Mexico

Analyst: Martin Carlens. Tel: +46-8-7638392. E-mail: martin.carlens@seb.se

Following the coronavirus shock, the authorities initially have been focusing more on safeguarding government finances than on stimulating economic activity. There is a risk that failure to adequately address the downturn and previous, underlying growth weaknesess will depress the economy further in the medium-term and that this will spill over on government finances down the road.

Country Risk analysis

Summary

Already prior to the coronavirus shock, the Mexican economy was in recession and facing a mediocre growth outlook. The shock, assumed to be significant but relatively short-lived, is expected to delay steps to improve private sector confidence and thus investment prospects, thereby affecting also medium-term growth prospects. In addition, the government's relatively limited policy stimulus, so far, to counter the downturn risks leading to a deeper and more drawn-out humanitarian and economic downturn than in other countries were the response has been upfront and significant.

The limited, immediate fiscal response to the downturn may largely safeguard headline fiscal numbers. At the same time, contingent liabilities are likely to rise while low growth in the near to medium-term should make it more challenging to reduce government debt.

One of the major sovereign credit rating agencies downgraded the sovereign one notch in mid-2019 and another step recently. Another of the major agencies downgraded the sovereign recently, mainly arguing that the current short-term shock to the economy is likely to affect already weak trend growth dynamics negatively over the next three years.

Recent economic developments

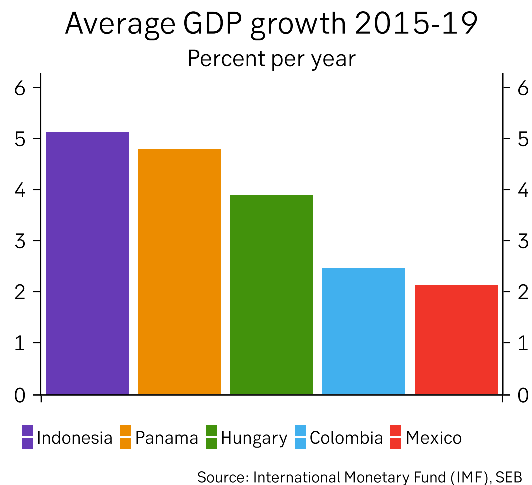
Economy in recession. Average economic growth in Mexico in the past five years has been low compared to country risk peers, and compared to many other large emerging markets. The roughly 2% average GDP growth is often attributed to poor productivity. On the other hand, growth rates have been somewhat less volatile than among peers. In 2019 activity surprised on the downside and came to a standstill with real GDP shrinking by 0.1%, burdened by cooling external demand and weak private sector investment. Recent data indicate that the economy, now also hit by the corona virus related effects, is firmly stuck in recession.

important your attention is drawn to the statement on the back cover of this report which affects your rights.

SEB

Poor economic growth suppressing inflation. Sub-par growth generated a decline in inflation over the past year. In early 2020 it reached 3.7% which is within the central bank's inflation target range. Meanwhile, unemployment has continued to rise.

External balances largely stable and reasonably strong. Weak domestic demand has been weighing on imports and contributed to a decline in the current account deficit to 0.2% of GDP in 2019. Foreign direct investment (FDI) fell compared to 2018 but still comfortably covered the current account deficit. The US-Mexico-Canada Agreement on free trade has now been ratified by Mexico and the US while the process is still ongoing in Canada. Although this is likely to reduce uncertainty around regional trade conditions somewhat, potential negative discretionary measures from the country's most important trade partner cannot be ruled out.



International reserves and IMF agreement provide a cushion. Meanwhile, foreign exchange reserves provide an adequate cushion, given the floating exchange rate. At about USD 189 bn they are equivalent to about 5 months of imports and more than twice the level of short-term debt. The country's two-year Flexible Credit Line (FCL) from the IMF was renewed in November 2019 and provides an additional reserve buffer. The country has access to about USD 61 bn. without any conditionality. The government also has a currency swap line with the Federal Reserve of USD 69 bn. and one with the US Treasury of USD 9 bn.

Financial markets have hammered Mexican assets. Global financial market sentiment versus Mexico was favourable in the run-up to the coronavirus shock. The global flight to safe assets since then has weighed heavily on Mexican assets. Investors reversing their carry trades and a broader USD strengthening has pressed the exchange rate, which has lost nearly 30% against the USD since the start of the year. Capital outflows in March were reported to be the largest on record, and bond spreads and CDS rates have soared to never seen levels.

Rating agency downgrades. One of the major sovereign credit rating agencies downgraded the sovereign one notch in mid-2019, and another notch recently. The agency argued that the downgrade reflected a combination of increased pressure on public finances from Pemex's deteriorating credit profile and an increasingly weak macroeconomic outlook. Another of the major agencies downgraded the sovereign in March, mainly arguing that the current short-term shock to the economy is likely to affect already weak trend growth dynamics negatively over the next three years. Two agencies have a negative outlook.

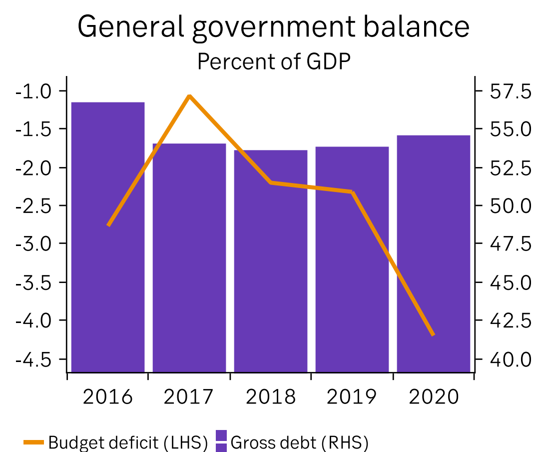
Economic policies

Policy uncertainty is high. Economic policy making continues to be perceived as discretionary, creating an uncertain investment climate in the real economy and hurting business sentiment. This is often cited as the key reason for the weak

private investment activity of the past years. A recent example is when the government's use of public consultations once again led to the halt in the construction of a major private project, this time a half-finished USD 1.4 bn brewery close to the US border. The government's announcement of the National Investment Agreement in Infrastructure by the Private Sector in late 2019 was seen as an attempt to rebuild some private sector confidence. The programme includes 140 investment projects and runs from 2020 to 2024 but still lacks some important details. So far, there few signs that the announcement has boosted business sentiment.

Fiscal track record remains strong. The country's strong fiscal policy framework has helped generate sound fiscal metrics for nearly two decades. This has been crucial for our view on the strength and credibility of the sovereign. In 2019, the headline government budget deficit edged down to 1.7% of GDP while the primary surplus remained steady. This was helped by the government using half of the budgetary stabilization fund (FEIP), despite the economy not facing any extreme circumstances.

Restrained fiscal response to the slowdown. Following the coronavirus outbreak, the government updated its budget, building it on the assumption that the economy would contract by 2.9% in 2020. At the same time, the President continues to stress a strong commitment to fiscal austerity. Contrary to most of its regional peers, the government, so far, has not announced any large countercyclical stimulus measures. Instead the President has ruled out new borrowing, any bailout of companies or tax cuts. While austerity may be laudable in principle, many observers are concerned that the limited response to the coronavirus crisis could lead to a deep and drawn-out humanitarian and economic crisis.



Government debt is moderate, interest rate costs are high. Following the primary surplus last year, government debt as a share of GDP was broadly stable at about 54% which is moderate compared to risk class peers. Roughly 80% of the debt is issued in local currency although a significant chunk is held by non-residents. The average maturity of debt is relatively long. Domestic interest rates have been high in the past few years as the central bank has worked to support the exchange rate. As a consequence, the government's interest rate costs on debt as a share of revenues are higher than most peers.

Contingent liabilities are significant. State-owned oil company Pemex's debt, equivalent to roughly 9% of GDP, is not explicitly guaranteed by the government but we ascribe a very high likelihood to that the government would assume its obligations in case of financial distress. And, indeed, the company's financial woes continue to worsen, reflected in credit rating agencies downgrading it further into junk territory recently. At the same time, the recent oil price downturn and gloomy growth forecast are making the government's plans for the company increasingly unsustainable. There is a risk that the longer it takes to

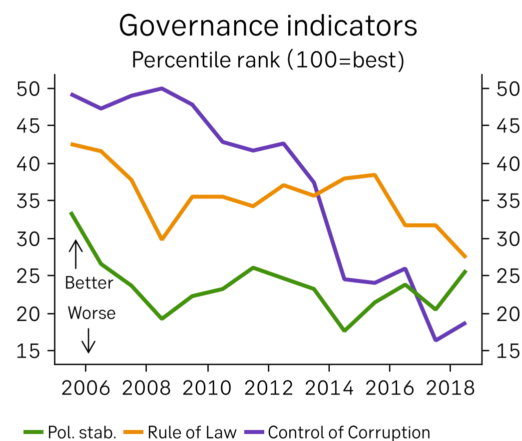
adapt its strategy, the more it could damage both Pemex and the sovereign balance sheets.

Monetary policy loosening is reducing high real interest rates. With inflation gradually declining towards the central bank's (Banco de Mexico, Banxico) 3%+-1% inflation target, the bank started a rate cutting cycle policy in 2019. Interest rate adjustments followed in the footsteps of the US Fed. Recently, it responded to the worsened growth outlook by cutting rates by 50 basis points to 6.50%. It has also injected liquidity into the banking system. Despite the cut, real interest rates remain relatively high. The flexible exchange rate regime and the central bank's robust inflation targeting framework remain important country risk strengths.

Banking sector broadly sound and stable. The small size of the banking sector, with total assets equivalent to less than half of GDP, poses a limited contingent liability for the government. The IMF in its 2019 Article IV report stated that the sector remains well capitalized, highly profitable and with the aggregate share of NPLs hovering close to record lows.

Political situation

Government maintains popularity. Andrés Manuel López Obrador (AMLO) left-wing Morena party and its allies maintain majorities in both chambers of the Congress and control 19 of 34 state congresses. This puts the government in a strong position to implement their political agenda. Despite slow growth and a high frequency of public violence, the President's approval ratings remain high, although down from the start of the mandate period. Meanwhile, the structural reform agenda, including tackling corruption and the informal sector, has largely stalled. While some governance related indicators have deteriorated recently, most of them are broadly in line with risk class peers.



Outlook

Facing another year of recession. The combination of lower oil prices, plunging US demand and the lower domestic demand following the lockdown of large parts of the economy will depress growth significantly for at least the first half of 2020. Despite expectations of a gradual recovery in 2H, our house forecasters Oxford Economics have slashed their growth forecast significantly. For the full year, they expect negative growth to the tune of 4%. This may be on the optimistic side. The IMF projects a decline of 6.6%. The drop in 2009, following the global financial crisis, was 5.3%.

Risks that growth slowdown could be worse and last for longer. Although GDP forecasts for 2020 have been cut recently, we see risks that growth can disappoint further this year and in 2021. One risk is a deeper than expected recession in the US**.** The Northern neighbour stands for roughly 80% of Mexico's exports, a large share of tourism and most of the remittances which normally fuel household

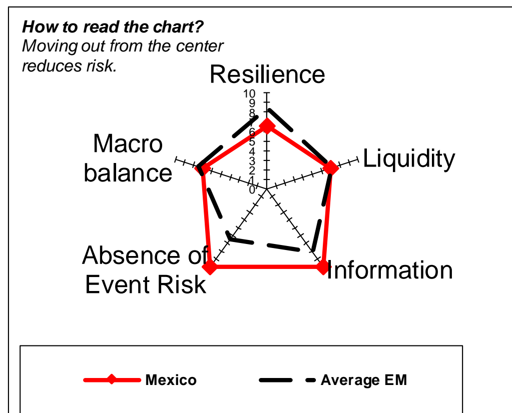
spending. Another risk stems from the government's initial relatively slow response to the health threat of the coronavirus. While this may prove to have been less harmful to domestic demand in the short term, it may risk leading to a more prolonged health and economic shock.

Government finances to worsen. The growth slowdown will pressure government revenues and require counter cyclical spending. This together with mounting spending pressures from the government's ambitious social and infrastructure agenda is likely to throw budget targets off track, despite the use of budget stabilization funds. Lower oil prices should only have a limited impact on government revenues as they are largely hedged. However, it will contribute to a worsening financial situation of Pemex. The IMF expects deficit to jump in 2020 but then revert to moderate levels while they expect a negligible rise in the government debt ratio. Our concerns on this point relates not as much to a near-term rise in deficit or debt but to the reduced likelihood that the government will be able to reduce government debt in the medium-term.

Hopes attached to new trade flows. Most observers agree that the coming into effect of the US-Mexico-Canada Agreement on free trade this summer will be positive for the economy, but generally don't expect it to lift growth to any significant degree.The authorities, on the other hand, are having great hopes that it will give the economy a significant boost in the medium-term. Hence, this could entail a positive risk. Another risk on the upside could be the that coronavirus related reduction in US business dependence of China will lead to increased US economic ties with Mexico over the medium-term.

Mexico: Risk Profile

Key ratios	2020
Population (mill)	129,1
GDP growth	-3,9%
GDP/capita (USD)	8341
Inflation	3,6%
Current account balance/GDP	-0,1%
Reserves/imports (months)	6
Government debt/GDP	55%



External ratings:
Moody's: A3 (neg)
Fitch: BBB-
S&P: BBB (neg)

Peers:
India
Indonesia
Hungary

Graph: Mexico's risk profile is stronger on *event risk* and *information*, but weaker on long term factors included in resilience. The macro balance score is also weaker, pulled down by the current and fiscal account imbalances.

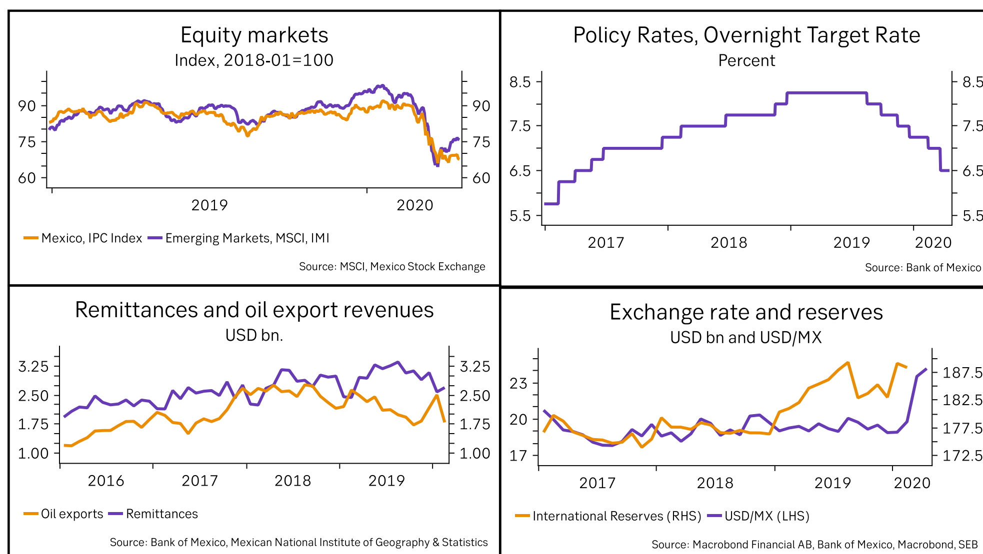
Mexico: Key Indicators

Macroeconomic	2016	2017	2018	2019	2020	2021	2022	2023
GDP (USD, bn)	1076	1163	1223	1260	1077	1210	1339	1413
GDP/capita (USD)	8420	8992	9677	9864	8341	9276	10162	10626
GDP (change)	2,6%	2,4%	2,1%	-0,1%	-3,9%	3,2%	2,9%	2,3%
Investments/GDP	21%	20%	20%	21%	22%	22%	22%	22%
Government finances								
Budget balance/GDP	-2,5%	-2,8%	-2,2%	-2,3%	-4,2%	-3,0%	-3,0%	-2,5%
Govt debt/GDP	53%	57%	54%	53%	55%	55%	55%	55%
Money and prices								
CPI inflation	2,8%	6,0%	4,9%	3,6%	3,6%	3,3%	3,3%	3,2%
Money demand (chg, yoy)	31%	29%	27%	24%	21%	19%	18%	18%
Stock prices avg.	45569	49019	47192	43257	46732	50324	53849	57935
Interest rates	4,6%	7,1%	8,0%	8,3%	6,2%	5,8%	5,8%	5,9%
Exchange rate (USD)	18,7	18,9	19,2	19,2	22,4	21,3	20,4	20,4
Trade/GDP	71%	71%	75%	74%	81%	77%	76%	77%
Oil price (Brent)	$44	$54	$71	$64	$46	$56	$62	$71
Balance of payments (USD, mn)								
Exports of goods	374 304	409 775	451 656	476 043	513 790	538 508	566 907	597 891
Imports of goods	387 369	420 764	464 850	455 828	363 194	392 410	456 007	493 660
Other:	-10 912	-8 064	-9 810	-22 659	-151 536	-137 817	-125 120	-127 089
Current account	-23 977	-19 053	-23 004	-2 444	-940	8 281	-14 220	-22 858
(% of GDP)	-2,2	-1,6	-1,9	-0,2	-0,1	0,7	-1,1	-2,6
FDI	29 312	26 947	21 223	13 867	15 657	15 987	16 195	16 403
Loan repayments	-59 129	-35 143	-37 540	-49 377	-57 020	-62 965	-68 205	-73 157
Net other capital flows	62 121	12 912	28 612	38 462	50 908	64 292	102 981	125 754
Balance of payments	8 327	-14 336	-10 709	508	8 605	25 596	36 752	46 143
External debt and liquidity (USD, mn)								
Reserves	170 072	166 010	167 503	170 580	174 615	193 099	207 332	220 757
In months of imports	6	5	4	4	6	6	5	5
Total debt	424 135	442 839	448 519	468 274	489 988	511 701	533 414	555 127
o/w short term debt	59 970	53 446	63 485	70 050	76 500	82 951	89 402	95 853

Source: Oxford Economics and SEB estimates.

Rating history (eoy)				
Fitch	BBB+	BBB+	BBB+	BBB
Moody's	A3	A3	A3	A3

Type of government: Presidential democracy
Next elections: Legislative July 2021, Presidential July 2024
Other:
Latest PC deal: 1989, fully repaid
Latest IMF arrangements: 2-year Flexible Credit Line of about USD 88 bn, expiring Nov 2019



Disclaimer

Confidentiality Notice

The information in this document has been compiled by Skandinaviska Enskilda Banken AB (publ) ("SEB").

Opinions contained in this report represent the bank's present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.

Skandinaviska Enskilda Banken AB. All rights reserved.