

**Rating Report**

**Report Date:**  
August 31, 2010

**Previous Report:**  
March 25, 2009



*Insight beyond the rating.*

# United Mexican States

## Analysts

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## Recent Actions

**March 25, 2009**

Confirmed

## Rating

Debt	Rating	Rating Action	Trend
Long-Term Foreign Currency	BBB	Confirmed	Stable
Long-Term Local Currency	BBB (high)	Confirmed	Stable

## Rating Update

DBRS has confirmed its ratings on the United Mexican States' (Mexico) long-term foreign currency securities at BBB, long-term local currency securities at BBB (high), and maintained Stable trends on both ratings. The Stable trends reflect Mexico's resilience and strong policy response to the sizable shock from the global financial crisis, and balance concerns regarding long-term fiscal and growth prospects.

The international financial crisis and a steeper-than-expected decline in Mexican oil production had a profound effect on the Mexican economy and public finances. The collapse in U.S. manufacturing caused the steepest decline in Mexican industrial production since the 1994-95 Tequila Crisis, as real GDP fell by 6.5% in 2009. Given Mexico's budgetary dependence on oil revenues, the decline in oil production required a significant fiscal adjustment to offset lower oil revenues. As global risk aversion accelerated, capital outflows from Mexico resulted in currency depreciation and sporadic liquidity pressures on corporates. An outbreak of the H1N1 virus added to the drag on economic activity. Risk perceptions increased further with a deteriorating security situation.

In spite of the shocks that Mexico experienced over the last three years, DBRS maintained Stable trends on Mexico's ratings, anticipating that the economy would rebound along with that of the United States, and that Mexico's record of sound and predictable macroeconomic management would materialize in a strong policy response. This did indeed occur in the form of a tax reform, well-engineered monetary easing, targeted assistance to financial intermediaries and interventions in the foreign exchange market. (Continued on page 2.)

## Rating Considerations

### Strengths

- (1) Strong macroeconomic policy framework
- (2) Good debt management, low debt burden
- (3) Well-regulated financial markets
- (4) Slow but steady record of structural reforms

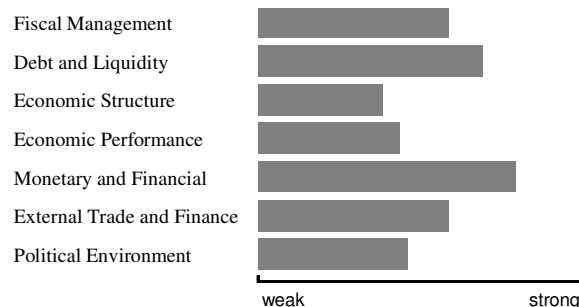
### Challenges

- (1) Inflexible public finances with revenues overly dependent on oil
- (2) Low productivity growth and export competitiveness
- (3) Bottlenecks in energy, labor and product markets
- (4) Severe income inequality, regional disparities
- (5) Containing drug-related violence

## Summary Statistics

For the year ended December 31	2010E	2009	2008	2007
Nominal GDP (US\$ billions)	1,018	875	1,090	1,026
GDP per capita (US\$)	9,391	8,135	10,217	9,694
Real GDP growth (% change yoy)	5.1%	-6.5%	1.5%	3.3%
Inflation (CPI % change yoy)	4.9%	3.6%	6.5%	3.8%
Interest rate*	4.5%	4.5%	8.3%	7.5%
Exchange rate (aver MXD/US\$)	12.60	13.51	11.13	10.93
Current account balance (% GDP)	-0.8%	-0.6%	-1.5%	-0.8%
Central govt balance (% GDP)	-2.7%	-2.3%	-0.1%	0.0%
Public sector debt (% GDP)	44.7%	44.5%	43.2%	38.1%

\* 28-day CETES/Target rate



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### Rating Update (Continued from page 1.)

Contingent financing from U.S. Federal Reserve swap lines and an International Monetary Fund (IMF) Flexible Credit Line supported these measures, as did rapid reserve accumulation by the Bank of Mexico, strengthening Mexico's external resilience. This action provided the backdrop for a strong economic rebound, currently underway, manageable public finances and expectations of lower debt ratios as of 2011.

Mexico has complemented these measures with slow but steady passage of economic reforms and improvements in microeconomic management under President Felipe Calderón. These reforms have brought important results that include a higher value-added tax, a more efficient corporate tax, greater electricity sector efficiency with the liquidation of Luz y Fuerza del Centro, a state-power supplier. Other measures include corporate governance improvements at Petróleos Mexicanos (Pemex), the state-owned oil company, and public pension reform that has reduced medium-term contingent liabilities. Most of these initiatives should help raise productivity growth over the medium term.

The ratings remain constrained by overexposure to the U.S. economy and by structural weaknesses that dampen economic activity. The most important of these are inefficient public companies, especially Pemex, whose oil production has declined more than expected, from 3.4 million barrels of crude oil per day in 2004 to 2.5 million in June 2010. Lower production has resulted in a sharp decline in oil revenues as a percentage of total revenues, from 36% in 2008 to 28% in 2009. Although this effectively lowers fiscal dependence on oil, the gap in the budget required immediate tax hikes. It appears that oil production has stabilized between 2.5 million and 2.6 million barrels per day. However, DBRS stresses that if oil production declines further, additional fiscal measures will be necessary to prevent Negative trends being assigned to the ratings over the medium term.

In recent months, security has become a central concern and is likely acting as a drag on economic activity. DBRS commends the government on its military offensive against the narcotics trade, but it will likely take several more years to produce lasting results. Drug traffickers have threatened local governments and approximately 28,000 people have perished in the conflict since 2006, including the gubernatorial candidate of the State of Tamaulipas in June 2010.

In spite of these concerns, DBRS takes comfort in Mexico's long-term prospects. Good and predictable macroeconomic management during the crisis and the resilience of the economy, as evidenced in the strong economic recovery underway, have stabilized Mexico's ratings. DBRS's greatest concern is in the structural barriers to higher productivity growth, especially in the oil sector. On the other hand, the more progress Mexico makes in reducing infrastructure bottlenecks and improving social services, the greater its ability to raise potential growth, which is still too low to produce a substantial upward trend in per capita incomes or redress income and regional inequalities. Creditworthiness would improve in the near term if the government implements the 2008 Pemex reform that makes oil contracts more flexible, further widens the value-added tax base, increases labor market flexibility and introduces competition in key sectors of the economy.

### Foreign Versus Local Currency Ratings

The BBB (high) local currency rating reflects the depth, resilience and investor diversity of Mexico's domestic debt market. DBRS rates the local currency one notch above the foreign currency because Mexico has more flexibility to generate financing in local markets than in foreign markets. DBRS views Mexico's local debt markets to be sufficiently liquid, flexible and well regulated to generate ample government financing over the medium term.

### Rating Considerations Details

#### Strengths

(1) **Strong macroeconomic policy framework.** The response to the international credit crisis was timely and appropriate, and the flexible exchange rate acted as an effective buffer. The Bank of Mexico's steady

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adherence to an inflation-targeted policy has proven effective in reducing Mexico's inflation rate down toward industrial country levels.

**(2) Good debt management and moderate debt burden.** Budgetary restraint and sound debt management have lowered the government's debt burden to moderate levels and reduced susceptibility to financial shocks, even after the slight increase in debt ratios following the crisis. The government debt portfolio favors local currency securities, reducing exposure to foreign currency volatility. The depth, liquidity and resilience of the local securities market have improved in recent years, reducing interest costs and allowing the government to increase the average duration of domestic debt.

**(3) Well-regulated financial markets.** Although Mexico's financial sector is extremely shallow, capital market supervision, governance standards and the regulatory system are among the strongest in emerging markets, providing a buffer against financial weakness in international banks.

**(4) Slow but steady record of structural economic reforms.** Since election in December 2006, President Calderón has moved forward with structural reforms that had stymied the previous administration. The legislature has approved reforms of public finances, the government pension system, education, the judicial system and the energy sector, and while far from comprehensive, the cumulative benefits have helped to increase policy flexibility.

### Challenges

**(1) Inflexible public finances with revenues overly dependent on oil.** At 28% of total revenues in June 2010, government dependence on oil revenue is high and destabilizing. Reducing this dependence and replacing it with non-oil revenue is critical to improving creditworthiness. Failure to do so should oil production continue to decline, could lead to Negative trends being assigned to the ratings over the medium term.

**(2) Low productivity growth limits competitiveness and improvements in living standards.** Higher investment in infrastructure and a more depreciated real exchange rate is allowing Mexico to gain market share in foreign markets. However, these improvements are likely offset by limited export diversification, leaving Mexico exposed to U.S. cyclical downturns. Lower average U.S. growth in the coming years and a deteriorated security outlook may limit Mexico's ability to increase potential GDP growth.

**(3) Bottlenecks in energy, labor and product markets.** Monopolies and special privileges in key sectors create distortions and inefficiencies across the economy. The government is being tested as it works to push forward long-delayed reforms in these sectors.

**(4) Severe income inequality and regional disparities.** Extreme poverty and income disparities have declined, yet these continue to hamper economic and social progress. The richest 10% of the population receive 36.3% of the country's total income, while the poorest 20% receive only 4.6%.

**(5) Containing drug-related violence.** Drug traffickers have intimidated and in some cases infiltrated local governments, and this appears to have dampened investment. The government's response has been appropriate, but it will take time to restore law and order.

### Fiscal Management and Policy

Prior to the international financial crisis, Mexico made progress in reducing deficits, improving debt dynamics, and introducing a balanced budget rule and fiscal reforms which helped to close corporate tax loopholes and firm up non-oil revenues. Partly because of these measures, public finances deteriorated as revenues declined during the crisis, but still compared favorably to the fiscal positions of many other mid-sized developing countries, as well as the majority of developed countries.

Mexico's fiscal policy response to the crisis was timely and effective in providing moderate easing. The government allowed a temporary deficit under the balanced budget rule of 0.5 percentage points to maintain investment and social programs. (The 2009 deficit of 2.3% of GDP includes Pemex (Pidiregas) investments. If we exclude these investments, as the Ministry of Finance and Public Credit does, the deficit is only 0.5% of

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GDP, and follows four years of balanced budgets.) Mexico's public finances experienced a second direct shock with a sharp decline in oil revenues, as production levels at the Cantarell oil field dropped off more suddenly than expected. To offset this decline, the government introduced tax measures worth 1% of GDP in 2010.

The 2010 tax measures increased the standard VAT rate by one percentage point to 16%, increased excise taxes, temporarily raised income tax rates and improved tax administration. However, it will take time for revenues to recover fully, and the deficit is expected to reach 2.7% of GDP in 2010 (0.7% of GDP excluding Pemex), before declining in subsequent years. Excluding Pemex investment, the government is expected to target a deficit of 0.3% of GDP when the 2011 budget is submitted in September 2010.

The 2010 budget estimates that crude oil production will stabilize at 2.5 million barrels per day, and will remain at this level through 2015, close to current output. Should oil production continue to decline below this level, further fiscal measures would need to be taken, particularly as social spending pressures rise in the coming years. The most important of these are the need to further widen the tax base, reduce value-added tax exemptions (food and medicine), simplify personal and corporate income taxes, reduce energy subsidies and implement a framework of medium-term expenditure planning.

The Ministry of Finance and Public Credit uses a formula to determine the oil price in the budget, and this typically is below the futures market expectation for the price of oil. The savings from the difference are channeled to stabilization funds. However, there is a cap on the funds. DBRS believes that eliminating the cap would be advantageous to building savings. A more comprehensive counter-cyclical structural fiscal rule designed to enforce spending discipline during years of high oil prices, would help to reduce deficits and debt over the medium term.

<b>Central Government Finances*</b>				
For the year ended December 31 (MXN billions)				
	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Revenues</b>				
Oil related (includes Pemex)	874	1,055	881	861
Income tax	534	562	527	448
IETU	45	47	0	0
VAT	408	457	409	381
Other taxes	139	142	111	102
Other revenues	383	150	158	84
Public enterprises (excl Pemex)	435	448	400	387
<b>Total Revenue</b>	<b>2,817</b>	<b>2,861</b>	<b>2,486</b>	<b>2,264</b>
<b>Expenditures</b>				
Current Expenditure	1,830	1,678	1,490	1,338
Wages & salaries	765	710	654	611
Subsidies & transfers	370	330	260	241
Revenue sharing	376	423	333	329
Capital expenditure	607	532	405	319
Non-programmable	652	662	588	598
Interest expense	232	197	211	211
<b>Total Expenditure</b>	<b>3,089</b>	<b>2,873</b>	<b>2,483</b>	<b>2,255</b>
<b>Central Government Balance*</b>	<b>-271.7</b>	<b>-11.7</b>	<b>3.3</b>	<b>8.4</b>
% of GDP	-2.3%	-0.1%	0.0%	0.1%
<b>Primary Balance*</b>	<b>-8</b>	<b>217</b>	<b>247</b>	<b>260</b>
% of GDP	-0.1%	1.8%	2.2%	2.5%
<b>Public Sector Balance (% GDP)**</b>	<b>-5.4%</b>	<b>-2.4%</b>	<b>-1.7%</b>	<b>-1.5%</b>

\* Budgetary Public Sector. All deficits include Pemex. Balances do not always sum due to statistical exceptions in official data.

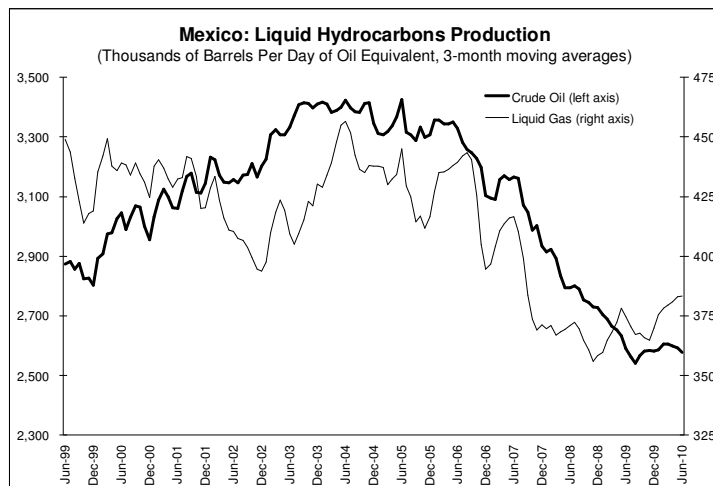
\*\* Public Sector Borrowing Requirement. 2009 DBRS estimate; excludes non-recurring revenues. Including these revenues brings the deficit to 2.7% of GDP. Source: Secretaría de Hacienda y Crédito Público, DBRS

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**Special Topic: Energy Sector**

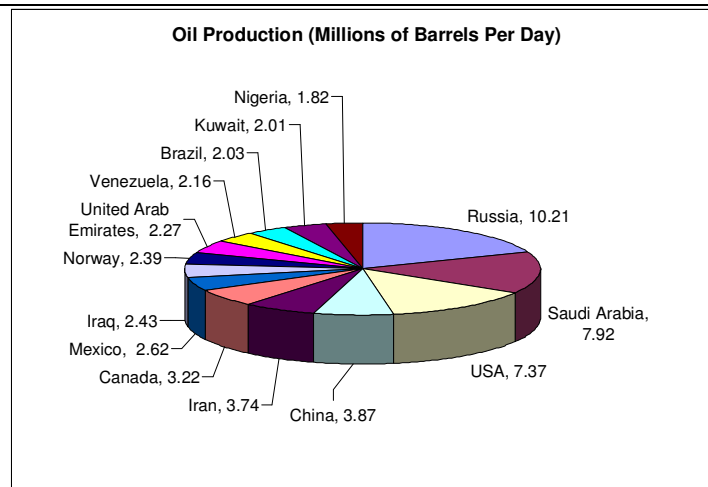
In October 2008, Mexico approved an energy reform to address the two biggest weaknesses of Mexico’s oil sector: low investment and inefficient production. More investment is needed to offset declining output. Crude oil production has declined sharply, from an average of 3.4 million barrels per day in 2004 to 2.5 million barrels by June 2010. This was largely due to production at the mature Cantarell oil field, which declined far more than expected.



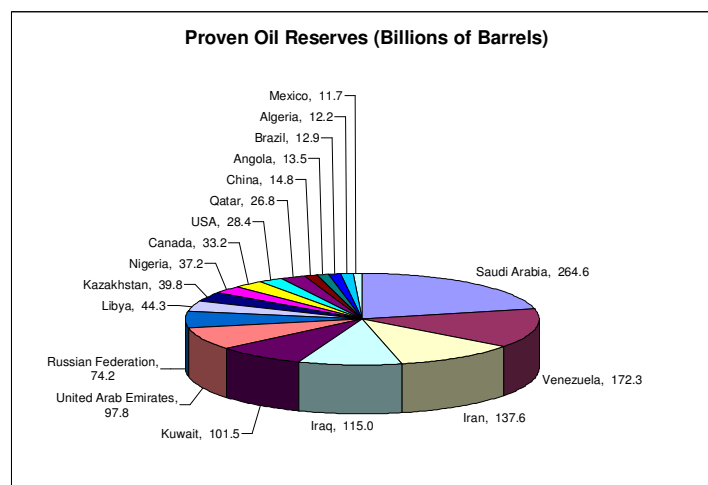
Source: INEGI, Pemex, DBRS estimates.

Declining output destabilizes public finances, the balance of payments and, to a lesser extent, the real economy. This is because first, oil and related products made up 28% of 2009 central government revenues, 17% of exports and 4.2% of GDP in 2008. Pemex estimates that the crude oil sector requires annual investment of 0.5% of GDP to offset declining output from existing fields. In 2009, exploration investment reached \$2.2 billion (0.4% of GDP), 83.3% and 69.2% higher than the investment in 2006 and 2007, respectively. In this way, Pemex has accelerated exploration in the Gulf of Mexico through the acquisition of seismic data and drilling of exploratory wells. It has also tried to increase the recovery factor in mature fields through recovery of existing projects.

As a result of this higher investment, Pemex has increased the replacement rate of proven hydrocarbon reserves through January 2010 to 77.1%, and the company expects this to continue rising until it reaches 100% in 2012. Nevertheless, development of new fields calls for mid-water drilling platforms and other technology owned by foreign companies. Until the 2008 Pemex reform legislation is fully implemented, the constitution prohibits Pemex from entering into joint-risk contracts with third parties, and this has prevented Pemex from investing sufficiently in exploration of new oil and gas fields.



Source: IEA, Pemex, DBRS. 2009 data. Non-OPEC countries include condensates, natural gas liquids and oil from unconventional sources.

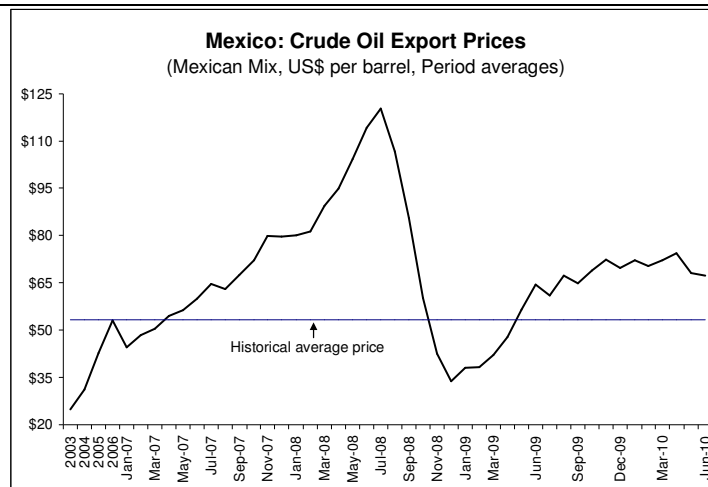


Source: BP, DBRS. 2009 data. Pemex: Mexico's proven reserves at 14.3 billion.

Second, Mexico refines petroleum products inefficiently. Mexico exports 1.4 million barrels of oil per day and is the third-largest supplier of crude oil to the United States. However, Mexico imports almost one-third of its refined products from the United States, and this could be cheaper if Mexican refineries were more efficient. Third, the government smoothes end-user domestic fuel prices by capping domestic fuel prices whenever international fuel prices rise above budgeted domestic fuel prices. When international prices are very high, this creates the possibility that domestic prices will be lower, leading to a negative gasoline tax.

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Source: INEGI, DBRS

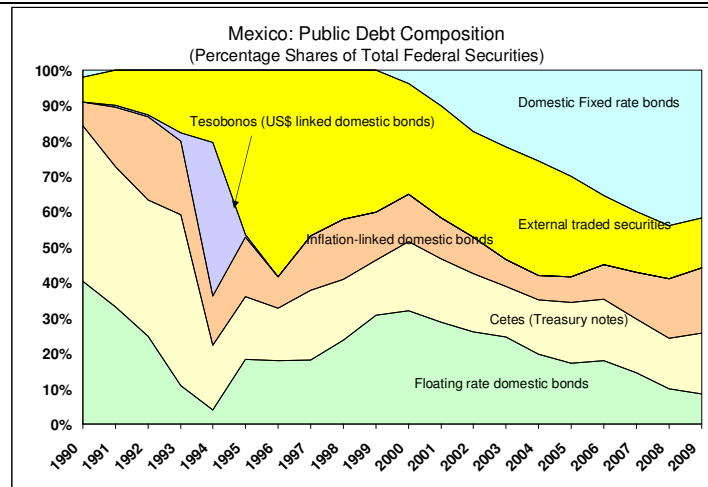
DBRS is concerned about these structural shortfalls, which constrain the ratings. However, there is a silver lining in the outlook for Mexico's energy sector. First, the 2008 energy reform was the first significant change to the oil sector since nationalization in 1938. Although the reform did not permit the granting of ownership rights over hydrocarbons to third parties, it opens up the possibility of complementary legislation in the future. As it currently stands, the reform is likely to improve efficiency, execution and corporate governance of Pemex. If the legislation is implemented, it may increase flexibility through contracts that offer incentives for new technologies, greater profit and the right to invest excess income. This opens up the possibility of shared technical cooperation with international energy companies.

Second, Mexico's 2008-2012 investment program should increase exploration of oil and natural gas, upstream maintenance and refining. While higher investment is needed, the existing investment program is likely to produce better results in natural gas production as well as some petrochemical products. The government estimates that oil production will stabilize between 2.5 million and 2.6 million barrels per day from 2011-2016. Although there are risks that oil production could continue to decline, it is more likely that production will stabilize in the Cantrell oil fields, leading to smaller declines, and that these declines will be offset by higher production in the Ku-Maloob-Zaap fields in the near term, and in the development of new deposits in Chicontepec and other fields over the medium term. Third, Mexico's energy trade surplus is recovering in line with international prices, and crude oil exports continue to outstrip imports of gas and other refined products.

### Debt and Liquidity

The crisis had the effect of increasing debt levels as budget deficits rose. DBRS estimates that the most comprehensive measure of government debt, gross public sector debt, increased by 6.6 percentage points between 2007 and 2009, from 38.1% of GDP to 44.7% of GDP. (Gross public sector debt includes Pemex, other state-owned companies, development banks, financing required for IPAB, a bank bailout fund, PIDEREGAS, or public investments financed by the private sector and FARAC, a toll road rescue program.) As the deficit is reduced, Pemex investment is curtailed and the recovery takes hold, debt-to-GDP could start to decline in 2011.

Part of the reason for this quick turnaround in the debt is that in recent years, Mexico has improved its public sector debt composition and risk management. Most notably, the substitution of local currency debt for foreign currency obligations, and the elimination of short-term U.S. dollar-indexed securities (Tesobonos) associated with the devaluation of 1994 have reduced Mexico's exposure to external shocks, a positive rating factor for both foreign- and local-currency sovereign ratings.



Source: SHCP, DBRS. All bonds are domestic except for 'externally traded'.

Along with a shift toward safer fixed rate domestic bond financing, the government has extended the average maturity of external bonds and consolidated the debt portfolio on liquid benchmark issues. The domestic government securities market is in fact one of the deepest, most liquid and efficient outside the major industrial countries. As recently as 2000, marketable government securities had an average maturity of 1.5 years, and long-term fixed-rate securities comprised only 15% of domestic government securities, with the longest maturity being three years. The bulk of domestic debt was short-term Treasury notes (CETES), or relatively illiquid floating-rate or inflation-indexed securities. Since 2000, the government securities market has been transformed. Long-term fixed-rate issues comprised 53% of domestic debt and the government extended average maturities through 2009 to 6.7 years. The yield curve extends to 30 years, with actively traded benchmark securities throughout the curve.

DBRS estimates that total public and private external debt amortizations for 2010 amount to only 1.9% of GDP, and average external debt maturities are 10.8 years. In mid-2010, the Bank of Mexico held international reserves worth \$105.6 billion, more than two times amortizations coming due in the current year, plus total public and private short-term external debt, providing a comfortable cushion against financial shocks.

## Economic Structure and Performance



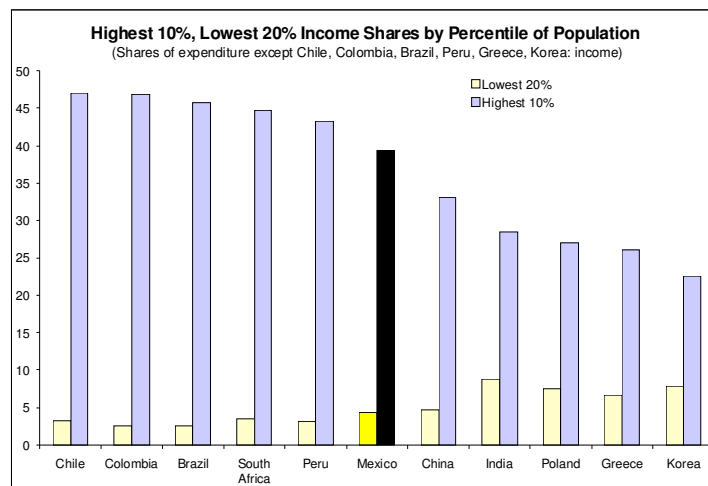
Source: INEGI, DBRS

During 2009, real economic activity declined by 6.5%, one of the deepest recessions in Latin America. The recession was the first serious test of Mexico's economic stability since the end of the "sexenio curse," the six-year presidential cycle that occurred in conjunction with economic crises. The central reason for the

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recession was the links between the Mexican and U.S. economies. The Mexican manufacturing cycle is closely aligned with that of its northern neighbor, and much of the sector is concentrated in exports to the United States.



Source: World Bank World Development Indicators, DBRS.

Despite the severity of the downturn, DBRS maintained Stable trends on Mexico's ratings because of its strong record of prudent macroeconomic policies, as well as the reforms that over the past two decades have resulted in a considerably more stable economy. As the U.S. manufacturing sector has recovered, so has Mexico's. Consensus expectations are that 2010 growth will be 4.5%, while signs are that the economy could expand by more than 5%, above the official estimate of 4.1%. Steady progress in improving regulatory standards, increasing transparency and establishing a legal framework for fostering competition have contributed to stability.

Even so, Mexico's business environment remains weak in important areas, and more progress on structural economic and legal reforms would strengthen creditworthiness. Mexico ranks 79th out of 181 countries in World Bank indicators of contract enforcement, and 141st on employing workers. Moreover, foreign direct investment (FDI) restrictions remain relatively tight. Net FDI inflows have been fairly robust, averaging 3.1% of GDP from 1999 to 2009. However, according to UNCTAD, which measures FDI potential according to country risk, economic openness, labor skills and other structural criteria, Mexico, like Russia, China and Brazil, has high inward FDI potential, but still low FDI performance. On a scale comparing 141 countries, Mexico comes in at 57 – above Brazil at 70, but below Russia at 20 and China at 32.

Three areas take priority for structural reforms: (1) stabilizing fiscal revenues, (2) strengthening market competition and reducing bottlenecks, and (3) improving the business environment by modernizing labor laws and raising educational standards. Mexico is addressing its infrastructure bottlenecks and other deterrents to investment by ramping up its public investment budget. In 2010, public investment was allocated a sizeable 5.1% of GDP. However, several infrastructure projects in the pipeline have been postponed.

One necessary component of higher and more stable growth is increasing living standards. The Ministry of Finance and Public Credit estimates per capita income at \$9,430 in 2010. Although incomes have grown at a healthy average annual rate of 7.4% from 2000-2008, the crisis has been a setback and they remain low. Indeed, Mexico's growth performance has not kept pace with many of its peers outside of Latin America. The ability to raise economic productivity and generate a sustainable rise in living standards and per capita incomes is an important factor in DBRS's assessment of the country's credit ratings.

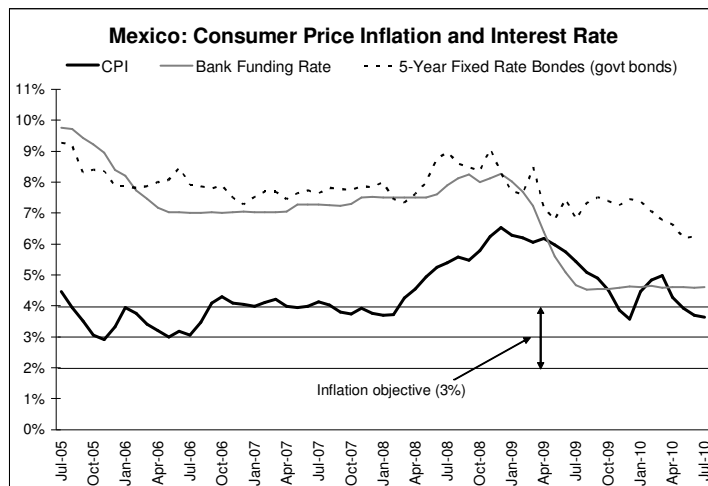
Severe income inequality also prevents Mexico from growing faster. According to the World Bank, the richest 10% in Mexico receives 36.3% of total income, while the poorest 20% receives only 4.6%. Among investment grade developing countries, this contrast is surpassed only by Chile, Brazil, South Africa and Peru. Mexico has made considerable efforts to improve opportunities for low-income groups, particularly in access to education.

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Average levels of education increased by over two years between 1985 and 2000 (latest available data). The bulk of this increase, however, was at the primary and secondary levels. University education, which is an increasingly important determinant of income, remains largely concentrated in upper-income families. The top 20% income group averaged eight years more education than the bottom 20% in 2000 and university graduates made up only 4.4% of the labor force. Increasing access to higher education requires extensive changes in the educational system in order to improve college preparation for lower income students.

**Monetary Policy and Financial Stability**



Source: Banco de México, DBRS.

Since the collapse of the banking system in 1995, Mexico has strengthened the institutional, legal and regulatory framework needed to embed a commitment to sound monetary policy and a stable financial system. Mexico’s subsequent general success in lowering inflation, especially core inflation, which excludes food and energy prices, and maintaining financial stability through the crisis have been important positive factors for DBRS’s rating assessment.

In 2002, the Bank of Mexico (the Bank) set an objective of reducing the medium-term inflation rate to 3%, plus or minus 1% for temporary deviations. Between 2002 and February 2008, the Bank’s inflation-targeting policy brought inflation close to industrial country levels. During the first quarter of 2008, food price inflation pressures increased. In response, the Bank tightened monetary policy. In December 2008, annual inflation reached a high of 6.53%, well above the Bank’s 3% objective.

The Bank correctly asserted that inflation would reach an inflexion point in the fourth quarter of 2008 as global activity and the prices of primary products and global food prices declined. Following this, a widening output gap during the first quarter of 2009 led the Bank to reverse monetary policy by cutting the policy interest rate by 375 basis points to 4.5%.

However, while year-on-year headline inflation eased further in February 2009 by 6.2%, core inflation rose by 5.78%, the highest since November 2001. This suggested that international financial market instability, and especially depreciation pressure on the Mexican peso, was driving up import prices and passing through to upward pressure on domestic prices. The peso depreciated 52% between mid-August 2008 and early March 2009. This placed the Bank in the difficult position of easing interest rates to offset declining domestic demand, but less than some market participants would have liked. Nevertheless, monetary policy has acted appropriately in light of conflicting signals on prices, falling demand and currency weakness.

Prior to the crisis, the Bank’s success in bringing down inflation and stabilizing the financial system encouraged the development of a deep, efficient and resilient domestic government securities market. The privatized pension system funds (AFORES) strengthened the demand for long-term government securities, helped to promote transparency and improved securities clearing and settlement systems.

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Despite improvements in the legal and regulatory system and bank balance sheets, financing for the private sector has lagged behind the government securities market. Complications for a number of corporates arose in 2008 when currency hedges backfired as the peso depreciated. Housing finance and commercial bank lending to businesses have recently expanded, but Mexico's financial intermediation relative to GDP is low compared to its peers.

**Balance of Payments**



Source: BIS, DBRS.

Since the late-1980s, Mexico has run small trade and current account deficits, as a result of strong import demand for intermediate goods and services. The crisis had the effect of lowering these deficits, as import demand tapered off. The crisis led to an abrupt slowdown in trade, with manufacturing and other exports declining 25%, as manufactured goods exports and oil prices declined, and intermediate goods and other imports falling 28%. This shrank the trade deficit, and the current account deficit in turn declined from 1.5% of GDP in 1998 to 0.5% of GDP by the first quarter of 2010 on an annualized basis.

The decline in manufactured goods exports and oil prices since late 2008 was significant since manufactured goods dominate Mexico's exports. In January 2009, manufactured goods were 82% of total exports, while petroleum products accounted for 13% of total exports. A large share of manufactured exports is intermediate goods, particularly auto parts, which are used as inputs for U.S. auto production. As such, manufactured exports tend to move in sync with U.S. industrial output. However, in the first half of 2010, auto production reached an all-time high. Not only did production return to pre-crisis levels, but was almost 5% above the level reached in the first half of 2008.

In recent years, high workers' remittances have offset small trade and services deficits in the current account. Between 2001 and 2007, annual workers' remittances rose sharply, from \$8.9 billion to \$26.1 billion. In part, the increase represented better reporting as a rising share of electronic funds transfers replaced cash transfers, which generally are not reported. Since October 2003, however, the growth in remittances has slowed, especially since March 2006 as the U.S. housing sector and construction industry decelerated, causing layoffs of Mexican-American workers in the United States. From November 2008 through January 2009, remittance growth declined sharply, but has since picked up.

Despite the attention given to China's exchange rate policy in recent years, Mexico's real effective exchange rate did not lose significant ground to China until August 2008, when the peso depreciated sharply against the U.S. dollar. In fact, from 2000-2006, Mexico's real effective exchange rate largely moved in lockstep with China's. However, the verdict is still out on which country will benefit more from access to the U.S. economy. Debate about Mexico's competitiveness should focus on the underlying fundamentals that drive economic growth and exports; namely, domestic investment, saving and productivity growth. Structural reforms to reduce economic bottlenecks, increase labor force skills and improve returns on private investment

are important to both higher economic growth and exports that are more competitive. In recent years and through the crisis, FDI inflows have been sufficient to fully finance Mexico's small current account deficits.

### **Political Environment**

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**Last election:** July 2006, presidential and congressional; July 2009, congressional

**Next election:** July 2012, presidential and congressional

**Party in power:** National Action Party (PAN)

The ruling National Action Party has working minorities in both houses of Congress, and must rely on the support of outside parties. The leftist opposition Party of the Democratic Revolution (PRD) has often opposed PAN legislation, compelling the government to rely on the Institutional Revolutionary Party (PRI) for support. Since taking office in December 2006, President Calderón has demonstrated an ability to work with the PRI to move reform legislation through the Congress.

Early in Calderón's administration, the government sent the military to interrupt the illegal narcotics trade. This led to arrests and seizures of drugs and weapons, but also stirred a violent reaction by drug cartels. Confronting the cartels was a politically brave policy, however reestablishing law and order is likely to take years. The government's efforts to confront the drug traffickers are positive for Mexico's ratings over the long term.

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**Mexico: Selected Indicators**

For the year ended December 31

(USD billions unless otherwise noted)

	2009	2008	2007	2006	2005	2004	2003
<b>Public Debt</b>							
Public sector	389.6	470.0	390.8	365.8	338.1	281.2	257.1
% GDP	44.5%	43.2%	38.1%	38.4%	39.8%	37.0%	36.7%
General government	270.5	274.1	234.0	205.7	179.9	161.6	153.1
% GDP	30.9%	25.2%	22.8%	21.6%	21.2%	21.3%	21.9%
<b>Domestic Debt</b>							
General government	200.1	215.3	173.5	153.5	114.0	97.4	93.8
% GDP	22.9%	19.8%	16.9%	16.1%	13.4%	12.8%	13.4%
<b>External Debt</b>							
Public sector	98.7	114.4	104.4	94.7	107.2	108.1	103.0
% GDP	11.3%	10.5%	10.2%	9.9%	12.6%	14.2%	14.7%
General government	70.4	58.7	60.5	52.2	65.8	64.2	59.3
% GDP	8.0%	5.4%	5.9%	5.5%	7.8%	8.4%	8.5%
Private sector	103.0	86.8	88.8	74.4	65.9	58.1	59.6
% GDP	11.8%	8.0%	8.7%	7.8%	7.8%	7.6%	8.5%
Gross external debt	201.7	201.2	193.1	169.1	173.1	166.2	162.7
% GDP	23.0%	18.5%	18.8%	17.8%	20.4%	21.9%	23.2%
Net external debt	101.8	105.9	105.9	92.8	99.0	102.0	103.6
% GDP	11.6%	9.7%	10.3%	9.7%	11.7%	13.4%	14.8%
<b>Fiscal Balances (% GDP)</b>							
Central government balance	-2.3%	-0.1%	0.0%	0.1%	-0.1%	-0.2%	-0.6%
Revenues	23.8%	23.6%	22.2%	21.8%	21.1%	20.7%	21.2%
Expenditures	26.1%	23.7%	22.1%	21.6%	21.1%	20.9%	21.8%
Interest payments	2.0%	1.6%	1.9%	2.0%	2.0%	1.9%	2.1%
Interest payments (% revenues)	8.2%	6.9%	8.5%	9.3%	9.4%	9.1%	10.0%
Primary balance	-0.1%	1.8%	2.2%	2.5%	2.2%	2.2%	1.9%
Public sector balance	-5.4%	-2.4%	-1.7%	-1.5%	-1.5%	-1.9%	-2.4%
<b>Balance of Payments &amp; Liquidity</b>							
Current account balance	-5.5	-16.2	-8.7	-4.8	-4.9	-5.2	-7.3
% GDP	-0.6%	-1.5%	-0.8%	-0.5%	-0.6%	-0.7%	-1.0%
Trade balance	-4.6	-17.3	-10.1	-6.1	-7.6	-8.8	-5.8
Net foreign direct investment (% GDP)	2.3%	2.3%	3.5%	2.7%	3.4%	3.7%	2.5%
International reserves	99.9	95.3	87.2	76.3	74.1	64.2	59.0
External liquidity ratio (%)	107%	105%	102%	97%	102%	100%	96%
International investment position	-389.4	-406.2	-396.9	-358.0	-340.3	-306.8	-277.4
International assets	239.0	234.2	217.7	177.4	159.4	134.4	117.9
International liabilities	628.4	640.4	614.6	535.4	499.7	441.2	395.3

Source: SHCP, Banco de Mexico, INEGI, BIS, JEDH, World Bank, IMF, DBRS

Notes: Public Sector Debt = cumulative public sector financing requirement (SHRFSP). Public sector balance includes PEMEX, other state-owned companies, development banks, financing required for IPAB (bank bailout fund liabilities), PIDEREGAS (public sector investments financed by private sector), FARAC (toll road rescue program), and other financing channeled to private and public sector. General government is consolidated government and social security funds. Public Sector External Debt excludes debt guaranteed by the public sector. Net External Debt is external debt less official reserve assets. Central government corresponds to the Budgetary Public Sector (federal government, social security funds and public enterprises under direct budgetary control). Gross and net external debt: June 2008. Exports are composed of goods, services, income and transfer revenues. External Liquidity Ratio = (Official Reserve Assets + exports of goods, services and income + net transfers) / (total amortizations + public and private short-term debt + imports of goods, services and income).



**United Mexican States**

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**Rating Table**

<b>Debt</b>	<b>Rating</b>	<b>Rating Action</b>	<b>Trend</b>
Long-Term Foreign Currency Debt	BBB	Confirmed	Stable
Long-Term Local Currency Debt	BBB (high)	Confirmed	Stable

**Rating History**

	<b>Current</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Long-Term Foreign Currency Debt	BBB	BBB	BBB	BBB	BBB
Long-Term Local Currency Debt	BBB (high)	BBB (high)	BBB (high)	NR	NR

Note:  
All figures are in U.S. dollars unless otherwise noted.

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