

Mexico Moves Up

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Positive policy and fiscal developments, as well as stabilizing oil production, seem likely to shore up Mexico’s near-term fundamental outlook.

Since 2006, our outlook for Mexico has been structurally cautious. In our view, declining production of oil, which is a major source of the nation’s revenue, would reduce Mexico’s fiscal flexibility and threaten its credit ratings. A ratings downgrade last year seemed to bear out these concerns.

But several positive developments have occurred recently that put Mexico in a better light. A recent policy shift, deft fiscal management and stabilizing oil production are likely to arrest the decline in Mexico’s fundamentals for at least the next couple of years.

Rising Dollar Reserves and Fiscal Progress

First, the new governor of Mexico’s central bank, Agustín Carstens, recently implemented a policy change under which the government would begin to accumulate dollar reserves. This approach is a major change from the policies of the previous central bank governor, who believed that the costs of accumulating additional reserves outweighed the benefits. But Mexico’s slowly eroding fundamentals and the steep global recession changed that

calculus. Today’s prevailing view is that more reserves are better. In the past six months, Mexico’s dollar reserves have jumped more than \$20 billion (**Display 1**). This higher reserve balance is a powerful bulwark against any future market volatility, in our view.

However, the policy change to stockpile additional reserves for currency defense is also a tacit acknowledgment that Mexico is no longer considered a standout among emerging-market credits. It’s clear that Mexico will be vulnerable to future crises, and that investors are unlikely to differentiate it based on its superior credit rating versus other emerging nations. The accumulation of dollar reserves will also further weaken the peso, although this will help the nation’s fiscal account balance. And the new policy also represents a subtle shift from what had been one of the most free-floating currencies in the emerging world over the past decade.

The second positive development for Mexico is the substantial progress it has made on the fiscal front. Last year, the government passed a 2010 budget that incorporated measures necessary to reduce

Display 1
Mexico’s Reserves Soar Under New Plan



Source: Bloomberg

Display 2
Mexico Piggybacks on US Recovery



Source: Federal Reserve Board, Haver Analytics and Instituto Nacional de Estadística y Geografía

a growing fiscal gap. Since then, an economic recovery has started, and it will likely allow the government to achieve its budget targets.

Of course, Mexico still faces substantial fiscal problems linked to an overreliance on oil revenues, but some amount of economic growth in the next two years will provide additional revenue to paper over those problems. In fact, we expect 2010 economic growth to reach about 4%—following a 6.5% contraction in 2009.

As always, the Mexican economy will be greatly dependent on the performance of the US economy, and there's reason to believe that the Mexican recovery can piggyback on the US recovery and continue to accelerate (**Display 2, previous page**).

Declines in Oil Production Stemmed

A third positive factor for Mexico is a halt in oil-production declines (**Display 3**). The fourth quarter of 2009 was the first quarter in which Mexico's oil production rose since the first quarter of 2006. The turnaround can be attributed to a big increase in spending on exploration and production by PEMEX, Mexico's state-owned oil company.

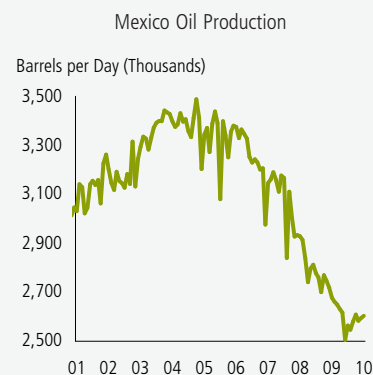
We estimate that oil production will likely stabilize around 2.5–2.6 million barrels per day for the next two years or so. However,

without a big commitment to deepwater petroleum production, which is impossible without another energy reform, most oil analysts doubt that the stabilization in oil production can last beyond that time-frame.

Meaningful reforms will likely be difficult for the balance of the Calderón administration. A number of important state-governor elections dot the calendar this year, and next year marks the beginning of the march to the 2012 presidential elections. Conventional wisdom says that the opposition PRI party will likely prevail, and PRI's intraparty divisions, combined with risk aversion in a party that believes it's poised to win, will likely keep the PRI from supporting fiscal or energy reforms. That support is crucial to the ruling PAN party's hopes of passing any reforms.

For this reason, we see the near-term future for Mexico as being shaped largely by its extremely competent team of technocrats in the central bank, finance ministry and public-credit departments. Given a reasonable external environment, we expect this group to produce the best possible outcome for the country under the circumstances. This means that credit-rating agencies will likely be satisfied with the country's forward outlook, and the growth in Mexico's dollar reserves may even inspire a shift to a more positive outlook. ■

Display 3
Oil Production Stabilizes



Source: Haver Analytics and Instituto Nacional de Estadística y Geografía

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