Mexico: **A Piñata of Investment Opportunities**

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Mexico is now the 12th largest economy in the world, with 108 million people and over $1 trillion of GDP. According to The World Bank its $753 billion Gross National Income and $7,310 income per capita are the highest in Latin America. Mexico is now firmly established as an upper middle-income country. Yet for investors Mexico remains a mixed-bag of opportunities, with some key sectors reserved solely for the state and others restricted to Mexican nationals. The country's future growth may be restricted by these self-imposed constraints.

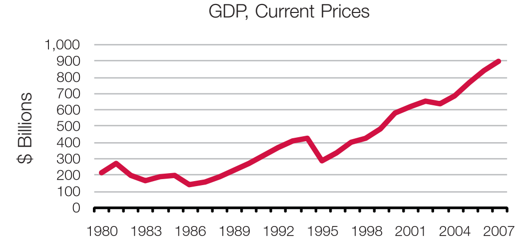
After the slowdown of 2001, the country has recovered with three consecutive years of economic growth, topping out at 4.8% in 2006. Interest rates have hovered around 7% in 2007, after having reached an historic low of less than 5% in 2002. Inflation rates are also at historic lows of around 4%, and unemployment rates in Mexico are the lowest of OECD countries at 3.2%.

From a historical perspective, the period from 1930 to 1970 has been dubbed by Marxist economists as the "Mexican Miracle." But the truth is it was a period of modest economic growth due to a model of import-substitution industrialization (ISI), which protected and promoted the development of national industries. With the ISI model in place, the country grew far slower than comparable economies in Asia that followed less protectionist policies. Disastrous changes in the economic structure included the nationalization of the oil and railroad sectors. And while population doubled from 1940 to 1970, real GDP per capita only increased from $300 to $850 in Mexico compared to $760 to $5,060 in the U.S. This triggered massive immigration to the U.S. in search of better economic opportunities.

After discovering vast oil fields at a time when oil prices were increasing and international interest rates were low, the government used international capital markets to fund the state-owned oil company, Petroleos Mexicanos (Pemex). This, in turn, provided an income source to promote social welfare. Soon Mexico multiplied its oil production to become the world's fourth largest exporter, and thus started its economic dependence on oil revenues.

By many measures Mexico is the most prosperous it has ever been, but poor tax collections and an overdependence on oil revenues remain serious obstacles to future growth.

GDP, Current Prices



Economic growth in Mexico has historically been unstable. For many years, the Mexican economy experienced slow growth, unstable development and a recurring balance of payments crisis, particularly in the first years of a new Presidency. Mexico's economy has undergone reforms designed to shift away from the government controlled development it previously pursued. Some of the reforms have been completed while others are still in progress.

Seven months into his term, President Felipe Calderon hopes to oversee greater economic growth than did his predecessor. However, he faces many challenges and opposition. First, tax revenues, excluding oil, are just 10% of GDP, the lowest in Latin America, where the average is 14%.

Better tax collection mechanisms are required to bring in legally mandated receipts. Also, more than a third of fiscal revenue is tied to oil revenues, which are volatile and unsustainable at historic highs. Pemex, the state-owned oil monopolist, is unable to supply the large volumes it once generated. Mexico's large oil reserves are diminishing, and yet still generate about 40% of the government's revenue.

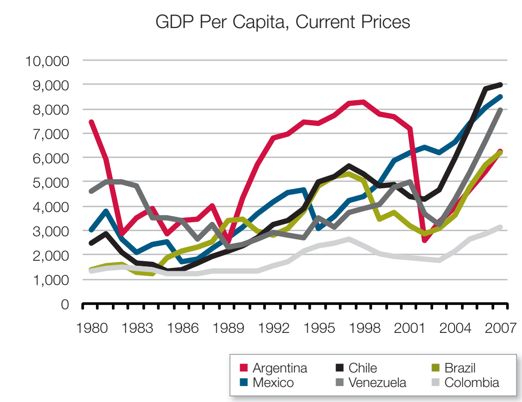
Weak tax collection rates result from: various exemptions and shelter schemes and a rampant underground economy. Taxation on capital gains seems to be more of an exception than the norm. Contingent federal liabilities have escalated over the past few years, with the fiscal deficit not reflecting disbursements such as Social Security.

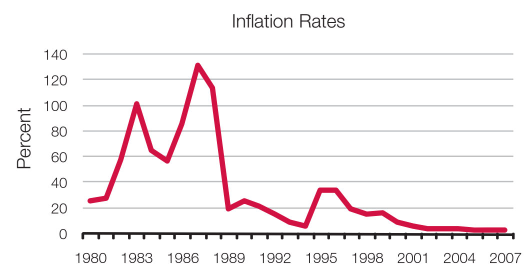
The Mexican government currently headed by Calderon's Partido Accion Nacional (PAN) party faces heavy resistance from the Partido de la Revolucion Democratica (PRD) opposition, and has formed an informal alliance with the Partido Revolucionario Institucional (PRI) to advance its legislative agenda.

Calderon's achievements to date have surprised skeptics. Anti-crime and anti-drug initiatives are the priority. Soon after taking office, the president sent 24,000 troops into drug producing and drug trafficking regions to suppress drug related violence. A restructuring of the federal police force has taken place, removing nearly 300 commanders. Drug testing for school students also has been introduced.

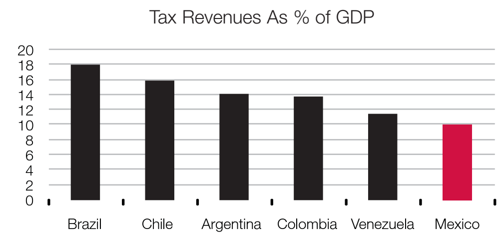
Calderon's most important achievement thus far has been pension reform, which was passed within two weeks of its presentation in March 2007. The reform bill will change the social security system for workers employed in the public sector, gradually reducing the financial burden to the state by increasing the minimum retirement age to an average of 59 years by 2028, from its current 49 years. It also increases workers' contributions to pensions to 6.1% of their salaries by 2012, compared to the current rate of 3.5%.

The need for reforms, including the privatization of petroleum, is urgent as Mexico faces a deficit of approximately 3% of GDP if fiscal changes are not made soon. Calderon's main mechanism for fiscal reform is a Flat Rate Business Contribution (CETU), which will



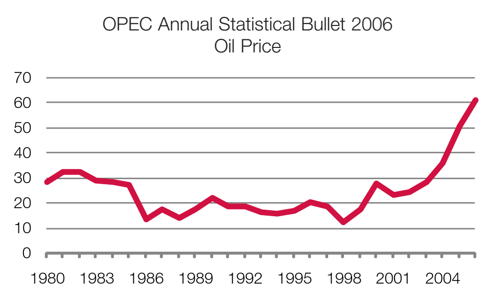


target businesses that currently pay the Tax on Profit (ISR), allowing them to slip through the many loopholes of the system. Unfortunately, CETU, however, is not intended to replace the ISR. The two will work concurrently, sealing the loopholes and allowing the government to increase tax revenues by approximately 25%. The reform also intends to increase efficiency in annual government spending by $4.2 billion in total expenditure. The reform requires the creation of a National Council for the Evaluation of Public Policy, which evaluates the budgets of the federal and state governments. It also allows the state to levy sales tax on goods and services that are already taxed by the federal government.



Calderon hopes to raise an additional 1% of GDP in taxes, unfortunately by increasing federal taxes by 2%. The primary new tax is an “informality tax” of 2% on cash deposits exceeding a cumulative monthly $1,850, which taxpaying workers will be able to deduct from their taxes. This is an attempt to tax unreported income.

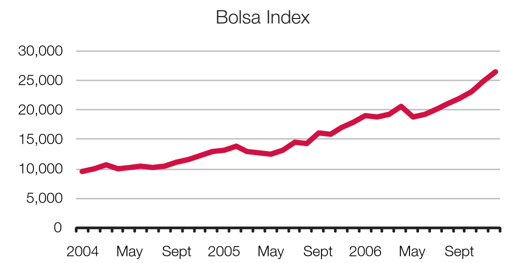
The government intends to step up efforts to crack down on tax evaders with stiffer penalties and stronger enforcement. There is also a new alternative minimum tax on firms, which works by taxing income, less investment and physical inputs, rather than just profits. The reformed tax code will tax some smaller businesses that were previously not paying taxes, and attempts to bring many informal businesses into the formal economy. The administration chose not to add a value-added tax (VAT) on medicine and staple foods due to significant opposition from the lower income representatives. If it fails, Mexico will not be the first emerging market that talks tough on reform while delivering little.



The economy of Mexico remains excessively tied to crude oil prices. Over 60% of Pemex’s revenues contribute to a third of the federal government's budget. As oil prices increase, the funds available to the government increase. However, Mexico has been riding the wave of rising oil revenues far too long. As the oil fields discovered today replace only a fraction of the oil fields that are in decline, the country is slowly losing its largest source of revenue.

The ultimate goal of the proposed reforms in their entirety is to reduce Mexico’s dependence on Pemex’s oil revenues. Sadly, Mexico’s constitution and laws state that the government owns all of the county’s oil reserves, which are diminishing at a fairly rapid pace. This guarantees large scale mismanagement and corruption. Calderon’s development plan offers legislation to enable private companies to profit from certain activities that were not specified in the constitution. Since it is unclear which of the deepest parts of the Gulf of Mexico are covered under the Mexican constitution’s restrictions to Pemex ownership, Calderon is proposing to circumvent Pemex, allowing private players to assist in development. The degree of management is underscored by the fact that Mexico does not have the technology to drill as deep as 1,500 meters into the Gulf. Thus, Calderon is seeking to enlist private firms for this capability.

By many measures Mexico is the most prosperous it has ever been. Along with encouraging paces of GDP growth and inflation reduction, high oil prices have enabled the government to have its first budget surplus in 10 years. In addition, the Bolsa stock index doubled in less than two years, from 10,000 in mid-2004 to 20,000 in 2006. One of Mexico's biggest advantages is its inclusion in the North American Free Trade Association (NAFTA), which has, since its implementation in 1994, greatly benefited the country. After having shifted from inward-focused development, exports became an integral part of economic growth, which NAFTA has clearly spurred. NAFTA has eliminated 85% of tariffs on non-oil and non-agricultural Mexican exports to the U.S., and 79% of exports to Canada. In 2004, only 1% of products were subject to tariffs, and after 15 years tariffs on goods traded between the three countries are set to be reduced completely. And yet immigration (both legal and illegal) continue unabated, as the Mexico economy lags that of the U.S.



Mexico's consumer credit growth, 400% since 2000, indicates a growing consumer class, which reduces dependence on exports. In addition to NAFTA, Mexico has the Maquiladora program, which allows Maquila operations to import foreign merchandise on a temporary basis. This merchandise is assembled, manufactured or repaired, and exported either back to the country of origin or to a third country. Lower wages, utilities and proximity make Mexico an ideal location for U.S. activities. Transportation costs from almost any location in the continental U.S. to Mexico are lower than to practically any place in Asia. As a result, the Maquila industry – Mexico's second largest – is an integral part of the country's economic drive. Furthermore, Maquilla operations combine the industrial processes, know-how, tools and labor of various countries in the manufacture and assembling of products, thus increasing efficiency and lowering production costs in Mexico, as well as transferring knowledge of these steps to local management. Finally, since the goods must be exported, Maquilas do not constitute significant competition for the domestic market. Thus, foreign investment as a part of the Maquila program is encouraged by the government and viewed as a way to transfer technology to Mexico, upgrade skills and increase the demand for Mexican goods.

A growing middle class has prompted demand for better education. Private schooling, previously considered a perk of the rich, is spreading slowly to the masses. Domestic and foreign firms are pushing investment into the private education sector, and see great potential in Mexico, as the market remains underserved.

What does all this mean? Historically, Mexico has primarily been an export-oriented country and was – until 2003, when China replaced it – the U.S.'s second largest trading partner. Therefore, investment is needed more than ever to achieve sustained development and poverty reduction. Investment opportunities exist in Mexico, prompted by the negotiation of free trade agreements and the Maquiladora program. However, growth is restrained by far ranging conditions where investment in many sectors is reserved wholly for the state. This includes oil, energy, telecommunications, and transport. Other sectors such as retail sales of petroleum, credit unions, development banks, savings and loan institutions, tourism and freight (except package or messenger deliveries), and domestic transportation are protected for Mexican nationals.

Mexico offers investment incentives. Approximately 95% of all investments do not require government approval. Investments that require applications and not exceeding $165 million are automatically approved. The Foreign Investment Law has eliminated export requirements (except for Maquiladora industries), capital controls and domestic content percentages. Recently Mexican states have begun to aggressively compete for investment with such incentives as reduced prices for real estate, employee training programs and state tax incentives. U.S. and Canadian investors generally receive most-favored-nation treatment in setting up operations or acquiring firms in Mexico as a result of NAFTA. U.S. and Canadian companies also have the right to international arbitration and the right to transfer funds without restrictions. NAFTA has also eliminated barriers to investment, such as trade balancing and domestic content requirements.

Any international investment comes with risks, such as currency risk, economic health, political stability, transparency of laws and general issues of red-tape. In Mexico, the peso is strong and investment is at an all-time high. Calderon is committed to enhancing trade and investment, reforming fiscal policies to benefit the economy, attacking crime and corruption and, most importantly, addressing the issue of diminishing crude oil reserves. With its growing GDP, a higher level of foreign direct investment than any other Latin American country and a political climate that is currently more open to investment than the past several decades, investing in Mexico could offer high rewards.

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