Mexico: Outlook, Challenges and Opportunities Down the Road

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Executive Summary

- Mexico is facing a perfect storm that is driving its economy into a recession comparable to the 1995 adjustment. However, this is a global crisis whose origin is external but which finds the Mexican economy in a stronger position
- The US economic slump explains the current Mexican economic plunge, but an early and more intense recovery will contribute to the expected Mexican upturn
- Mexico has implemented critical reforms whose benefits are contributing to diminish the impact of the crisis: a flexible exchange rate system, a credible central bank as an inflation fighter, a prudent management of fiscal policy over the past 10 years
- The banking system is a source of stability rather than a worry, with high capital ratios, good coverage of non-performing loans, and thus a willingness to continue meeting credit demand
- The crisis makes evident that the room for maneuver of economic policy has reached its limits. Mexico needs to go forward with the economic reform process, urgently on the fiscal policy side, in order to increase its long term growth capability

Index

Mexico is facing the perfect economic storm ...

... with domestic strengths and vulnerabilities

The challenge ahead: go forward with the economic reform process

Appendix

The current environment has implied a stressful scenario…

- International risk aversion
- A plunge in international trade
- Influenza outbreak
- Organized crime
- Political conflict (white noise)

…that Mexico has dealt with satisfactorily

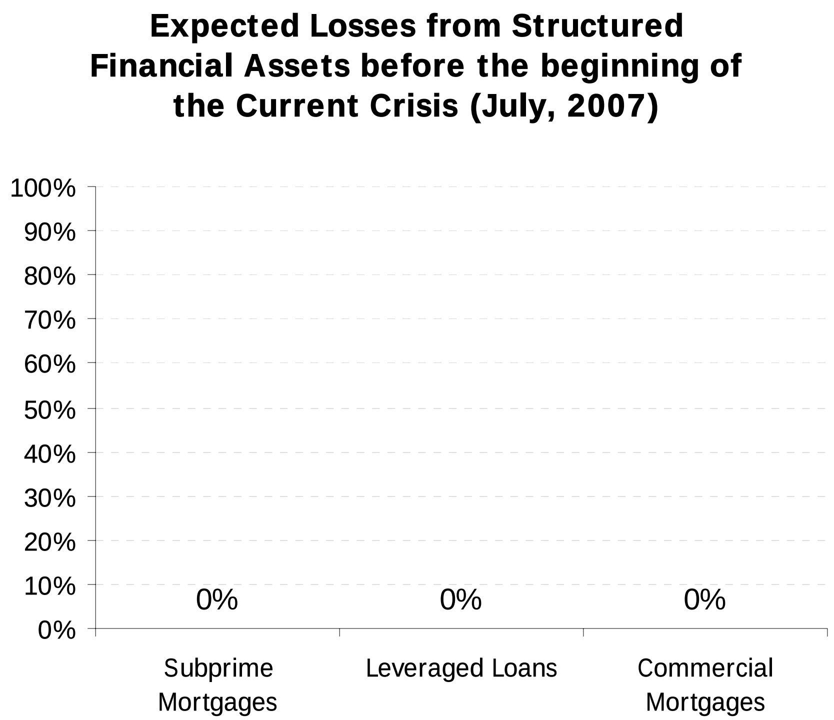
- Domestic demand: Labor market faces a smoother cycle than other recessions
- Inflation: After a nominal shock (FX), CPI path incorporates a feebler demand and expectations remain anchored
- External accounts: Orderly adjustment and open access to liquidity sources
- Financial markets : Orderly adjustments according external factors

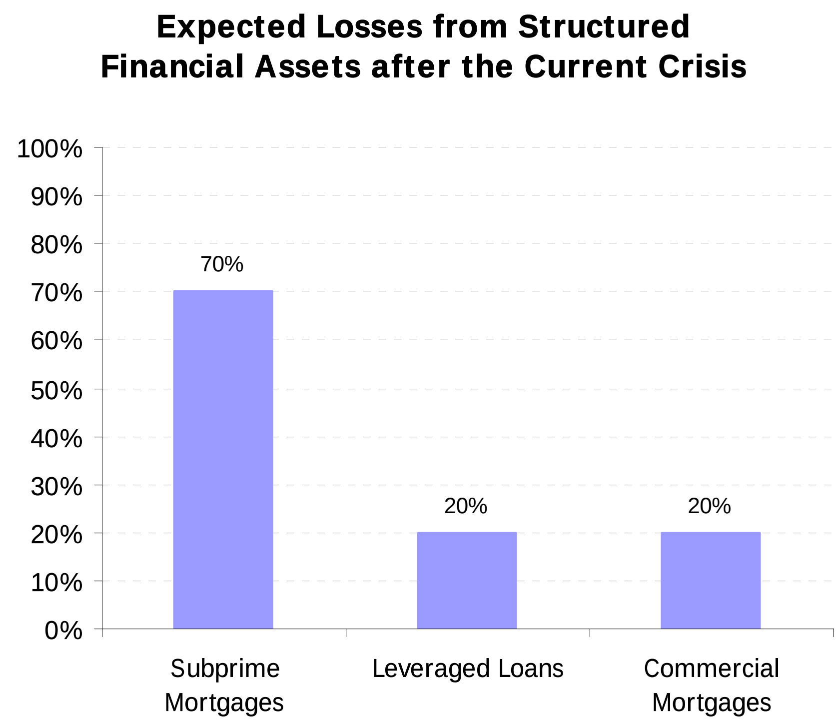
Economic Outlook

Perfect storm: stressful adjustments

Risk aversion

The crisis developed in summer of 2007 after uncovered risk arises in structured financial products…

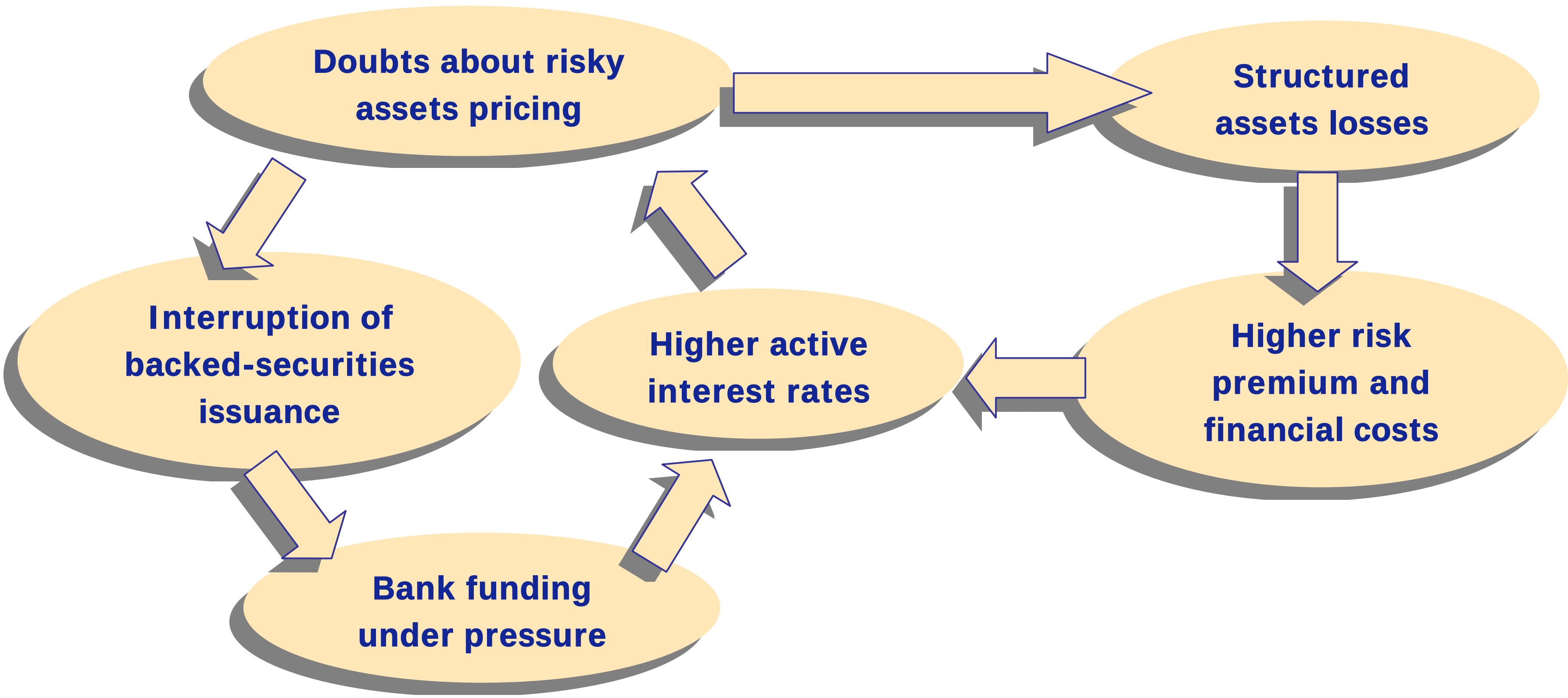




Perfect storm: stressful adjustments

Risk aversion

...and sparked a vicious cycle between financial losses and a drain on liquidity constraints



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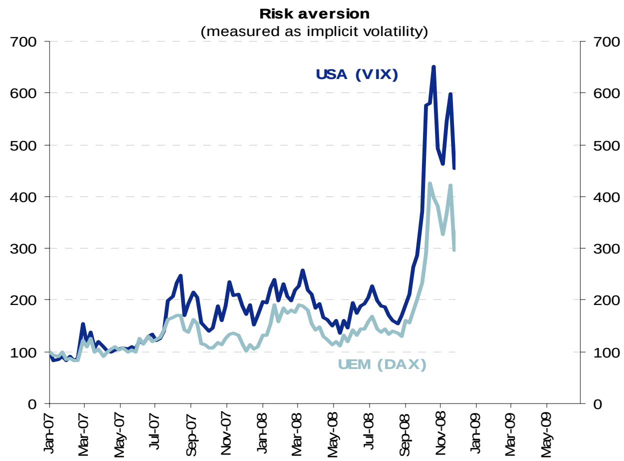
Perfect storm: stressful adjustments

Risk aversion

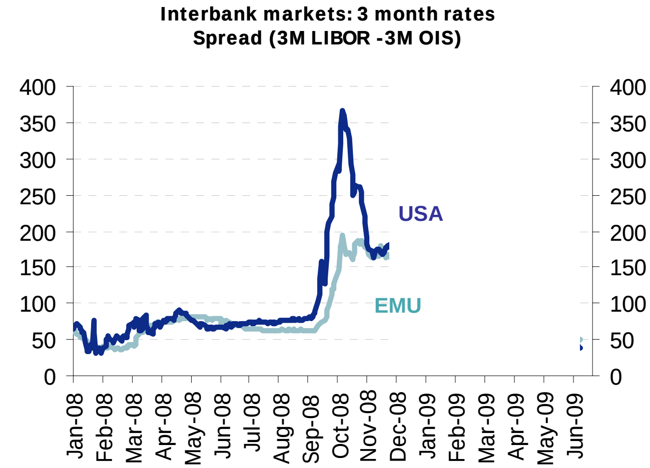
After Lehman Brothers bankruptcy (Sept 08) the risk intensifies

1) Extreme Risk Aversion



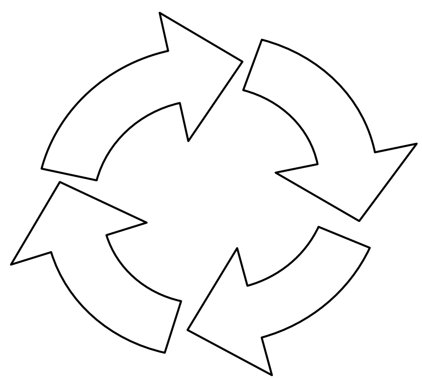
Source: Bloomberg

2) Extreme Liquidity Tensions



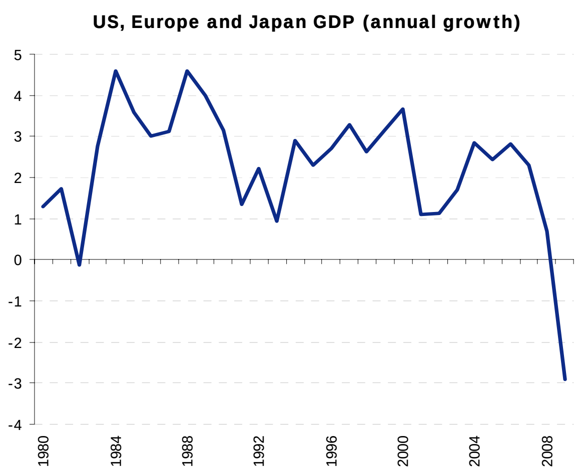
Source: Bloomberg

The bankruptcy of Lehman Brothers worsened the vicious circle between financial and real variables

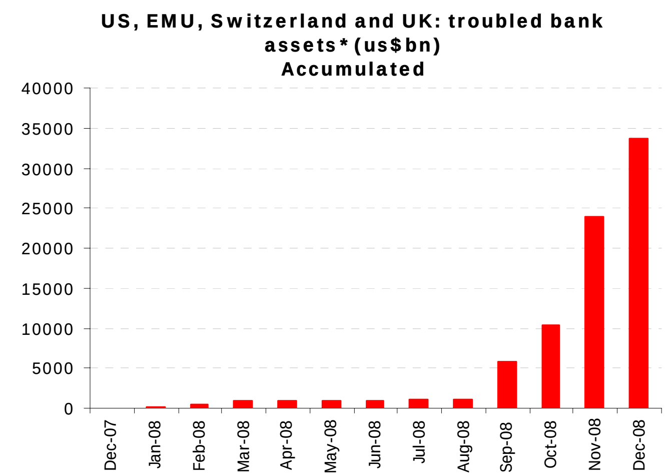


Global Recession

4) Global Recession

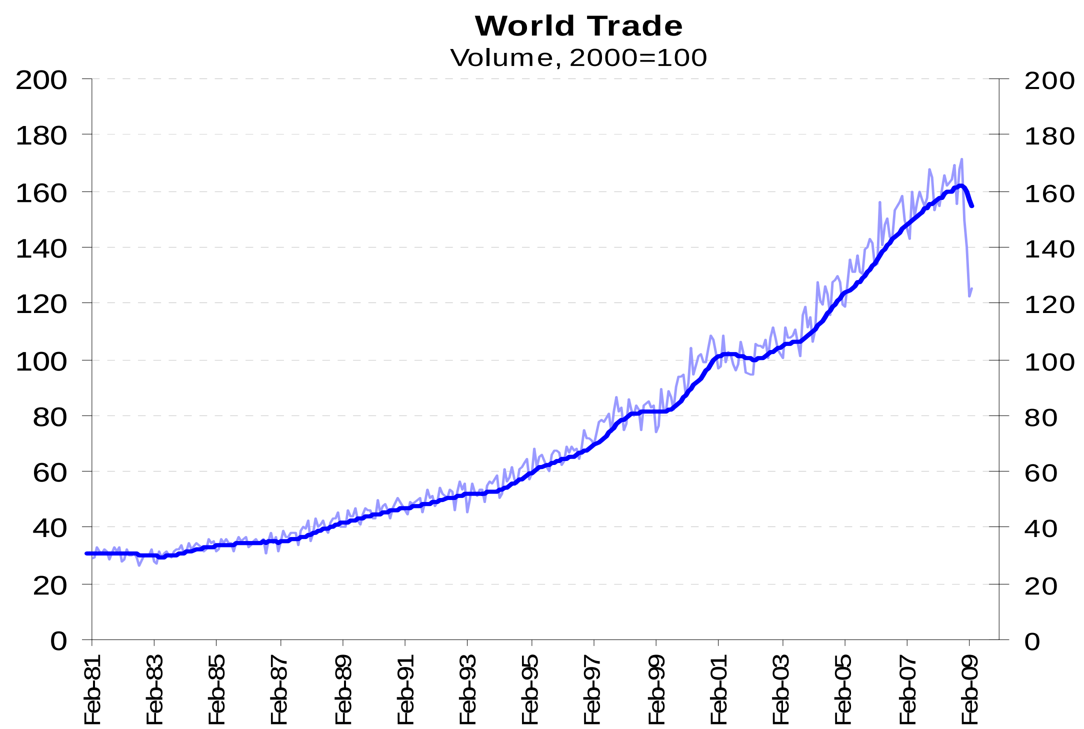


3) Solvency Problems



Risk aversion

The plummeting of World Trade is unprecedented



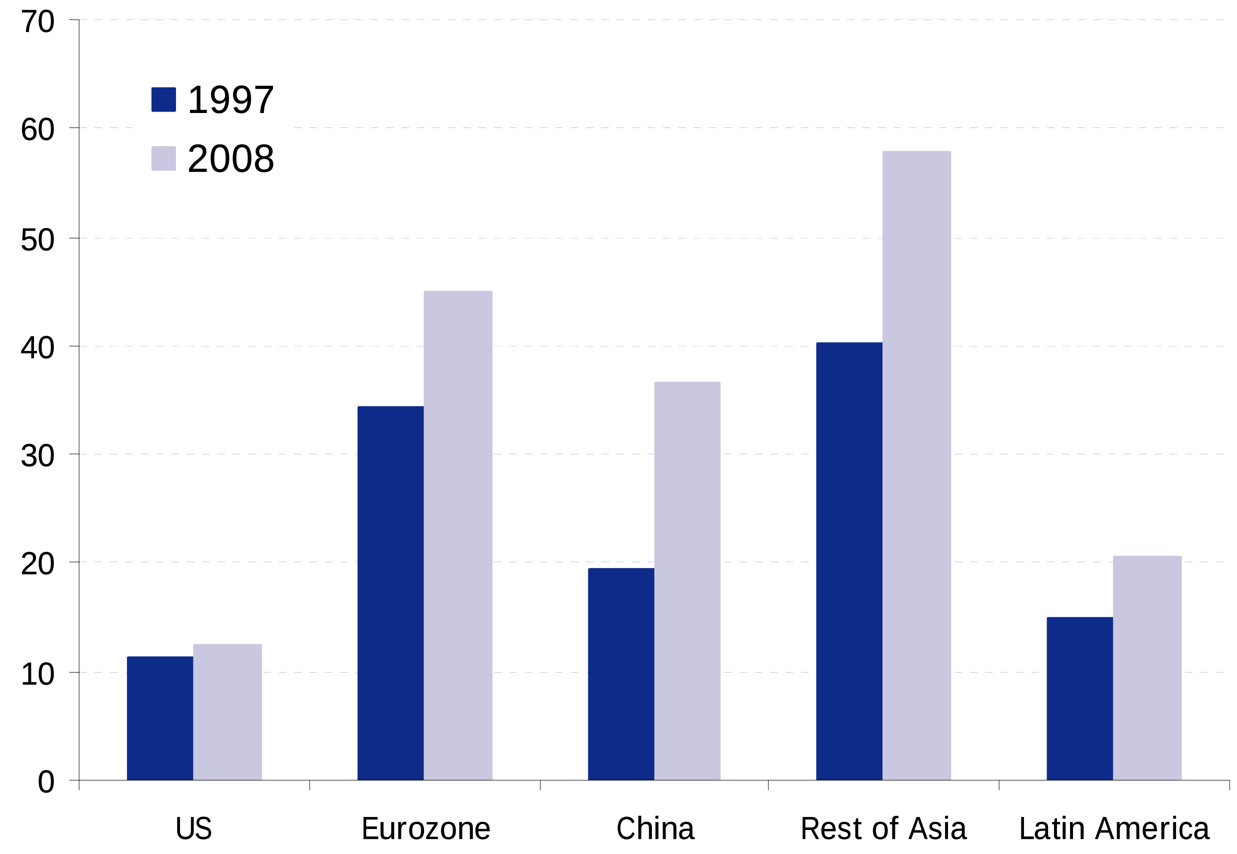
Source: DST

The trade finance "crunch" has contributed to the global trade adjustment, that impacts deeply on more open economies

Risk aversion

And it comes when dependency of external demand is at its height

Exports over Domestic Demand (%)



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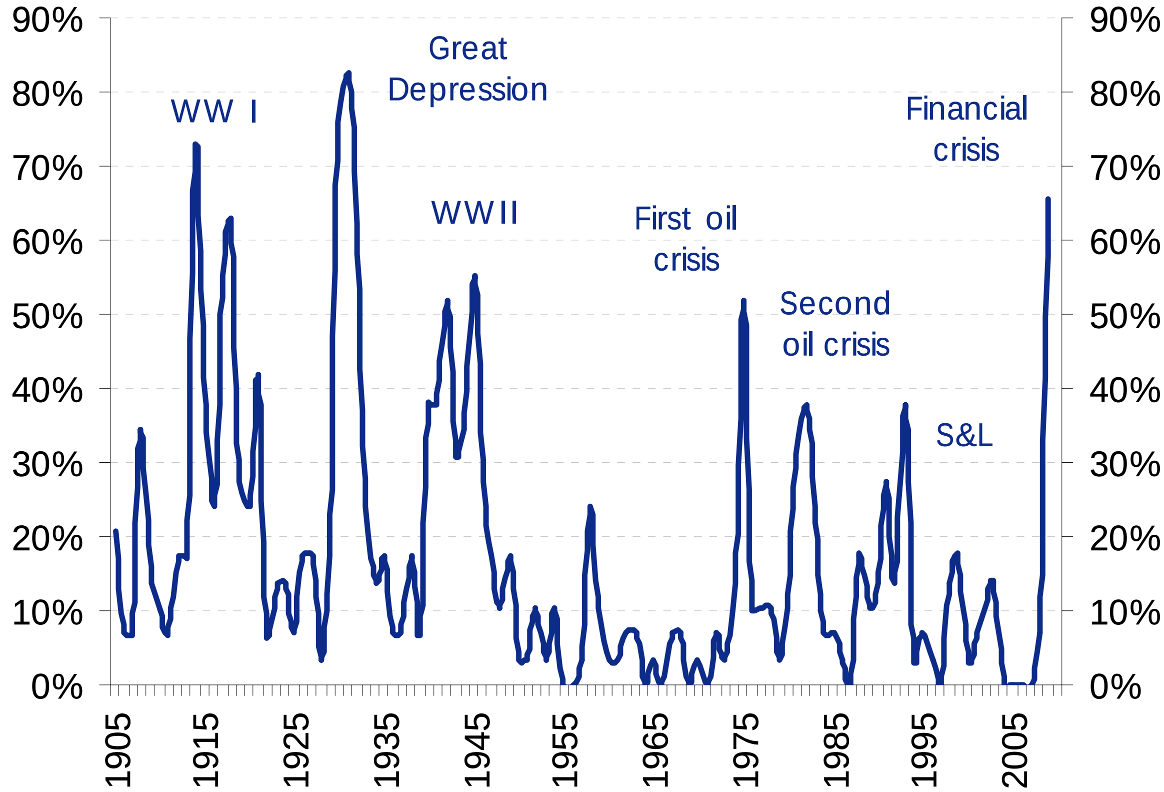
Perfect storm: stressful adjustments

Risk aversion

Never since the Great Depression have so many countries been contracting at the same time

Number of countries in recession in the same year (as a % of total countries)



Source: BBVA ERD

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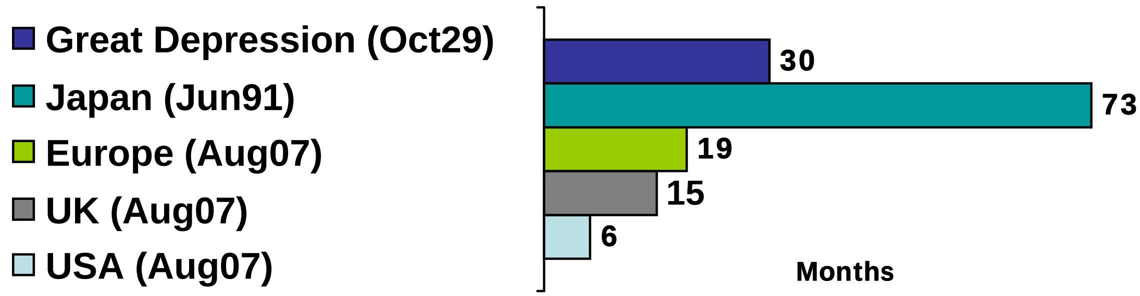
Perfect storm: stressful adjustments

Risk aversion

Developed countries have implemented policy measures to overcome the risk: the USA Government has been one of the most active

Monetary policy

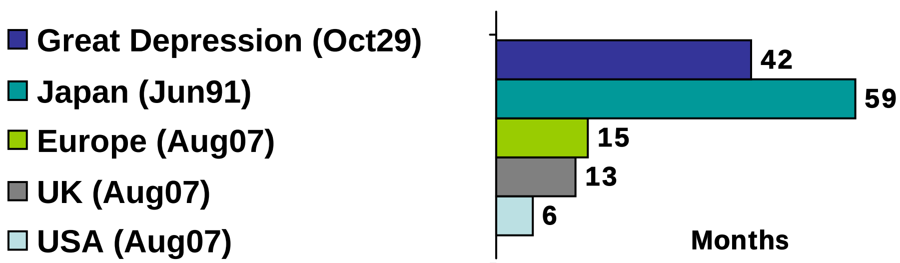
Time to zero real interest rates*



* /Using ex-post inflation for the Great Depression. Inflation expectations for Japan, Europe, UK, USA.

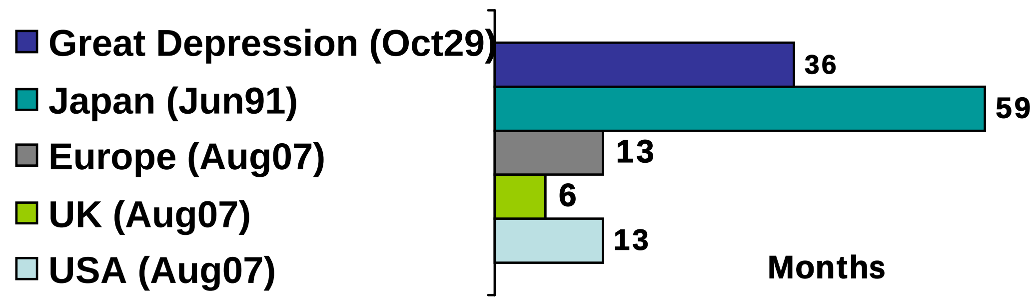
Fiscal policy

Time to first fiscal package



Financial stabilization

Time to first injection of public K



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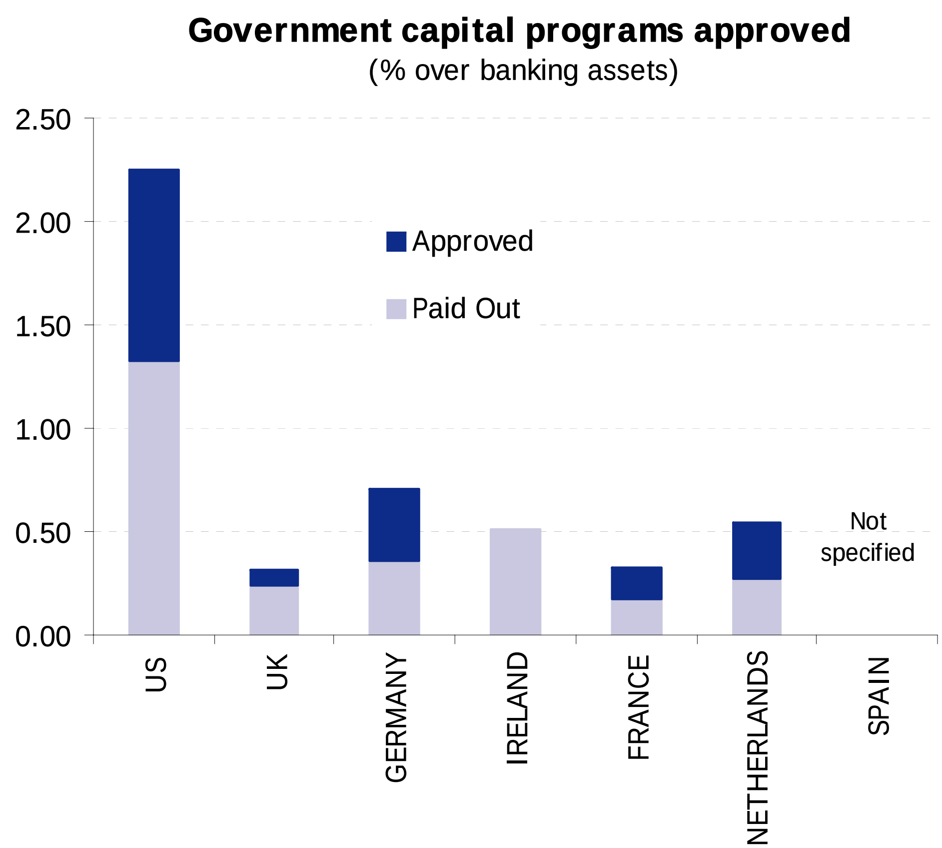


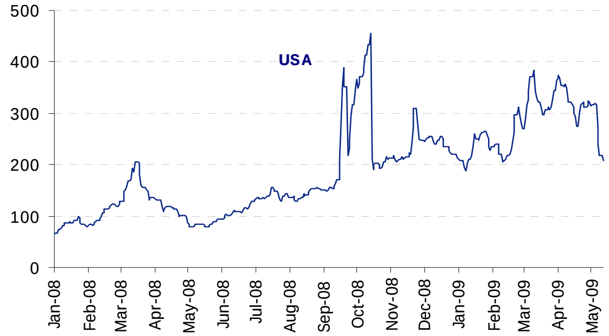
Perfect storm: stressful adjustments

Risk aversion

Stress tests in USA and countercyclical measures start to break it

A. Stress tests imply a base to limit uncertainty

Banks' credit risks: CDS 5 yr Senior Debt (bp)



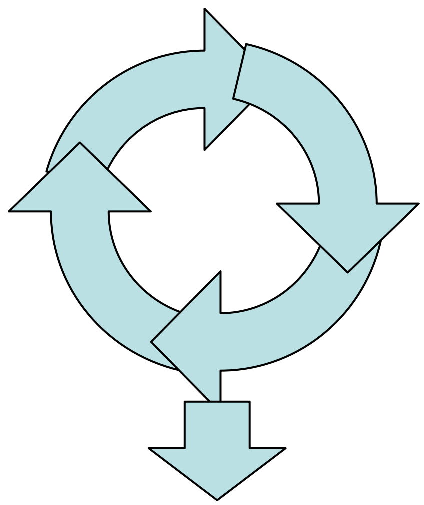
Source: Bloomberg

B. Moderation in financial tensions, although very gradual

USA: Financial Tensions Indicator
100 = January-07

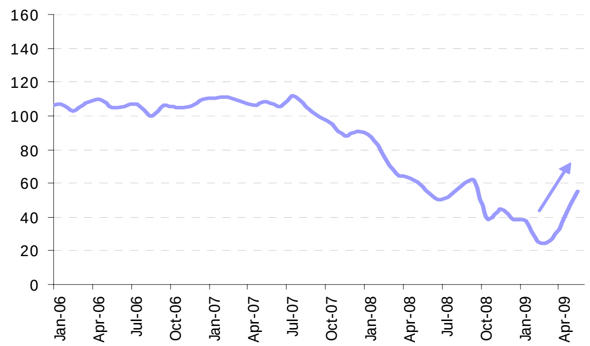
Source: BBVA-ERD

First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread



D. Stabilization of confidence still at very low levels

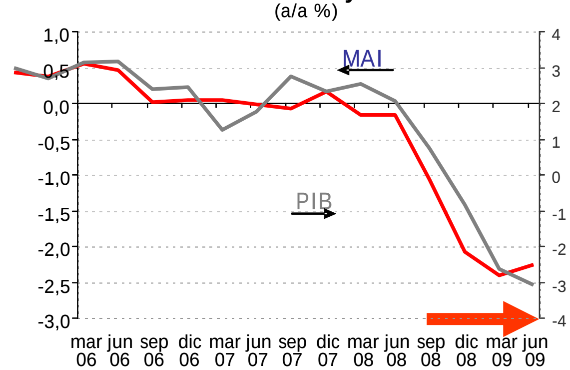
US: Consumer confidence Index



Source: Datastream and ERD-BBVA

C. First indicators of stabilization, with support of public policies

GDP and Activity Indicator
(a/a %)



Fuente: SEE

Influenza outbreak

The economic impact of influenza is delaying the Mexican recovery

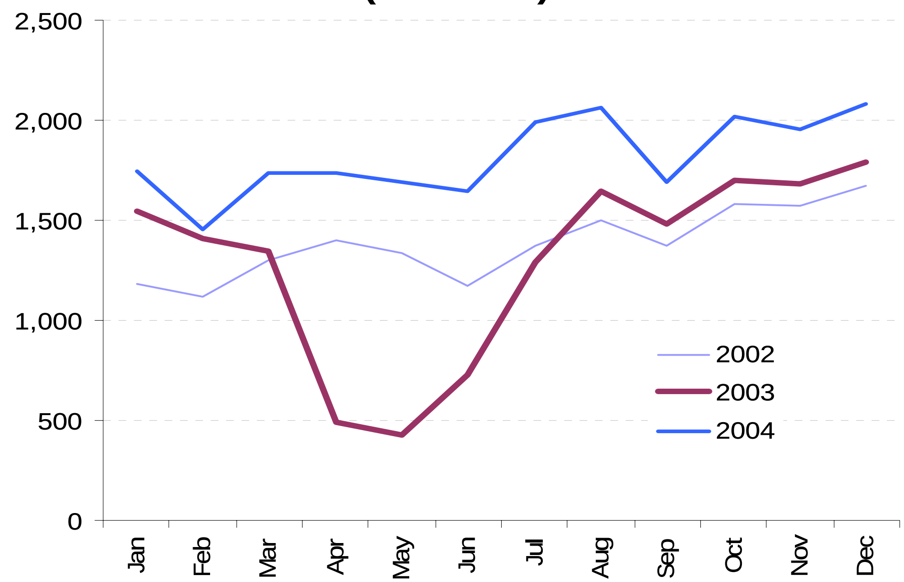
Flu Outbreaks

	SARS, 2003		A Type Influenza, 2009	
	World	HK	World	Mexico
Infection				
Number (persons)	7,338	1585	39620	6241
as percentage of population	0.117	22.643	0.590	5.674
Countries	29	--	66	--
Mortality Rate (% of infected people)	9.6	17.0	0.4	1.7

SARS: figures are refered to the first six weeks, it is comparable to A Type influenza

Source: BBVA ERD based on WHO statistics

HK 2003: Number of Tourists (thousand)



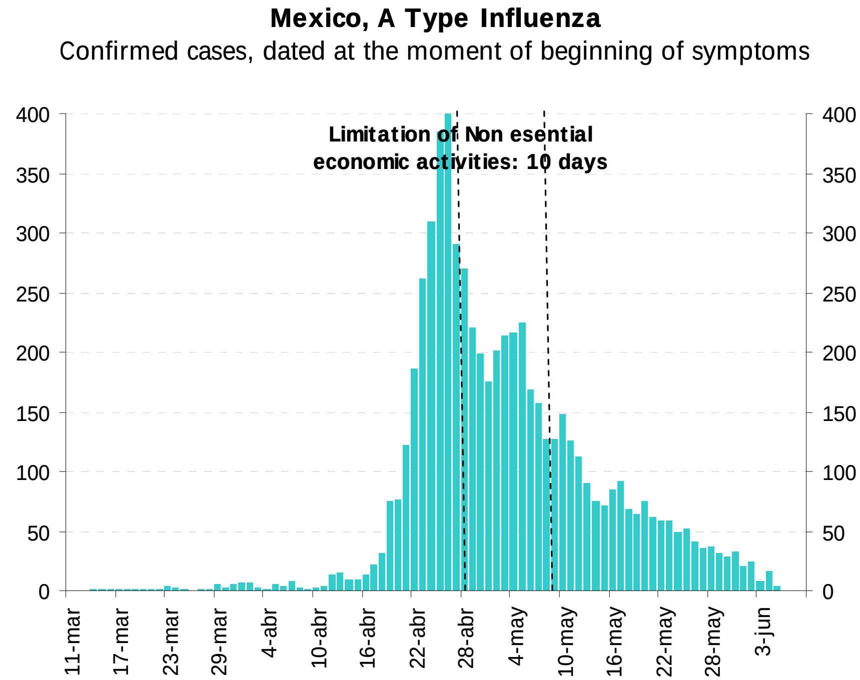
With respect to the last comparable episode, (Hong Kong, SARS, 2003), the epidemic is more contagious but less deadly

In Hong Kong, the epidemic hit essentially through a fall in the touristic demand and also in consumption expenditure

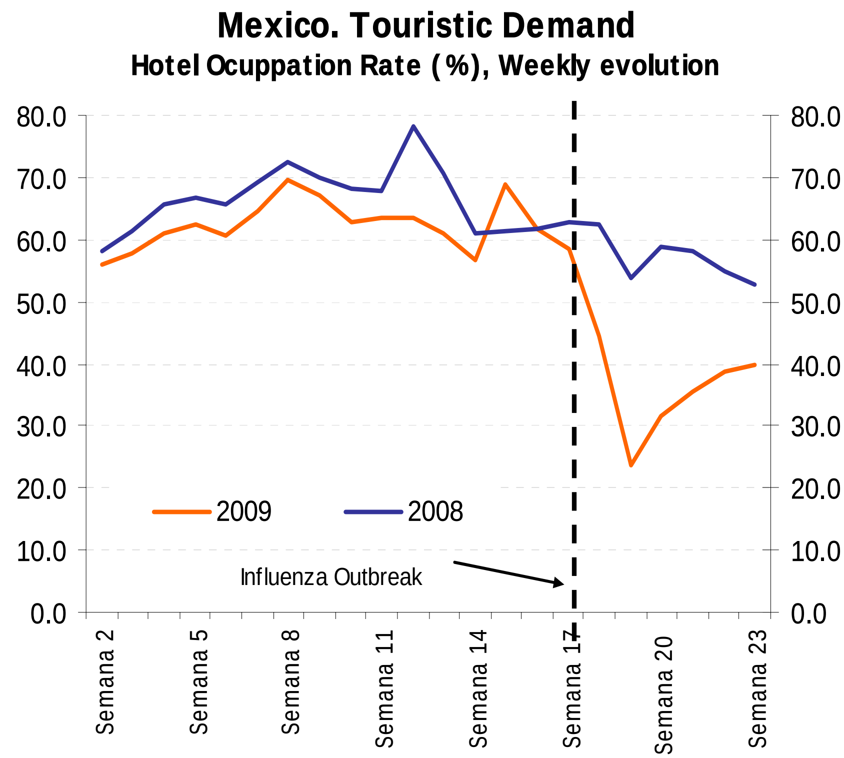
Perfect storm: stressful adjustments

Influenza outbreak

The economic impact of influenza is delaying the Mexican recovery



Source: Secretaría de Salud, México



Source: Secretaría de Turismo

The epidemic does not have the degree of mortality of previous events and its speed of contagion is being reduced, but it supposed a closing of the nonessential activities during 10 days…

… and it produced a "fear to the contagion" that lasts and hits in activities like the tourist ones

The economic impact of influenza is delaying the Mexican recovery

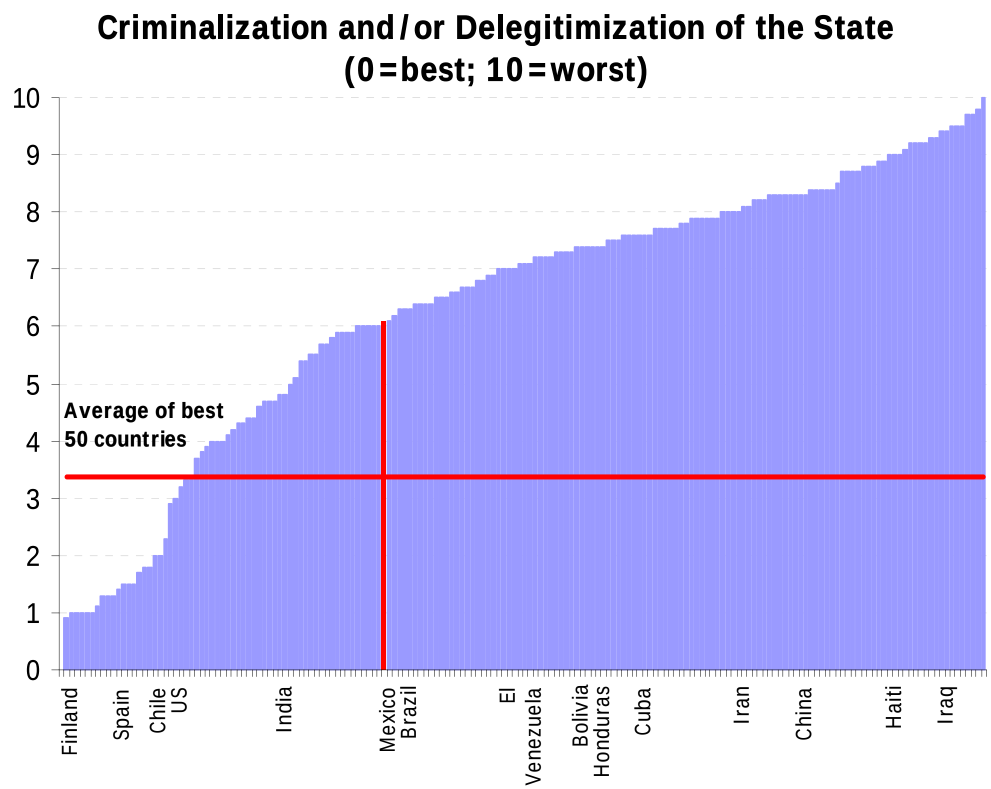
Influenza Impact on Mexican Economy
pp, deviation from baseline

Secretaría de Hacienda	-0.3;-0.5
Secretaría de Salud	
Lower contagion (15%)	-0.5
Average contagion (25%)	-1.0
Upper contagion (35%)	-3.7
BBVA ERD	
"Case study: Hong Kong"	-0.8
"Supply and Demand Shocks Approach"	
A Scenario	-0.9
B Scenario	-2.0
C Scenario	-3.8
Pro-memoria	
2009 GDP growth, alternative forecasts	
Banxico (without influenza impact)	(-3,8;-4.8)
Treasury Dptmnt.	-5.5
Mexican Consensus, average	-5.7
IMF, WEO	-3.7

The rank in the diverse estimations on the impact of influenza in the economic scene is ample. It depends on hypothesis on the impact derived from the closing of activities, the absenteeism by disease and the smaller cost (tourism, consumption) by the fear to the contagion

Social situation

Organized Crime is a permanent challenge to Mexico and political situation, but it is not exclusive to Mexico



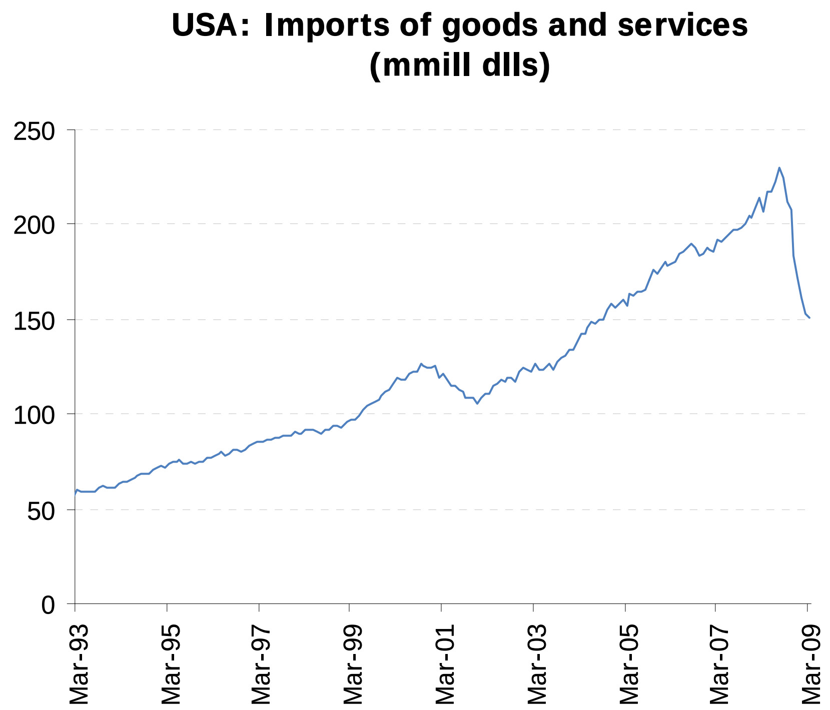
Drug-related violence has risen dramatically in recent years but the federal government has acted decisively to contain the activities of criminal organizations by mobilizing the army against them

Source: Fund for Peace, 2008

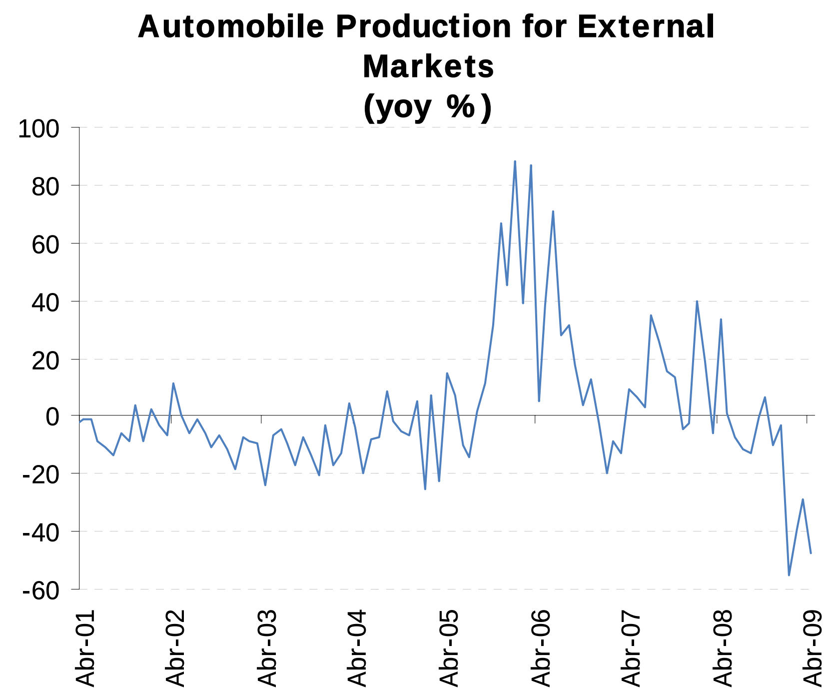
Perfect storm: stressful adjustments

Activity slump

The plunge of USA consumption restrained Mexican manufacturing activity such as the car industry



Source: Federal Reserve

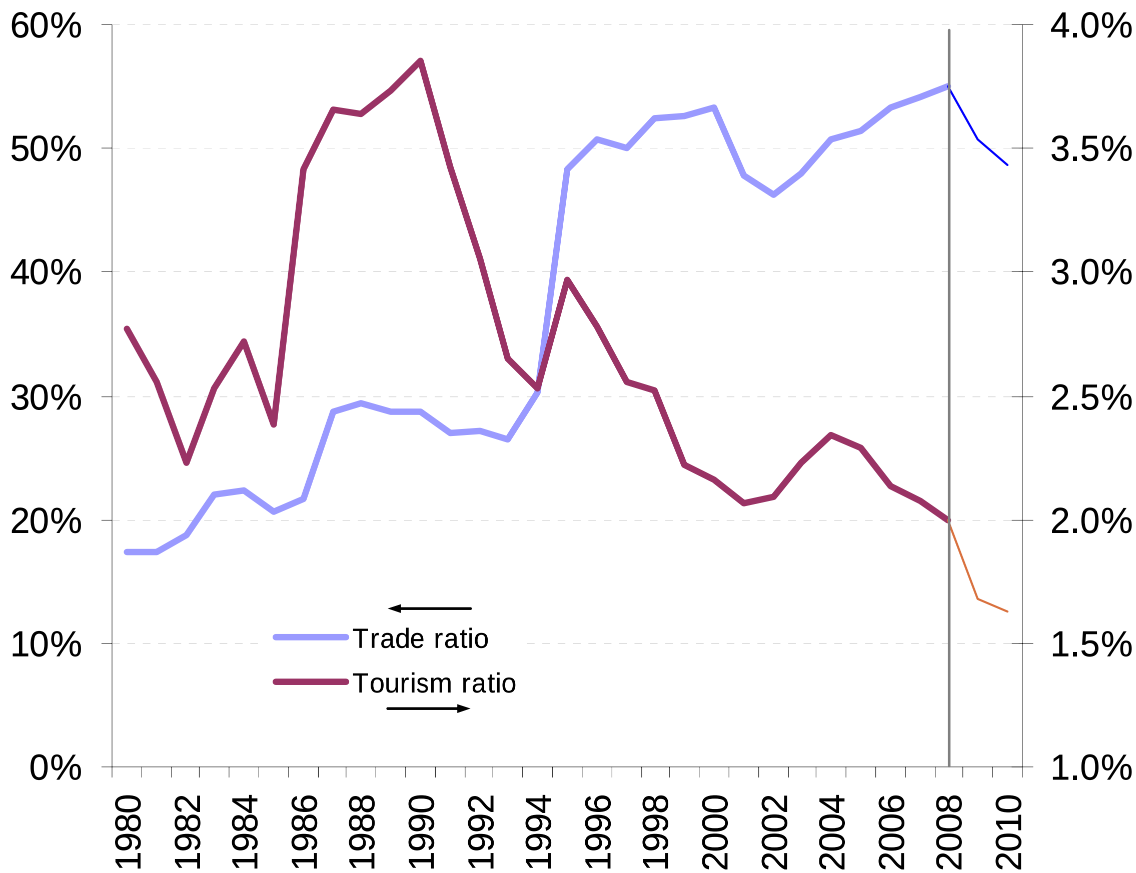


Source: AMIA (Mexican Asociation of Automotive Industry)

Activity slump

A global slowdown means lower trade activity that is a pillar of the Mexican economy

Mexican trade ratio (exports plus imports to GDP) **and tourism ratio** (tourist income plus outcome to GDP)

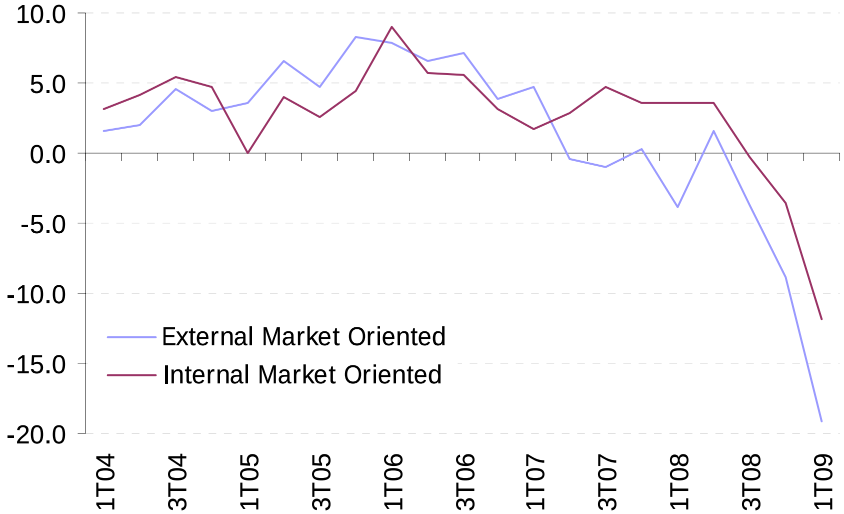


Perfect storm: stressful adjustments

Activity slump

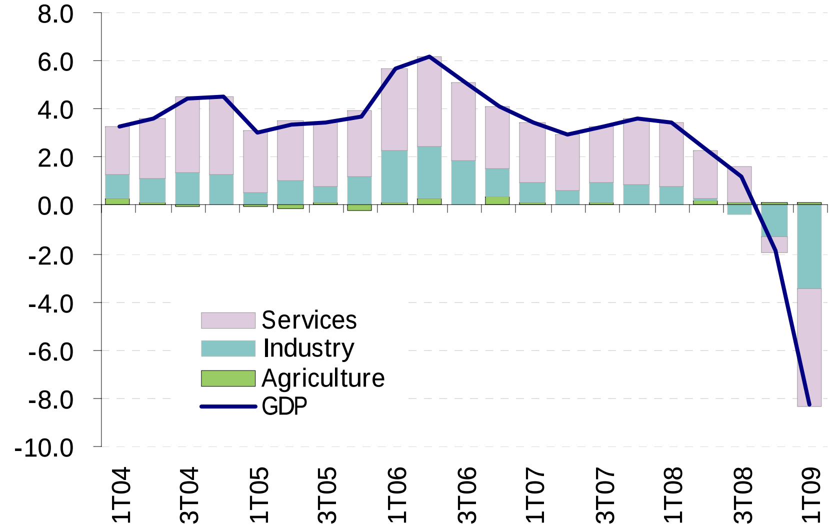
The external shock has passed trough domestic markets due to lower household income after the rebound of unemployment

Manufactures excluding Autos [1] (yoy %)



1 For "External Market Oriented", sectors with correlation coefficient with respect to USA manufactures is higher than 0.6 are considered (2004-2008).
Source: BBVA based on INEGI

GDP: yoy% & contributions to growth



Source: BBVA based on INEGI

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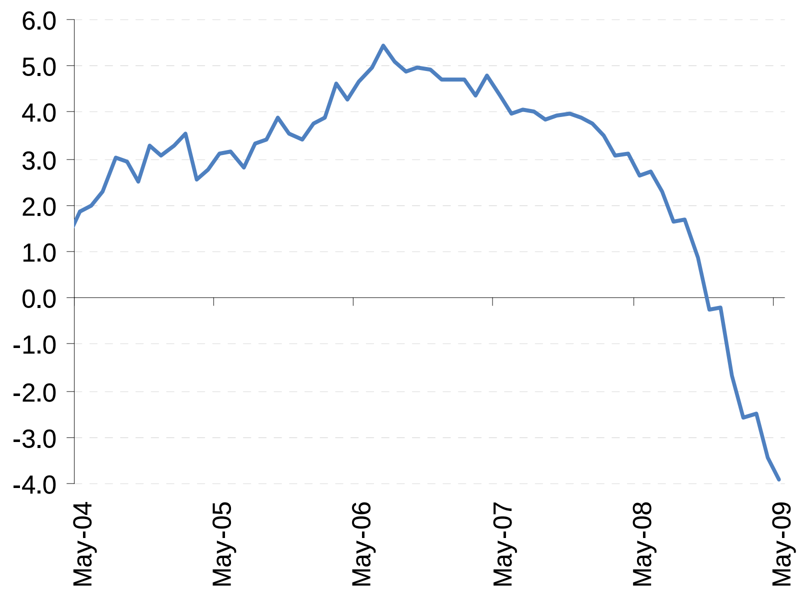
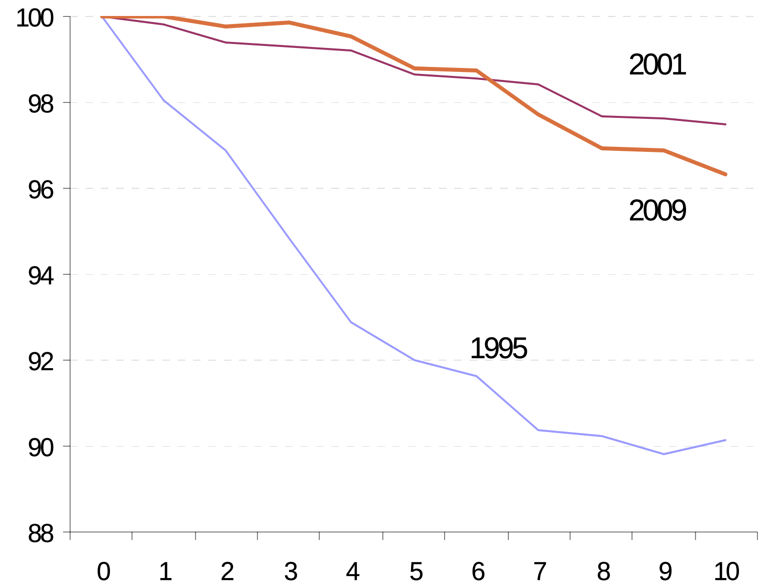
Perfect storm: positive signals

Domestic demand

The labor adjustment has been severe but smoother than in other recessive periods



Source: BBVA based on IMSS



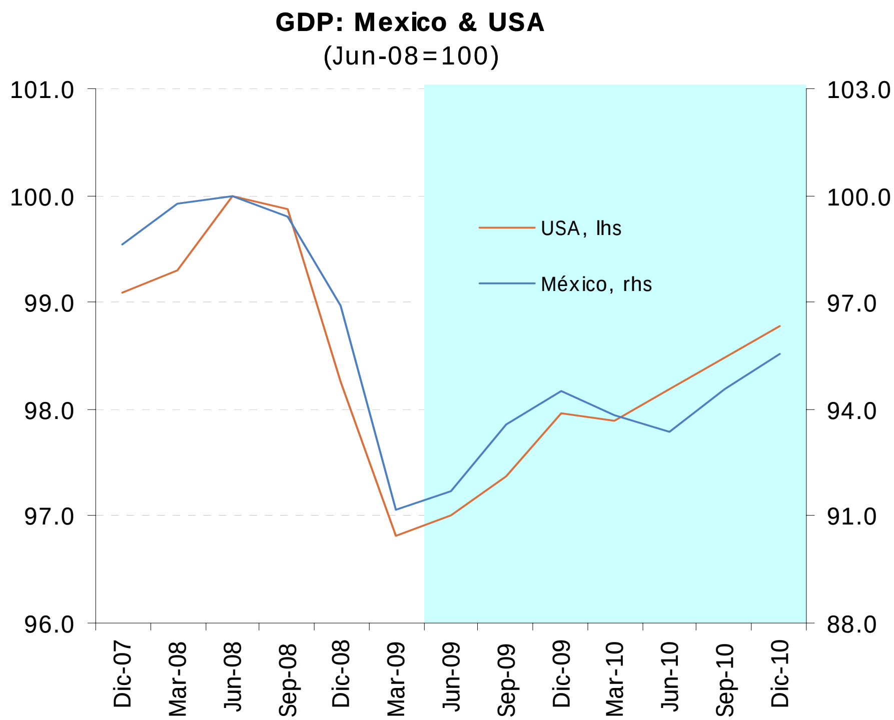
Source: BBVA based on IMSS

Despite the drop in activity, labor market performance enables us to be moderately positive about the potential recovery ahead

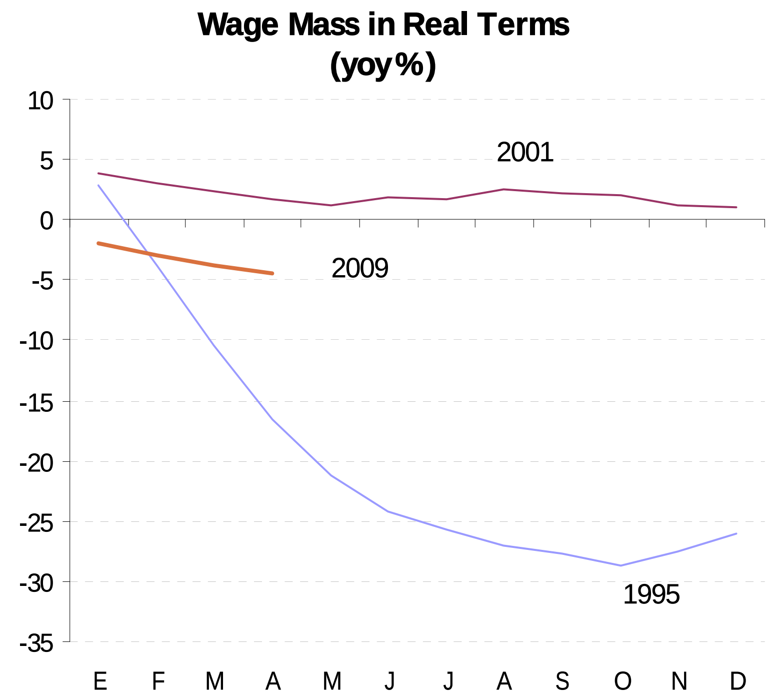
Perfect storm: positive signals

Domestic demand

Although difficult the recovery in Mexico depends on USA cycle, domestic demand could be favorable thanks to real payroll dynamics



Source: BBVA



Source: BBVA

The recovery of the United States will be comparatively less intense than on previous occasions, without arriving in 2010 at growth near its potential.

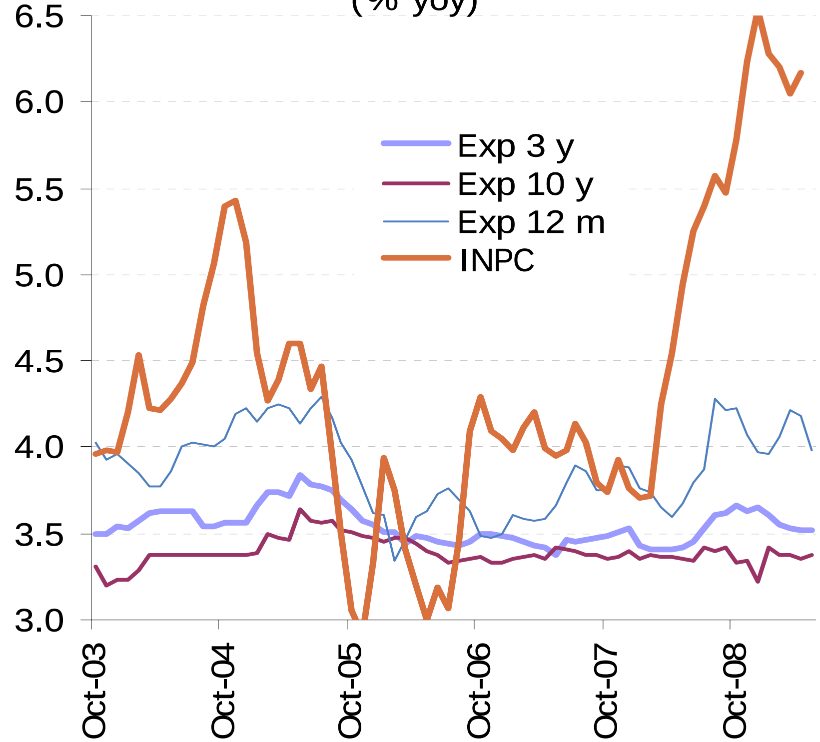
Perfect storm: positive signals

Inflation

Despite a huge FX depreciation, inflation expectations and unionized wage increment in the economy remain anchored

Inflation and contractual wages
(% annual)

Mexico: CPI and Expectatives
(% yoy)

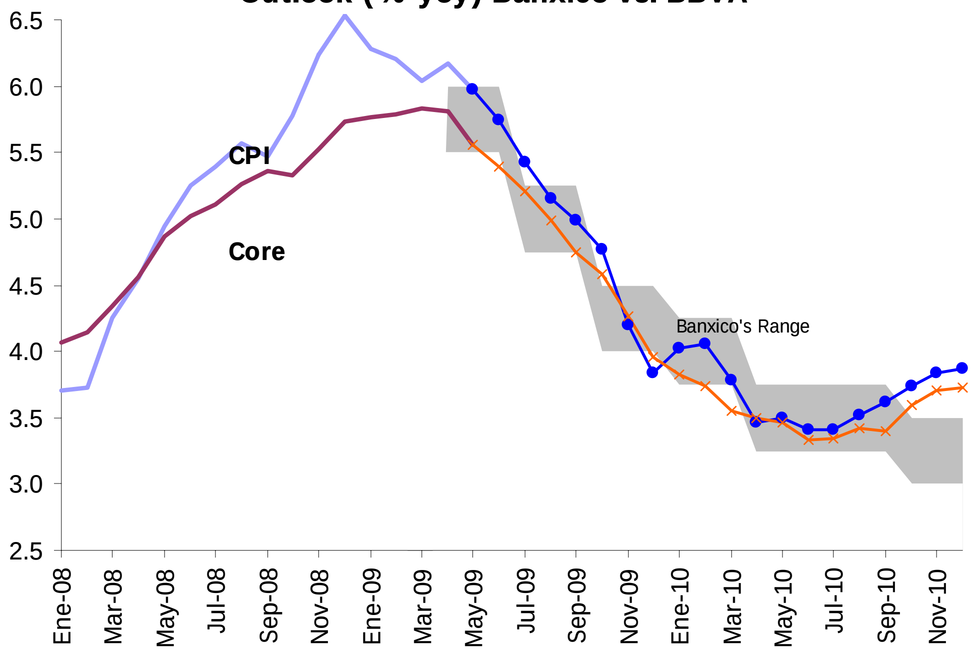


Perfect storm: positive signals

Inflation

We estimate a drop in CPI in the 2H09 due to a broader output gap, FX stabilization, subsidized public prices and anchored expectations

Mexico: CPI and Core performance and Monthly Outlook (% yoy) Banxico vs. BBVA



We forecast an inflation of 3.8% yoy end-of-period and a moderate increase by the end of 2010, but very likely within Banxico's range

External accounts

Mexico is facing its first recession without BoP crisis: even under stress scenario the external borrowing needs for the economy still contained

Balance of Payments adjustments: external borrowing requirements for 2009

Liquidity requirements for 2009	bd	% GDP
Current Account deficit	16.3	-1.9
Private sector debt payments (Capital Account)*	27.7	-3.2
TOTAL	**44.0**	**-5.0**

Sources of liquidity for 2009		
International Reserves	75.6	8.6
FDI **	11.0	1.3
Oil options at current price (BoP income)	10.9	1.2
FMI-FCL	47.0	5.4
FED-SWAP	30.0	3.4
TOTAL	**174.5**	**19.9**

Current Account deficit for 2010	18.4	-2.1
Remaining liquidity for 2010	152.2	17.4

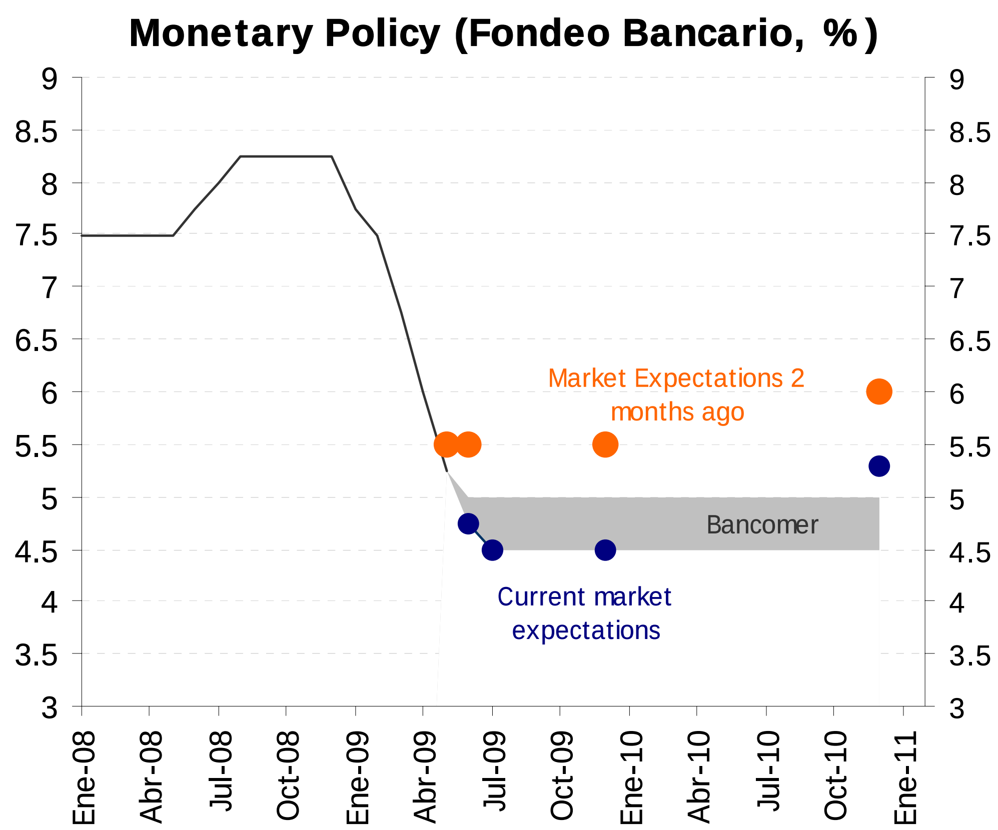
* BBVA estimates considering Central Bank and Ministry of Treasure data

** BBVA forecast under prudent assumptions of FDI

Note: Capital account in Mexico do not include potential income for private sector (i.e. debt refinancing)

Financial markets

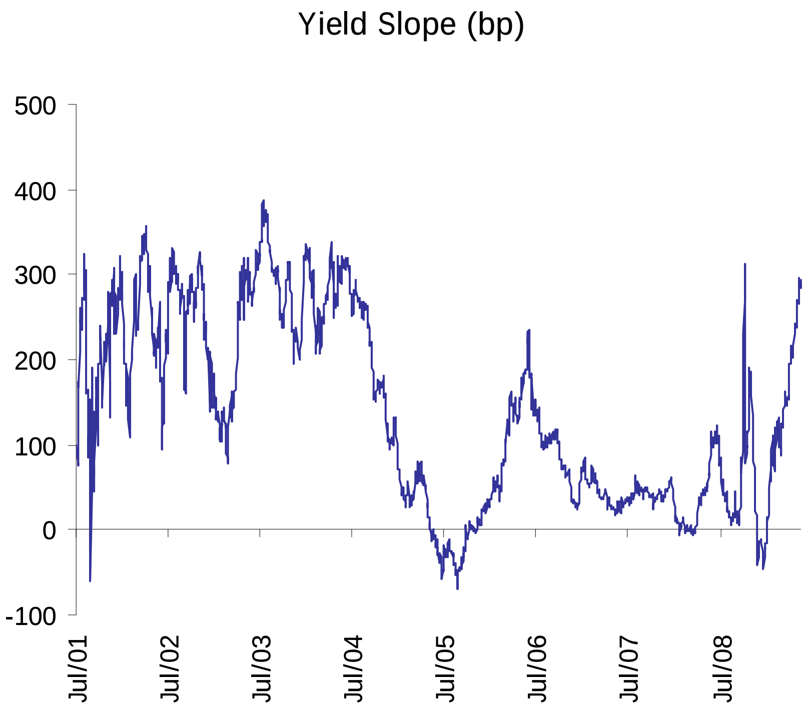
The weak economic recovery and current inflation path open space to keep the monetary pause until the end of 2010, against market expectations (surveys).

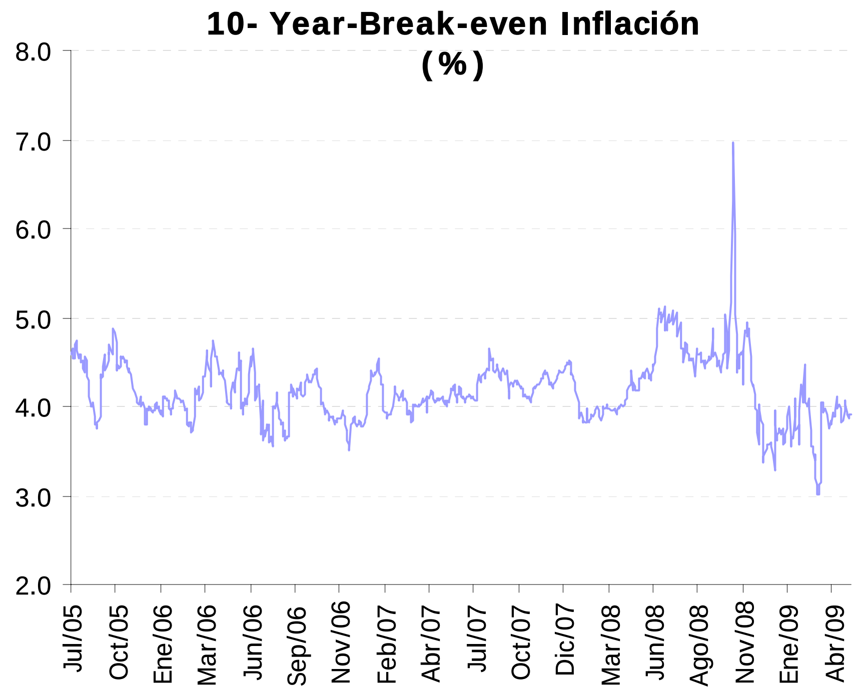


Perfect storm: positive signals

Financial markets

The slope will flatten relying on lower risk aversion and anchored inflation expectations





Source: Bloomberg and ERD own estimations

Perfect storm: positive signals

Financial markets

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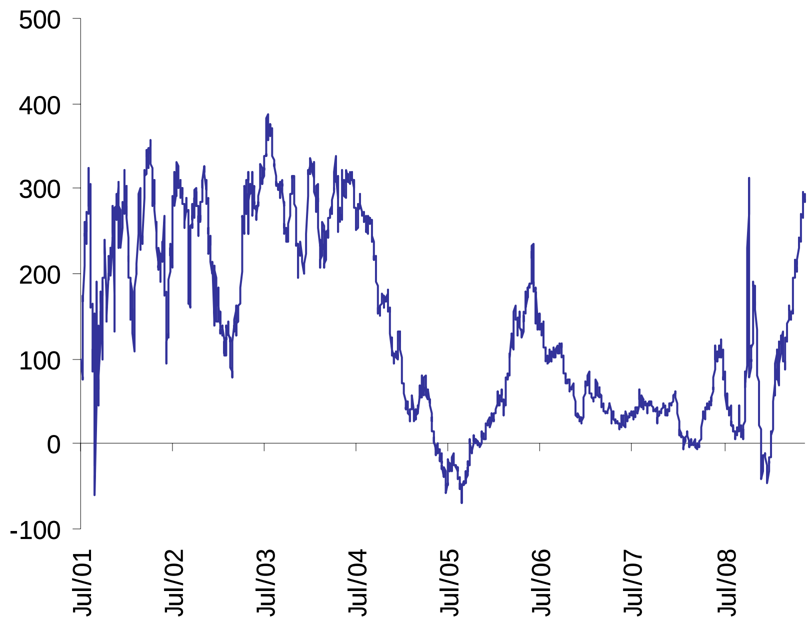
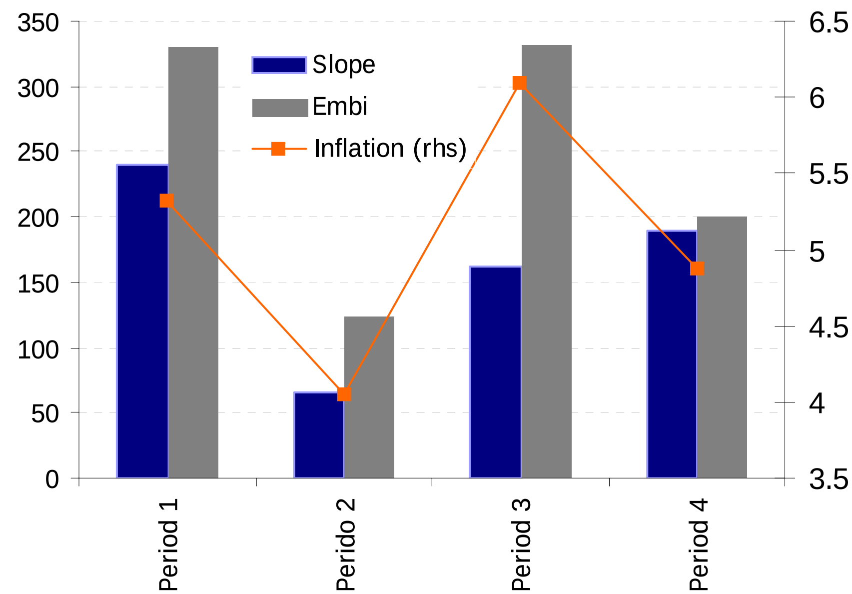
Yield Slope (bp)



Yield slope, Embi and inflation averages across different periods (bp, %)



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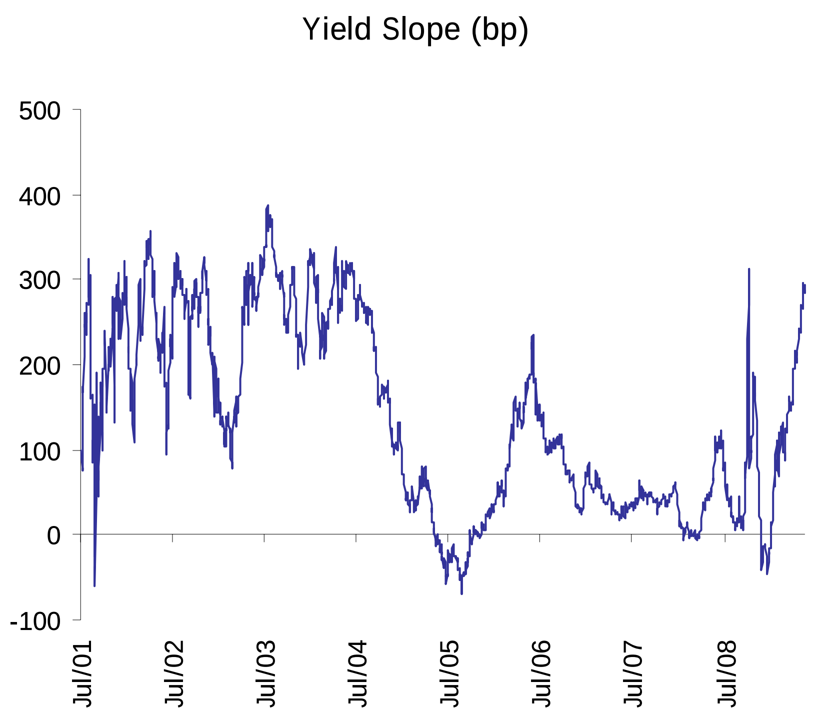
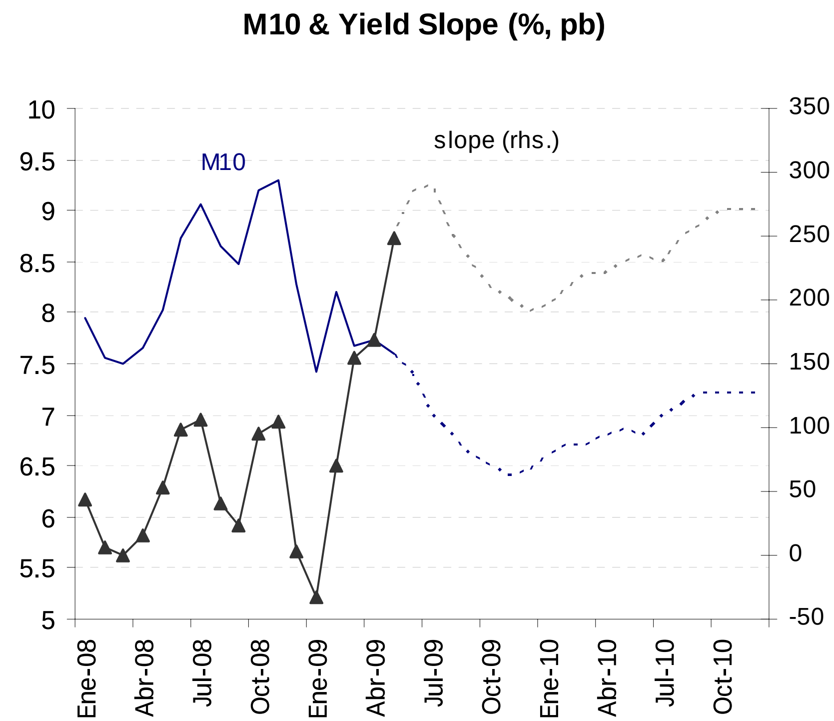
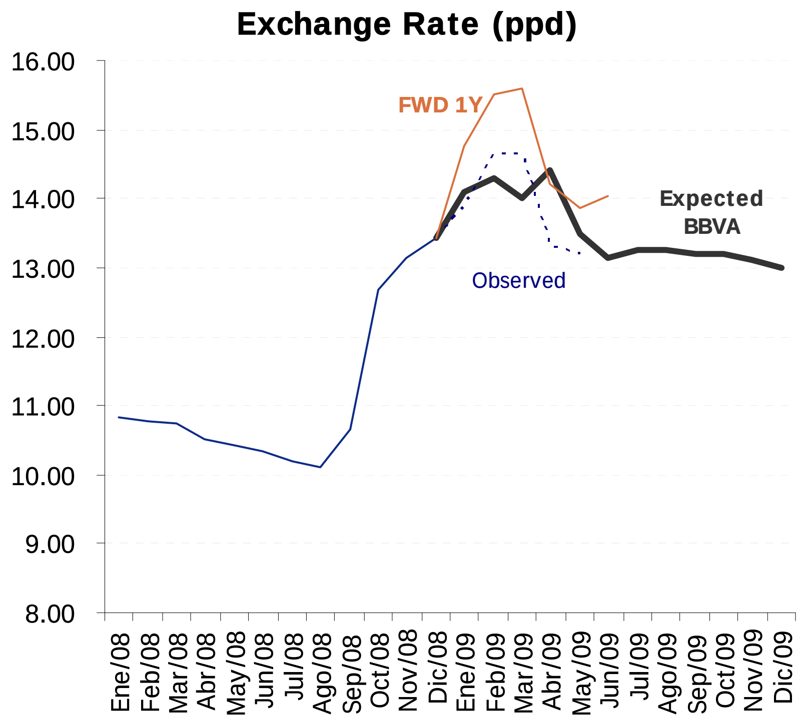
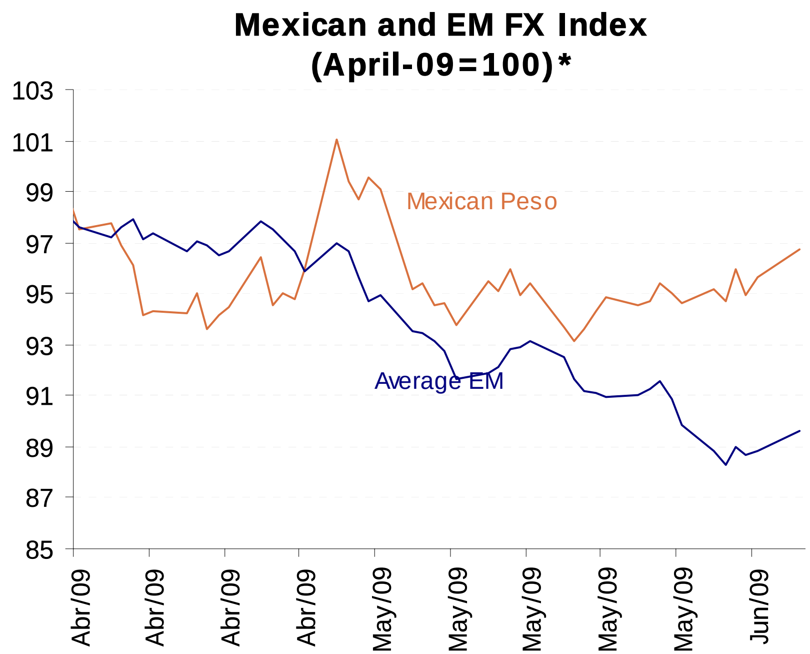




Financial markets

The exchange rate should continue appreciating supported by lower global risk aversion and domestic factors such as inflation anchored expectations. However, Mexico is lagging vs other emerging markets





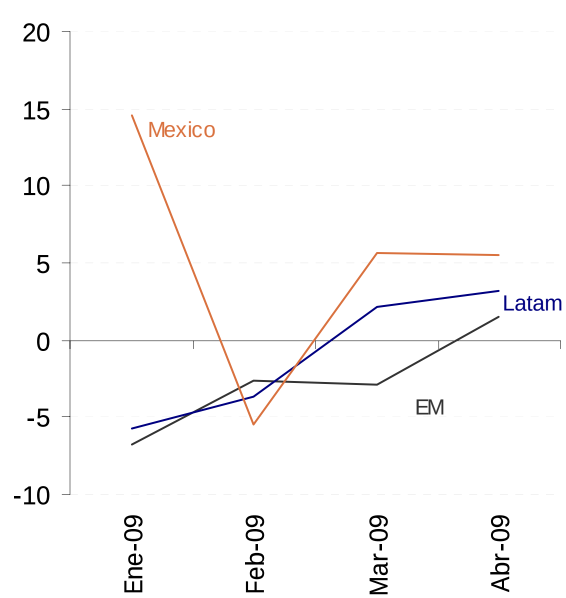
Source: ERD, Bloomberg
* Average performance of 7 markets: Brazil, Peru, Colombia, South Korea, Russia, Phillipins, Malysia.

The forward by the end of the year trades at 13.7 ppd

Financial markets

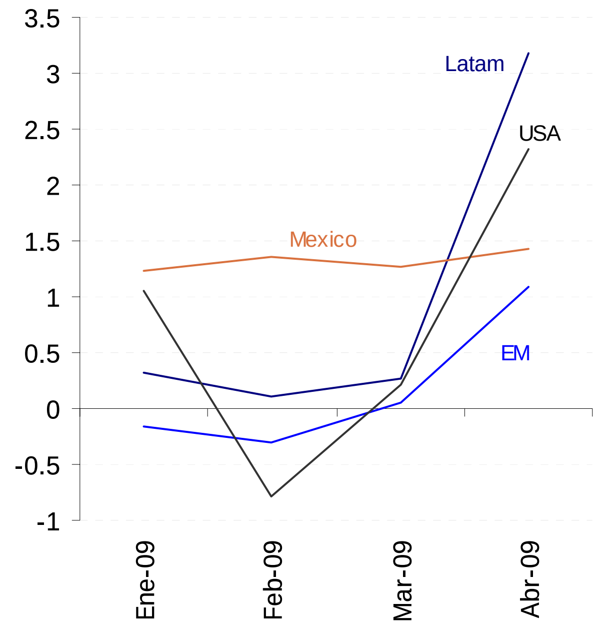
The rate of increasing foreign capital inflows in Mexico depends mostly on global bond market strategies

Net Inflows % of Total Holdings in the Bond Market



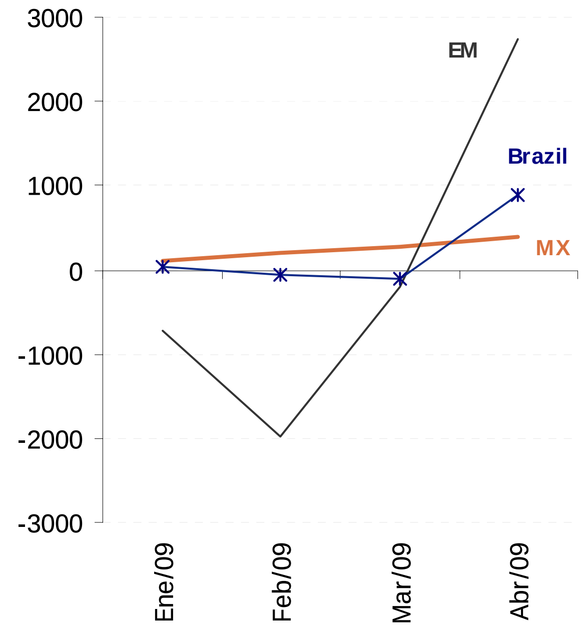
Source: EPRF

Net Inflows % of Total Holdings in the Equity Market



Source: EPRF

Accumulated Equity Net Flows in Mexico & EM (millions dlls)



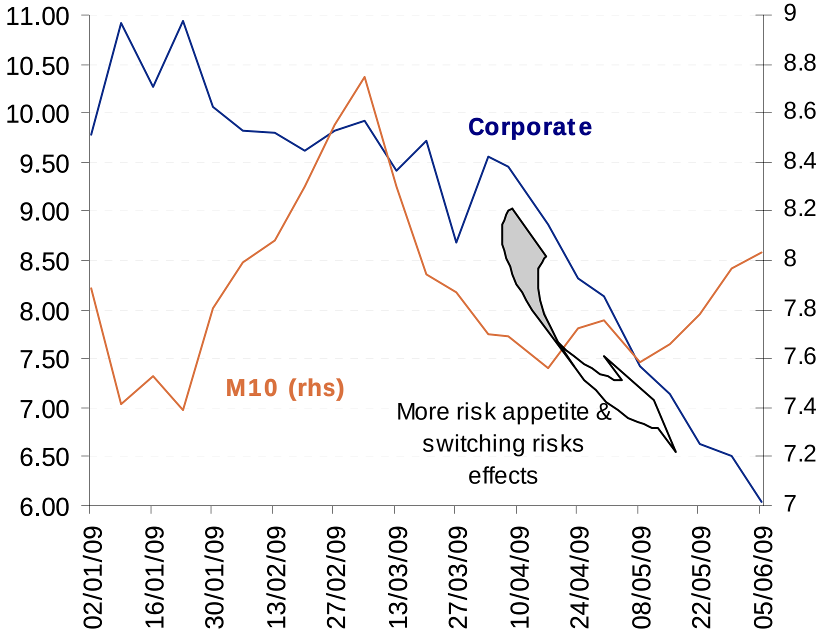
Source: EPRF, ERD

The lower risk aversion has increased the capital inflows in developed and commodity-oriented equity markets. This could partially explain the steadiness of the Mexican peso.

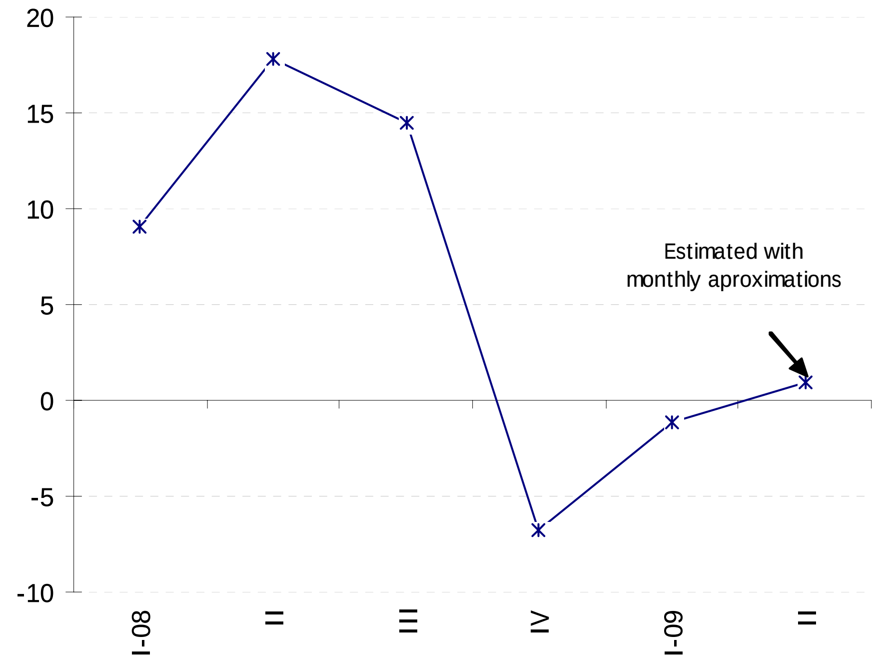
Financial markets

Lower risk aversion (search for assets exposed to more risks) have been shaping the current curve's trend and is more evident on Corporate debt market

Short & medium term weighted corporate rate vs M10 (%)



Corporate debt issuance (bn pesos)



Public Debt Holdings breakdown

The yield fall on Corporate debt market by higher risk preference is intensified by the slowly recover on new issuance.

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Economic Outlook

	2006	2007	2008	2009	2010
GDP	5.1	3.3	1.4	**-6.3**	**1.7**
Consumption	5.2	3.6	1.5	**-3.2**	**1.1**
Investment	10.4	6.7	4.2	**-12.9**	**5.4**
Exports	11.0	5.6	1.6	**-14.7**	**-1.6**
Imports	12.7	7.0	4.6	**-11.0**	**-0.1**
Employment	4.6	4.2	2.0	**-4.4**	**-1.0**
CPI (avg)	3.6	4.0	5.1	**5.2**	**3.9**
CPI (eop)	4.1	3.8	6.5	**3.8**	**3.9**
Fondeo (eop)	7.0	7.5	8.3	**4.5**	**4.5**
M10 (eop)	7.6	8.0	8.3	**6.4**	**7.2**
Exchange Rate (eop	10.9	10.9	13.7	**13.0**	**12.4**
Aux:					
GDP USA	2.8	2.0	1.1	**-2.0**	**1.1**
CPI (avg)	3.2	2.9	3.9	**-0.4**	**1.4**

Index

Mexico is facing the perfect economic storm …

… with domestic strengths and vulnerabilities

The challenge ahead: go forward with the economic reform process

Appendix

Strengths

- Prudent Fiscal and Monetary policies
- Trade partnership with USA
- Structural Reforms (i.e. Pensions)
- Demography

→

- Public debt profile
- Access to external flows
- Contained inflation
- A solid bank industry
- Comparative advantage

Vulnerabilities

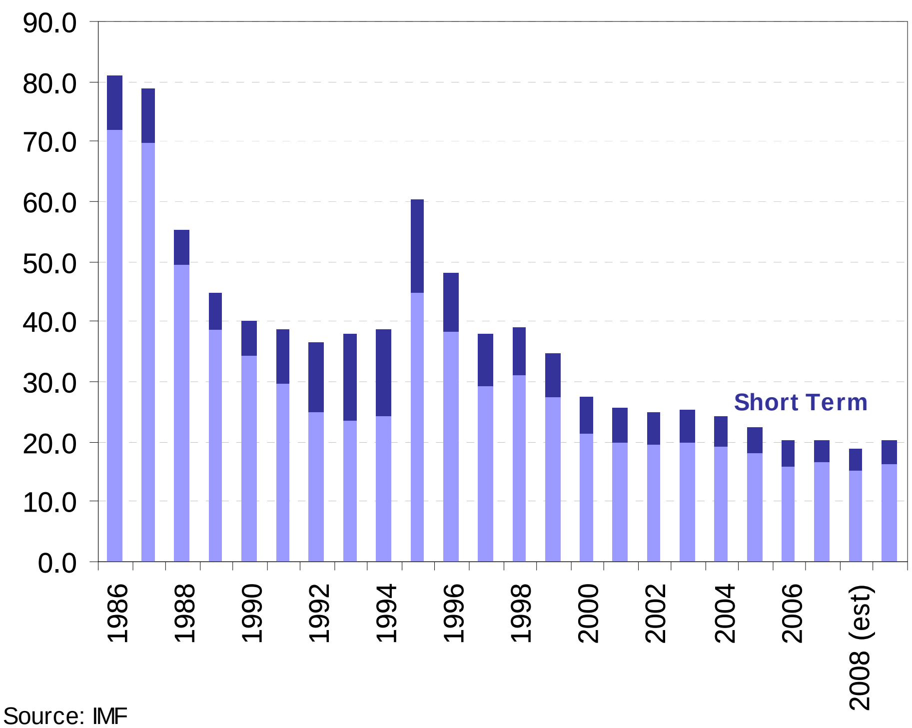
- Budget balance risks
- Increase local market competition
- Public services quality & prices
- Income distribution & poverty

Structural Reform Agenda → Improve Potential Growth

Prudent policies

The first counter-cyclical fiscal policy in Mexico supported by prudent economic policy behavior

Mexico, External Debt, % GDP



Source: IMF

Mexico: Fiscal Measures for 2009 (% GDP)

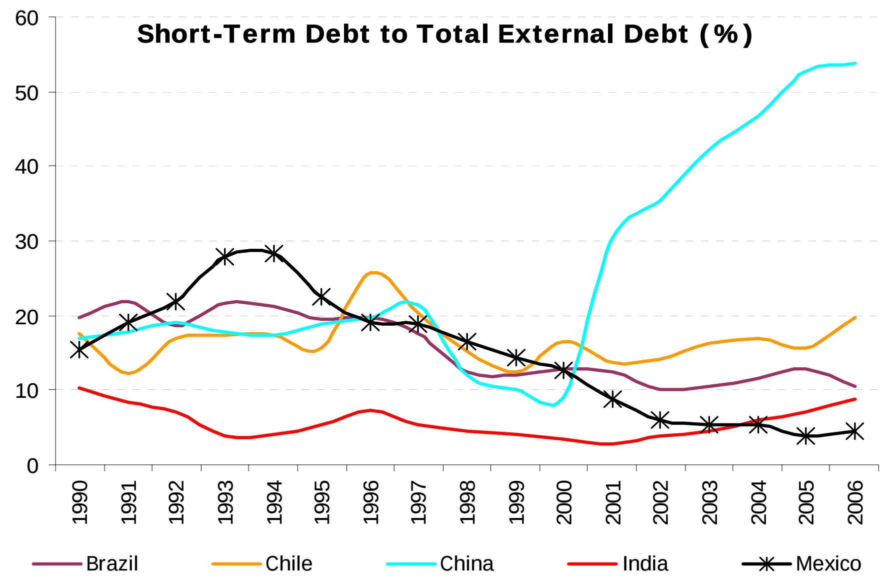
Fiscal Package		Tax*	Current expend.	Capital expend.	**Total**
Countercyclical Plan	Oct. 8th & 20th, 2008			0.5	**0.50**
Countercyclical Plan	Jan. 7th, 2009		0.3	0.2	**0.50**
Influenza Recovery	May 5th	0.125	0.002		**0.13**
Austerity Plan	May 28th		-0.3		**-0.30**
TOTAL		**0.13**	**0.00**	**0.70**	**0.83**

* Expected lower tax collection

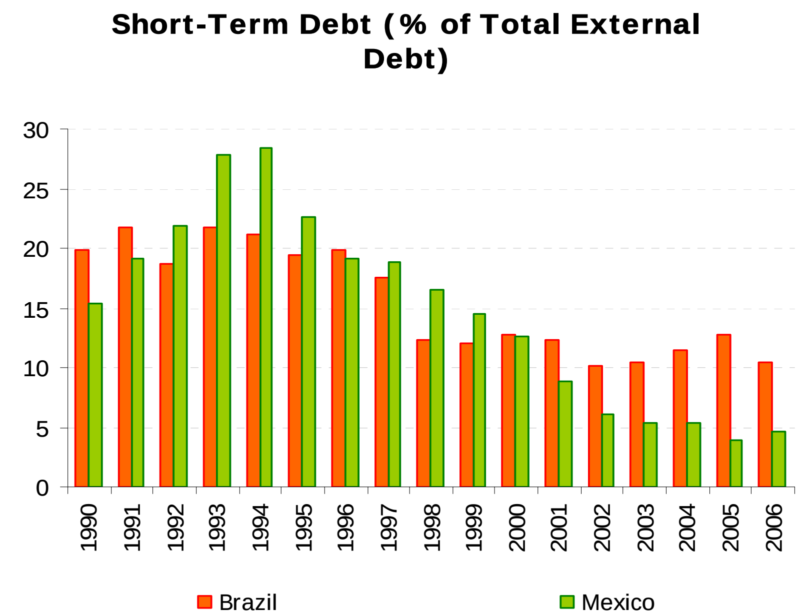
Source: BBVA and Ministry of Treasury. Figures could be different from official sources due to own estimations

Prudent policies

A lower degree of short-term debt as % of total external debt might help to diminish Mexico´s vulnerability to debt mismatches and balance sheet effects



Source: WDI



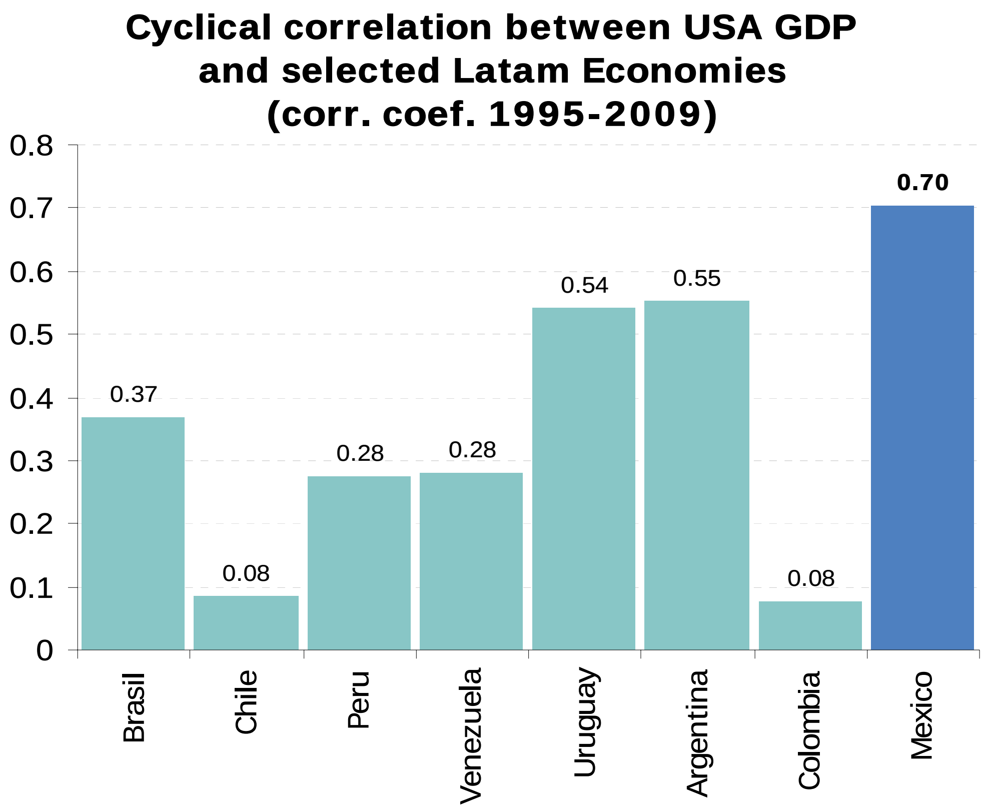
Source: WDI

In recent years, Mexico has improved the structure of its external debt, reducing the vulnerability of foreign-currency-denominated debt to external shocks further than all BRICs.

Mexico compares better than Brazil regarding the current structure of the external debt.

NAFTA

A quicker recovery in Mexico is foreseeable after the start of an expansionary cycle in USA

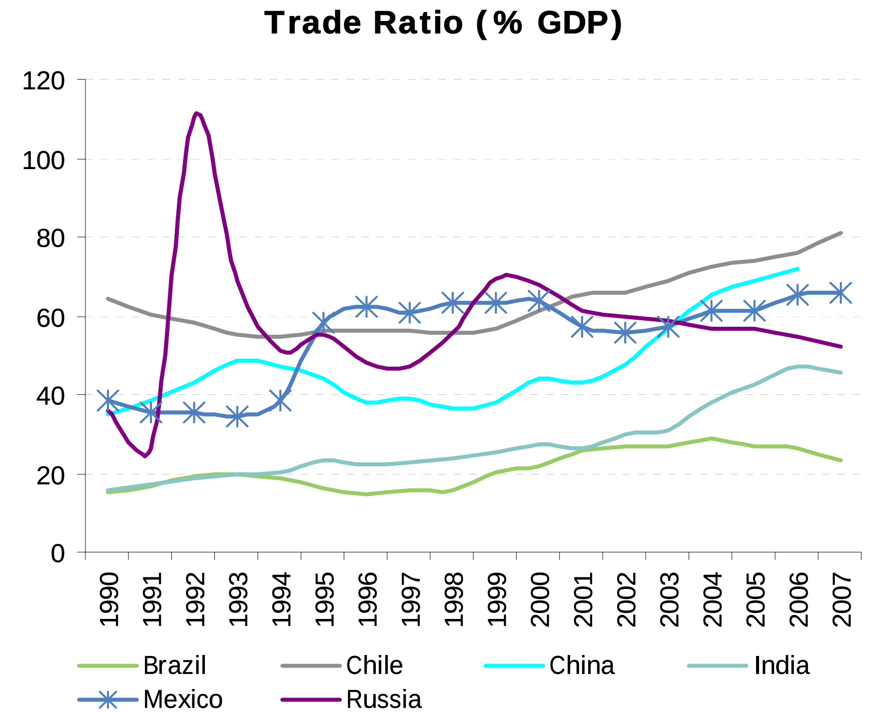


The strongest fiscal and monetary impulse in USA economy should translate first to Mexico

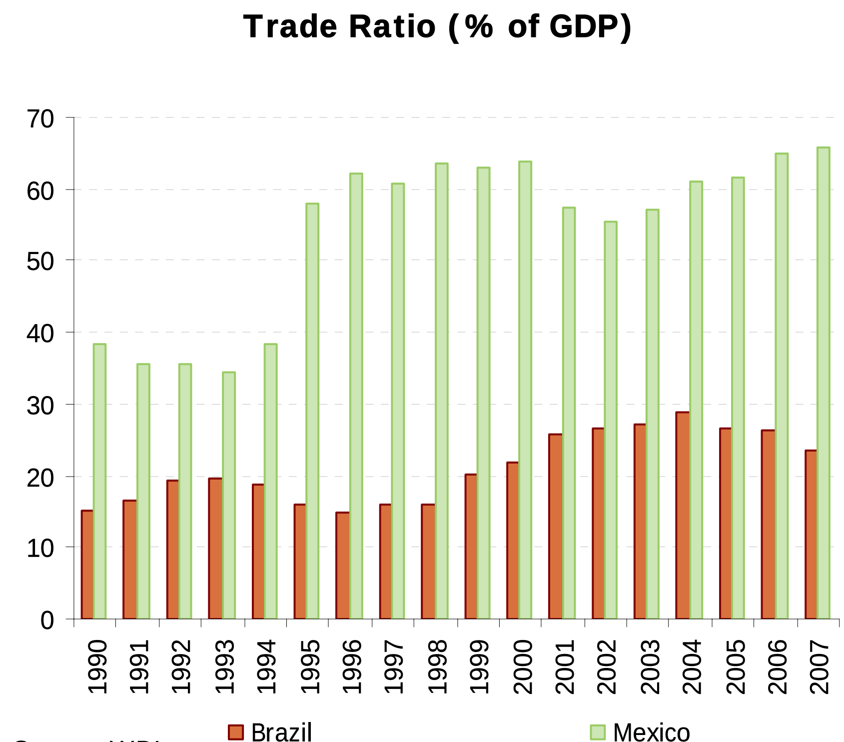
Strengths

NAFTA

A higher degree of international trade might act as a shock absorber to external turbulence



Source: WDI



Source: WDI

Mexico shows a high degree of openness to trade above all BRICs except China

Mexico is far more open to international trade than Brazil

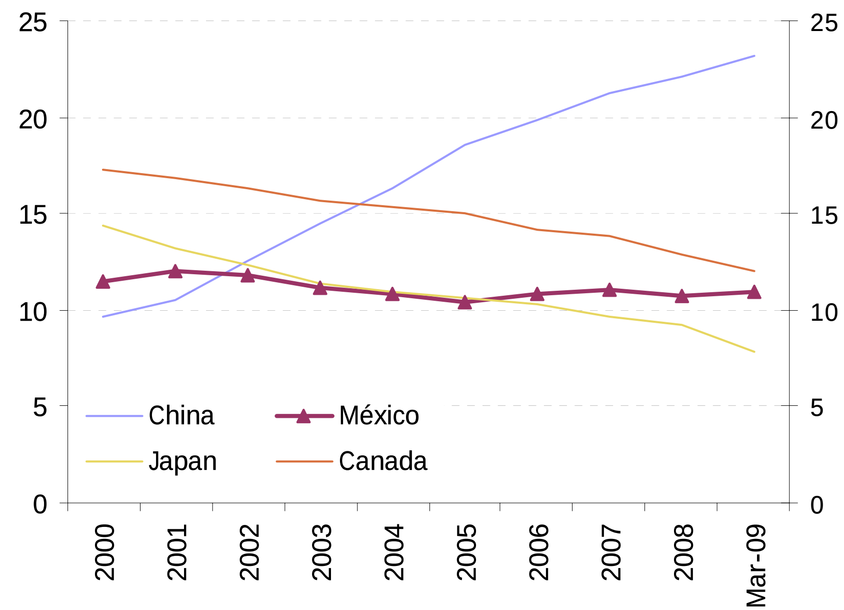
Comparative advantage

The comparative advantage is still in place despite higher international competition

Car production in NAFTA region
('000, units 2008)

	Production	Share %	YoY %
USA	7,982	67.1	-18.6
Canada	1,939	16.3	-19.5
Mexico	1,973	16.6	+ 5.0
Total	11,894	100.0	-15.6

US: Imports of Manufactured Goods
(breakdown by country)

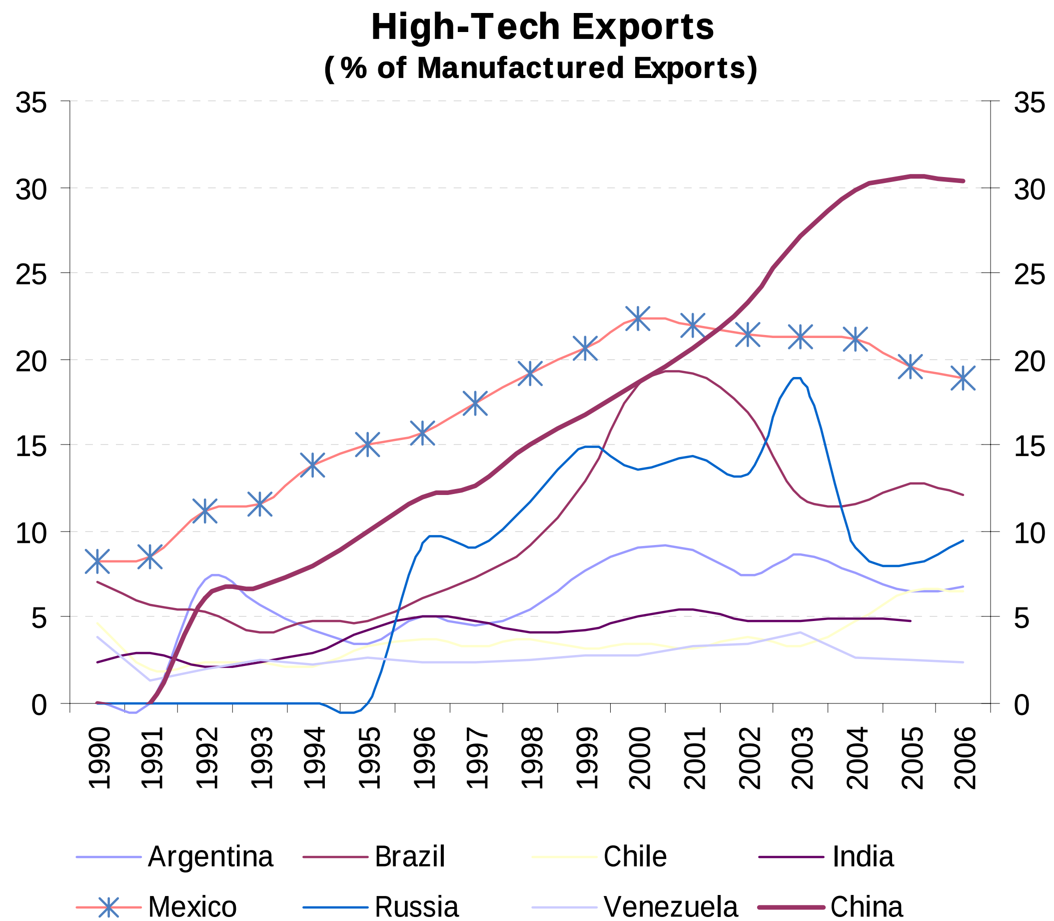


Source: BBVA with US Department of Commerce data

The Mexican market share in USA imports started to stabilized

Comparative advantage

Mexico has a comparative advantage in high-tech exports vs other LATAM. China has emerged as its strongest competitor in recent years.



Source: WDI

BBVA

Strengths

Solid Banking Industry

Legal Framework Improvements to Banking and Credit Activity have strengthened the Mexican Banking System:

* 1) New Accounting Rules for Non-Performing Loans

Make changes to comply with international standards. To timely and correctly measure non-performing loan problems

* 2) More Strict Bank-Capitalization Rules

To improve quality of assets considered for capitalization purposes

* 3) Legal Framework Improvements for Credit Activity

Cost and time minimization of the recovery of delinquent loans

* 4) More Strict Rules for Credit Rating

Establish precautionary measures so the banks can face credit risk problems properly

Strengths

Solid Banking Industry

Legal Framework Improvements to Banking and Credit Activity have strengthened the Mexican Banking System:

* 5) Compulsory Requirement for Establishing an Internal Credit Risk Measurement Unit in Banks

To strengthen credit-risk management

* 6) Compulsory Requirement for Credit Bureau Consultation Before Granting a Loan

To reduce credit risk

* 7) Limited Deposit Insurance in Operation by IPAB

To prevent Moral-Hazard Problems

* 8) Adoption of Early Warning System of Capitalization Index

To avoid a sudden and unanticipated fast deterioration of capital index

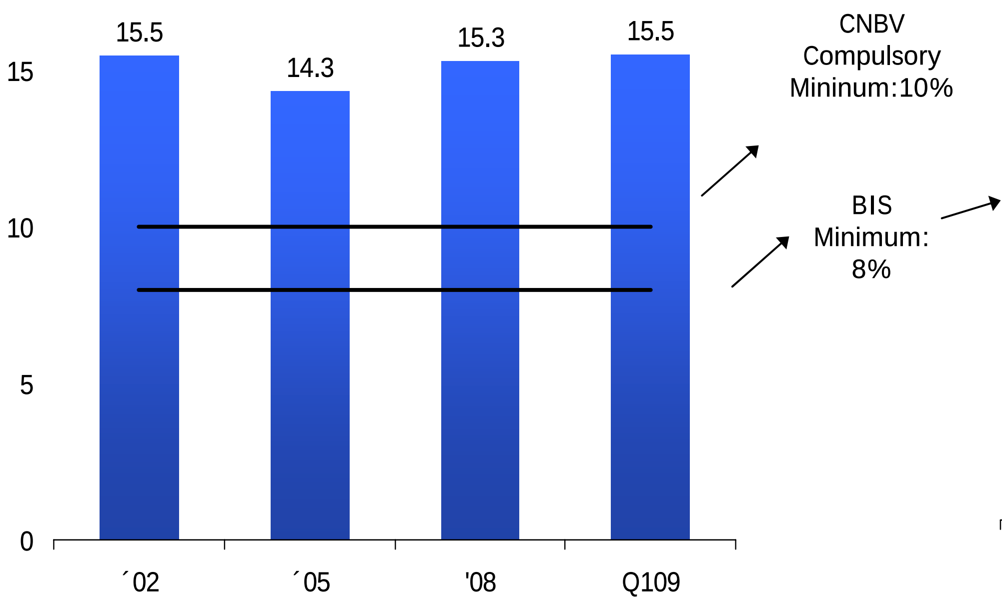
BBVA **Strengths**

Solid Banking Industry

The Mexican Banking System has a high capitalization index, above that of developed economies

Mexican Banking System Capitalization Index

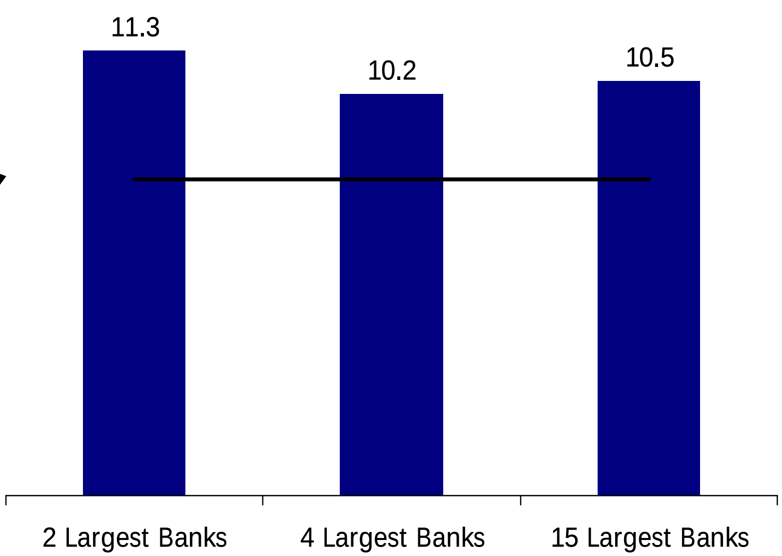
Bank's capital / Total risk assets, %



Source: CNBV

US Bank Capitalization Index after Banking Bailout* (2009)

Tier 1 Capital / risk-weighted assets, %



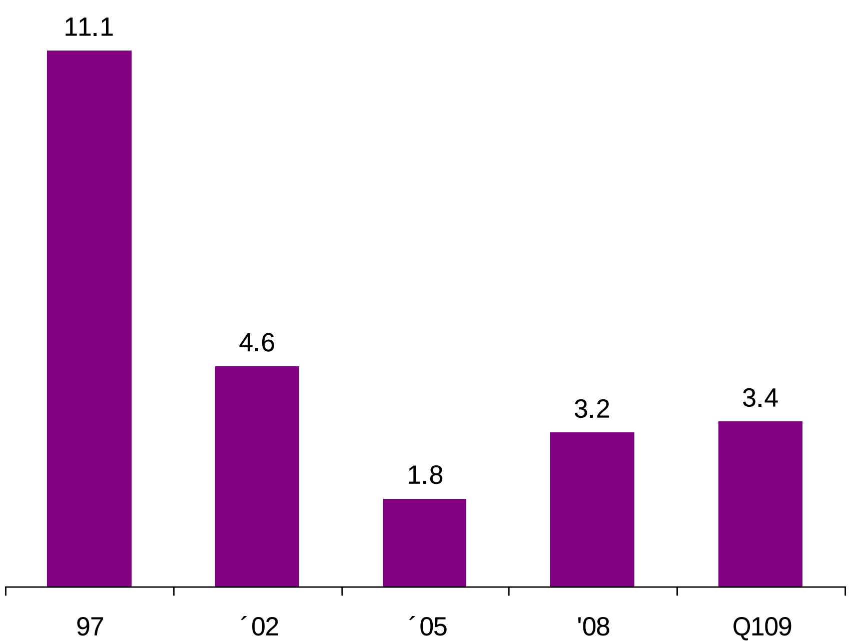
* These indexes include banking bailout 1.3% of GDP for the US Banking System

Source: Federal Reserve Stress-Tests, April 2009

Solid Banking Industry

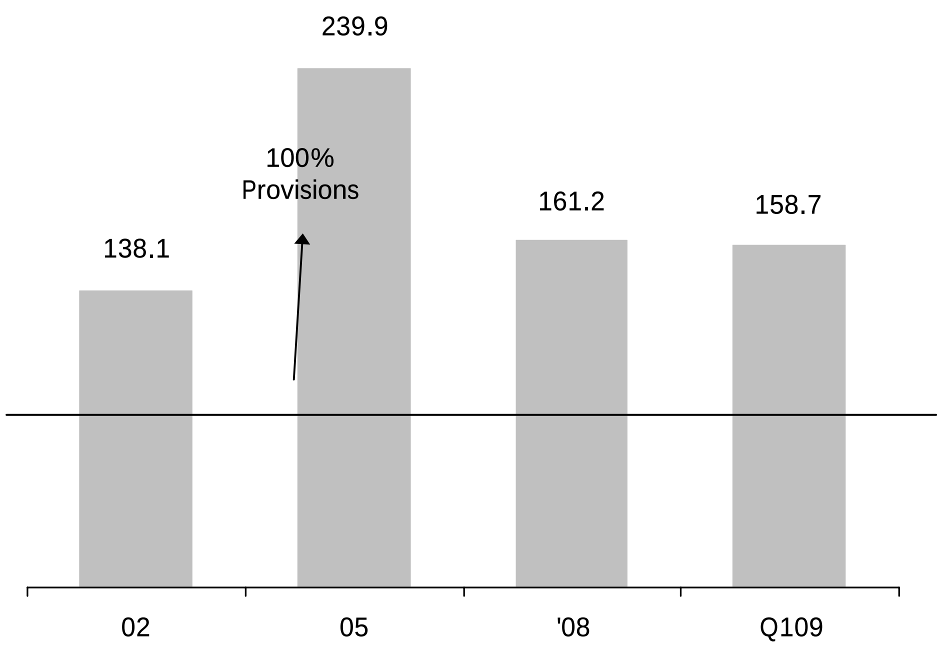
The Delinquency Index of the Mexican Banking System is low and its Ratio of Reserves to non-performing loans is high

Delinquency Index
(Non-Performing Loans / Total Loans, %)



Source: CNBV

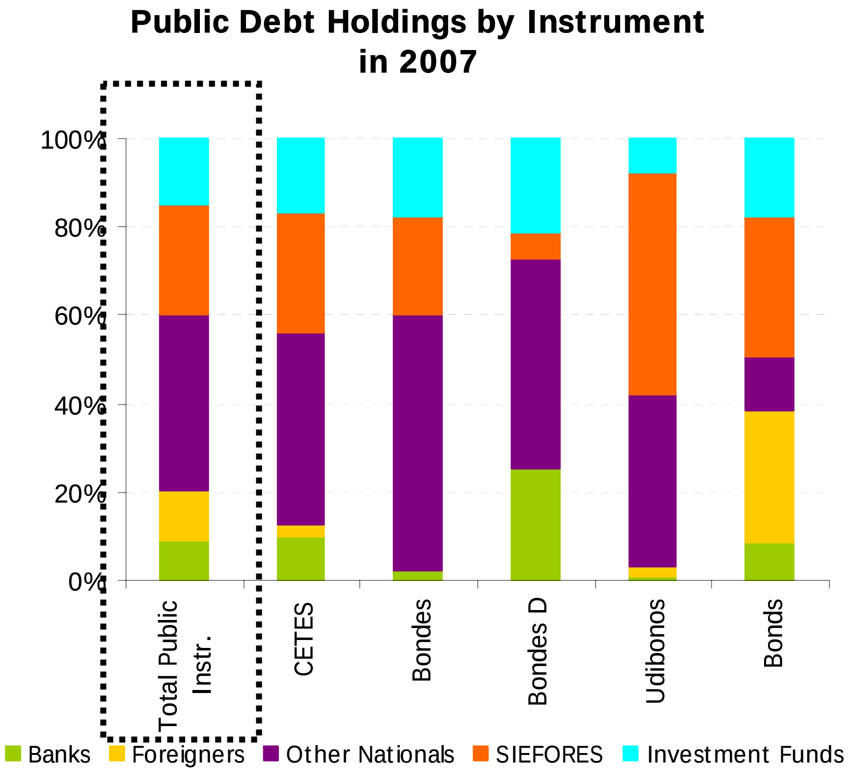
Reserves Index
Bank Loan Reserves / Non-Performing Loans, %



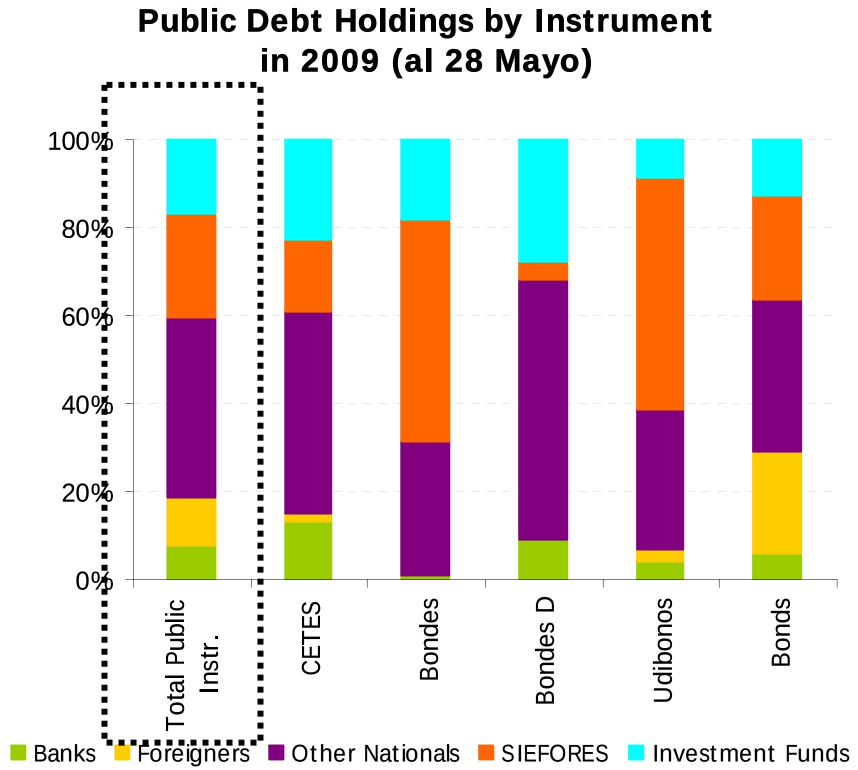
Source: CNBV

Bond market

The Public Debt breakdown by holder is very stable through time. Foreigners hold 11% of Mexican Public Debt Holding



Source: Banxico and ERD BBVA Bancomer



Source: Banxico and ERD BBVA Bancomer

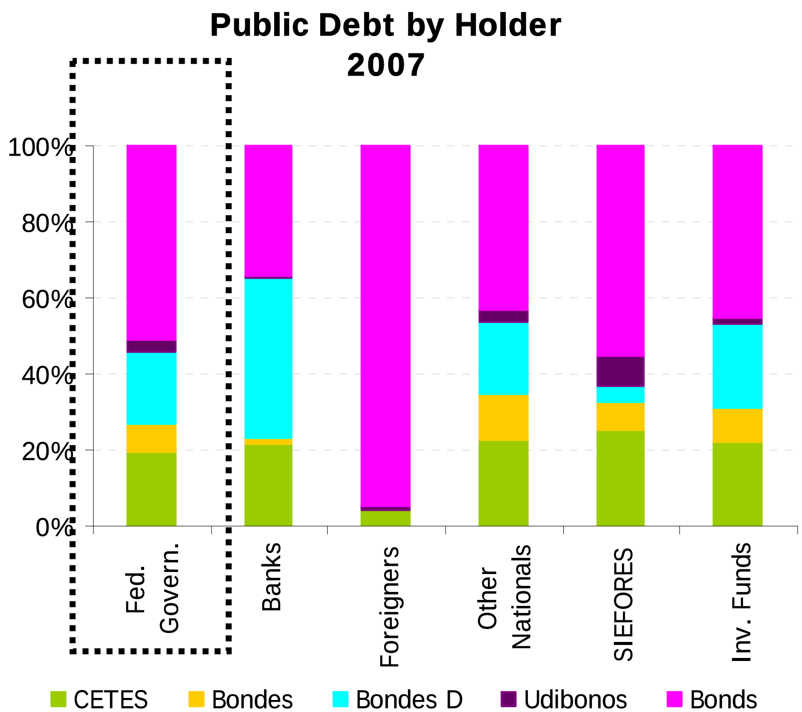
Other Nationals hold about 40% of Public Debt and they tend to maintain a higher proportion of their holdings in CETES and BONDES D. Foreigners hold round 11% of public debt mainly through bonds holding almost 23% of the total.

BBVA

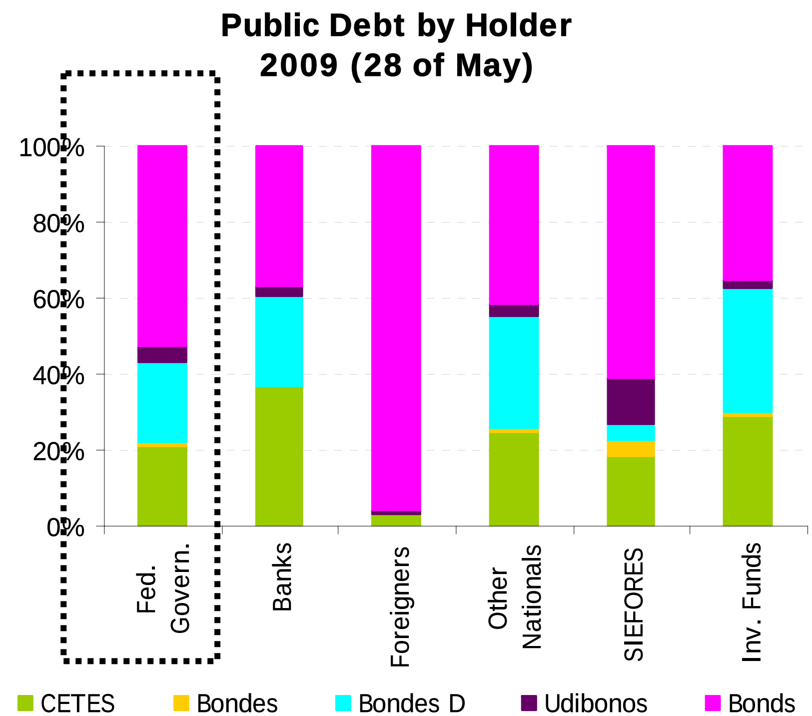
Strengths

Bond market

Around 90 % of foreign holdings are in bonds. Banks have tended to balance their holding of CETES and bonds while other nationals and Investment funds have increased their holding in Bondes D.



Source: Banxico and ERD BBVA Bancomer

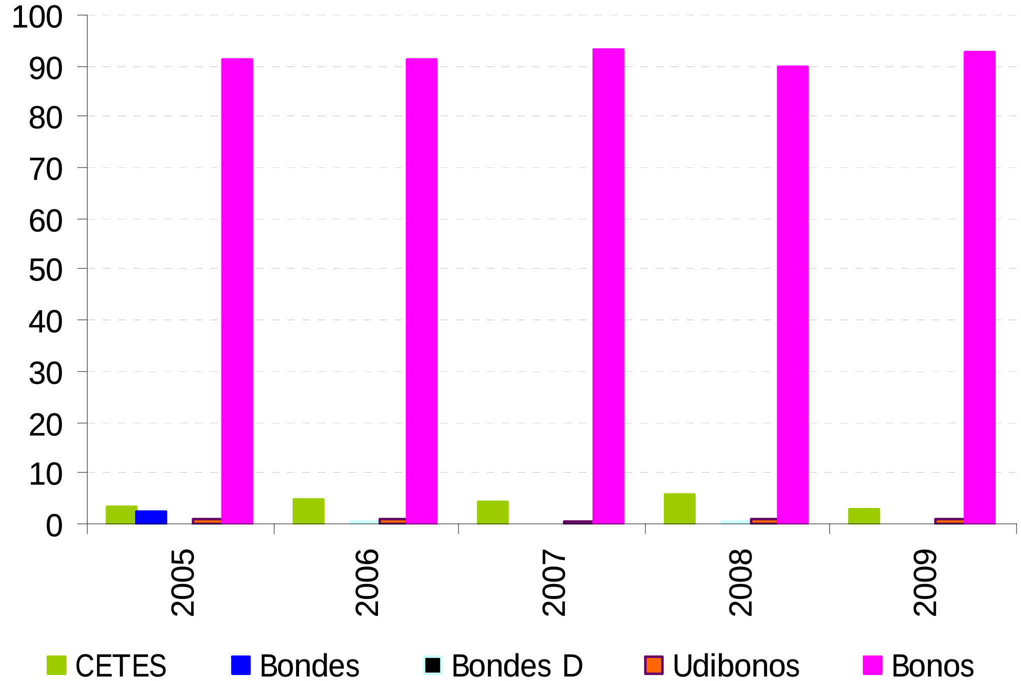


Source: Banxico and ERD BBVA Bancomer

Bond market

The high concentration of foreign holdings in bonds have been maintained through time.

Holdings of Public Debt by Foreigners (%)

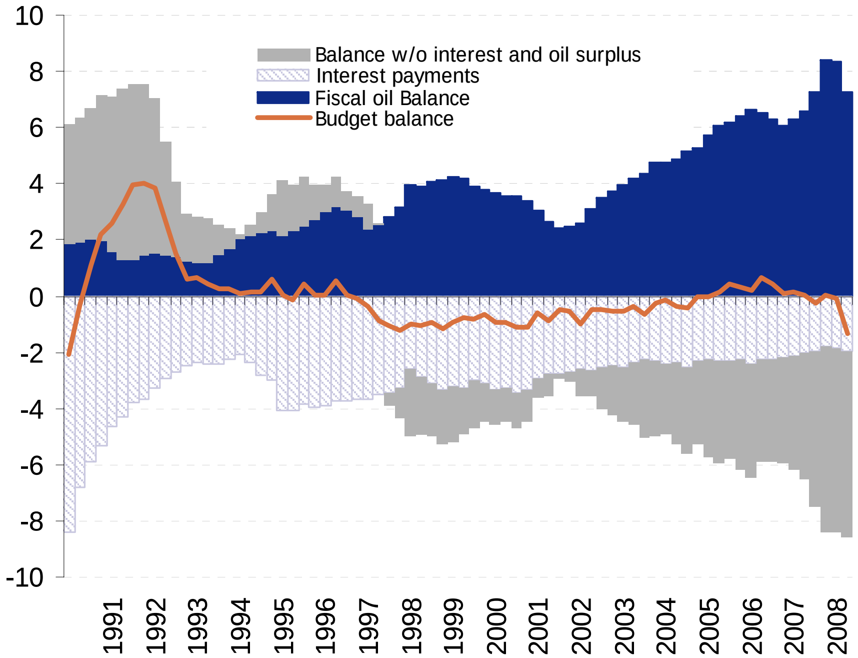


Source: Banxico & ERD BBVA Bancomer

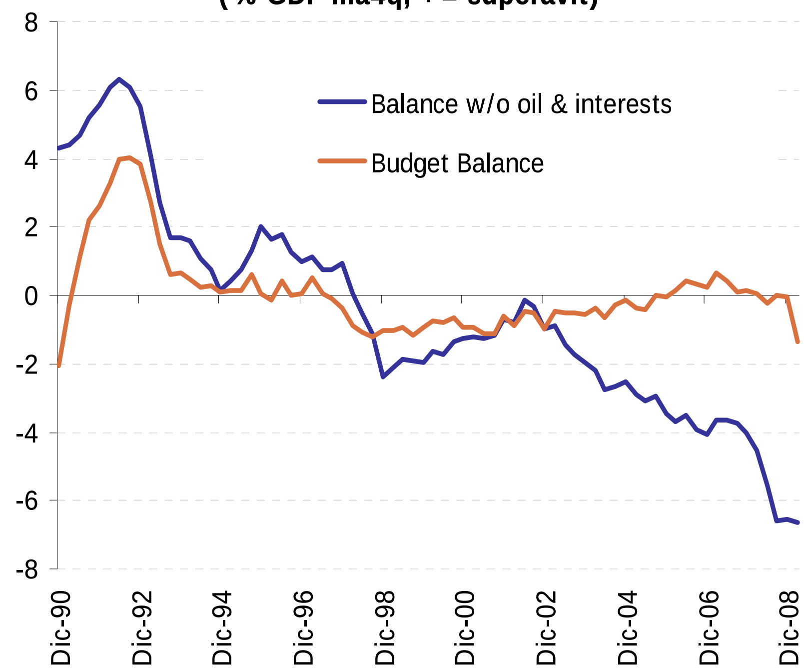
Public Budget

A prudent fiscal policy helped to sustain countercyclical measures for the first time ever. Notwithstanding, the budget balance is under risk

Mexico: Contribution to Budget Balance (% GDP, neg. = funding requeriments)



Mexico: Budget balance definitions (% GDP ma4q, += superavit)



Budget balance close to equilibrium supported by oil revenue and lower interest rates payments

… without interest payments and oil revenue the fiscal deficit could be close to 6% of GDP

Public Budget

Even in a stressful scenario for balancing the fiscal budget, the government has some breathing room to secure a fiscal reform

Mexico: Budget equilibrium for 2009 y 2010

(% GDP, primary deficit)

		Central Scenario			Stress Scenario		
		Fiscal deficit target	Negative drivers	Positive drivers	Fiscal deficit target	Negative drivers	Positive drivers
TOTAL 2008		**-1.8**			**-1.8**		
a	Lower oil export receipts		-1.3			-1.4	
b	Lower non-oil receipts (linked to activity)		-0.7			-0.9	
c	Oil options income			1.2			1.2
d	Oil stabilization fund (total balance)			1.3			1.3
e	Non-recurrent receipts			0.6			0.6
f	Fiscal loss after influenza		-0.2			-0.2	
g	Austerity measures (May 28th)			0.3			0.3
h	Stabilization funds savings		-1.2			-0.9	
TOTAL 2009		**-1.8**			**-1.8**		
i	Lower oil export receipts		-1.0			-1.2	
j	Lower non-oil receipts (linked to activity)		-0.5			-0.7	
k	Stabilization fund outlays (k=-h)			1.2			0.9
l	Austerity measures to reach fiscal target			0.3			1.0
TOTAL 2010		**-1.8**			**-1.8**		

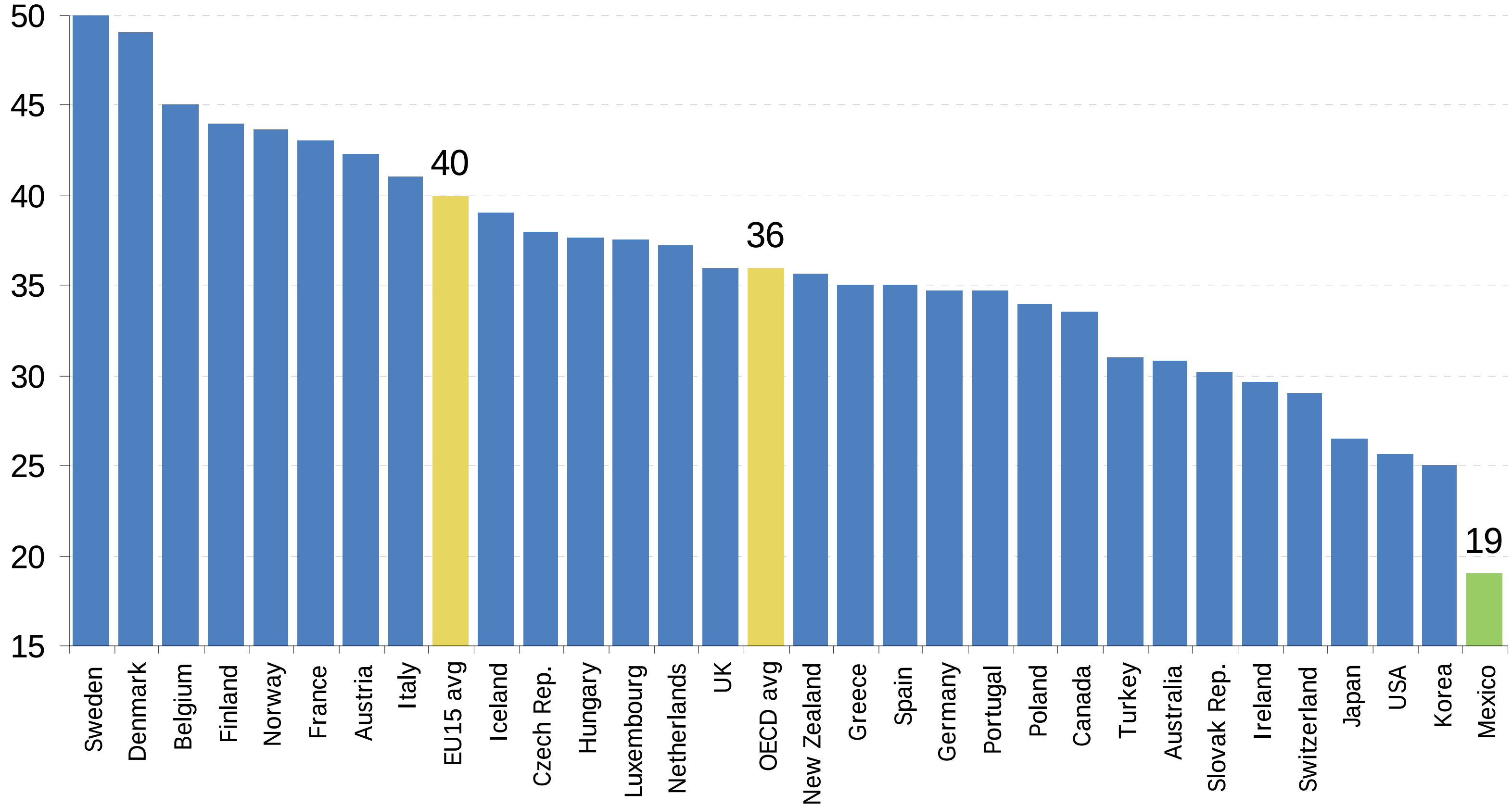
Notes: Stabilization Funds accounts 13% GDP (end of Masch 2009). Other dedicated funds (such as FARP) are 0.5% GDP

Source: BBVA with SHCP data

Public Budget

Poor tax collection in Mexico: almost half of the tax receipts in the European Union and OECD average

Overall tax collection (% GDP)



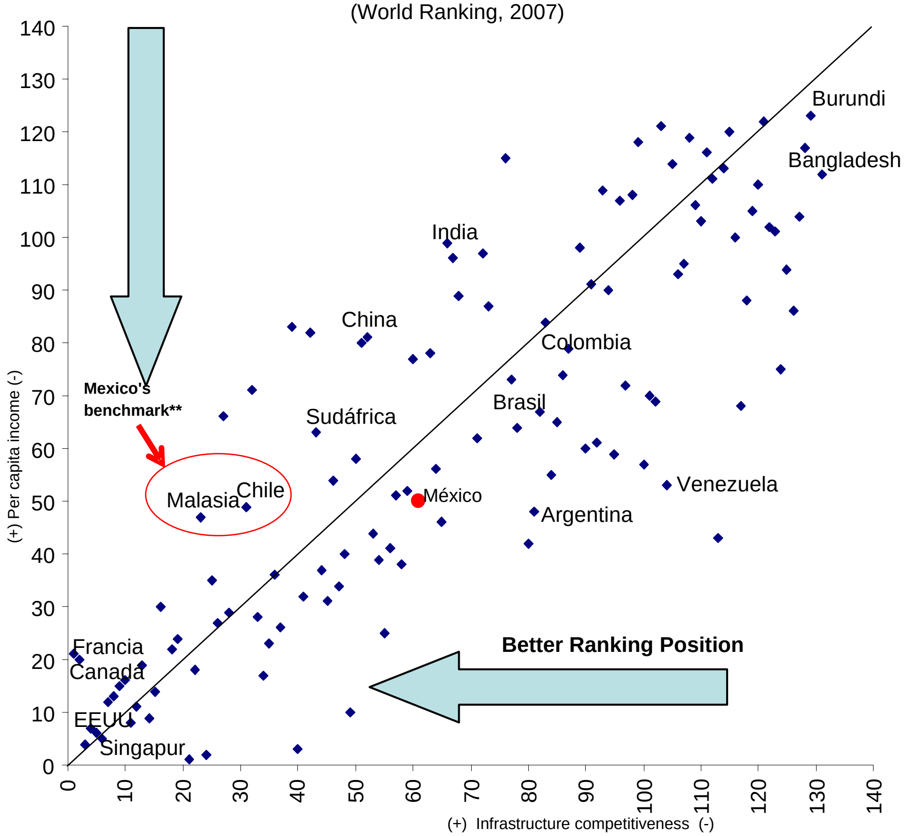
Source: BBVA Bancomer with data from the OECD Factbook 2007

Vulnerabilities

Public goods supply

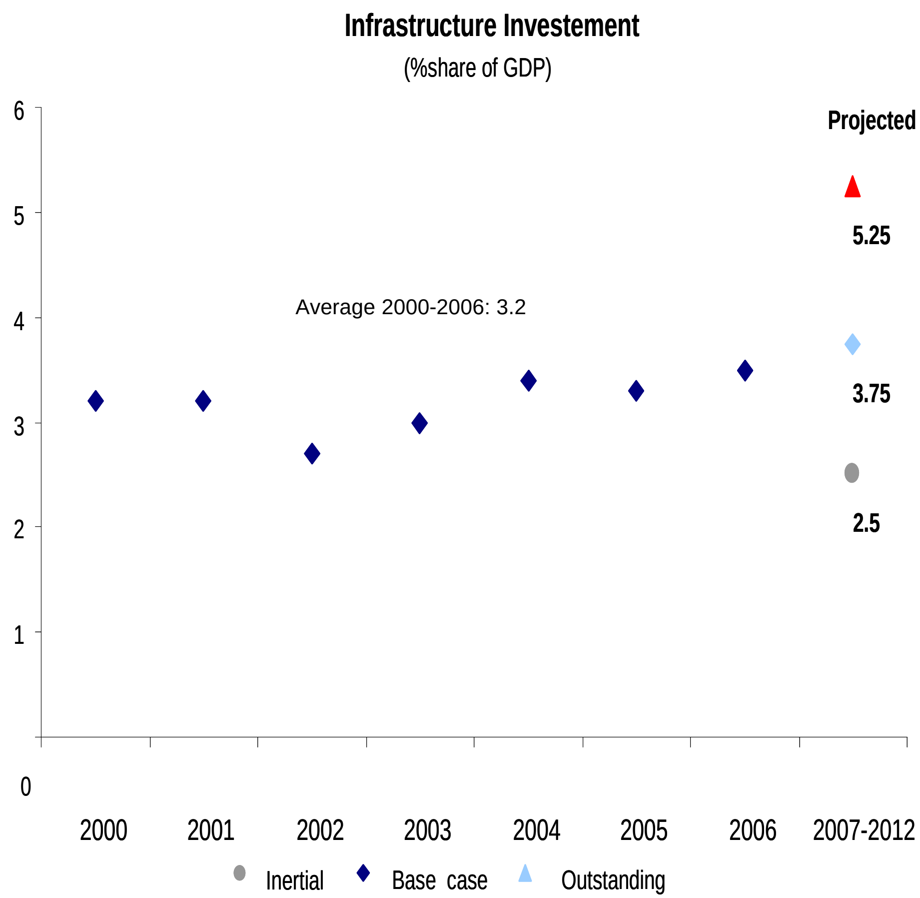
Deficient supply of public services due to outlays & receipts constraints

¿Where should Mexico stand in infrastructure competitiveness?
Per capita income vs. infrastructure competitiveness
(World Ranking, 2007)



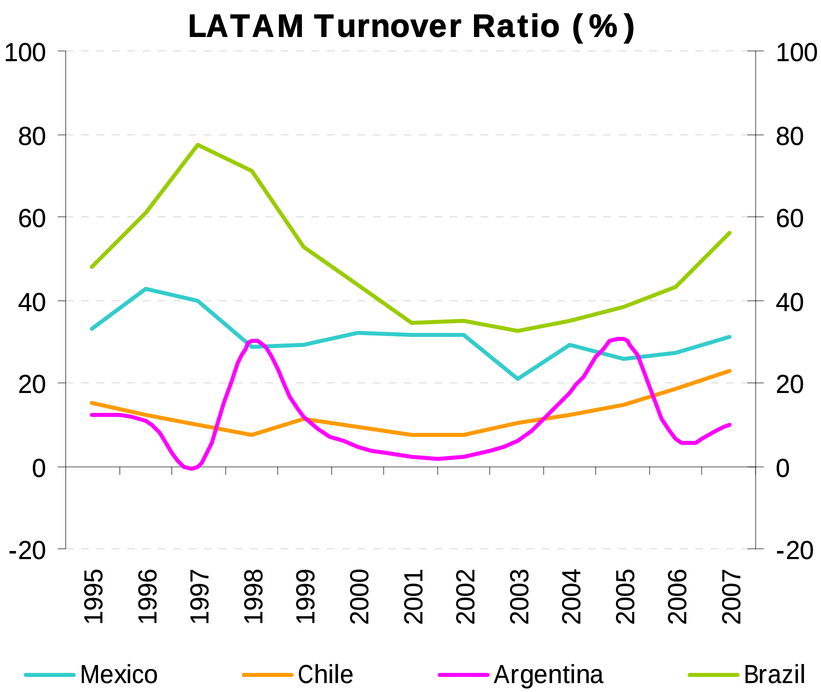
* Purchasing Power method
** Countries with similar per capita income and higher infreastructure competitiveness
Source: BBVA Bancomer with data from World Economic Forum and The World BanK

Target: moving from 60 to 30 in infrastructure competitiveness rankings meant increasing investment significantly

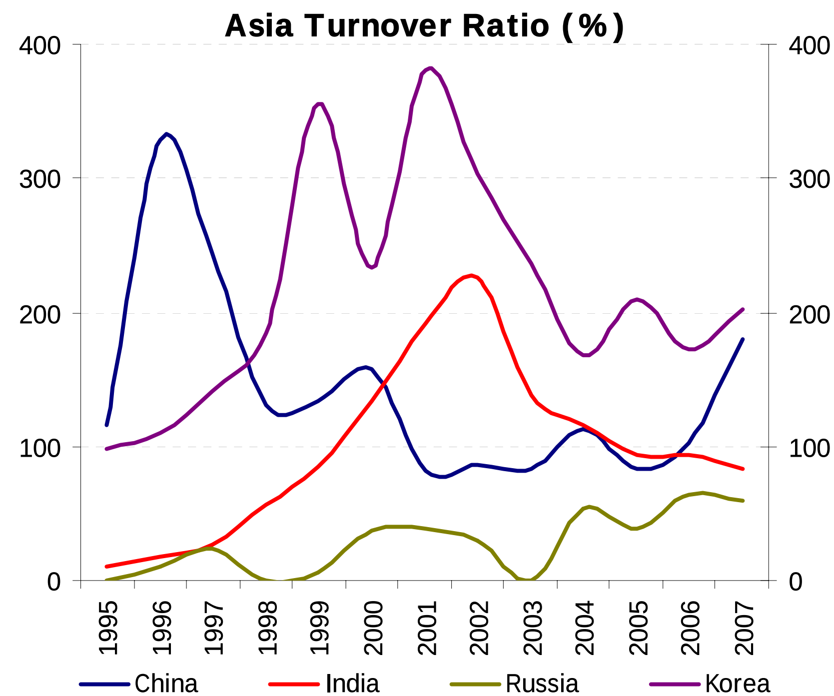


Stock Market

The turnover Ratio indicates that among the largest LATAM countries, Brazil has the most active and liquid stock market, followed by Mexico



Source: WDI

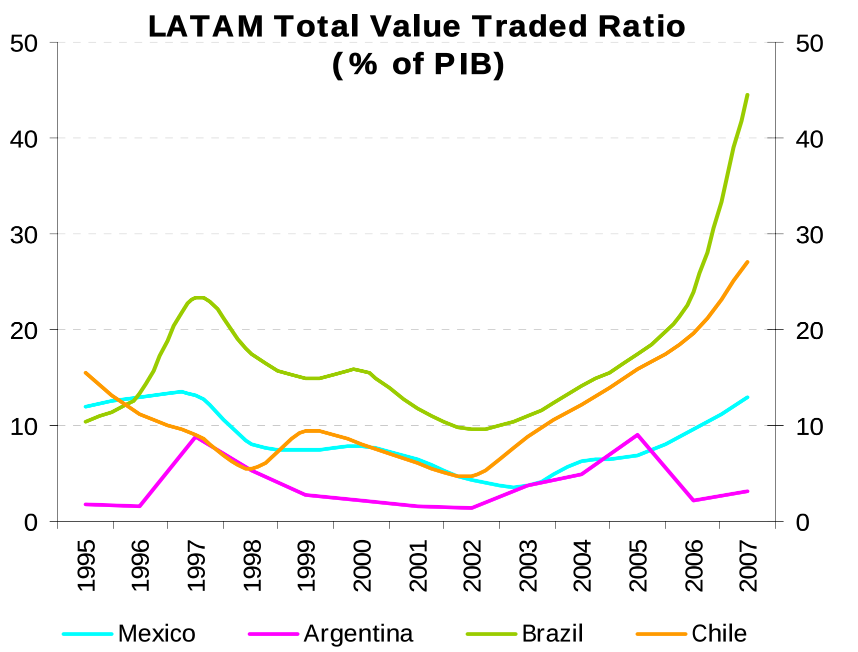


Source: WDI

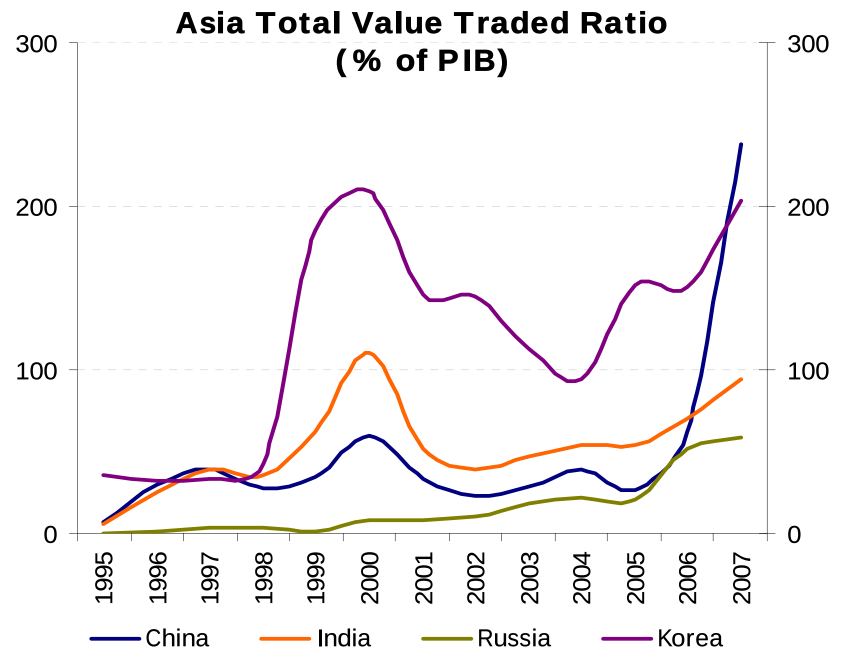
The extent of activity is almost twice in the former though, suggesting that Brazil seems to have a clear advantage over Mexico and the other LATAM stock markets.

Stock Market

Among LATAM, Brazil and Chile stock markets have grown the most in the last decade



Source: WDI



Source: WDI

In 2007, the stocks traded were about 44% and 27% of GDP, respectively, well above Mexico´s 13%. Still, LATAM stock market sizes are far below Asian ones, where the stocks traded that year in China and Korea were higher than 200% of GDP.

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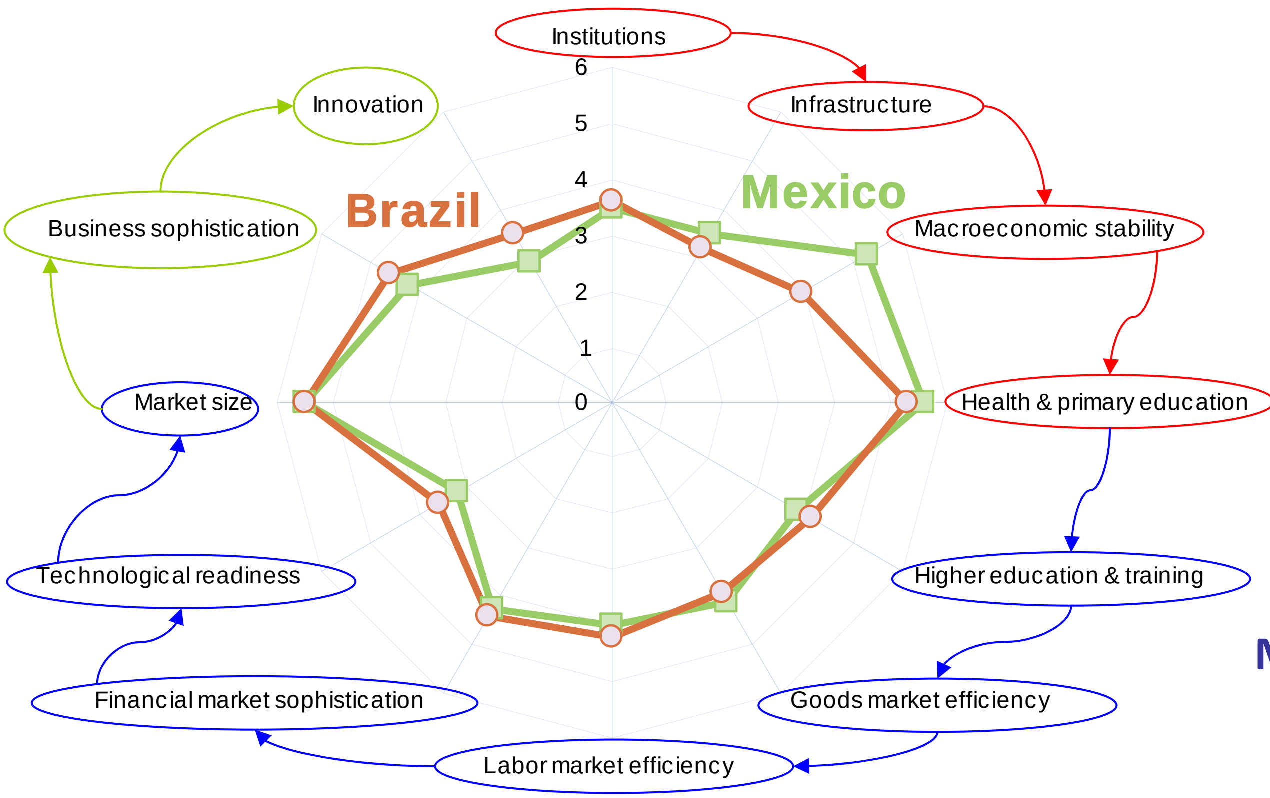
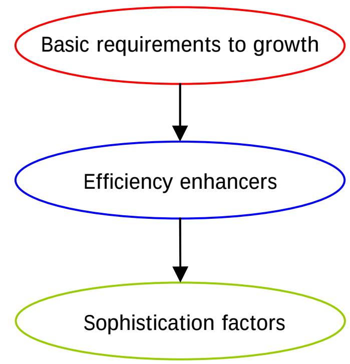
The challenge ahead: go forward with the economic reform process

Appendix

Brazil and Mexico are similar in terms of “pillars of competitiveness”. The WEF still considers macroeconomic stability an advantage for Mexico

Pillars of Global Competitiveness Index (scores)



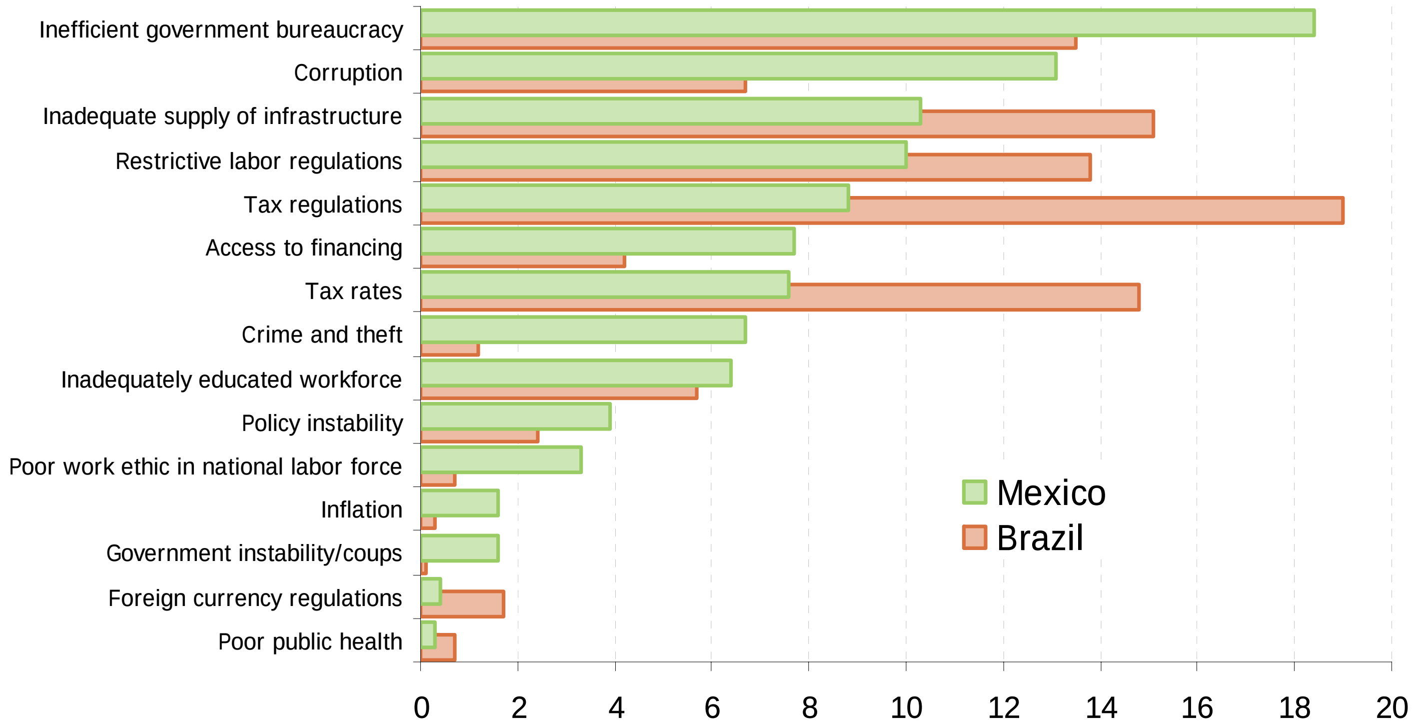


Source: Global Competitiveness Report, WEF (2008-2009)

Mexico has to enhance efficiency to jump to another stage of development: REFORM AGENDA

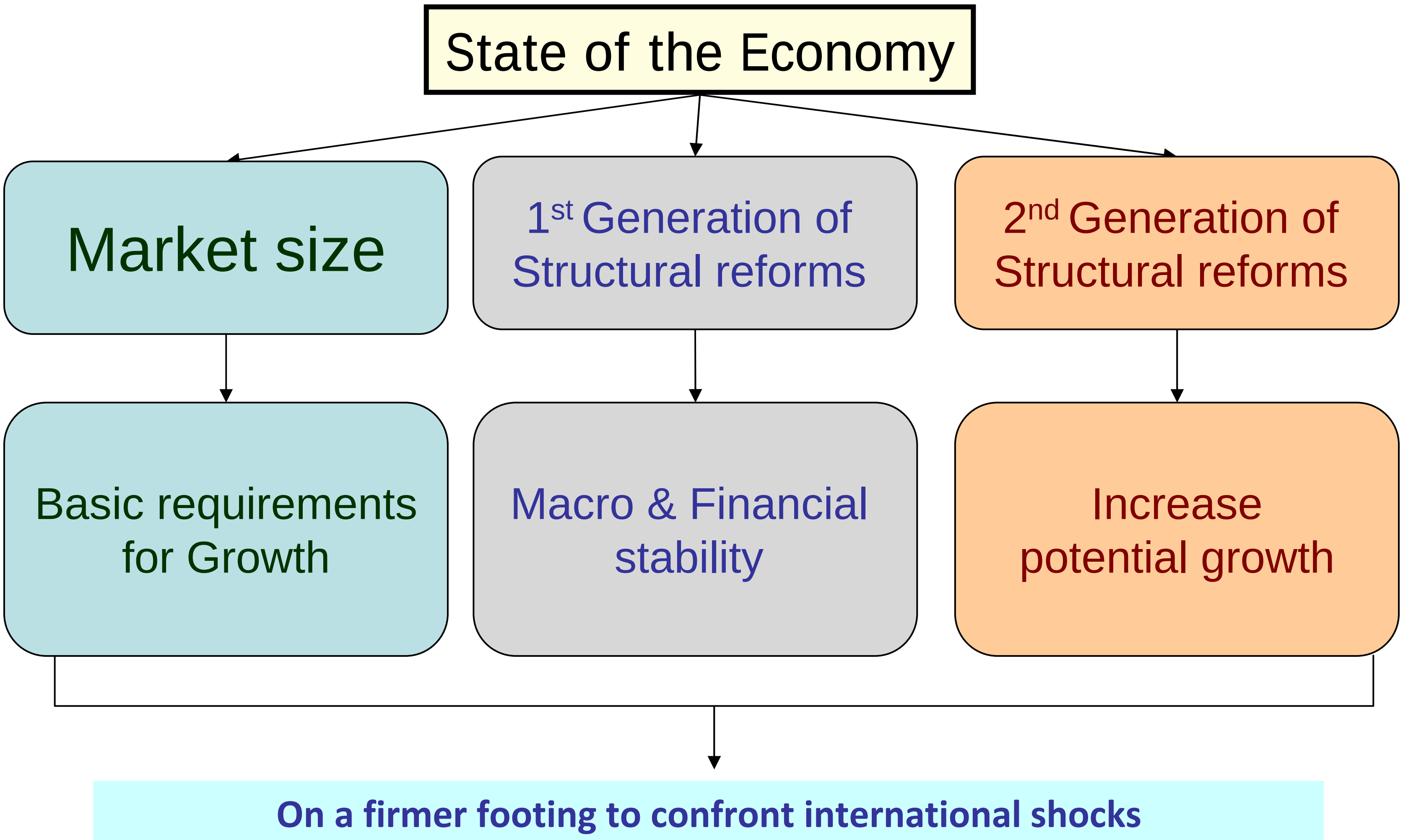
In LATAM, Brazil and Mexico have similarities in terms of "pillars of competitiveness"

"The most problematic factors for doing business" (WEF 2008-09)



"Doing business" in Mexico faces higher bureaucratic constraints than in Brazil; however, tax, labor and infrastructure issues are big concerns for businessman in this southern country

The Mexican economy is on track to increase its potential growth



Important advances in structural reforms: public workers pension reform, a partial fiscal reform, and a gradual opening of energy

Pending Economic Agenda

1. Efficiency in tax collection
2. Efficiency in public disbursements
3. Adequate energy supply
4. Increase human capital
5. Flexible labor markets
6. Law enforcement
7. Market competition and access to markets

	Base	Reforms
Productivity (TFP)	0.3	1.2
Potential Output	2.9	4.2

Fuente: FMI, Mexico, Staff Report 2004

Mexico is on track to higher potential growth in the near term

Potential GDP: Contributions

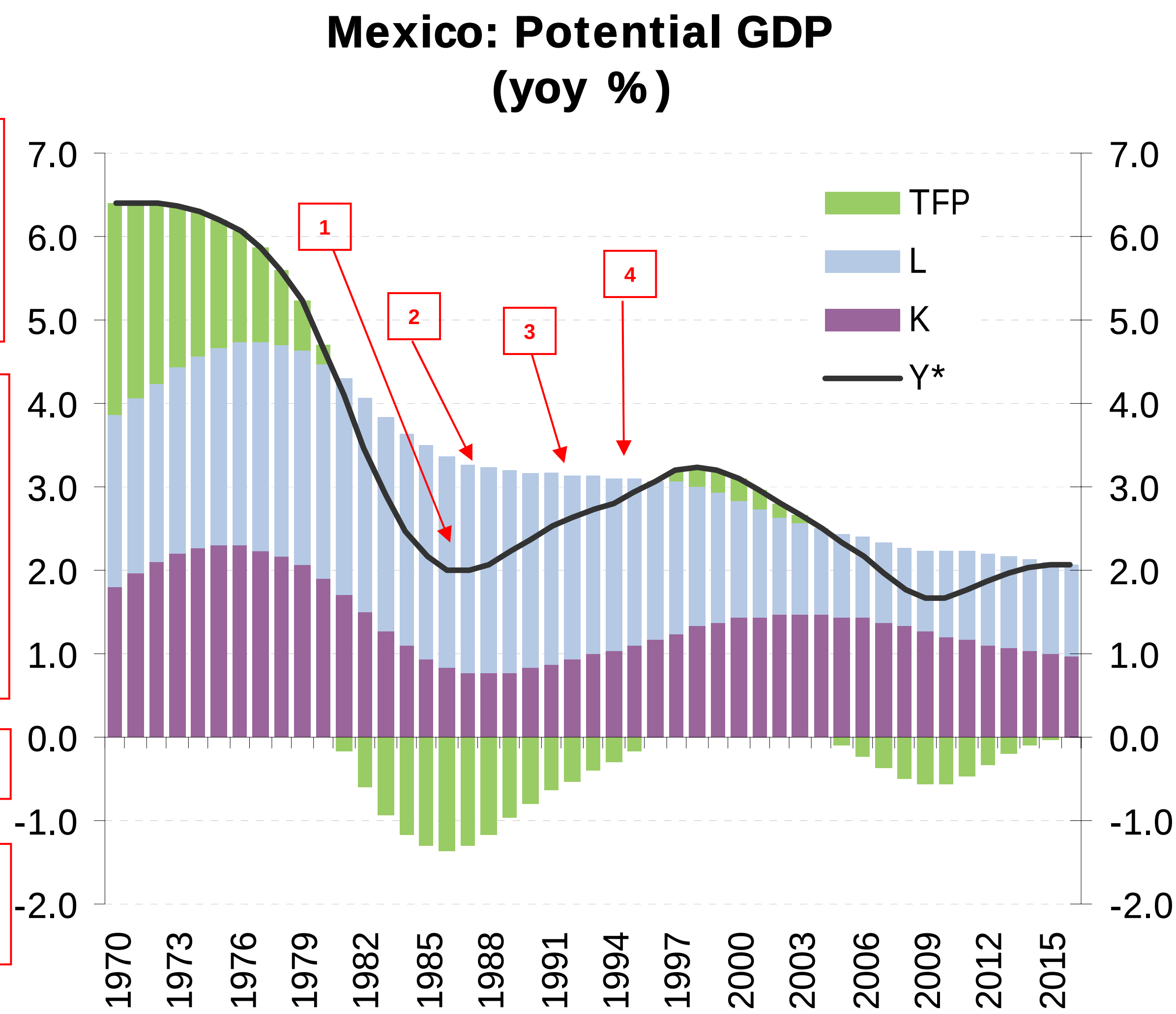
1 Unilateral tariff reduction (88)
Sectors deregulation (late 80s)

2 FDI promotion:
- FDI openness (91, 93)
- FX flexible regime (94)
- Bank privatization (91, 95, 98)

Antitrust Law (92)

3 NAFTA (94)

4 Private sector workers reform (97)



Political environment: Mexico has a busy electoral calendar this year

The entire lower house of the federal congress will be replaced, while six state governorships are also at stake

Elections in Mexico 2009

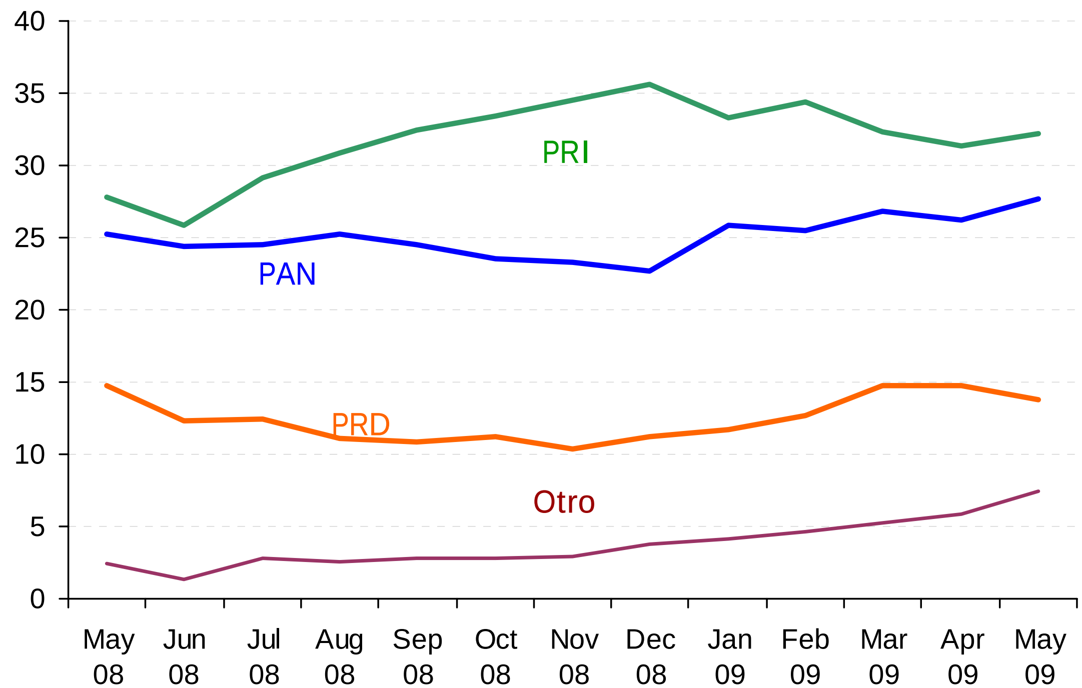
Date	Federal Congress	Governor	Mayor	Local Congress
Jul. 5	500	1 Camp.	125 State of Mexico.	75 State of Mexico.
		1 Col.	11 Camp.	35 Camp.
		1 N.L.	10 Col.	25 Col.
		1 Son.	16 D.F.	66 D.F.
		1 S.L.P.	46 Gto.	36 Gto.
		1 Qro.	125 Jal.	40 Jal.
			33 Mor.	30 Mor.
			51 N.L.	42 N.L.
			18 Qro.	25 Qro.
			58 S.L.P.	27 S.L.P.
			72 Son.	33 Son.
Sep. 27			38 Coah.	
Oct. 18			17 Tab.	35 Tab.
Total	**500**	**6**	**620**	**469**

Source: Federal Electoral Institute (IFE) and state electoral institutes

Political Environment: the opposition PRI has kept its lead in the latest poll

Since the start of formal campaigning at the beginning of May, the ruling PAN has been gradually closing the gap but still faces an uphill struggle to overtake the PRI

Voter Intentions for Lower House of Congress (Probable voters, %)



Source: Consulta Mitofsky

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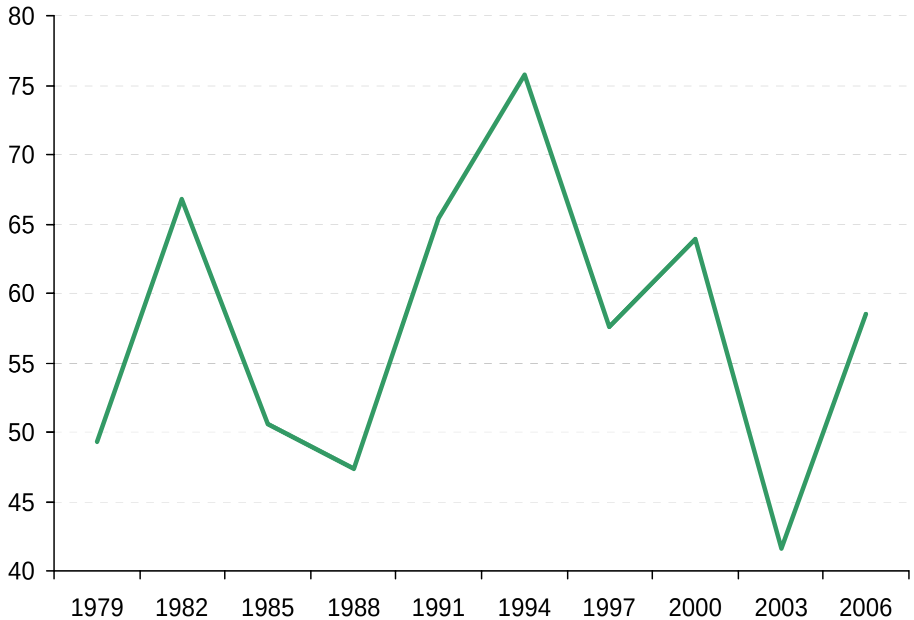
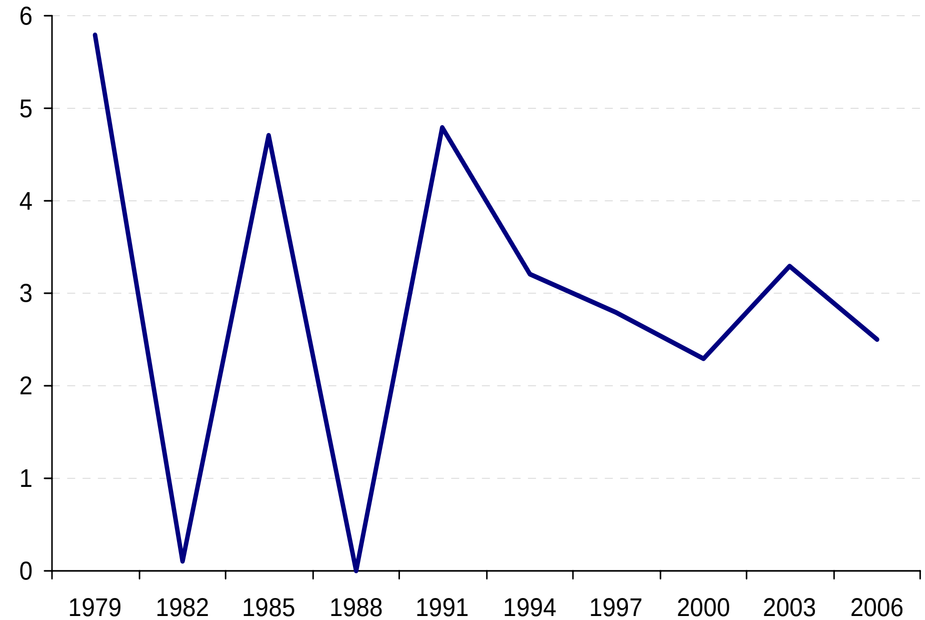
Political Environment: Low voter turnout has been frequent at mid term elections

The percentage of voters choosing to stay at home could reach record levels (between 65% and 69%); there is also a campaign on the Internet urging people to cast blank ballots as a form of protest against the established parties

Elections to Lower House
(Voter turn-out, %)



Elections to Lower House
(Null votes, %)



Source: CIDAC

BBVA

Political Environment: Approval of bills will remain dependent on inter-party agreements

The possibility that a specific party will secure an overall majority of 251 seats in the 500-member Chamber of Deputies looks remote

Likely shape of the Chamber of Deputies (2009-2012) (Estimate based on voter intentions in May survey)

	2003	2006	Minimum	Maximum
PRI	224	104	210	238
PAN	151	206	148	171
PRD	97	123	80	93
PVEM	17	19	9	14
PT	6	17	4	7
Convergencia	5	18	4	7
Panal	---	9	4	7
PSD	---	4	0	0
Total	**500**	**500**		

Source: Consulta Mitofsky

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Political Environment: Conclusions

* Neither the PRI nor the PAN are in a strong enough position to secure an overall majority in the 500-seat lower house

→ The ruling PAN will remain dependent on the opposition PRI for approval of key items of legislation in the next three years

* Fiscal reform can be approved by a simple majority, but meaningful energy or labour reform will require a two-thirds majority in both houses

→ Full-blown structural reform will be hard to negotiate; however, the recession provides an opportunity for more drastic action

* Growing disenchantment with the political system will be reflected in low turnout at the polls; up to 10% of voters could also cast blank ballots

→ Soaring crime, recession, job losses and the lingering effects of the health emergency will discourage many from voting

* Low voter turn-out is expected to benefit the better organized political parties, particularly the PRI, whose "core" voters will flock to the polls

→ The PAN was boosted by the government's handling of the flu epidemic; divisions in the PRD have hurt its standing with voters

* Incoming legislators will be under strong pressure to deliver and need to urgently address the voter's lack of trust in their elected representatives

→ A new electoral reform will be a necessary first step in restoring confidence in the political system

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The challenge ahead: go forward with the economic reform process

Appendix

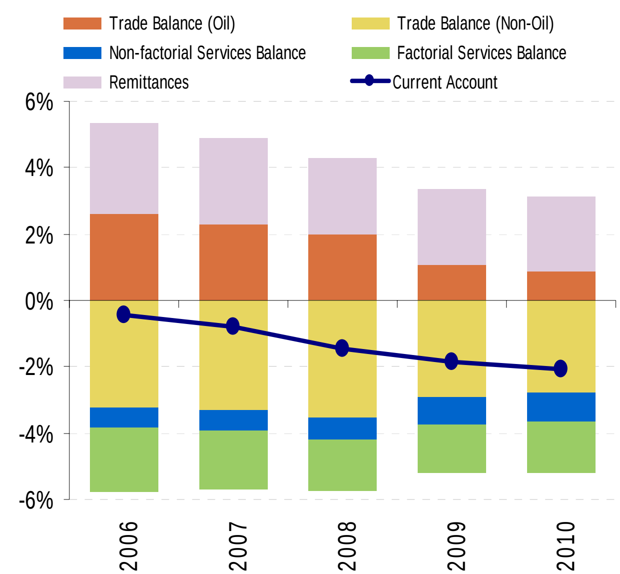
Current Account Outlook

Mexico: Current Account

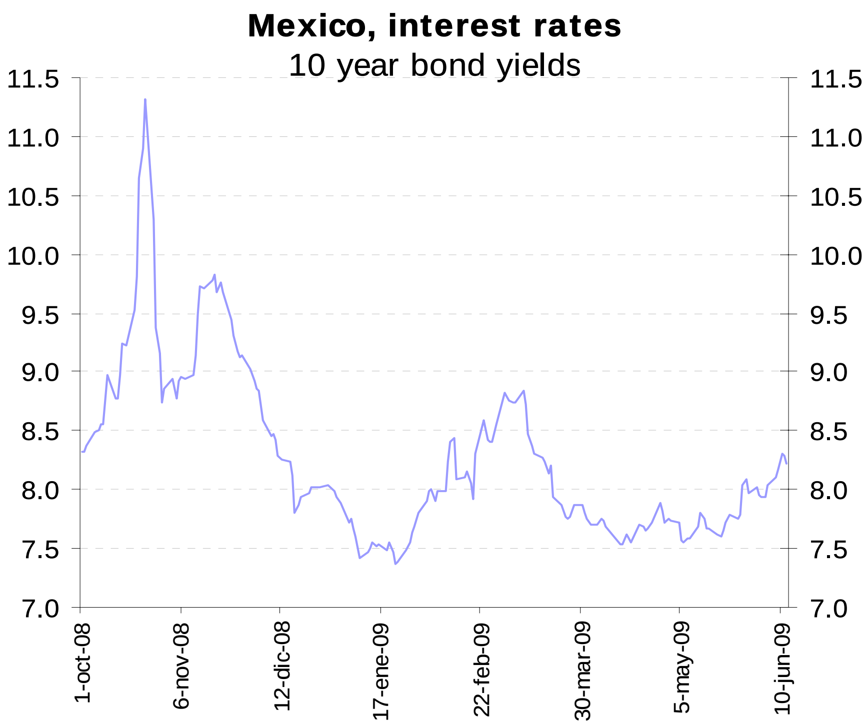
	1Q-08	2Q-08	3Q-08	4Q-08	2008	1Q-09	2Q-09	3Q-09	4Q-09	2009	2010
billion dollars											
Current Account	**-2.6**	**-2.1**	**-4.5**	**-6.6**	**-15.7**	**-1.1**	**-6.1**	**-5.7**	**-3.5**	**-16.3**	**-19.8**
Trade Balance	-1.6	-0.9	-6.4	-8.3	-17.3	-1.9	-0.3	-8.8	-5.3	-16.2	-18.5
Non-factorial Services Balance	-0.8	-1.9	-2.4	-1.9	-7.1	-0.7	-2.4	-1.7	-2.9	-7.7	-8.6
Factorial Services Balance	-6.0	-6.2	-2.1	-2.5	-16.8	-4.0	-4.5	-1.2	-3.0	-12.7	-14.8
Remittances	5.9	6.9	6.5	6.2	25.5	5.5	1.0	6.1	7.8	20.4	22.0
% GDP											
Current Account	**-0.9%**	**-0.8%**	**-1.6%**	**-2.4%**	**-1.4%**	**-0.5%**	**-2.8%**	**-2.6%**	**-1.6%**	**-1.9%**	**-2.1%**
Trade Balance	-0.6%	-0.3%	-2.4%	-3.1%	-1.6%	-0.9%	-0.1%	-4.0%	-2.4%	-1.9%	-1.9%
Non-factorial Services Balance	-0.3%	-0.7%	-0.9%	-0.7%	-0.6%	-0.3%	-1.1%	-0.8%	-1.3%	-0.9%	-0.9%
Factorial Services Balance	-2.2%	-2.3%	-0.8%	-0.9%	-1.5%	-1.8%	-2.1%	-0.6%	-1.4%	-1.5%	-1.5%
Remittances	2.1%	2.5%	2.4%	2.3%	2.3%	2.5%	0.5%	2.8%	3.6%	2.3%	2.3%

Surce: BBVA forecast

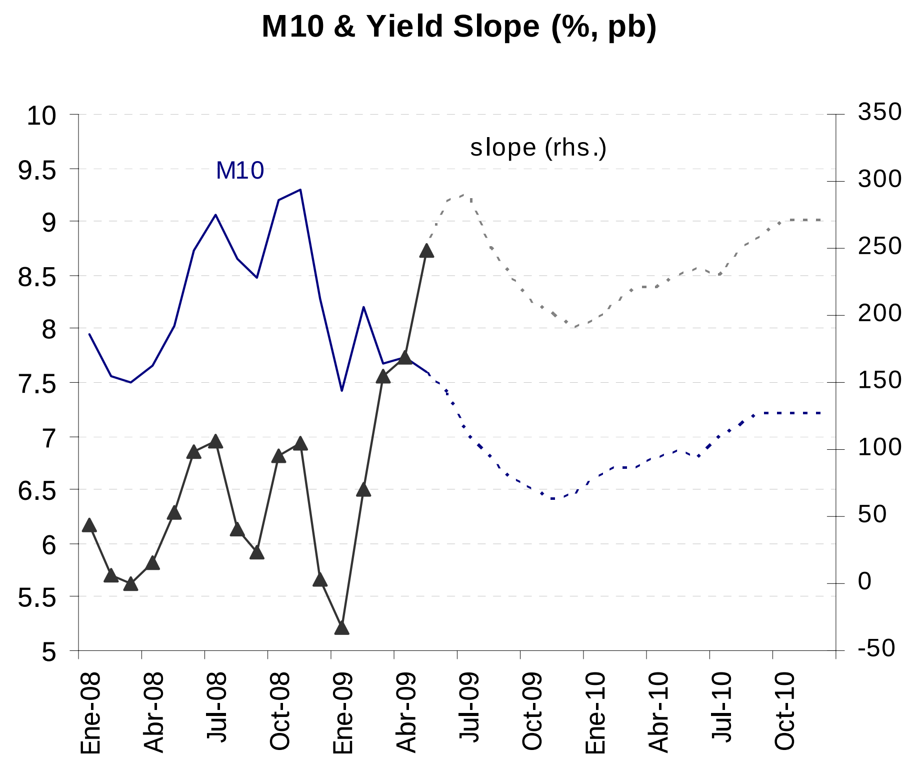
Mexico: Current Account (% GDP)



The increase in Long term Interest rates in Mexico will be short lived



Source: BBVA ERD



Since last ALCO, long-term interest rates have increased in Mexico

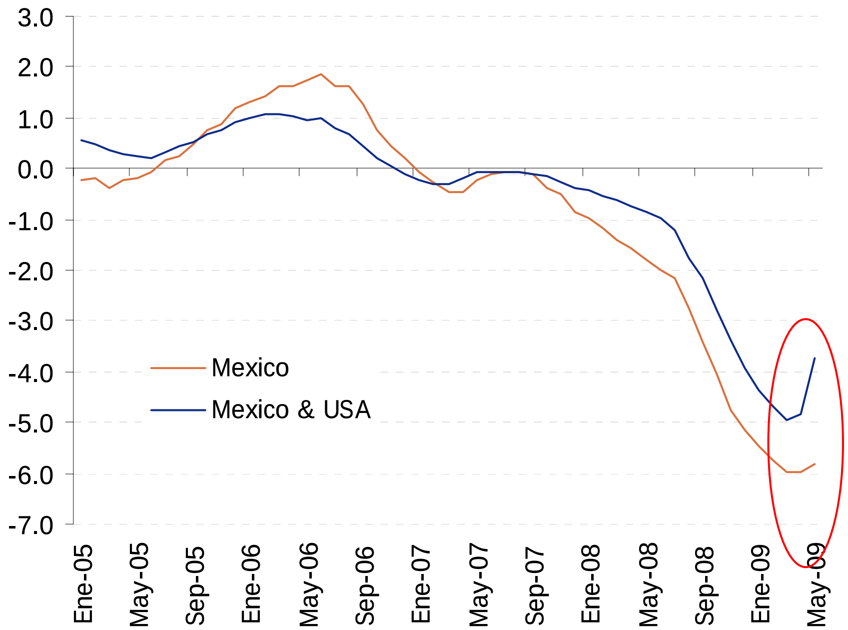
But this increase will be temporary, it is related to slope deepening that will be corrected sooner

Appendix

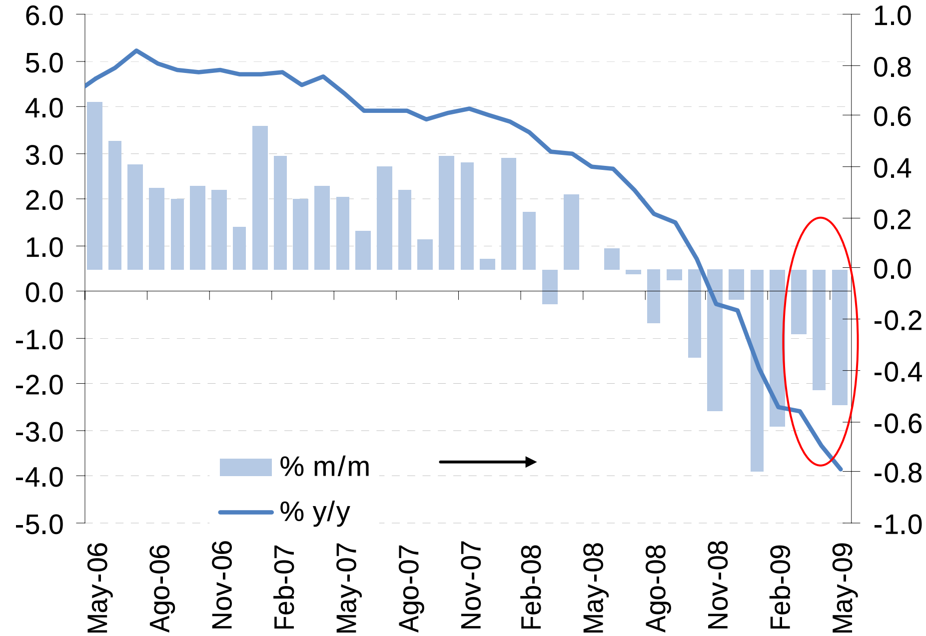
Cyclical prospects

Mexico is in a period of deep recession as a consequence of its big exposure to US. First signals of deterioration easing have been halted by the impact of influenza

Mexico: Leading Activity Index (Standarized yoy%)

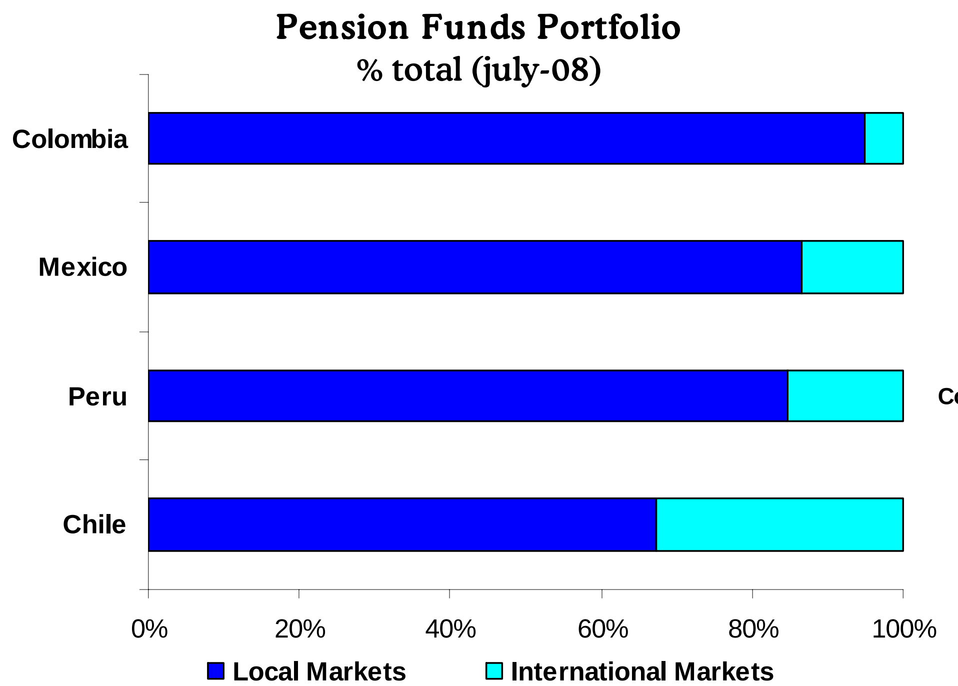


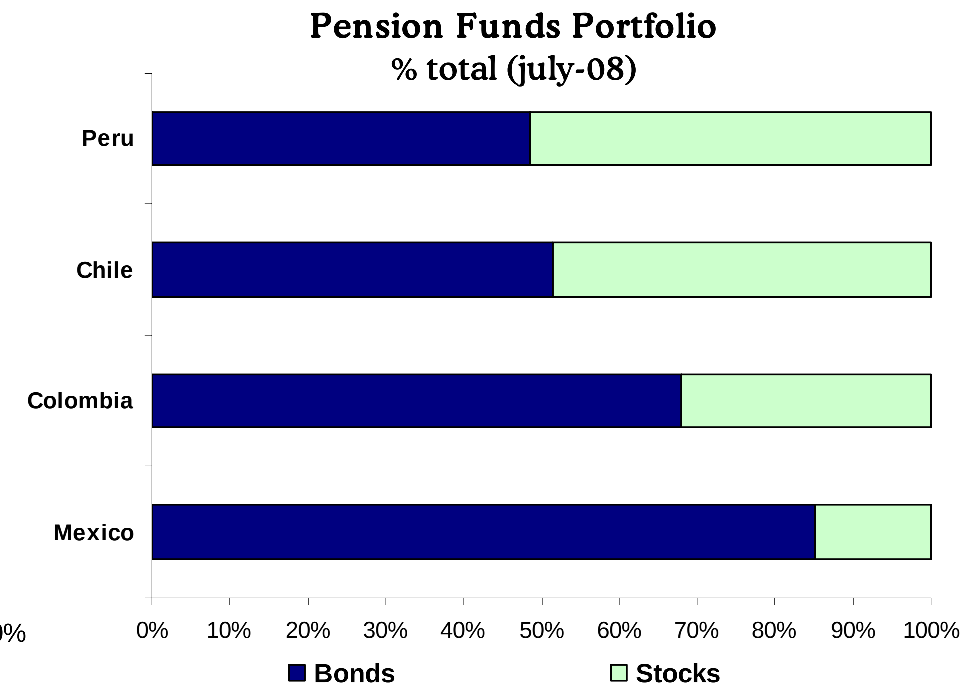
Formal Private Sector Employment (% y/y and m/m, SA)



Source: BBVA and IMSS

Pension funds management

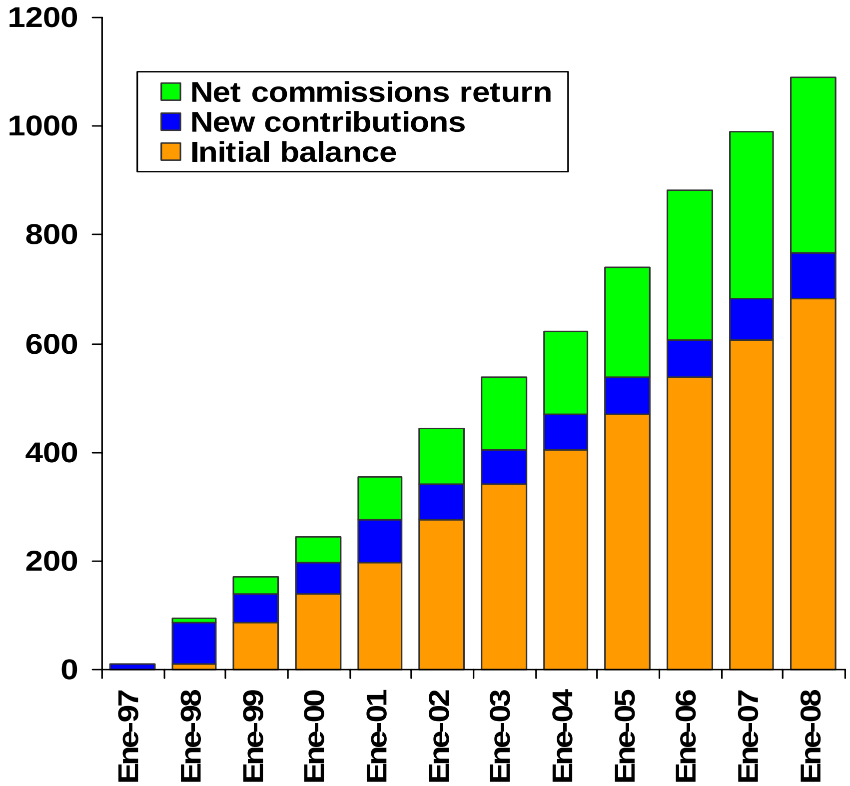




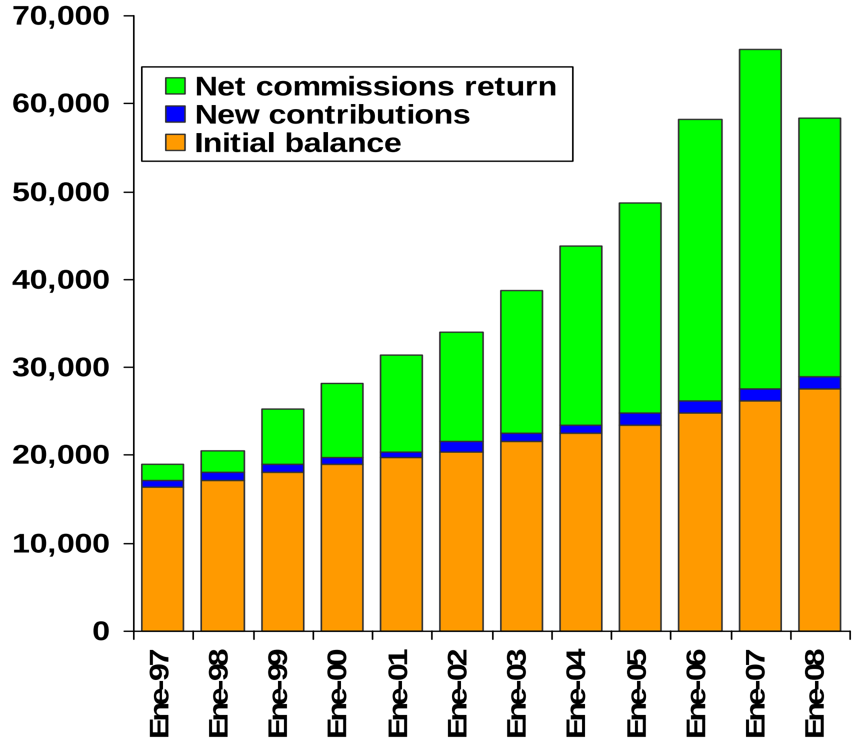
Pension funds in Mexico tend to keep a higher exposure to local assets as well as higher involvement in bonds

Pension funds management

Mexico: Afores AUM
(Balance in billions of local crcy, dec-07, eop)



Chile: AFP AUM
(Balance in billions of local crcy, dec-07, eop)



* Mexican Afores includes for 2008 Funds from public workers (ISSSTE)

Assets under Management (AUM) in Mexico reflects a similar performance to other countries systems.

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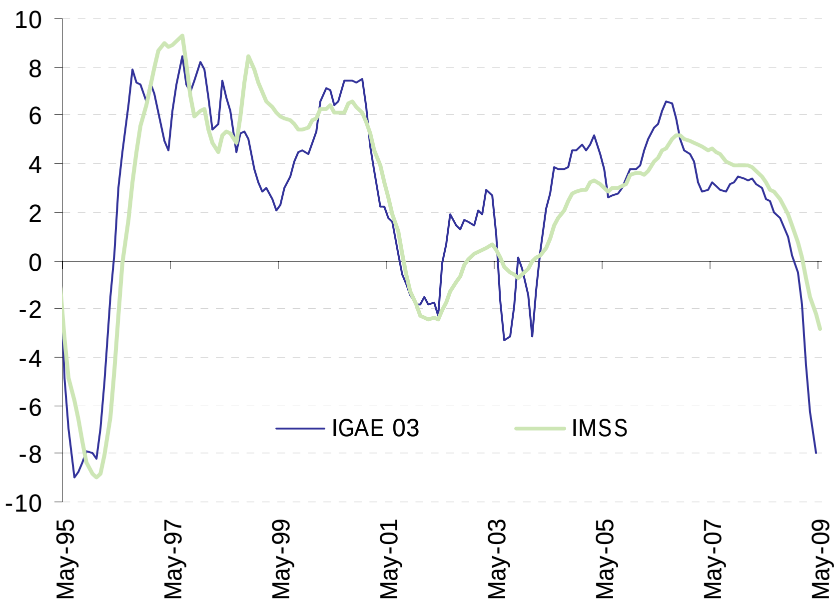
Appendix

The employment adjustment will be intense but different from previous falls in this activity

IGAE & Formal Private Employment (yoy %)



Employment Evolution

Formal employment, net creation May09

	Level	yoy%	
	Millions	Thousands	yoy%
Total	13,849.8	-484.9	-3.4
Agriculture	348.6	-5.3	-1.5
Industry	4,857.4	-526.1	-9.8
Minning	96.7	4.6	4.9
Manufactures	3,486.9	-423.1	-10.8
Construction	1,101.3	-114.3	-9.4
Electric	172.5	6.8	4.1
Services	8,643.8	46.5	0.5
Commerce	2,831.3	-3.7	-0.1
Transports	748.2	-21.1	-2.7
Personal	3,319.1	13.9	0.4
Social S.	1,745.2	57.3	3.4

Source: BBVA with IMSS data

The employment adjustment in this cycle is less intense than on activity, affected mostly by capital intensive activities

Manufacturing and construction are the sectors with major negative impacts

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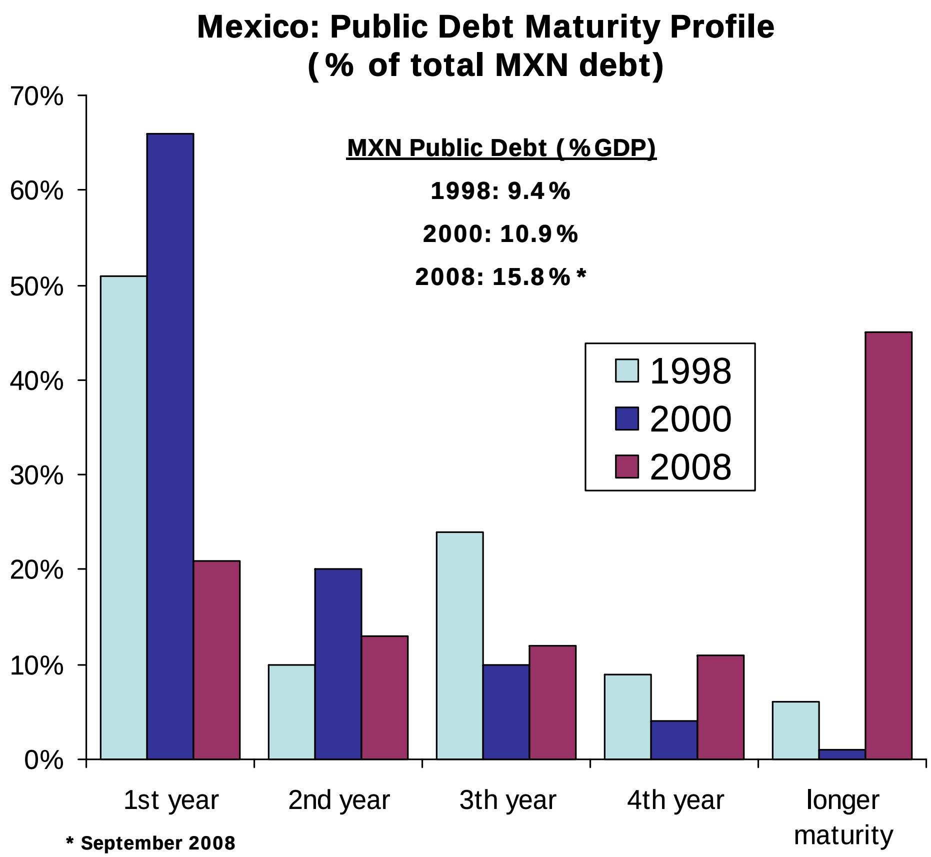
Appendix

Public sector borrowing requirements: Mexico has radically changed the picture of its public finance



* September 2008

Fiscal discipline: Lower financial requirements in Mexico to face short term debt in pesos

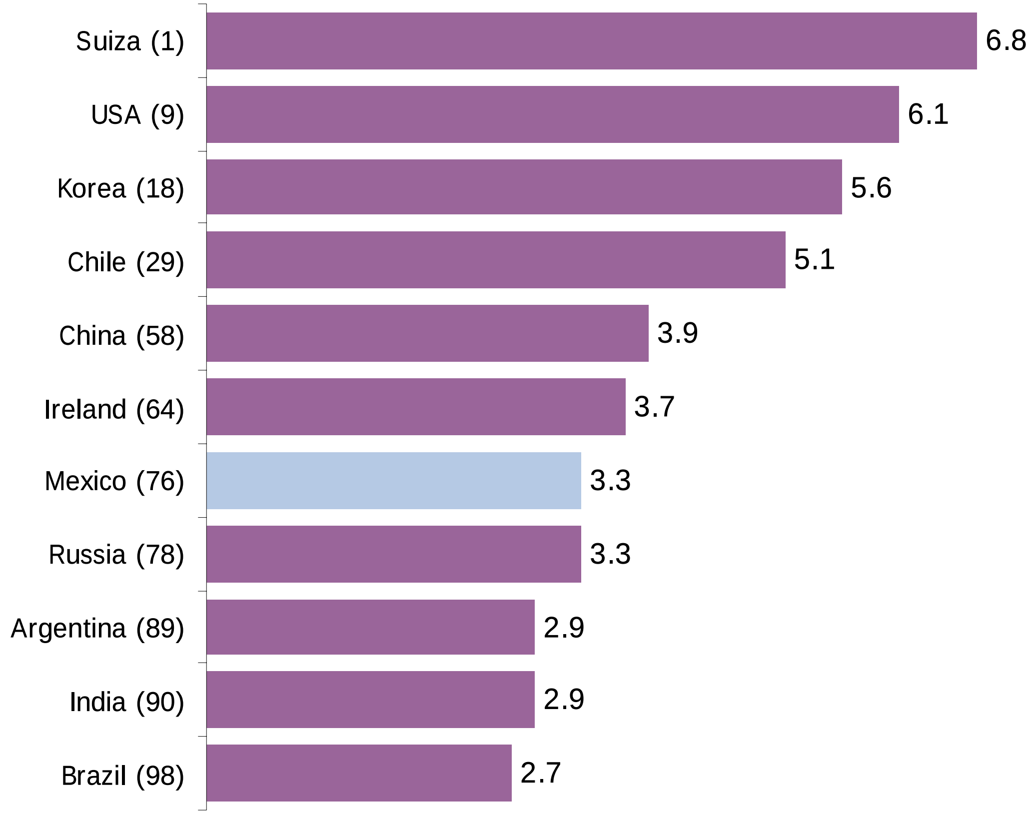
Government has established a pattern of prudent management of fiscal and debt policy over the past 10 years

Foreign currency debt has a convenient time structure with lower short term requirements

Public services

Deficient supply of public services due to outlays & receipts constraints

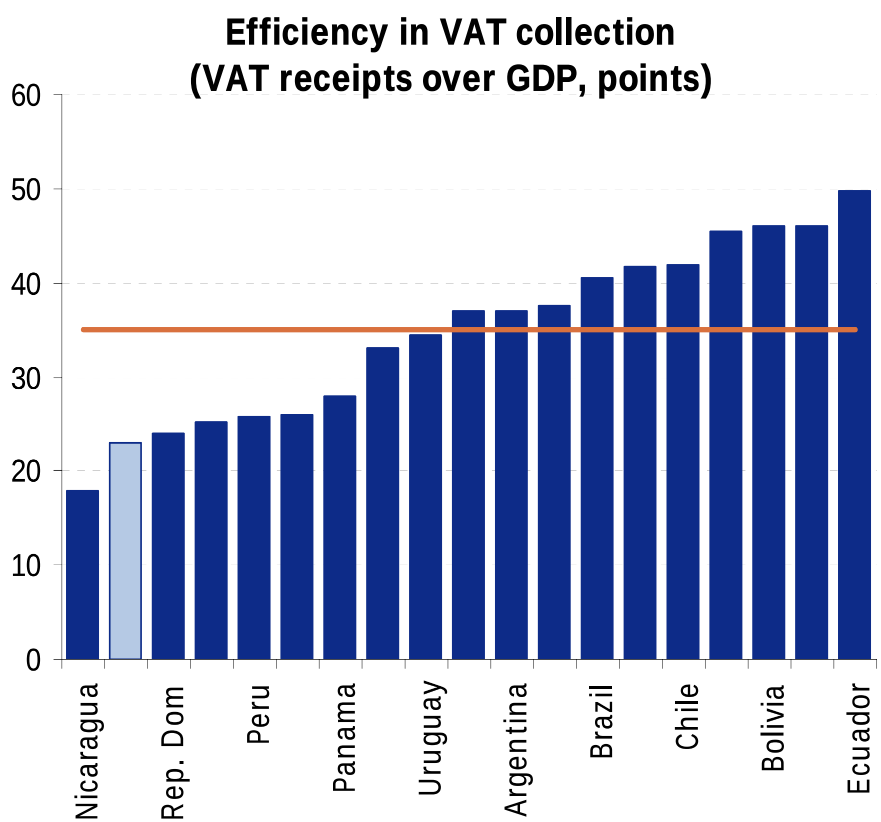
Quality of overall infrastructure
(1=underdeveloped; 7=extensive & efficient)



Source: The Global Competitiveness Report, 2008-09. WEF

Mexico is ranked 76th. out of 134 countries in relation to quality of infrastructure

The efficiency of tax collection in Mexico is low due to a complex VAT system and multiple tax rates

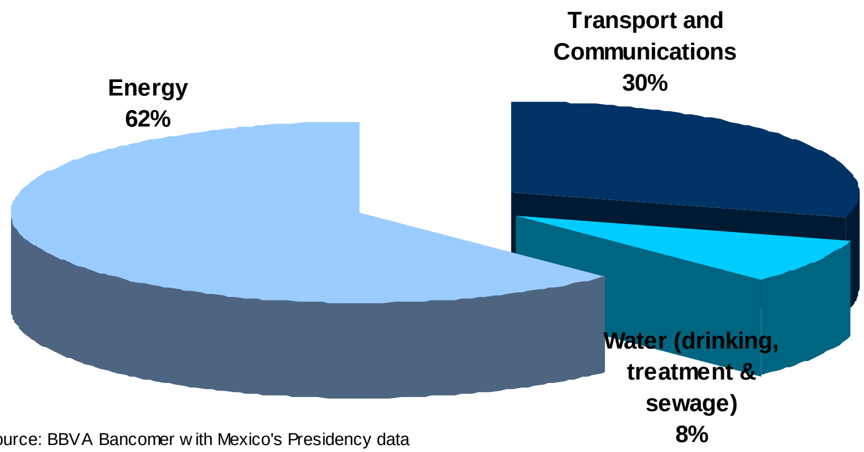


- **Mexico has four VAT rates according to activity and/or region: acreditable 0% rate, 15% general rate; 10% rate for border sales; and non-acreditable 0% rate.**
- **The VAT system is regressive: 10% of population with lower income receive only 4.5% of the implicit VAT subsidy; meanwhile 10% with more income get 21%**
- **Almost 40% of national consumption does not pay VAT**
- **The VAT tax collection efficiency in OECD is between 50 and 65%**

Investment requirements totaled Ps 2.5 trillion (over US 200 bn)

National Infrastructure Program 2007-2012

Total: $2.5 Trillion pesos



Source: BBVA Bancomer with Mexico's Presidency data

National Infrastructure Program: Where will the money come from?

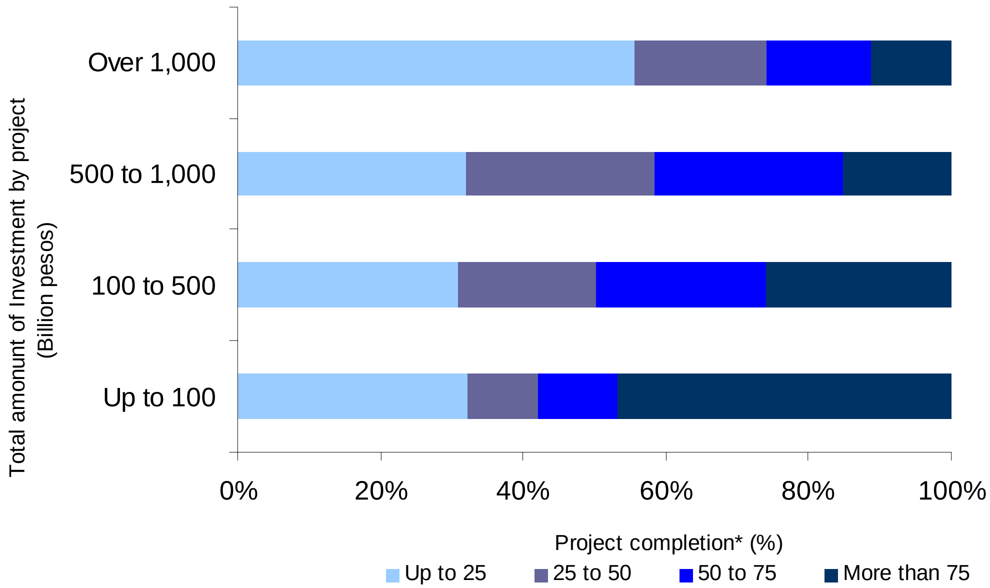
	Total investment (Billion pesos)	Private investment (% share in total)
Total	**2,522**	**21.6**
Non-energy activities	941	57.8
Roads	287	44.6
Telecomms	283	93.3
Ports	71	77.5
Airports	59	45.8
Railroads	49	44.9
Water (drinking, treatment, & sewage)	192	25.0
Energy	1,581	---
Oil extraction	822	---
Electricity	380	---
Oil refining, natural gas & petrochemicals	379	---

Source: BBVA Bancomer with Mexico's Presidency data

In non-energy sectors, private sources are expected to finance nearly 60% of required investment

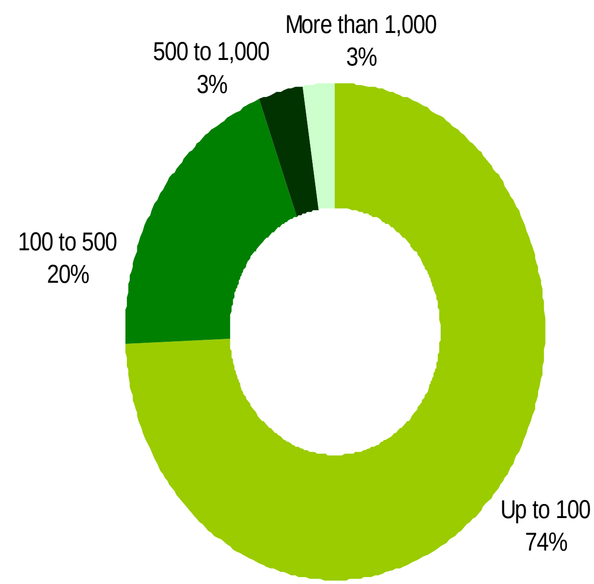
Completing projects hasn't exactly been easy however

Infrastructure Investment with Federal Goverment Support: Non-oil activities



* As of December 2008
Source: BBVA Bancomer with data from the Ministry of Finance

How big are the infrastructure projects in non-oil activities?
(Billion pesos and share of total projects)

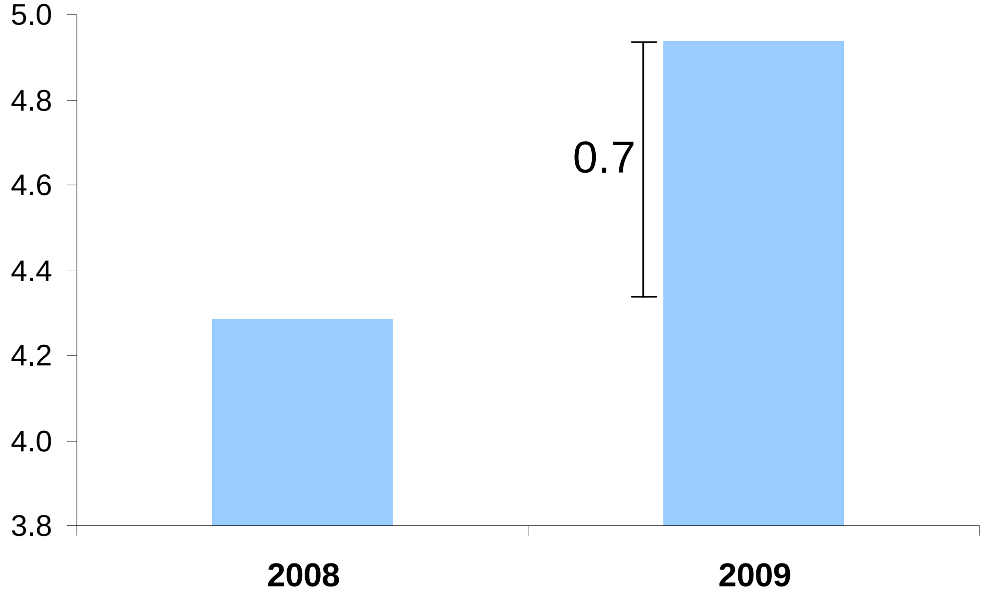


Source. BBVA Bancomer with data from the Ministry of Finance

Despite the obstacles (inexperience, legal framework, global recession) a close look allows for some optimism, specially in non-oil activities and small projects

In 2009 infrastructure investment will partially offset recession

Government Relies on Infrastructure Investment to counter the effects of the economic downturn
(Infrastructure investment as a % share of GDP)



Source: BBVA Bancomer with data from the Ministry of Finance

Infrastructure investment will partially offset emploment losses in 2009
(Total workers)

	Thousands
Total	**111**
Services	39
Manufacturing	27
Commerce, hotels & restaurants	15
Construction	14
Communications & transport	8
Agriculture	4
Mining	3
Utilities	2

Source: BBVA Bancomer with data from INEGI

Reaching nearly 5% of GDP, infrastructure investment might restore over 100 thousand jobs otherwise lost due to the recession

After a difficult start, things finally start looking better

- Between oil and non-oil activities, investment projects among the latter have done much better
- Although the global financial crisis has reduced private investors interest, government financed projects in roads, electricity and water are running in line with expectations
- More than 50% of the projects in non-oil activities are rather small and it is feasible that they will be completed in their original terms
- Recent legal reforms approved by Congress will effectively remove several regulatory obstacles and accelerate the process of preparing and executing the projects
- Global financial stability will be a key issue in undertaking the more ambitious projects, like Punta Colonet’s port, Riviera Maya’s Airport, several toll roads, among others
- Yet several challenges still remain along the road, like the lack of experience in infrastructure projects, increased fiscal deficits, and limited political support for more aggressive reforms in the energy sector, where more than 60% of the total investment plan is allocated

- Mexico is facing a perfect storm that is driving its economy into a recession comparable to the 1995 adjustment. However, this is a global crisis whose origin is external but which finds the Mexican economy in a stronger position
- The US economic slump explains the current Mexican economic plunge, but an early and more intense recovery will contribute to the expected Mexican upturn
- Mexico has implemented critical reforms whose benefits are contributing to diminish the impact of the crisis: a flexible exchange rate system, a credible central bank as an inflation fighter, a prudent management of fiscal policy over the past 10 years
- The banking system is a source of stability rather than a worry, with high capital ratios, good coverage of non-performing loans, and thus a willingness to continue meeting credit demand
- The crisis makes evident that the room for maneuver of economic policy has reached its limits. Mexico needs to go forward with the economic reform process, urgently on the fiscal policy side, in order to increase its long term growth capability

Mexico: Outlook, Challenges and Opportunities Down the Road

Jorge Sicilia
Chief Economist US & Mexico
BBVA

June 2009

Additional resources from International Organisations to support Mexico´s efforts to fight Swine Flu Virus

- On April 26, 2009 The World Bank announced the availability of more than US$205 million in fast disbursing funds to Mexico to support its efforts to fight the spread of the Swine Flu virus.
- US$25 million will be re-directed from the ongoing Mexico health project (PROCEDES) to meet urgent needs such as the purchase of drugs and related supplies.
- US$180 will be devoted to the Global Facility for Avian Influenza to help the full range of strategic, epidemiologic, regulatory, institutional and operational activities needed. This project will be fast-tracked so that the funds can be disbursed whithin 3-5 weeks.
- At the end of April it was announced that the Inter-American Development Bank (IADB) will facilitate several loans to Mexico summing up US$3,000 million to fight the effects of both the global economic crisis and Swine Flu Virus. This is a record figure in Mexico´s history.
- These loans will follow the standard banks´s terms and conditions.
- The first disbursement will be for US$200 to be expected after the July´s elections.

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Details of the oil hedging by the Mexican Government

- To mitigate the effects of oil´s price falls on public finance an the domestic economy in 2009 and meet programmed public spending.

- Resources from the “Fondo de Estabilización de los Ingresos Petroleros” a public “fideicomiso” created by the Treasury Department in 2001.

Option premium	US$1,500 million
Period	Dic. 2008 – Nov. 2009
Strike Price	US$70 per barrel
Quantity hedged	330 millions of barrel
Current estimated value	US$9,553 million (this is the expected compensation)