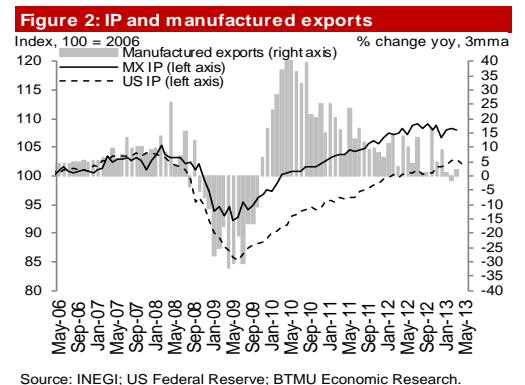


Economic activity: Cyclical deceleration in 2013

- Mexico's real GDP growth slowed in 1Q13 owed to calendar and post-election effects, as well as to the lagging rebound of industrial production from weak global demand and deceleration in the US in 2H12. Mexico is expected to grow by around 3.2% in 2013, down from above-potential growth of 3.9% in 2012.
- In 1Q13, real GDP expanded by 0.45% quarter-on-quarter (qoq/sa) and 0.8% year-on-year, decelerating from 0.77% qoq/sa and 3.18% yoy in 4Q12. (Figure 1.) The 1Q included a lower number of working days because of Easter Week (last year, the holidays were observed in 2Q), and followed the strong government spending growth of an election year. So far in 2013, there have been delays to government spending from the change of administration.
- The export-oriented industrial production sector has been an important growth driver post-2008/09 global crisis on the back of competitive gains in labor costs and a weaker peso (MXN), though it has displayed recent deceleration upon weak global demand and IP activity in the US. IP slowed in 2H12 and has had a slow start in 2013 which will weigh on growth this year. IP fell by 1.7% month-on-month/sa and rose 3.3% yoy in April (Figure 2). Deceleration has been broad-based. Construction fell by 3.1% mom/sa on account of delayed public works spending, changes to the government's housing program, and stressed homebuilders. Manufacturing dropped by 1.2% mom/sa upon slower activity in the auto and non-auto production segments.
- Cyclical and structural gains point to the recovery of economic activity in 2H13 and into 2014. Construction should receive a lift from the execution of public expenditures and manufactured exports should begin to benefit from gradually improving external demand and pick up in the US industrial cycle. And, the advancement of reforms still looks to raise supply-side driven growth in the medium-to-longer term via enhanced productivity and competitiveness.

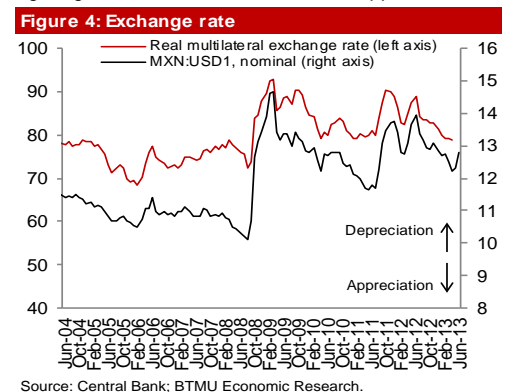
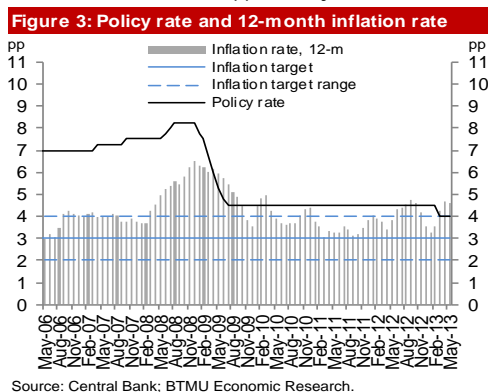


Policy rate: On hold

- The Central Bank of Mexico (Banxico) kept the policy rate unchanged at 4.00% at its latest meeting held on Friday, June 7th, setting a neutral tone in the accompanying statement. (Figure 3.) Banxico will likely remain on hold for now. It may adopt a bias to ease in 2H13 if economic activity slows more than expected and if ongoing appreciation pressures from capital inflows continue to pressure the MXN.
- Banxico's decisions will also probably be influenced by the relative monetary policy stance compared to advanced economies, especially the US. If the Federal Reserve does not begin to unwind QE this year, Banxico would be more inclined to cut the policy rate; but if the Fed moves to scale back QE sooner than expected, Banxico would hold. If Banxico were to cut the policy rate, it is not expected to do so until inflation falls back within the target range in 3Q.
- Inflation is currently above Banxico's target range of 3% +/- 1%, reflecting temporary upward pressures from supply-side shocks (drought and bird flu) to food prices. The 12-month consumer price inflation rate came in at 4.63% in May, down from 4.65% in April. However, non-core inflation remains below 3%.

FX: Strengthening MXN

- The MXN is expected to strengthen—with external volatility in the nearer term—towards MXN12.2:USD1 by end-2013, from an average of MXN13.2:USD1 in 2012. Note that, in nominal and real terms, the MXN has yet to appreciate to pre-2008/09 levels. (Figure 4.) MXN strength is underpinned by solid fundamentals, stable growth, investment inflows, and the outlook for reforms. Prospects for a stronger USD from eventual QE tapering are also supportive.
- Because the MXN is a highly liquid emerging market currency, volatility in FX fluctuations is likely in the near term given global risk uncertainty; however, the general appreciation trend of the MXN should continue to be supported by favorable fundamentals as long as global risk sentiment remains supportive.

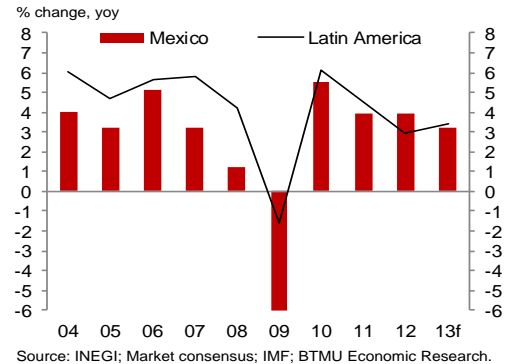


The challenge and opportunity: To raise growth through advancement of the reform agenda

Why is there a need for reforms?

- The primary motivation is to raise GDP growth via increased competitiveness and productivity.
- Growth of the Mexican economy has been stable over the last decade, and its macroeconomic stability has been rooted in predictable and solid fundamentals which include low inflation, low public debt stock, low fiscal deficits, and a flexible exchange rate. Yet, in terms of growth, it has underperformed relative to the average for the Latin America region (Figure 5).
- Stronger expansion has been stifled by dated, rigid regulations that have kept key sectors of the economy—such as energy—closed off from private investment and other key sectors restricted from market competition. Although Mexico's economy is highly open to international trade, competition in domestic markets is limited. Productivity growth is sluggish.
- The advancement of the reform agenda to raise competition, investment, and productivity in key sectors could elevate the economy's potential GDP growth rate from 3.5% to within the range of 4%-6% in the medium-to-longer term, depending on the reach and implementation of the reforms.

Figure 5: Real GDP growth- Mexico vs. Latin America



What sectors are the reforms targeting?

- Reforms in labor, education, and telecommunication have already been passed by Congress since November 2012 to present. Financial, electoral, energy, and fiscal reforms are up next in 2013.

Main points of focus.

- **Financial reform: Increase transparency, boost competition, and deepen credit penetration.**
The financial reform attempts to improve transparency, boost competition, cut lending costs, and spur lending growth. Mexico has one of the lowest credit penetration rates among Latin American and emerging economies. (Figure 6.) Corporate lending is more limited than consumer lending.
- **Energy reform: Open oil, gas, and electricity sectors to some degree of foreign investment to grow exploration and production.**
The reform will aim to increase the competitiveness of the energy sector through private-sector participation. The opening of the state-controlled oil sector to private investment will be contentious and it will require constitutional change. At this point, privatization of PEMEX looks unlikely; however, the government may end up compromising on another scheme such as profit-sharing to attract private players. First proposals are expected in 2H13 (Figure 7).
- **Fiscal reform: Diversify government revenues by increasing non-oil income.**
The fiscal reform is expected to diversify revenues by broadening the tax base and simplifying the tax code. It would aim to reduce dependence on oil income—which currently accounts for one-third of government revenues—and, thus, reduce vulnerabilities from fluctuations in oil prices. (Figure 8.)

Timing.

- The political climate for cross-party cooperation is favorable compared to the engrained gridlock of previous years. Given that an agreement among political parties to cooperate—Pact for Mexico—is in place, the outlook is encouraging for the advancement of the structural reform agenda this time around.
- There will be limited progress prior to local elections on July 7th. After these elections, the financial reform is likely to be voted on by Congress during an extraordinary summer session. Proposals for the electoral reform will likely follow, prior to proposals for energy and fiscal reforms. Because the electoral reform is a requirement for the Pact for Mexico, its progress will be very important in setting the pace for the latter reforms.
- The energy and fiscal reforms may now be presented in September when the ordinary sessions of Congress resume. Depending on the pace of progress, both reforms could be approved before the end of the year. However, given their level of importance, negotiations could take longer.
- The energy and fiscal reforms are the most critical, but the passage of reforms in other areas such as labor, telecommunications, and the financial sector are key to spurring more market competition, providing reform momentum, and building political capital. The weak 1Q13 GDP growth result may also serve as further incentive for political collaboration on reforms.

Managing high expectations: Scope and implementation of reforms will determine outcome.

- Expectations going into 2H are high. However, there is still much to prove. Ultimately, the success of the structural reform agenda will be measured by the scope and implementation of the changes.

Figure 6: Credit to the private sector

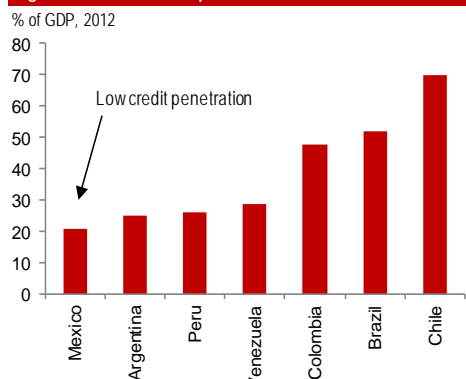


Figure 7: Crude oil production

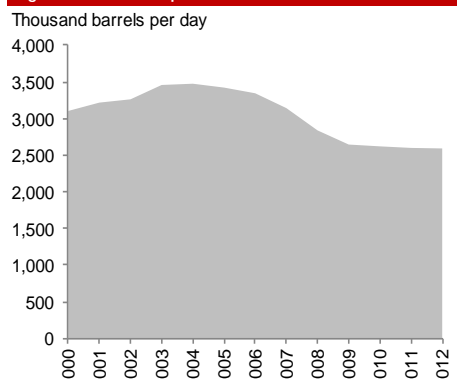
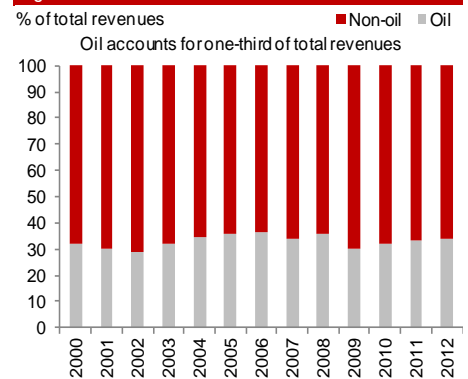


Figure 8: Government revenue: Oil versus non-oil





For historical data and commentary following BTMU's Economic News Releases, see our website at: <https://reports.us.bk.mufig.jp/portal/site>.

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