of exchange rate regime	Managed float	Managed float	Managed float	Managed float	Managed float	n.a.	n.a.
Dollarisation ratio	56.1	11.2	33.0	1.5	0.0	32.7	8.9
REER volatility (10yr rolling SD)	2.8	6.9	6.7	4.3	10.6	5.5	5.2

Source: Fitch

Strengths

- Macroeconomic stability in Mexico is supported by a relatively strong institutional framework, including an independent central bank. Mexico has a track record of prudent policies including disciplined fiscal policies.
- A flexible exchange rate and the inflation-targeting regime have buttressed the overall policy framework. Mexico's five-year inflation rate is lower than the 'BBB' median.
- Dollarisation in the financial system is relatively low and this has helped the system weather the sharp depreciation of the Mexican peso during the global credit crisis.

Weaknesses

- Mexico's five-year GDP growth performance has lagged behind those of peers. Its vulnerability to the global credit crisis was highlighted by its sharp recession in 2009.
- The volatility of REER is higher than the peer median, which to some extent reflects Mexico's non-intervention FX policy (until Q408) relative to its peers.

Commentary

Despite the tax increases and the increase in certain public sector prices, the 2010 inflation readings were better than the central bank's previous forecasts. The better-than-expected outcomes have been due to the appreciation of the currency, the greater competition among some of the retail chains, the continuing negative output gap and favourable global inflationary conditions. Weak domestic demand conditions have tempered demand and wage-led inflationary pressures. In light of the better performance, the BOM has reduced its inflation forecasts, with inflation estimated to remain between 4.25% and 4.75% in 2010.

Although inflation continues to remain moderate, the BOM has been less successful in converging to its medium-term inflation objective of 3% (even in 2009, when commodity prices were materially lower than in 2008 and when the economy contracted sharply), reflecting inflationary inertia in Mexico. The oligopolistic behaviour of firms in critical input markets and the uncertainty related to the trajectory of public sector tariffs appear to be partly responsible for this inertia.

To further enhance communication with the markets, the central bank will begin publishing the minutes of its monetary policy meetings from 2011 onwards. The number of pre-determined monetary policy announcement dates will be reduced to eight from 11 in 2011.

Comparative Analysis: Structural Features

Mexico

	Peru ‘BBB’	Mexico ‘BBB’	Russia ‘BBB’	Thailand ‘BBB’	Brazil ‘BBB–’	‘BBB’ median	‘A’ median
	2009						
GNI per capita PPP (USD, latest)	7,980	14,270	15,630	5,990	10,070	11,650	21,300
GDP per capita (USD, mkt exchange rates)	4,346	8,029	8,746	3,890	8,097	7,111	16,327
Human Development Index (percentile, latest)	57.4	71.2	61.3	52.4	59.1	60.2	78.4
Ease of Doing Business (percentile, latest)	69.8	78.1	36.9	94.0	29.7	58.3	77.0
Trade openness (CXR and CXP % GDP)	27.4	31.2	29.6	68.5	13.1	48.8	69.0
Gross domestic savings (% GDP)	24.2	22.2	25.4	31.3	16.4	24.2	26.8
Gross national savings (% GNP)	22.1	23.4	23.5	29.9	15.3	23.5	23.1
Gross domestic investment (% GDP)	20.6	23.6	18.7	20.8	16.5	22.4	20.2
Private credit (% GDP)	24.6	25.0	44.4	88.1	48.8	62.2	107.6
BSR indicators	C1	C1	D3	C1	C3	n.a.	n.a.
Bank system CAR	13.5	16.5	14.0	16.1	18.6	n.a.	n.a.
Foreign bank ownership (% assets)	46.8	74.0	18.3	13.0	18.2	n.a.	n.a.
Public bank ownership (% assets)	12.7	0.0	39.2	12.5	41.4	20.4	15.0
Default record (year cured)[a]	1997	1990	2000	None	1994	n.a.	n.a.

[a] Modern sovereign rescheduling history: 1982, 1986, 1990 (capital losses incurred as a result of the 1990 Brady deal)
Source: Fitch and World Bank

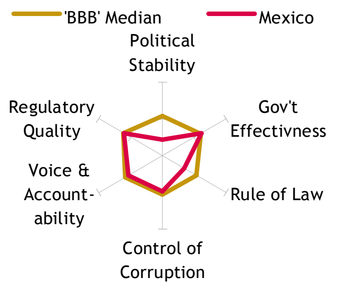
Strengths

- Mexico’s per capita income is higher than the ‘BBB’ median and its human development indicators are also more favourable than the peer median.
- Mexico ranks better than peers on Ease of Doing Business indictors.
- The banking sector remains relatively robust, as reflected by the BSI of ‘C’. The MPI of ‘1’ suggests a low vulnerability to a banking crisis. Foreign participation remains high, which limits the risk of contingent liabilities for the sovereign.

Weaknesses

- Mexico’s savings and investment rates are lower than the peer median and partly help explain the relatively modest trend growth of Mexico.
- The level of financial intermediation is relatively low in Mexico. At 24% of GDP, private credit is lower than the peer median and hinders the transmission of monetary policy.
- On the World Bank’s governance indictors, Mexico compares unfavourably with the ‘BBB’ medians on political stability and rule of law. The rise in drug-related violence, if sustained, could further dent investment and growth prospects.

Governance Indicators



Source: World Bank, Fitch

Commentary

The Mexican financial system faced a moderate deterioration in loan portfolio, with non-performing loans reaching a peak of 3.9% in May 2009 before declining to 2.5% in November 2010. The system remains liquid and well capitalised, and loan-loss provisioning levels are sufficient. Banks traditionally fund themselves through deposits and local funding and have not relied heavily on external borrowing.

The recovery in bank lending has been quite gradual due to the deterioration in loan portfolio (particularly related to the consumer sector) and a weak recovery in private investment so far. Credit demand remains weak, although the authorities believe that credit supply should resume once domestic demand is more firmly entrenched.

Comparative Analysis: External Finances

Mexico

	2009					Last 10 years	
	Peru 'BBB'	Mexico 'BBB'	Russia 'BBB'	Thailand 'BBB'	Brazil 'BBB–'	'BBB' median	'A' median
GXD (% CXR)	107.8	70.8	122.7	40.2	196.6	96.4	86.7
GXD (% GDP)	29.6	21.8	38.8	29.2	24.3	47.2	49.9
NXD (% CXR)	-6.8	-1.7	-75.2	-66.0	16.7	18.0	-18.7
NXD (% GDP)	-1.9	-0.5	-23.8	-48.0	2.1	8.8	-12.9
GSXD (% GXD)	58.9	38.2	11.0	20.0	32.0	33.8	16.5
NSXD (% CXR)	-35.7	-9.7	-105.2	-64.9	-59.8	-8.6	-25.1
NSXD (% GDP)	-9.8	-3.0	-33.3	-47.2	-7.4	-5.2	-15.9
SNFA (USDbn)	12.5	26.4	409.7	134.0	116.2	3.1	5.5
SNFA (% GDP)	9.8	3.0	33.3	50.8	7.4	6.4	15.5
Ext. debt service ratio (% CXR)	11.0	15.3	23.7	2.0	23.7	14.2	11.8
Ext. interest service ratio (% CXR)	5.0	4.3	6.7	0.7	8.2	3.8	2.6
Liquidity ratio (latest)	286.9	135.9	356.3	325.5	202.0	137.0	138.3
Current account balance (% GDP)	0.2	-0.7	4.0	8.3	-1.5	-2.7	-0.8
CAB plus net FDI (% GDP)	3.6	0.1	3.4	8.6	0.7	0.5	2.2
Commodity dependence (% CXR, latest)	69.4	22.4	64.8	20.6	40.2	19.9	12.1
Sovereign net FX debt (% GDP)	-9.9	-5.8	-31.5	-46.7	-11.0	-	-

Source: Fitch

Strengths

- Mexico's current account deficits are relatively small when compared with the 'BBB' median. Mexico's imports adjust quite quickly to exports due to the high import content of exports. This facilitates fast adjustment in the face of external shocks.
- Mexico's gross and net external debt indicators compare favourably with the 10-year 'BBB' median.

Weaknesses

- Mexico's commodity dependence is slightly higher than the 10-year 'BBB' median.
- Although Mexico's international liquidity ratio is in line with the 10-year 'BBB' median, it is lower than the current 'BBB' median. Although the flexible exchange rate reduces the need to maintain a large reserves cushion, the unexpected increase in private-sector demand for foreign exchange in 2008-2009 highlighted the need for the country to accumulate further reserves.
- Mexico is a net sovereign external creditor although to a smaller degree compared with the current 'BBB' median and some of the commodity exporters in the low-investment-grade category. This reflects the lower level of reserve accumulation and a less significant paydown of external debt by the Mexican authorities compared with some of its rating peers in recent years.

Commentary

If Pemex's external liabilities were added to sovereign external debt (as the oil company is 100% owned by the government) Mexico would be a net public sector external debtor.

The BOM has been building its reserves cushion through a rule-based mechanism. Under the rule, the BOM sells put options, which gives the private sector the ability to sell US dollars to the central bank (a maximum of USD600m in a month) should the exchange rate be appreciate more than the 20-day moving average. Through this mechanism, the central bank accumulated more than USD4bn in international reserves in 2010.

Comparative Analysis: Public Finances

Mexico

	2009					Last 10 years	
	Peru 'BBB'	Mexico 'BBB'	Russia 'BBB'	Thailand 'BBB'	Brazil 'BBB−'	'BBB' median	'A' median
Budget balance (% GDP)	-2.5	-2.6	-6.2	-3.5	-3.4	-2.4	-2.3
Primary balance (% GDP)	-1.2	-0.6	-5.4	-1.4	2.0	-0.2	-0.1
Revenues and grants (% GDP)	18.7	18.0	34.3	20.4	38.0	31.6	34.2
Volatility of revenues/GDP ratio	6.8	4.3	4.6	7.8	5.5	6.7	7.3
Interest payments (% revenue)	6.9	10.8	1.6	6.3	14.4	7.4	5.2
Debt (% revenue)	136.9	213.4	29.9	145.7	165.0	118.6	120.8
Debt (% GDP)	25.6	38.4	10.3	29.7	62.8	34.6	33.4
Net debt (% GDP)	18.0	31.8	-1.5	22.2	44.5	28.5	28.4
FC debt (% total debt)	63.9	14.4	40.8	19.7	6.6	34.1	24.8
CG debt maturities (% GDP)	1.9	7.1	0.7	5.0	10.2	6.0	5.6
Average duration of CG debt (years)	7.2	4.3	5.3	-	2.2	4.3	3.7

[a] GG if not otherwise specified
Source: Fitch

Strengths

- Mexico's fiscal credibility is underpinned by the authorities' willingness and capacity to consistently meet the annual fiscal targets. In some years, this has meant spending cuts when revenue has fallen short of expectations. Mexico passed modest revenue-enhancing measures in 2007 and 2009 and pension reforms to reduce the vulnerability of public finances.
- The development of Mexico's local government debt markets has helped the country ride the global credit crisis relatively well. Prudent liability management has contributed to extending the maturity and duration of debt and reducing the share of foreign-currency debt in total debt.

Weaknesses

- Mexico's revenue base remains quite modest compared with rating peers. Non-oil tax revenue is very low at about 10% of GDP in 2010. Fiscal buffers in terms of the oil stabilisation fund are also quite modest and expose Mexico's public finances to potential shocks in oil income.
- Mexico's interest/revenue ratio is higher than the 'BBB' median, highlighting the narrowness of the revenue base.
- Mexico's debt/GDP ratio remains higher than the 10-year 'BBB' median, although it is in line with the current peer median. Mexico has the highest government debt/GDP ratio among the low-investment-grade sovereigns that have significant fiscal dependence on commodity revenue.

Commentary

Mexico's liability management efforts continue to be sound and have resulted in an increase in the average maturity and duration of domestic debt. In 2010 the Mexican bonds were included in Citigroup's WGBI index, which increased fixed-income flows to the country.

Mexico was the first country in Latin America to issue a USD1bn 100-year bond in the international markets. Although the share of foreign currency debt in total debt rose modestly during the global financial crisis (due to the greater reliance on multilateral funding), the government is likely to maintain it at about 20%. The government has already pre-funded its external market amortisation for 2010-2012.

Fiscal Accounts Summary

(% of GDP)	2007	2008	2009	2010f	2011f	2012f
General government						
Revenue	**16.0**	**17.9**	**18.0**	**17.0**	**16.9**	**17.3**
Expenditure	**18.3**	**19.8**	**20.5**	**19.4**	**19.6**	**19.7**
O/w interest payments	1.7	1.6	1.9	1.8	1.8	2.0
Primary balance	-0.6	-0.2	-0.6	-0.4	-0.7	-0.2
IPAB and FARAC flows	0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Overall balance	**-2.2**	**-2.0**	**-2.6**	**-2.4**	**-2.7**	**-2.4**
General government debt	**30.4**	**33.8**	**38.4**	**38.0**	**38.4**	**38.6**
% of general government revenue	189.8	188.3	213.4	222.9	226.3	222.3
General government deposits	5.5	6.0	6.6	6.5	6.5	6.5
Net general government debt	24.9	27.8	31.8	31.5	31.9	32.1
Central government						
Revenue	14.4	16.3	16.3	15.3	**-**	**-**
O/w grants	0.0	0.0	0.0	0.0	-	-
Expenditure and net lending	17.1	18.4	19.0	17.9	**-**	**-**
O/w current expenditure and transfers	14.2	14.9	16.4	15.3	-	-
- Interest	1.7	1.6	1.9	1.8	-	-
O/w capital expenditure	2.9	3.5	2.6	2.6	-	-
Current balance	0.3	1.4	-0.1	0.1	-	-
Primary balance	-1.0	-0.4	-0.8	-0.7	-	-
Overall balance	-2.7	-2.1	-2.7	-2.5	**-**	**-**
Central government debt	27.5	30.8	34.9	34.5	-	-
% of central government revenue	190.7	188.6	214.3	225.0	-	-
Central government debt (MXPbn)	**3,108.2**	**3,752.1**	**4,154.4**	**4,489.8**	**-**	**-**
By residency of holder						
Domestic	2,420.9	2,900.1	3,195.2	3,167.6	-	-
Foreign	687.3	852.0	959.2	1,322.3	-	-
By place of issue						
Domestic	2,649.1	3,187.5	3,518.9	3,804.7	-	-
Foreign	459.1	564.5	635.5	685.1	-	-
By currency denomination						
Local currency	2,649.1	3,187.5	3,518.9	3,804.7	-	-
Foreign currency	459.1	564.5	635.5	685.1	-	-
In USD equivalent (eop exchange rate)	42.3	41.7	48.7	55.7	-	-
By maturity						
Less than 12 months (residual maturity)	736.2	850.1	843.6	793.9	-	-
Average maturity (years)	6.5	7.2	7.0	0.0	-	-
Average duration (years)	3.9	4.3	4.3	0.0	-	-
Memo						
Non-financial public-sector balance (% GDP)[a]	0.0	-0.1	-2.3	-2.7	-	-
Nominal GDP (MXPbn)	11,290.8	12,172.3	11,888.0	12,976.7	14,015.3	15,057.1

[a]For 2009 and 2010, includes Pemex's total investment.
Source: Ministry of Finance and Fitch estimates and forecasts

External Debt and Assets

(USDbn)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross external debt	**167.0**	**160.9**	**162.6**	**163.9**	**169.0**	**175.5**	**170.2**	**195.5**	**204.6**	**192.2**
% of GDP	28.8	25.9	25.1	23.4	22.3	20.7	17.9	18.9	18.7	21.8
% of CXR	86.6	86.4	86.4	83.3	74.6	68.1	57.0	60.4	59.7	70.8
By maturity										
Medium- and long-term	134.8	135.2	139.9	141.8	150.3	155.8	149.3	172.2	180.6	169.1
Short-term	32.3	25.7	22.7	22.1	18.7	19.7	20.8	23.3	24.1	23.2
% of total debt	19.3	16.0	14.0	13.5	11.1	11.2	12.2	11.9	11.8	12.1
By debtor										
Monetary authorities	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
General government	**64.4**	**61.6**	**59.5**	**60.7**	**67.4**	**68.8**	**54.3**	**63.3**	**62.9**	**73.5**
O/w central government	64.4	61.6	59.5	60.7	67.4	68.8	54.3	63.3	62.9	73.5
Banks	**12.4**	**4.7**	**2.9**	**2.8**	**3.3**	**4.4**	**5.5**	**4.8**	**3.4**	**4.6**
Other sectors	**90.2**	**94.6**	**100.2**	**100.4**	**98.3**	**102.3**	**110.3**	**127.4**	**138.3**	**114.2**
Gross external assets (non-equity)	**89.1**	**99.2**	**99.9**	**107.7**	**117.1**	**137.0**	**151.0**	**182.6**	**199.2**	**196.9**
International reserves, incl. gold	35.6	44.8	50.7	59.0	64.2	74.1	76.3	87.2	95.3	99.9
Other sovereign assets nes	8.0	3.2	1.8	2.3	0.6	0.6	0.6	0.0	0.0	0.0
Deposit money banks' foreign assets	9.8	16.1	11.9	13.0	15.8	17.6	19.7	21.6	22.5	23.7
Other sector foreign assets	35.8	35.2	35.5	33.4	36.5	44.6	54.3	73.8	81.4	73.3
Net external debt	**77.9**	**61.7**	**62.7**	**56.1**	**51.8**	**38.5**	**19.2**	**12.9**	**5.4**	**-4.6**
% of GDP	13.4	9.9	9.7	8.0	6.8	4.6	2.0	1.2	0.5	-0.5
% of CXR	40.4	33.1	33.3	28.5	22.9	15.0	6.4	4.0	1.6	-1.7
Net sovereign external debt	20.8	13.6	7.1	-0.7	2.6	-6.0	-22.7	-24.0	-32.4	-26.4
% of GDP	3.6	2.2	1.1	-0.1	0.3	-0.7	-2.4	-2.3	-3.0	-3.0
Net bank external debt	2.6	-11.4	-9.0	-10.2	-12.5	-13.3	-14.2	-16.8	-19.1	-19.1
Net other external debt	54.5	59.4	64.7	67.0	61.8	57.7	56.0	53.6	56.9	40.9
Net international investment position	**-**	**-249.1**	**-256.3**	**-277.4**	**-306.8**	**-340.3**	**-357.9**	**-396.6**	**-405.4**	**-352.9**
% of GDP	-	-40.1	-39.5	-39.6	-40.4	-40.2	-37.7	-38.4	-37.1	-40.1
Sovereign net foreign assets	**-20.8**	**-13.6**	**-7.1**	**0.7**	**-2.6**	**6.0**	**22.7**	**24.0**	**32.4**	**26.4**
% of GDP	-3.6	-2.2	-1.1	0.1	-0.3	0.7	2.4	2.3	3.0	3.0
Debt service (principal & interest)	**38.2**	**30.3**	**25.0**	**32.5**	**42.5**	**31.1**	**33.3**	**31.5**	**37.6**	**41.4**
Debt service (% of CXR)	19.8	16.3	13.3	16.5	18.8	12.1	11.2	9.7	11.0	15.3
Interest (% of CXR)	7.1	6.8	6.4	5.9	5.0	4.8	4.7	4.6	4.2	4.3
Liquidity ratio (%)	53.2	70.7	114.9	109.9	107.5	139.9	144.6	148.4	132.9	135.9
Net sovereign FX debt (% of GDP)	4.7	2.3	1.1	-0.1	-0.6	-1.9	-3.6	-4.4	-4.9	-5.8
Memo										
Nominal GDP	580.8	621.9	648.6	700.3	758.6	846.1	949.1	1,033.2	1,093.7	879.9
Gross sovereign external debt	64.4	61.6	59.5	60.7	67.4	68.8	54.3	63.3	62.9	73.5

Sources: NBP, IMF, World Bank and Fitch estimates and forecasts

Debt Service Schedule on Medium- and Long-Term Debt

(USDbn)	2011	2012	2013	2014	2015	2016+
Sovereign	**2.21**	**1.82**	**3.19**	**3.62**	**2.79**	**37.47**
Official bilateral	0.02	0.02	0.02	0.02	0.03	0.38
O/w Paris Club	-	-	-	-	-	-
Multilateral	0.65	0.68	0.70	0.81	0.58	10.47
O/w IMF	-	-	-	-	-	-
Other	-	-	-	-	-	-
Bonds placed in foreign markets	1.55	1.12	2.47	2.79	2.18	26.61
Non-resident holdings of domestic debt	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest	3.15	2.21	2.91	2.67	2.50	22.74
Total sovereign debt service	**5.37**	**4.03**	**6.10**	**6.29**	**5.29**	**60.21**
Private sector						
Amortisation	12.69	13.36	11.66	15.22	10.68	87.61
Interest	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total private debt service	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memo						
Non-sovereign public sector	6.97	4.11	4.50	4.31	2.97	63.29

Sources: Ministry of Finance, Central Bank and Fitch

Balance of Payments

(USDbn)	2007	2008	2009	2010f	2011f	2012f
Current account balance	**-8.7**	**-16.2**	**-5.7**	**-6.5**	**-12.6**	**-15.7**
% of GDP	-0.8	-1.5	-0.7	-0.6	-1.1	-1.3
% of CXR	-2.7	-4.7	-2.1	-2.0	-3.5	-4.1
Trade balance	**-10.1**	**-17.3**	**-4.6**	**-2.3**	**-6.9**	**-8.3**
Exports, fob	271.9	291.3	229.8	291.8	312.3	338.8
Imports, fob	281.9	308.6	234.4	294.2	319.2	347.1
Services, net	**-6.5**	**-6.8**	**-7.8**	**-10.3**	**-11.7**	**-12.6**
Services, credit	17.6	18.5	15.4	16.7	17.7	19.1
Services, debit	24.1	25.2	23.2	26.9	29.3	31.7
Income, net	**-18.6**	**-17.7**	**-14.8**	**-15.2**	**-15.7**	**-17.4**
Income, credit	7.6	7.1	4.7	4.0	5.0	5.4
Income, debit	26.2	24.8	19.5	19.2	20.7	22.8
O/w: Interest payments	14.9	14.5	11.7	14.0	17.0	18.0
Current transfers, net	**26.4**	**25.4**	**21.5**	**21.3**	**21.7**	**22.6**
Memo:						
Non-debt-creating inflows (net)	20.0	19.6	10.5	7.0	15.0	15.0
O/w equity FDI	20.5	23.1	6.4	6.0	11.0	11.0
O/w portfolio equity	-0.5	-3.5	4.2	1.0	4.0	4.0
O/w other	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (-= Increase)	10.8	8.0	4.5	21.0	13.4	8.3
Gross external financing requirement	25.3	39.3	35.4	26.2	37.3	40.7
Stock of international reserves, incl. gold	87.2	95.3	99.9	120.9	134.3	142.6

Sources: IMF and Fitch estimates and forecasts