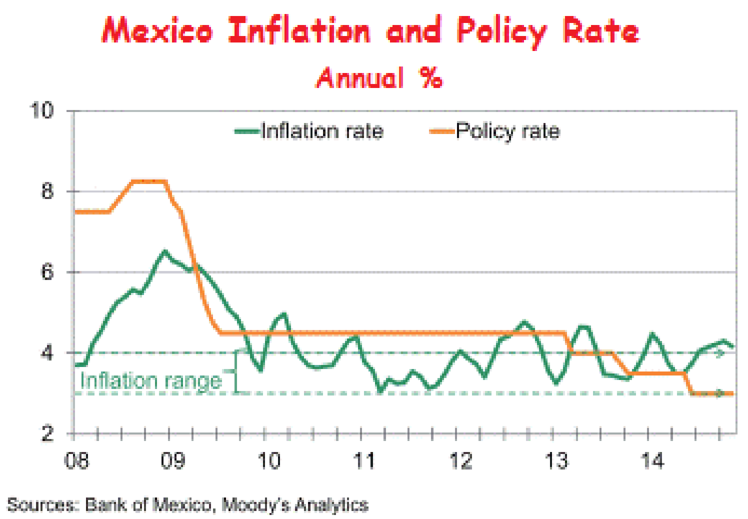
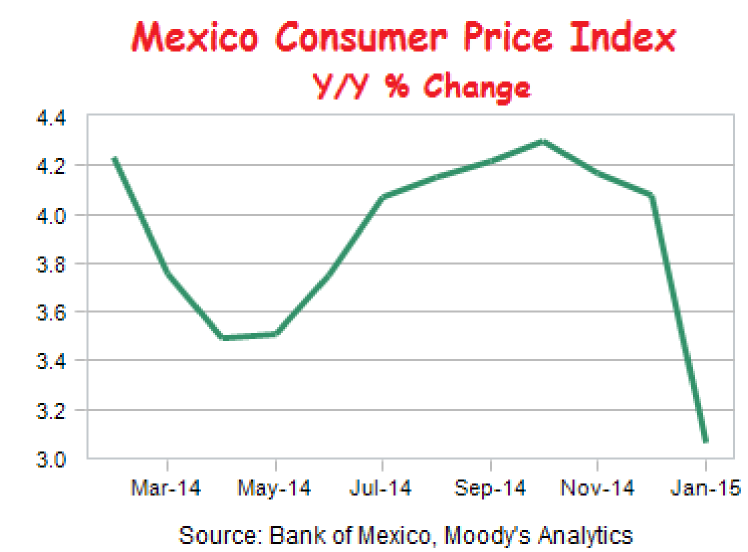
Mexico's Economic Outlook





The Mexican economy is struggling to gain momentum in its recovery from a slowdown that began two years ago. Economic growth slowed to 1.7% in 2013, the first year with the new government, down from 3.9% in 2012. Growth is estimated to have picked up to only around 2% in 2014.

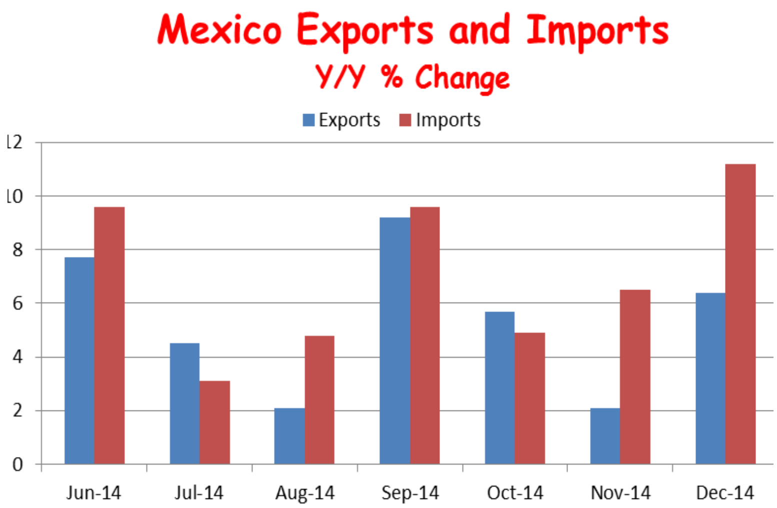
New reforms have been placed in an effort to boost the economy. The government is focusing on increasing the nation's production capacity and created a five-year plan on infrastructure development. Unfortunately, however, the plunge in oil prices has resulted in a significant decline in oil-related fiscal revenue. As a result, the government has been forced to perform budget cuts, hurting the growth forecast for Mexico's economy. GDP is now expected to grow by only around 2.5% this year compared to the 3% previously expected.

To help lift the economy, Mexico's central bank has cut the policy interest rate three times since 2013 to 3%, a record low. The rate cuts have resulted in the Mexican peso falling to a six-year low, raising imported inflation. The government's fiscal stimulus spending, along with tax hikes on some food staples, also caused inflation to increase in 2014. Meanwhile, since the price of domestic fuel is fixed by the government, falling oil prices are not reflected in the nation's inflation rate.

Given that it has now been a year since the introduction of the new taxes, Mexico's inflation rate has declined due to a higher comparison base. Nevertheless, the upcoming rate hikes in the U.S. are expected to put additional downward pressure on the peso, causing imported inflation to increase further. As a result, the central bank will likely perform rate hikes in the coming months to ease price pressures.

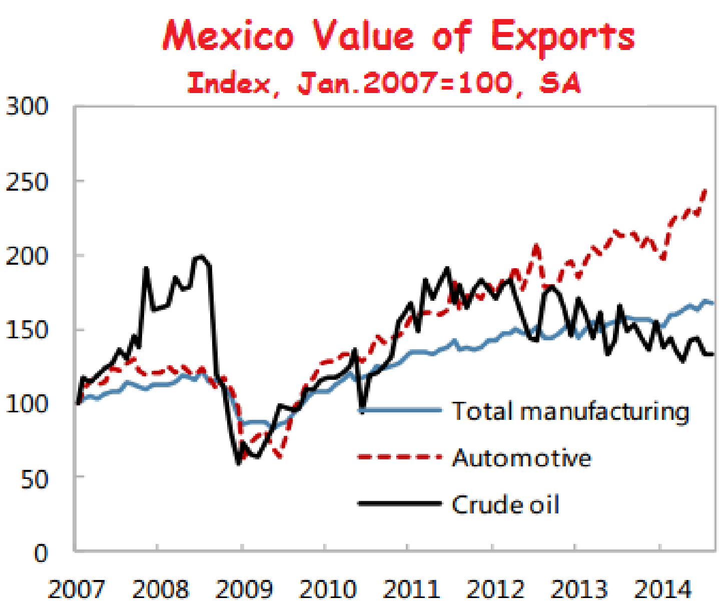
Source: The Economic Intelligence Unit

The strengthening dollar has caused Mexico's exchange rate to depreciate by over 10% since last year. Despite the weaker peso, Mexico's imports growth rate remains strong due to a rebound in intermediate goods imports. This is very good news because it suggests that business confidence is improving. Imports are expected to pick up further as a result of the anticipated increase in demand caused by the government's expansionary policies.



Source: Banco de Mexico, INEGI, SAT and SE, Moody's Analytics

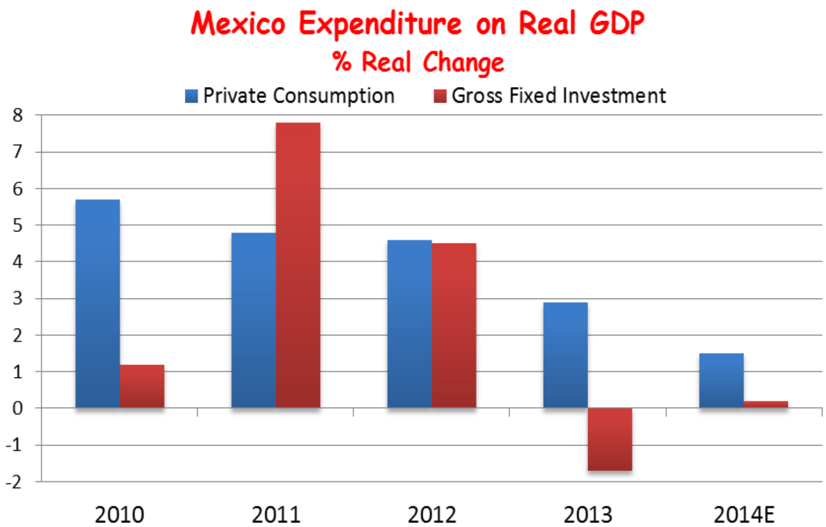
The weaker peso, along with robust manufacturing exports to the U.S., has kept the nation's exports growth rate strong. Manufacturing exports particularly related to autos have experienced the strongest gains, with auto exports increasing by almost 20% compared to a year earlier. Mexico is now the fourth-largest exporter of cars, exporting around 80% of its auto production. Since the nation exports mostly to the U.S., strong economic conditions in the U.S. should keep Mexico's manufacturing exports lifted in the near term.



Graphic Source: IMF Country Report No. 14/319

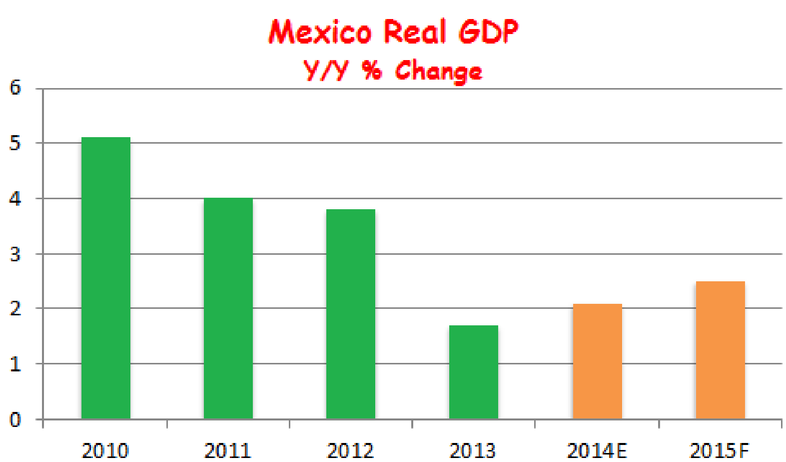
Data Sources: National Authorities, Haver Analytics, Dealogic, and IMF Staff Calculations

Thankfully, stronger exports to the U.S. have outweighed the negative effect of declining oil prices on Mexico's oil export receipts. The plunge in oil prices has resulted in the nation's oil exports, which account for about 12% of overall exports, to plummet by over 40% compared to a year earlier. Unfortunately, oil export receipts will remain suppressed with the reduced oil prices. Part of the government's plan involves reform in the energy sector to increase the production capability of oil. While this should eventually boost oil exports, it will take a few years to see the results of these efforts.



Data Sources: IMF, International Financial Statistics, Economic Intelligence Unit

Source: Instituto Nacional de Estadistica Geografia y Informatica INEGI, Moody's Analytics



Data Sources: IMF, International Financial Statistics, Economic Intelligence Unit, Moody's Analytics

Mexico's lackluster economic recovery is largely due to weak private spending. Investment plummeted in 2013 due to the negative effects of transitioning to a new administration. New taxes on investment and the uncertain economic environment caused firms to continue to retrench in 2014. Meanwhile, new taxes on disposable income, rising inflation and the falling peso have all weighed on consumption spending.

Both consumption and investment are expected to pick up this year as fiscal stimulus spending takes effect and the lower interest rates encourage spending. The strong exports to the U.S. are also expected to boost investment, particularly in the manufacturing sector, which should eventually lead to higher incomes and consumption spending.

Government efforts in boosting the nation's production capacity should also encourage investment spending this year. The government's infrastructure investment has resulted in an increase in temporary jobs, particularly in the construction, transportation and communications sectors. Although the increase in government spending has helped to boost employment in the public sector, new taxes and the uncertain economic climate have weighed on labor demand in the private sector. Until Mexico's economy shows signs of a more rigorous recovery, businesses will remain reluctant to hire.

Overall, we see that Mexico's economy is stalling and giving mixed signals of recovery. The new reforms, increase in government spending and improved external demand are expected to boost the economy this year. Improving economic conditions in the U.S. are a major factor influencing Mexico's exports growth. Employment, production and spending are all expected to increase slowly over the year due the government's expansionary efforts.