Country Focus: Mexico

July 2016

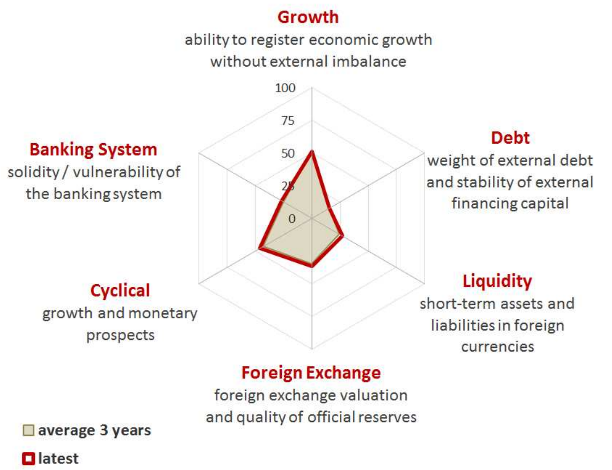
Country Focus: A positive view on Mexico, despite gradual deterioration in Risk ratings

The combination of Mexico's economic and financial performances shows a low degree of risk (32-B) with no early warning signals of a major shock. Though the momentum of domestic demand is expected to slow down and the currency could face volatile pressures in a highly uncertain international environment, resilience factors are still dominant, including recently announced structural reforms, a guaranteed support from IMF, and a diversified industrial structure. A broader uncertainty however is now related to the possibility of Donald Trump's election in the US.

Overall favourable combination of risks

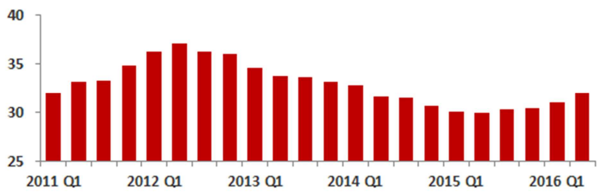
The low degree of risk is derived from strong macroeconomic fundamentals and the positive impact of US progressive economic recovery. Sound macro-economic policies, a flexible exchange rate regime and a robust banking system have helped the economy to withstand successive external shocks (global financial crisis, European debt crisis, tapering tantrum, oil price fall). Economic activity has benefitted from a strong domestic demand (while external demand is affected from slowdown in global trade) and ongoing implementation of structural reforms promoted by President Peña Nieto's government (energy, telecommunication, education, etc.)

Mexico: Performances on Fundamental Balances
(0: best to 100: worst)



However, after a continuous improvement since 2012, the Risk rating has marginally deteriorated for the last few quarters on the back of the rise of financial volatility and still low oil prices. The greater uncertainty of international environment (notably dynamics of US activity and monetary tightening) has indeed significant effects on the exchange rate, the monetary policy, and *in fine* the economic growth. In addition, the sensitivity to oil is very important as oil sector has registered years of under-investment and oil prices have remained subdued.

Mexico: Average Economic & Financial Risk Rating
(from 0= lowest to 100: highest risk)



Softening domestic demand momentum ahead

The most recent position on the Cyclical Balance remains in a favourable area, nevertheless the decline of *real economic pressure* indicates a potential deterioration of the momentum of domestic activity in 2017 (still at a positive level). Economic growth has remained modest (+2.6% y/y in 2016Q1 after +2.4% in 2015Q4) supported by domestic consumption (via retail sales, private credit and real wages) and services on the supply side. But, industrial production still endured resilient headwinds related to weak oil output, sluggish manufacturing exports and fiscal consolidation.

In addition, our quantitative model and the position of *monetary pressure* (just below the *overheating* area) suggest a more hawkish stance for the Central Bank in relation with the Fed rates hike in the coming quarters and/or higher volatility, though inflationary pressures are efficiently controlled (inflation around +2.5% y/y in 2016 so far, still below the mid-point of the central bank's target range).

Relative tensions on external performances

The position into the *liquidity risk* area on the Foreign Exchange Balance due to the insufficient *forex reserves quality* indicates continuous risks of financial volatility in the short term, even though the large depreciation of Mexican Peso (MXN) between mid-2014 to June 2016 (-30% against USD) is now providing a substantial competitive advantage (undervaluation of above -30% in 2016Q1). The substantial decline of forex exchange reserves (USD -20bn since Jan. 2015 to USD 175 in May 2016) is however largely offset by the renewal and extension of the precautionary arrangement by the IMF (Flexible Credit Line of USD 88bn).