



On The Ground In Mexico: Validating Key Concerns

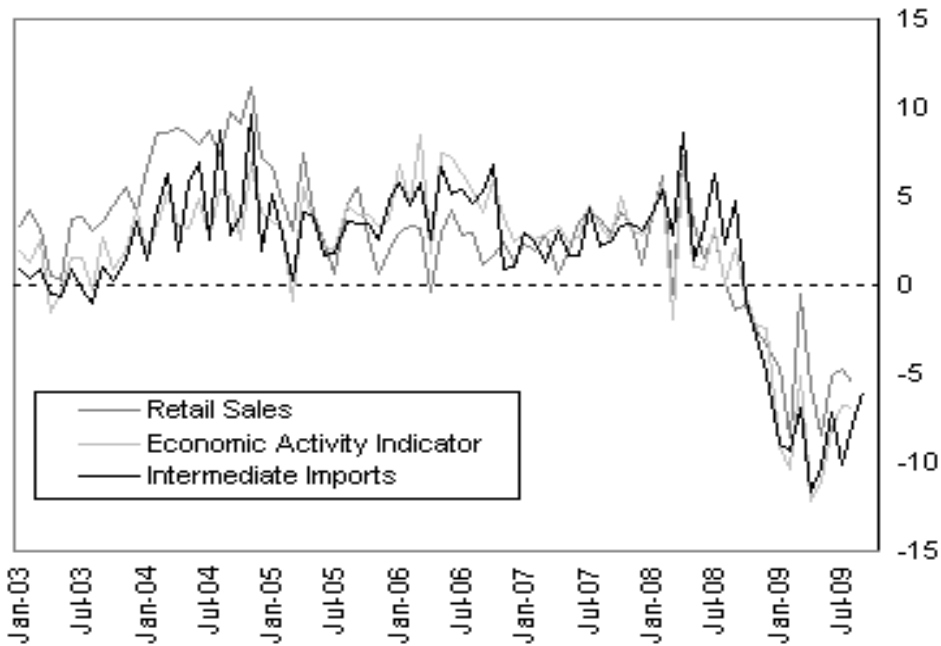
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Cautious appears to be the best way to describe sentiment among Mexico City's executives and bureaucrats at present, or at least that was the feeling Risk Watchdog came away with after spending a week on the ground there. This is not surprising, given the severity of the blow to Mexico's economy from the recent downturn. For example, my colleagues at BMI are anticipating a real GDP collapse of 7.1% in 2009, worse than the 6.2% contraction witnessed in the aftermath of the infamous Tequila Crisis, which must be particularly hard to swallow given the reforms implemented by successive administrations since the start of the decade.

That's not to say companies aren't looking for ways to exploit the new economic reality. One area of particular interest appears to be the country's demographic and regional breakdown, in order to locate the segments most likely to experience growth in light of lower consumer spending power going forward. Others are looking to less developed markets for opportunities, such as the diverse and often precarious economies of Central America. It must be noted, however, that while the largest players have both the willingness and ability to seek new business prospects in the current climate, the same does not seem true for most of the economy. In short, rather than bolstering my confidence, the trip served to confirm some of my more pressing concerns regarding the future of Mexico's economy.

All Eyes On The US

While the country's business and political elite clearly realise the need to diversify away from the US, it appears that the northern neighbour is still the first market most Mexican businesses look to for exports and investment. True, exports to the US as a percentage of total exports have fallen from 90% to 80% in less than a decade. But with the correlation between intermediate goods imports and domestic economic activity actually increasing over the past five years, Mexico remains more dependent than ever on its traditional maquila sector – the key beneficiary of which is the US. Given my bearish take on the medium-term outlook for the US consumer, this is clearly bad news for Mexico's growth potential.



Key Economic Activity Indicators, % chg y-o-y

Perhaps more concerning is that even if the motivation is there, it's hard to see in which direction Mexican exporters should turn. For one, problems of doing business with some of the Andean region's left-wing governments appear to be rising (while some are able to profit under Venezuelan President Hugo Chávez's administration, this is clearly not a market many Mexican companies are now seeking to enter). Further south, and talk of a free trade agreement with Brazil seems little more than a pipedream for the time being, with many Brazilian companies likely to remain wary of the monopolistic and state-protected nature of many of their Mexican counterparts (plus most firms which can afford to mount the significant entry barriers to South America's largest economy have already done so). This leaves Europe and Asia as the two other principal contenders for export diversification. The problem here is that with the former having a much more competitive business environment and the latter lower labour costs, without a freeing up of the domestic energy market it's hard to see where Mexico's competitive advantage lies.

In The Shadow Of A Downgrade

The second and more immediate concern on most people's minds was the question of a sovereign credit downgrade. Here again conversations with locals did little to alleviate my concerns that a downgrade (by at least two of the three major ratings agencies) is on the cards. The 2010 budget does not go far enough in reining in spending, and the dominance of the opposition Partido Revolucionario Institucional at all levels of government bodes ill for further fiscal and energy reforms until 2012 at the earliest. While most of the bad news may already be priced in to Mexican assets, it would be surprising not to see at least some short-term weakness resulting from a downgrade, which if combined with a renewed bout of global risk aversion could presage another substantial downleg in Mexican assets.

Bad news is not the whole story, however. There is clearly some benefit to having one of the most stable banking sectors in the region, and a resource-rich domestic economy of over 100 million inhabitants means there is certainly more potential for growth than other less well-endowed regional states. The key question is whether Mexico will be able to take advantage of these attributes to become a key EM player. As an old Mexican proverb states, 'the shrimp that sleeps gets carried away by the current'. Risk Watchdog believes that while some Mexican businesses

will no doubt find ways to benefit in the new economic environment, the current over the next few years will simply be too hard for many local firms to begin diversifying into other markets.