

Economic

Credit Agencies

Moody's: Baa1

S&P: BBB

Fitch: BBB

Nominal GDP (2005)

USD 768 bn

Population (2005):

106.2 mn

Total Trade / GDP (2005):

56.6%

Currency:

Mexican Peso (MXP)

Exchange regime:

Independently floating

Merchandise Imports from Canada (2005; INEGI):

USD 6.2 bn

Main sources of Foreign Exchange (excl. FDI):

Maquiladora exports

Largest Merchandise Trading Partner:

United States (88%)

Main imports:

Intermediate goods (76%)

Consumer goods (13%)

Risks to the Outlook



US industrial production exceeds expectations.



Oil production falls more than expected. Political noise escalates.

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Market Spotlight: Economic strength continues to prove solid offsetting concerns relating to June's Presidential election results. Volatility remains a risk. ■ GDP growth is now forecasted to reach 4.3% in 2006, gross fixed investment was up 14% y/y in May ■ ■ Remittances are up 23% H1 y/y while Q2 growth registered 4% y/y. ■ Canada's merchandise exports to Mexico are up over 42% YTD (CAD terms) on broad based gains. ■ The auto sector is booming with production to July up 31.3% led by Ford, GM and Volkswagen (up 210%, 32% and 23% respectively).

Real Economy: We expect GDP growth to average 4.3% in 2006. Year-to-date growth has been consistently strong, with H1 growth up 5.1% y/y. High auto production will continue to support growth but modest US industrial production, to which Mexican growth is highly correlated, and the impacts of a weakened housing market in the US will take growth to 3% next year. Consumer demand will remain strong in 2006 but will follow the same pattern as overall growth. Investment will also boost GDP, but its impact will be scaled back by the high level of coinciding imports. Long term GDP growth is estimated at 3-3.5% annually. This can improve but only with reforms that are necessary to promote competitiveness and productivity.

Monetary Policy: Central Bank credibility continues to grow. A landmark was reached in July with inflation under 4% for 12 consecutive months, the first time in well over 30 years such a result has been achieved. Most importantly, inflation expectations within the private sector continue to trend towards the 3% target. Another signal of improved central bank credibility. Currency volatility may emerge in the coming 12 months, a consequence of risks relating to the Presidential elections and tightened global monetary conditions. Recently inflation has risen albeit because of factors beyond the control of the Central Bank (including because of tomato prices).

Fiscal: Fiscal accounts have improved but the gains have been incremental and not really a resulting from significant measures undertaken by the government. The task of improving fiscal accounts has been more or less automatic considering the high oil price and the low interest rate environment. In fact the 0.1% deficit in 2005 represents a one percentage point improvement over the result recorded in 2000. Longer term, the reliance on oil revenues (36% of central government revenues) and uncertainty on how government expenditures would respond to a large decline in the price of crude are concerns. Pemex continues to be used as a cash cow and the company regularly has to resort to debt financing to maintain operations.

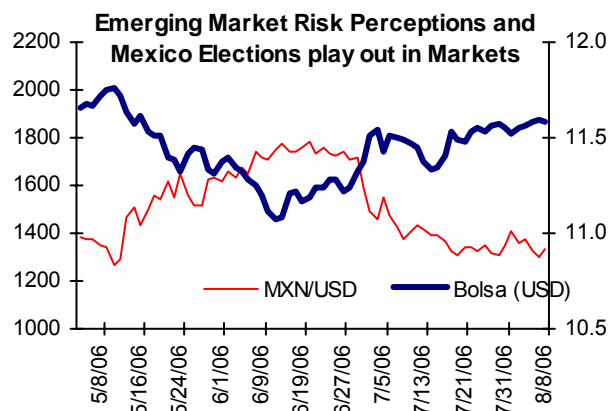
External: The current account should be roughly balanced in 2006, boosted by the US\$1.2bn surplus recorded in Q2 '06 - the largest since Q2 1987. Remittances are now the second most important source of foreign currency, after oil. External debt to GDP and external debt service are quite low. Additional positive factors include the government's preference for issuing domestic currency debt along with debt buybacks in 2006. Sovereign bond spreads have begun to creep upwards but remain near historic lows. Portfolio flows should be watched closely.

Outlook: *The outlook is subject to some uncertainty. Recount uncertainty should be short lived but there are downside risks. Longer term, Mexico's competitive position versus China will be a factor. Post election, reforms should become a priority but will prove politically unpopular. In particular the government must find a way to increase its tax take while lowering dependence on oil revenues. Meanwhile the trend of declining oil reserves must be reversed. Labour market reforms should also be a high priority to boost employment and productivity in the formal sector. Absent reforms, a rather lackluster medium-term GDP growth rate of 3.0-3.5% is nothing to get excited about. Effective debt and monetary management has been the key to improved credit conditions in the country, but additional improvements will be hard to come by. Failing to advance the reform agenda over the next two years could catalyze a reversal in the trend of Mexico's credit quality.*

Economic Indicators

	00-04 avg.	2005	2006	2007
GDP (% growth, real)	2.5	3.0	4.3	3.0
Inflation (%chg, pa avg.)	6.0	4.0	3.3	3.5
Fiscal Balance (% of GDP)	-0.8	-0.1	0.0	-0.3
Exports (% comp. annual growth)	6.6	14.0	18.0	5.0
Imports (% comp. annual growth)	6.7	12.7	16.0	7.0
Current Account (% of GDP)	-2.1	-0.6	-0.1	-0.5
Reserves (months of curr. debits)	2.9	2.7	3.3	3.2
External Debt (% of GDP)	26.0	21.2	20.1	20.1
Debt Service Ratio (due)	20.8	17.8	15.5	15.4
Exchange Rate (to USD; eoy)	10.3	10.8	11.2	11.5

Source: EIU and EDC Economics



Political

Political Structure

Federal Republic

President

Vicente Fox

President-elect

Felipe Calderón

Legislative Bodies

- National: Chamber of Deputies (500 seats); Senate (128 seats)
- State: 31 state governors and legislatures

Major Parties (seats in Congress; Senate)

- Partido Accion Nacional (PAN) (206; 52)
- Partido de la Revolucion Democratica (PRD) (123; 29)
- Partido Revolucionario Institucional (PRI) (104; 33)

Last Elections

- All levels: July 2006

Next Elections

- Chamber of Deputies: July 2009
- All levels: July 2012

Press Freedom Survey:

- 2006 Score: 48 – Partly Free
- (0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:

- 2005 Score: -0.41 (-2.5: Worst; +2.5: Best)
- worldbank.org

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General Political Environment:

In 2000, Mexican voters broke with 71 consecutive years of rule by the Partido Revolucionario Institucional (PRI) and elected Vicente Fox of the Partido Accion Nacional (PAN) president. This development was seen as a major step forward for democracy in Mexico.

President Fox has struggled to implement reform in the face of an uncooperative Congress and the minority status of his party. This lack of reform is blamed for Mexico's inability to increase its competitive position in the global economy and growth rates too low to improve the standard of living of large portions of its population. Mexican society is increasingly polarized between those who have prospered and see improving business conditions as a major priority, and those who remain poor and want a focus on poverty reduction.

This split became clear in the results of the presidential elections of July 2, 2006. A difference of less than 1% separated Andrés Manuel López Obrador of the left-leaning PRD and Felipe Calderón of the pro-market PAN. A federal tribunal responsible for deciding a course of action and declaring a president ruled in early September that widespread irregularities had not taken place and named Felipe Calderón President-elect. Nevertheless, López Obrador has indicated that he will continue to protest with various tactics, some of which have the potential to hamper the ability of the new legislature to conduct business. As such, a climate of uncertainty is expected to prevail in Mexico at least until the new president is inaugurated in December.

Other developments may herald significant changes in the Mexican political landscape. The PRI lost many seats in both the Congress and the Senate, and its candidate finished a distant third in the presidential election. New leaders from the ranks of PRI loyalists and dissidents alike may emerge in the short term.

No one political party gained a majority position in the legislature. In conjunction with the bitterness surrounding the electoral challenges and the PRI defeat, there is a strong possibility that the next government will be prone to the kind of legislative stalemate and piecemeal progress that has characterized the Fox administration. The main challenge for Mexico's next national leader will be to forge a positive environment for negotiation and compromise between parties in Congress and the Senate so that further economic, social, and political progress can be made.

Investment Environment:

Mexicans' historic suspicions regarding foreign investment are receding. However, any decision to open the oil and electricity sectors to foreign investment remains very controversial and nationalist sentiment will likely prevail over the short term.

Mexico's legal system is quite weak, corrupt and politicized. Recent reforms to the Mexican legal system have served to start improving the framework. Commercial morality is also improving, albeit at a slow rate. It is important to note, however, that a culture of corruption continues to exist in Mexico and it will likely take a generation before it starts to ebb. Access to domestic and international arbitration is guaranteed by law and by free trade agreements such as NAFTA.

Security issues receive significant attention as kidnap rates have risen steadily and drug-related murders are often in the news. The drug-related violence is largely contained to known locations, and tends to flare from time to time. Border security is an issue of increasing importance in Mexico's relationship with the US.

Political Violence:

The rebel Zapatista National Liberation Army ("EZLN") has been largely peaceful since the late 1990s and its leaders appear be standing by their 2005 announcement that the organization will be re-oriented towards a more traditional, albeit firmly grass-roots based, political role. Other anti-government and insurgent groups exist but do not pose serious threats to national security.

Strikes and demonstrations are frequent in Mexico and can influence government decisions. A long-standing teacher's strike in the state of Oaxaca has evolved into a volatile dispute over the continued leadership of Governor Ruiz. The central government will have to be very careful to manage a solution which will avoid setting a precedent for popular protest to remove elected officials.

Political Outlook

The numbers of supporters that respond to López Obrador's calls to protest against the election process is dwindling, as is the risk of significant related violence. Some uncertainty is expected to persist over the short term, at least until President Fox steps down on 30 November. Over the longer term, there is a strong sense within the country that the state can no longer afford to tread water on important issues without putting economic and political health at risk in the medium term. Tax reform, unemployment, competitiveness in manufacturing, and the modernization of Mexico's petroleum giant, Pemex, are issues that require decisive action from the next administration. It is also likely that Calderón will have to address social spending to some extent.