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Fitch Solutions

July 2020
Vol 37 Issue 7

Latin America Monitor

Mexico

Growth To Contract A Record 7.1% In 2020

Key View

- At Fitch Solutions, we have become increasingly downbeat on the Mexican economy, due to a still-growing Covid-19 outbreak, a sharp contraction in growth in the US, and the deteriorating performance of national oil company Pemex.
- As a result, we have revised down our 2020 real GDP growth forecast to -7.1% y-o-y, from -5.7% previously, and in 2021 to 1.8%, from 2.8%.
- Risks to our forecast remain to the downside, given continued uncertainty around the duration and magnitude of the Covid-19 shock, as well as some risk of social unrest.

We at Fitch Solutions are further revising down our 2020 real GDP growth forecast for Mexico to -7.1% y-o-y, from -5.7% previously, for several reasons.

First, we have recently revised our US growth forecast for 2020 to -4.9% y-o-y, from -3.7%. The Mexican economy is highly leveraged towards the US, which receives roughly 80%

...continued on page 2

Post-Covid-19: Strong Pull Factors For Manufacturers 5

The Covid-19 crisis will prompt a sharp downturn in economic activity in Mexico over 2020. Social distancing and movement restrictions will crimp Mexico's industrial productivity and service sector activity. Furthermore, investment into the country will also suffer amid deteriorated sentiment, while exports will contract from tightening global demand.

Impact Of Covid-19 On Consumer Spending Patterns Will... 11

Mexico's consumer outlook will contract significantly in 2020 due to the impact of Covid-19, with real household spending projected to decline by 6.1% for the year, a revision down on the 2.0% y-o-y growth we forecast for 2020 in the pre-Covid-19 environment.

REGIONAL INDICATORS

Latin America	2019e	2020f	2021f	2022f
Nominal GDP, USDbn	5,203.1	4,512.6	4,841.9	5,179.2
Population, mn	647.04	652.88	658.65	664.35
GDP per capita, USD	8,041.4	6,911.9	7,351.3	7,795.9
Real GDP growth, %	0.9	-5.2	2.2	2.5
Inflation, %	6.8	6.7	5.6	5.3
Goods exports, USDbn	1,135.5	1,042.8	1,087.9	1,143.8
Goods imports, USDbn	1,112.0	1,031.6	1,086.5	1,146.8

Note: e/f = estimate/forecast. Source: Fitch Solutions

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LATIN AMERICA RISK INDEX

Our Country Risk Index scores countries on a 0-100 scale, evaluating short-term and long-term political stability, short-term economic outlook, long-term economic potential and operational barriers to doing business. For a detailed methodology, visit fitchsolutions.com or contact us using the details on page 1.

RISK INDEX TABLE

	Short Term		Long Term		Operational	Country
	Political	Economic	Political	Economic	Risk	Risk
Chile	64.2	52.5	78.2	62.9	64.9	64.6
Uruguay	68.1	53.8	75.7	59.0	54.6	61.0
Mexico	63.3	59.0	58.0	64.4	52.2	58.2
Peru	60.2	58.8	61.5	64.0	48.7	57.0
Brazil	57.9	48.1	68.2	60.6	50.0	55.8
Colombia	61.3	54.2	60.6	59.8	52.1	56.7
Argentina	57.9	43.3	63.9	52.6	49.3	52.7
Ecuador	49.0	48.5	55.2	53.7	46.1	49.8
Venezuela	29.2	14.0	44.7	18.9	28.5	27.3
Regional Average	**56.8**	**48.0**	**62.9**	**55.1**	**49.6**	**53.7**
Global Average	**62.6**	**48.1**	**62.0**	**52.8**	**49.7**	**54.1**

Note: Scores out of 100; higher score = lower risk. Source: Fitch Solutions

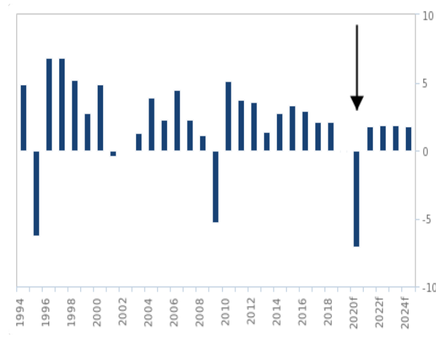
MEXICO – ECONOMIC OUTLOOK

...continued from front page

of Mexican exports as well as providing the bulk of tourism, remittances and investment inflows. Our weaker forecast for the US implies that these factors will provide less support for growth in Mexico than previously expected.

Mexico Faces A Historic Decline In Economic Activity In 2020

Real GDP Growth, % y-o-y



f = Fitch Solutions forecast. Source: INEGI, Fitch Solutions

Second, real GDP growth came in at -1.6% q-o-q and -2.4% y-o-y in Q120, the largest drop since 2009, despite the fact that Mexico did not implement a national lockdown until March 30. The decline was largely driven by weaker external demand. We expect the pace of decline will accelerate sharply in Q2, as lockdown measures come into full effect and external demand bottoms out.

Third, the government has implemented drastic cuts to its operational budget, including 25% salary cuts for high-ranking officials and a 75% reduction in spending on general services and supplies, among other measures, which together are expected to save roughly USD25.0bn. We believe that these pro-cyclical cuts will likely prove to be counter-productive, by reducing aggregate demand in the midst of an economic recession.

Fourth, national oil company **Pemex** lost an estimated USD23.0bn in Q120, by far the largest quarterly loss on record, and larger than the USD18.0bn loss the company posted for the entirety of 2019, amid continued production declines and a crash in global oil prices in March. While we at Fitch Solutions had forecasted oil revenues to decline in 2020, the scale of Pemex's losses in Q120 were significantly larger than we expected. This also implies that the company may require financial support from the Mexican government, which would leave less funds for other forms of fiscal stimulus.

Fifth, new cases of the coronavirus have continued to climb, despite nation-wide shutdown orders from the Mexican government and media reports indicating that testing capacity is still not at the level seen in most of Mexico's Latin American peers. This suggests that Mexico likely remains several weeks away from being able to phase out restrictions on

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travel and commerce. As a result, the economy likely has little chance of recovery until the second half of the year.

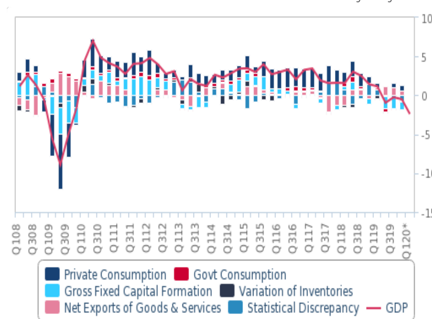
In addition, we have also revised down our growth forecast for 2021, from 2.8% to 1.8%, as the government's muted fiscal response implies a slower rebound from Covid-19 than we had anticipated. The government's announced stimulus measures amount to roughly 1.0% of GDP, among the lowest in Latin America, with little support budgeted for larger businesses. Given the government's unwillingness to step in to stimulate the economy, we expect that unemployment and business failures will be higher than they otherwise would be, elongating the downturn. In addition, the business community has broadly been critical of the administration's response, suggesting that business confidence and investment are likely to remain low in the quarters ahead, though we note that the sector's strong fundamentals will continue to draw interest in the long term.

Risks to our forecast remain to the downside, despite our downward revision. Given Mexico's exposure to external conditions, a slower-than-expected rebound in the US and other developed markets would weigh heavily on the country's growth outlook. In particular, a second wave of cases either within Mexico or globally in the second half of 2020 would likely mean that our view of a gradual economic recovery after Q220 will not play out.

Additionally, while not our core view, we see a growing risk of social instability in Mexico in the coming months. Public perception of the government's Covid-19 response has generally been unfavourable, with some polls showing AMLO's net approval falling into negative territory for the first time during his term. In addition, small episodes of unrest have occurred across the country, such as protests by healthcare workers, and drug cartels have stepped forward in some regions to provide goods to citizens despite the government's objections. As the virus is gradually controlled in the months ahead, we see a risk that brewing discontent translates to public demonstrations, which could increase investor unease and spark capital flight from the country.

Q220 Likely To Set Record For Deepest-Ever Contraction

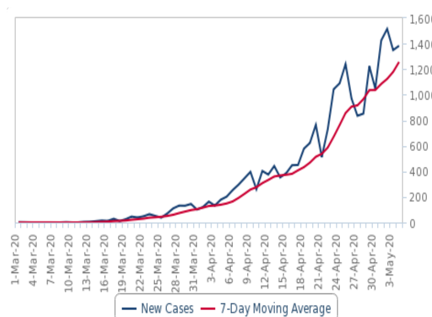
PP Contribution To Real GDP Growth, % y-o-y



* = preliminary data. Source: Banxico, INEGI, Fitch Solutions

Mexico's Cases Curve Continues To Climb

New Confirmed Covid-19 Cases



Source: Our World In Data, Fitch Solutions

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MEXICO – ECONOMIC OUTLOOK

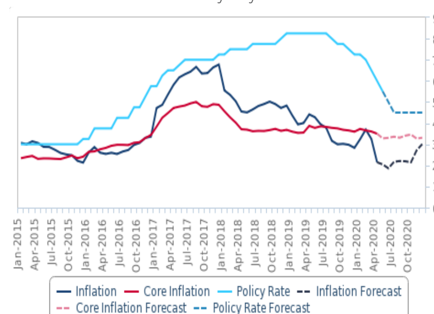
Quick View: Another 100bps Of Interest Rate Cuts Likely By End-2020

The Latest: On May 14, policymakers at the Banco de México (Banxico) unanimously decided to cut the central bank's benchmark interest rate by 50 basis points (bps) to 5.50%. This marks 275bps of cumulative cuts since the beginning of Banxico's easing cycle in August 2019.

Implications: The bank's decision was in line with our and consensus expectations, and aligns with our view that monetary policy in Mexico will ease considerably in the near term to support economic activity. Price growth has sharply decelerated in recent months, slowing to 2.2% y-o-y in April, down from 3.3% in March. The 1.0% m-o-m deceleration recorded in April is the steepest monthly fall since at least 1969. This was due to the recent crash in oil prices as well as the demand shock stemming from Mexico's Covid-19 outbreak and the lockdown measures put in place in response. This print indicates a growing negative output gap, suggesting that Banxico will continue to ease its policy to provide more stimulus to the economy.

Subdued Inflation Will Provide Banxico With Space To Support Collapsing Economy

Banxico Overnight Rate, %, & Consumer Price Growth, % y-o-y



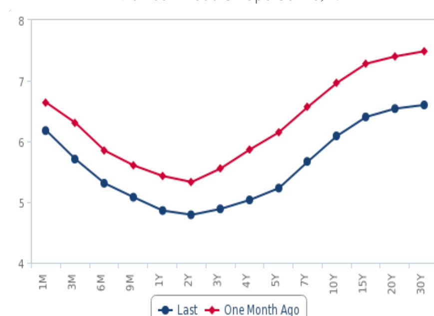
Note: Inflation target is 3.0%. Source: Banxico, Fitch Solutions

What's Next: We now expect Banxico will enact 100bps of additional cuts to its benchmark rate by end-2020, from 50bps previously. These cuts will likely be front-loaded in the first half of the year, potentially at unscheduled meetings. This will bring the rate to 4.50% by end-2020, the lowest level since mid-2016. The reason for this revision is two-fold:

We have revised down our forecast for real GDP growth in 2020 to a 7.1% contraction, with risks still firmly to the downside as Covid-19 cases continue to rise and fiscal spending remains on the sideline. This suggests that the negative output gap is significant, implying space for significant monetary stimulus.

Market Expectations Have Moved Towards Additional Easing In Months Ahead

Mexican Peso Swaps Curve, %



Source: Bloomberg, Fitch Solutions

Given aggressive monetary easing across most markets globally and the April inflation print showing a decline in price pressures despite the sell-off in the MXN, we believe Banxico has room to bring the benchmark rate below 5.00%. Real rates in Mexico remain among the highest in emerging markets.

That said, a number of factors could result in fewer interest rate cuts than we currently expect. In particular, a renewed sell-off in the Mexican peso could drive a spike in inflation, constraining Banxico's ability to supply monetary stimulus. Additional cuts to the credit rating of national oil company **Pemex** or the Mexican sovereign could also be the catalyst for outflows.

Related Research:

- Mexico To Contract A Record 7.1% In 2020, May 5
- Quick View: Unscheduled Rate Cut In Mexico Not A Surprise, April 22
- Banxico To Bring Benchmark Interest Rate To 5.00% By End-2020, March 24

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MEXICO – ECONOMIC OUTLOOK

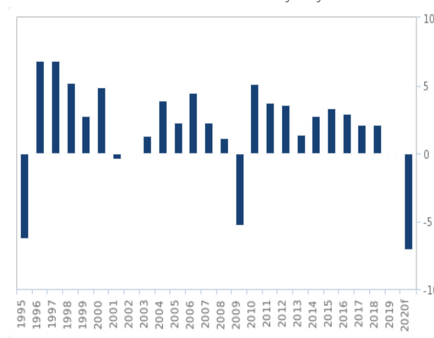
Post-Covid-19: Strong Pull Factors For Manufacturers

Key View

- The Covid-19 crisis will prompt a sharp downturn in economic activity in Mexico over 2020.
- Social distancing and movement restrictions will crimp Mexico's industrial productivity and service sector activity. Furthermore, investment into the country will also suffer amid deteriorated sentiment, while exports will contract from tightening global demand.
- As pandemic risks subside, and movement restrictions are eased, we believe that there is greater scope for Mexico to recover and benefit from renewed FDI into its automotive industry, as automakers look to bring their supply chains closer to home in order to comply with the US – Mexico – Canada Agreement (USMCA) and to reduce their dependence on Chinese manufacturing.
- Mexico offers an attractive operating environment for automakers, due to its strong industrial policies, low labour costs and ability to manufacture complex goods and its proximity to the US and Canada.

Largest Recession In Mexico Since 1995 Looms

Real GDP Growth, % y-o-y



f = Fith Solutions forecast. Source: INEGI, Fitch Solutions

The Latest

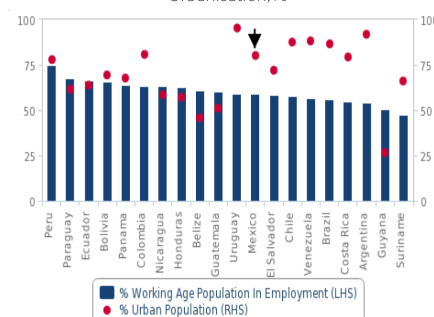
- On March 30 2020, Mexico declared a state of emergency due to the spread of Covid-19, suspending all non-essential activities in the public, private and social sectors.
- On April 16 2020, the government extended the state of emergency and accompanying restrictions in most municipalities until May 30 2020, forcing businesses in non-essential activities (such as heavy industries and tourism) to close their doors, placing jobs at risk.

Pandemic Threat And Choppy Policy Responses Place Key Sectors And Jobs At Risk

The negative economic impact of the Covid-19 crisis and country-wide shut-down will see Mexico sink into a deeper recession in 2020, with our Country Risk team forecasting real GDP growth of -7.1% y-o-y. Real GDP growth came in at -1.6% q-o-q and -2.4% y-o-y in Q120, the largest drop since 2009. Sentiment among businesses was already weak due to domestic policy uncertainty under Andrés Manuel López Obrador's (AMLO) administration, and this will likely be exacerbated by the government's delayed response to the Covid-19 crisis. The national government of Mexico, like Brazil, has not handled the response to the virus in a targeted and consistent manner, and the pandemic has exposed rifts between local governments that have implemented varying levels of stringent restrictions and national policymakers that appear to have pushed for a less aggressive response. Between February 2020 (when local confirmed cases emerged), until the end of March 2020, AMLO underplayed the extent of the Covid-19 crisis and resisted taking strong action to control the spread. The delayed and choppy responses from the policymakers risks exacerbating the impact and duration of the outbreak in Mexico, particularly affecting the services sector and other labour-intensive industries such as manufacturing.

Jobs Losses To Exacerbate Already Low Employment Levels

Working Age Population In Employment, % & Urbanisation, %



Source: World Bank (WDI), Fitch Solutions

AMLO's administration has announced that it will not incur additional public debt, nor will it support tax breaks for corporations and that it will continue with austerity measures. On April 22 2020, AMLO announced 11 new austerity measures that Mexico will implement amidst the Covid-19 pandemic, which include hiring freezes and the government postponing its

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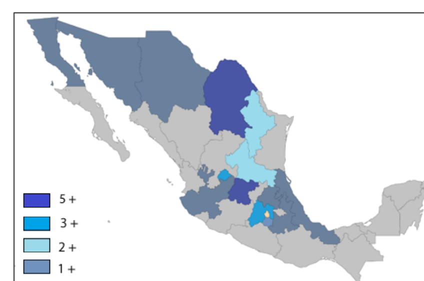
expenses, including the federal government refraining from spending 75% of its budget allocated to supplies. This could jeopardise the viability of many firms in Mexico's key sectors, such as services, tourism and manufacturing sectors. According to 2019 World Bank data, Mexico has a working-age population of 85.8mn, the second-highest in Central and South America, of which 59.1% were in employment. However, Mexico's economy will likely see significant job losses in the industrial and services sectors over 2020 due to the negative impact of the Covid-19 pandemic. According to the Mexican Ministry of Labour, the country lost over 345,000 formal private-sector jobs between March and April 2020 – more than the net number of jobs created in 2019.

US Border And Central States Vulnerable To Job Losses

Number Of Automotive OEM Assembly Plants



Source: d-maps, Fitch Solutions

The services and small business sectors will be among some of the hardest hit, with the tourism and food and beverage industries facing a downturn. According to the International Labour Organisation (ILO), the largest proportion of Mexico's workers were employed in the services sector in 2018, accounting for 61.1% of the country's employment. Informal employment stood at 60.7% of total employment in non-agriculture sectors, according to the ILO, demonstrating the magnitude of jobs that are reliant on small-scale trade and the informal economy. In the beverages industry, the production of beer accounts for over 650,000 direct and indirect jobs, and as it is not deemed an essential industry, production has halted, placing a high number of jobs at risk. According to Fitch Solutions, Mexico was the sixth most visited destination globally in 2019, and its hotel and food sector accounted for 8.1% of total employment in the same year. This means that the grounding of airlines, border closures and the subsequent drop in tourist arrivals will place added pressure to value addition.

Autos Manufacturing, A Key Economic Driver...

Mexico is one of the leading manufacturers of autos and autos parts globally, with 28 automotive original equipment manufacturers (OEMs) operating assembly plants in the country as of January 2020. In 2019, employment in the manufacturing sector as a percentage of total employment stood at 16.6%, increasing from 15.0% in 2009. According to Mexico's Automotive Industry Association, the autos sector employed over 3.5mn workers in the country, which represents around 40% of the manufacturing industry's employment. The majority of autos plants are in the states bordering the US, such as Coahuila, which has five auto OEM assembly plants. Its capital, Saltillo, an automotive manufacturing hub, employs three times more workers in the manufacturing sector than any other area of employment. A number of states in central Mexico, such as Guanajuato, Estado de Mexico and Aguascalientes, are also popular destinations for OEM assembly plants.

In recent years Mexico has seen a noticeable up-tick in investment into its automotive manufacturing industry. Over 2017-2019, Mexico's automotive industry attracted at least USD5.5bn (the actual number is larger, as not all projects announced the value of their

MEXICO – OPERATIONAL RISK SCORES

	Operational Risk	Labour Market Risk	Trade and Investment Risk	Logistics Risk	Crime & Security Risk
Mexico Score	52.2	57.5	57.9	57.4	35.9
Central and South America Average	46.0	49.9	44.7	46.3	43.0
Central and South America Position (out of 20)	5	4	3	3	15
Global Average	49.6	50.2	49.5	49.3	49.2
Global Position (out of 201)	83	55	70	64	146

Note: 100 = Lowest risk; 0 = highest risk. Source: Fitch Solutions Operational Risk Index

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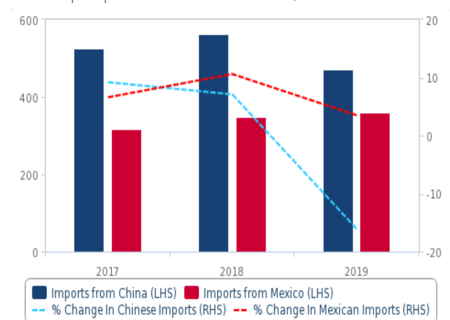
investments) worth of investments over 97 individual projects. This is partly driven by the impact of the US-China trade war and the new USMCA (which increases regionalism and localisation requirements), which motivated auto companies to move their supply chains closer to the North American autos market. The new USMCA is the successor to the 24 year-old North America Free Trade Agreement (NAFTA), and is focused on deepening rule-based integration and modernisation along the lines of the Trans-Pacific Partnership and other modern US-led trade agreements.

Near-Shoring Trend To Accelerate As Mexico Becomes Key US Supply Market

US – Top Import Partners And Values, USDbn (2017-2019)



Source: Trade Map, Fitch Solutions

.. Hit By Lacklustre External Demand In 2020

Demand: The global automotive market will remain weak throughout 2020 as consumers turn away from non-essential spending (including vehicles and other manufactured consumer goods) to focus on essential spending and contagion-risk mitigation measures in 2020. In April, Fitch Solutions forecasts that global vehicle sales and global vehicle output will decline by 10.1% and 10.3% respectively, in 2020, due to weakening economic activity and vehicle demand.

Production: The near-term weakness in the global automotive industry will place investment commitments into Mexico's auto industry on hold in 2020. Covid-19-related domestic and international responses will cause supply chain disruptions and production stoppages amid tepid global demand for Mexico's autos exports. This will see some firms stop operations and many workers laid off, particularly in the northern and central states, albeit temporarily. US brands such as **Chrysler**, **Ford Motor** and **General Motors**, have stopped production in Mexico throughout Q120-Q220 and many workers have been furloughed. That said, near-term risks are weighted to the downside, contingent on the extent of the demand destruction caused by the pandemic. In turn, weaker demand for Mexican-produced vehicles and components will increase the pressure on companies to cut costs, leading to a reduction in their workforce in 2020.

Autos Outlook, Beyond 2020

We believe that production stoppages and layoffs in Mexico's autos manufacturing industry throughout 2020 will largely be reversed as pandemic risks subside in the quarters ahead. We forecast that global vehicle sales will stabilise in 2021 and expand by 1.7%, which will see global vehicle output increase by 2.4% over the same period. Automotive companies will likely follow through with their investment commitments from 2021 onwards as

KEY INDUSTRIAL HUBS – MANUFACTURING WAGES PER HOUR (2019)

Country	Average Manufacturing Wages Per Hour (USD)
Germany	58.6
Japan	44.1
South Korea	36.6
Spain	24.9
US	22.6
Czech Republic	20.0
Canada	18.0
Thailand	13.6
Turkey	12.7
Morocco	11.1
Brazil	9.4
Philippines	4.6
South Africa	4.1
China	3.6
Mexico	3.0
India	0.7

Source: Various government sources, Fitch Solutions

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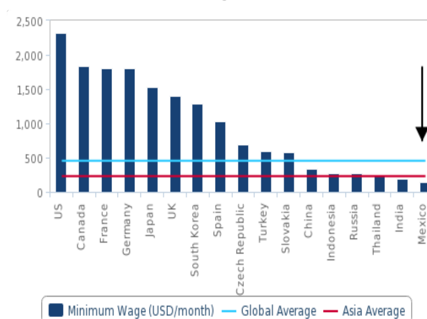
Mexico's automotive industry will continue to entice investment, due to its attractiveness as a manufacturing base. Mexico scores 52.2 out of 100 in Fitch Solutions' Operational Risk Index, ranking fifth out of 20 Central and South American countries and 83rd globally out of 201 countries. The country's key strength is its labour market, particularly the ample availability of a low cost and relatively well-educated workforce. Mexico's investment environment is another strong point, with highly diversified and modern industries, and significant amounts of private investment and FDI. Mexico's location in North America and its access to the rest of the world enables new cost-cutting measures relating to faster time to market, easier communications and better production efficiency. For companies in North and Latin America, manufacturing in neighbouring Mexico provides nearshore benefits that no other regional peer can.

Mexican Wages Most Competitive Among Global Manufacturing Hubs

Global – Minimum Wages, USD/month (2019)



Note: As applicable to the worker assumed in the case study. Source: World Bank 'Doing Business', Fitch Solutions

Near-Shoring: A Boon For Mexico's Labour Market

A more regionalised approach to manufacturing will lead to more sustainable and resilient supply chains. Near-shoring also provides companies with the benefits of reduced lead times and shipping costs. Shipping a container from Mexico to the US will cost less than half of what it would cost to ship the same container from China to the US.

China and Mexico combined supply a third of the United States' imports. Indeed since the build-up of US-China trade tensions, most US firms have been increasing their imports from Mexico and decreasing imports from China. Between 2017 and 2019, the US decreased its imports from China by 10.1%, while increasing its imports from Mexico by 14.4%. In 2019 alone, the US increased its imports from Mexico by USD12.1bn, while decreasing its imports from China by USD90.8bn. Furthermore, the share of US imports from Mexico has increased from 13.1% of total imports in 2017 to 14.1% of total imports in 2019, while US imports of Chinese goods has decreased from 21.9% of total imports in 2017, to 18.4% of total imports in 2019. Therefore, as near-shoring gains further momentum as pandemic risks subside going into 2021 and beyond, we are likely to see the flow of investment into Mexico's automotive industry gradually recover.

USMCA Trade Deal Remains Pivotal To Regional Market Access

In October 2019, the US, Mexico and Canada announced they had reached a deal to replace the 24 year-old North America Free Trade Agreement (NAFTA) with the USMCA. Much of the new agreement is focused on deepening rule-based integration and modernisation along the lines of the Trans-Pacific Partnership and other modern US-led trade agreements. In addition to market access for trade in goods, the agreement also focuses on the regulatory environment, intellectual property, procurement, dispute settlement, trade in services and other areas not included in the 1994 deal, such as e-commerce. In 2019, the progress of the negotiation of the agreement saw an increase in investment activity.

..But Businesses In Mexico Need More Time To Meet Requirements

While the agreement was due for implementation in July 2020, the Covid-19 crisis may prompt policymakers to seek to postpone the adoption of certain provisions of the USMCA, in order to ensure that companies can meet the new more stringent 'rule of origin' requirements. Indeed, Mexican automotive bodies and a number of US senators have raised concerns over the lack of adequate time for the autos specific requirements to be implemented under the USMCA. In addition the three countries are yet to identify representatives for the USMCA dispute settlement committee.

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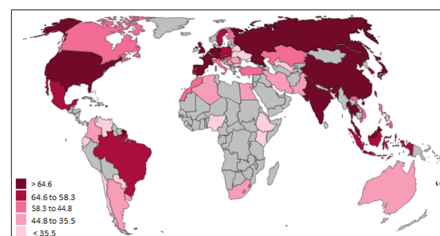
As per the agreement, Mexico must also implement new labour laws that allow for greater protection of workers, including women and migrants, as well as increased wages and better working conditions for Mexican workers. These new laws are further intended to make unionisation simpler for Mexican workers which should help with bargaining between employers and employees and bring Mexico's labour market closer to the level of Canada and the US. Failure to implement such reforms, would mean that Mexican produced vehicles would not be able to qualify for tariff-free access to Canada and the US, which would increase operating costs for Mexico's automotive industry and could lead to workforce cuts, as well as increased automation to accelerate compliance and improve efficiency.

Mexico Remains Highly Attractive Autos Manufacturing Destination
Autos Production Risk/Reward Index Heat Map



Note: Scores out of 100; higher score = more attractive market.
Source: Fitch Solutions Autos Production Risk/Reward Index

Globally-Competitive Mexican Wages To Support Near-Shoring Movement, Despite Increases

Mexico has long had a competitive advantage as a low-cost labour location for multinational Canadian and US companies. The country outperforms globally in terms of its general minimum wage, which stands at USD140.6 per month (compared to the global average of USD453.7 per month) according to the latest World Bank 'Doing Business' estimates.

In the automotive sector in particular, a typical salary falls between USD484 and USD1,250 per month in Mexico, compared to the average salary of USD3,309 in the US. The USMCA requires Mexico's automotive industry, or at least 40%-45% of automobile parts, to be made by workers who are paid at least USD16.00 per hour by 2023. In the automotive trade, in particular, we are set to see the sector be subject to minimum-wage requirements for the first time. While these provisions will increase costs and due diligence for Mexican businesses, they will likely be applied gradually over the medium term. Even so, at USD16.00 per hour, Mexico's average wages in this autos sector remain more competitive than those experienced in its northern neighbours. According to the US Bureau of Labour Statistics, as of March 2020, the average wage in the manufacturing sector in the United States stood at USD22.59/hour. In addition to having lower wages than the US and Canada, when compared to global manufacturing hubs such as China, India and Turkey, Mexico still outperforms by a notable margin.

Mexican Autos Remain An Attractive Long Term Proposition

Despite the short-term challenges, Mexico will remain an attractive investment destination thanks to its low-cost operating environment, strong industrial policy, ability to manufacture complex goods such as cars and car parts, and its proximity and access to the North American automotive market. This is reflected by Mexico's performance on our Autos Production Risk/Reward Index (RRI), which measures the attractiveness of a country for automotive production based on several Risk and Reward categories. In our Autos Production RRI, Mexico scores a strong 63.2 out of a possible 100 (higher score = more attractive for manufacturing), which outperforms both the global average of 50.0 and the Americas regional average of 43.6. This ranks Mexico as the 14th most attractive automotive production location globally and the second most attractive location in the Americas region, behind only the US. Mexico's high level of attractiveness for autos production will see it remain the preferred investment destination for vehicle and component manufacturing among the USMCA parties, which will further support the country's labour market.

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Mexico Readies For Industry 4.0

Lastly, we highlight that Mexico's manufacturing industry is well placed to capitalise on the Fourth Industrial Revolution, or Industry 4.0, as it has seen strong development in its electronics manufacturing industry which will afford it the skills to keep up with the shifts in manufacturing demands towards more high-tech/precise components. Industry 4.0 is primarily defined as the blurring of physical, digital and biological worlds framed by disruptive technologies, which will impact how humans live, work and relate to each other. Going deeper, Industry 4.0 is a heavy mix of technology advancements: breakthroughs in fields such as artificial intelligence (AI), robotics, autonomous vehicles, 3D printing, nanotechnology and quantum computing, have created a complex web of new opportunities for governments, businesses and citizens alike.

We note that this development in Mexico's technology manufacturing industry is a double-edged sword as it will accelerate the rate of automation, especially if its robotics industry continues to develop at a fast pace, and consume manufacturing jobs in the process. That said, continuing the process of getting the country's industries ready for Industry 4.0 will further upskill its work force and maintain its position as an attractive manufacturing destination over the long-term. As of 2019, technology companies such as **Samsung**, **Foxconn**, **Intel**, **Sharp**, **Plantronics**, **Panasonic**, and **Flextronics** all have manufacturing operations in Mexico. Furthermore, according to the World Bank, Mexico's high-technology exports increased at an average annual rate of more than 9% over 2008-2018, which reflects the fast pace that its electronics manufacturing industry is able to develop and the growing interest from manufacturers looking to establish operations in the country. The country's various incentives for industrial development remain an added attraction for investors.

MEXICO – FREE TRADE ZONES AND INVESTMENT INCENTIVES

Free Trade Zones and Investment Incentives	Main Incentives Available
Maquiladora Initiative (IMMEX) There are four main FTZs: San Luis Potosi, Mexico City, Monterrey and Guanajuato	Businesses enjoy exemption from import tax and deferred customs duties payments. Open to all industries, offering: • Lower customs duties • Delayed payment of tariffs • Reduced bureaucracy for exports and imports • Local access to customs officers
ZEEs (Special Economic Zones). ZEEs were introduced by the Mexican government with the aim of promoting economic growth and investment in certain estates of the country that have fallen behind with respect to other parts of Mexico in industrial and economic development (for example in Chiapas, Guerrero and Michoacán).	The main tax incentives are the following: • Taxpayers obtaining income generated within the ZEEs will be granted an income tax reduction of 100% during the first 10 fiscal years and a 50% income tax reduction for the following five fiscal years, subject to compliance with certain requirements. • A 0% VAT rate will be applicable to goods acquired by investors in the ZEEs to the extent that certain documentation requirements are met. Furthermore, investors in the ZEEs may be able to obtain accelerated VAT refunds for goods acquired by Mexican residents located outside the ZEEs. Finally, Mexican residents outside the ZEEs may apply a 0% VAT rate to services or the leasing of goods provided to investors in the ZEEs, subject to the compliance of certain requirements.- • In addition, no VAT is applicable to transactions among taxpayers within the ZEEs. • Additional tax incentives may be available at a state level. These are typically negotiated with the local tax authorities on a case-by-case basis and depend on the nature of each specific investment project.

Sources: ProMéxico, Fitch Solutions

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MEXICO – INDUSTRY OUTLOOK

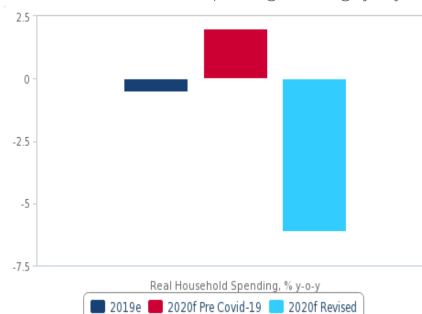
Impact Of Covid-19 On Consumer Spending Patterns Will Drive Demand For Discount And Wholesale

Key View

- Mexico's consumer outlook will contract significantly in 2020 due to the impact of Covid-19, with real household spending projected to decline by 6.1% for the year, a revision down on the 2.0% y-o-y growth we forecast for 2020 in the pre-Covid-19 environment.
- The food and drink sector is projected to remain somewhat shielded from the overall downturn in spending, with consumers focusing their spending on priority purchases (food, non-alcoholic drinks products and health) and reducing their spending within other segments. Within the food and drink sector we expect the economic reality of the global impact of Covid-19, will filter down to consumers.
- We believe that the main consumer spending shift within the food and drink segment, will be consumers trading down price points. In this environment it is the MGR discount and wholesale format that we expect to record gains and will be where MGR players will focus their investment.

Mexico Consumer Spending 2020 Revisions

Real Total Household Spending (% change y-o-y)



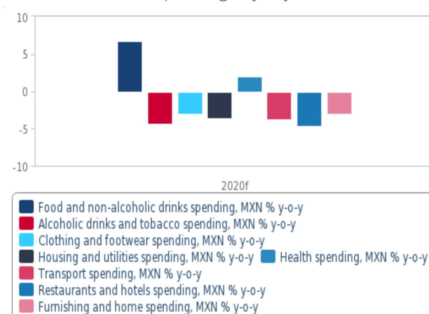
e/f = Fitch Solutions estimate/forecast. Source: National sources, Fitch Solutions

Mexico's consumer outlook will contract significantly in 2020 due to the impact of Covid-19, with real household spending projected to decline by 6.1% for the year, a revision down on the 2.0% y-o-y growth we forecast for 2020 in the pre-Covid-19 environment. The food and drink sector is projected to remain somewhat shielded from the overall downturn in spending, with consumers focusing their spending on priority purchases (food, non-alcoholic drinks products and health) and reducing their spending within other segments. In 2020, we forecast consumer spending within the food & non-alcoholic drink sector to expand by 6.7% y-o-y, this is an upward revision from the 5.9% y-o-y we previously forecast for 2020, pre-Covid-19, and marks an improving outlook on the growth estimated for 2019 of 4.5% y-o-y.

Our view of an improving year-on-year outlook for food and drink spending by Mexican households is based on consumer behavior and supply and demand dynamics. On the behavioral front the pandemic has led Mexican consumers to place greater spending focus on priority purchases, as was displayed in March when instances of stockpiling and panic buying were reported. On the supply side, a lockdown, which began towards the end of March across numerous states (which remains in place at the time of writing: May 15 2020) has led to a shuttering of restaurants. While consumers can still receive food from the food services sector, via delivery or takeaway, we believe consumers will have shifted the bulk of their spending on food toward grocery stores (the spending route our food data measures). On the demand side, interlinked with behavior, is the priority that consumers will place on food spending at this time. We believe that consumers will cut back their spending within other retail segments (fashion for example) to focus on food purchases.

Food & Non-Alcoholic Drink Spending To OutPerform

Spending, % y-o-y



f = Fitch Solutions forecast. Source: INEGI Mexico, Fitch Solutions

The economic reality of lockdown measures and the impact of the spread of the disease globally will filter down to consumers. In Mexico the Fitch Solutions Country Risk team has revised down the country's growth, based on an impact assessment of Covid-19 and the measures the government has implemented to contain its spread. Real GDP for Mexico is now projected to decline by 5.7% y-o-y, a deepening on the -0.1% contraction recorded in 2019. Our 2020 economic projection is now that Mexico will record a harder recession than that following the global financial crisis, when in 2009 the country's economy contracted

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by 5.3%. While we project a growth outlook for food and non-alcoholic drinks purchases y-o-y for 2020, we are expecting to see structural shifts within this segment. We believe that this will lead to consumers trading down price points within the food and drinks sector.

In this economic environment, with consumers trading down price points, purchasing patterns will focus on the discount sector and in Mexico on wholesalers and discount stores. Therefore MGR players that boast wholesale and discount operations will be best positioned to navigate the impact of the Covid-19 crisis on consumer's spending patterns. The table below outlines the key players in Mexico's MGR discount and wholesale segments.

SELECTED DISCOUNT RETAILERS

Supermarket	Parent Company	Format	Details
Bodega Aurrera	Walmart	Discount Store	In 2019 Walmart undertook an expansion strategy within its Bodega operations, opening 125 stores
Tiendas Nieto	Grupo Salinas	Discount Store	The company Grupo Salinas operates more than 730 Tiendas Nieto stores,across 18 states in Mexico.
S-Mart	S-Mart	Discount Store	S-Mart operates 84 stores in Mexico, mainly located in the northern Mexican states of Chihuahua, Nuevo Leon, and Tamaulipas.
Sam's Club	Walmart	Wholesaler	Walmart operates 163 Sam's Clubs stores in Mexico and represents 20.7% of total sales of Walmex sales (only operates this format in Mexico). It was the most popular format in Q120 due to panic buying but also suggesting that consumers are price sensitive.
City Club	Soriana	Wholesaler	Soriana operates 32 City Club stores in Mexico. In Q120 City Club reported increased membership. As well as City Club, Soriana also operates including hypermarkets and convenience store formats.
Costco	Costco	Wholesaler	The company operates a total of 39 wholesalers in Mexico.

Source: News sources, Fitch Solutions

MEXICO – DATA & FORECASTS

	2016e	2017e	2018e	2019e	2020f	2021f	2022f
Nominal GDP, USDbn	1,077.9	1,157.7	1,222.1	1,258.7	1,009.0	1,081.9	1,170.4
Real GDP growth, % y-o-y	2.9	2.1	2.1	-0.1	-7.1	1.8	1.9
GDP per capita, USD	8,739	9,278	9,684	9,866	7,825	8,305	8,896
Population, mn	123.33	124.78	126.19	127.58	128.93	130.26	131.56
Consumer price inflation, % y-o-y, eop	3.4	6.8	4.8	2.8	3.0	3.4	3.9
Consumer price inflation, % y-o-y, ave	2.8	6.0	4.9	3.6	2.6	3.2	3.7
Central bank policy rate, % eop	5.75	7.25	8.25	7.25	4.50	5.00	5.50
Exchange rate MXN/USD, ave	18.66	18.93	19.22	19.26	22.75	22.58	22.35
Exchange rate MXN/USD, eop	20.73	19.79	20.18	19.18	23.00	22.15	22.55
Budget balance, MXNbn	-503.8	-238.5	-495.0	-398.4	-1,001.1	-570.9	-633.0
Budget balance, % of GDP	-2.5	-1.1	-2.1	-1.6	-4.4	-2.3	-2.4
Goods and services exports, USDbn	398.5	437.4	479.8	491.7	434.7	449.9	485.1
Goods and services imports, USDbn	420.6	458.3	502.5	492.2	443.1	457.9	493.7
Current account balance, USDbn	-24.2	-20.1	-22.0	-2.4	-13.0	-10.7	-11.2
Current account balance, % of GDP	-2.2	-1.7	-1.8	-0.2	-1.3	-1.0	-1.0
Foreign reserves ex gold, USDbn	176.5	172.8	174.8	180.9	186.3	191.9	197.6
Import cover, months	5.5	4.9	4.5	4.8	5.5	5.5	5.2
Total external debt stock, USDbn	422.6	441.6	453.0	491.1	532.0	578.1	625.0
Total external debt stock, % of GDP	39.2	38.1	37.1	39.0	52.7	53.4	53.4
Crude, NGPL & other liquids prod, '000b/d	2,459.6	2,228.3	2,072.7	1,923.3	1,848.7	1,882.4	1,909.6
Total net oil exports (crude & products), '000b/d	842.1	678.9	623.5	590.8	574.8	573.3	569.6
Dry natural gas production, bcm	38.0	33.6	30.8	29.2	28.4	28.0	28.7
Dry natural gas consumption, bcm	34.6	27.1	21.3	16.4	15.8	16.0	16.5

e/f = Fitch Solutions estimate/forecast. Source: National sources, Fitch Solutions

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