FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Mexico at 'BBB-'; Outlook Stable

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Fitch Ratings - New York - 17 Nov 2021: Fitch Ratings has affirmed Mexico's Long-Term Foreign-Currency and Local-Currency Issuer Default Ratings (IDRs) at 'BBB-' with a Stable Rating Outlook.

KEY RATING DRIVERS

Mexico's rating is supported by a prudent macroeconomic policy framework, stable and robust external finances, and stable government debt/GDP projected at levels below the 'BBB' median. The rating is constrained by weak governance, muted long-term growth performance, continued policy intervention affecting investment prospects and the implications for the federal government's finances from its strategy of alleviating Pemex's tax burden.

The Stable Outlook is supported by the relatively strong performance of public finances, notwithstanding medium-term challenges. This supports our assessment of macro policy credibility as a rating strength and backstop to private sector confidence despite continued microeconomic policy interventions and governance challenges.

Mexico's public finances continue to outperform rating and regional peers. Modest above-the-line fiscal support throughout the pandemic has resulted in narrow fiscal deficits and a smaller increase of the debt to GDP ratio than for most other 'BBB' rated countries. However, in Fitch's view, the limited fiscal impulse will likely result in higher social costs (e.g. higher poverty indices and subemployment), increasing the risk of economic scarring and weighing on future growth potential. Fitch anticipates general government deficits (approximation used by Fitch for comparison purposes and in its sovereign rating model) of 2.5% of GDP in 2021 and 2.3% in 2022, from 2.4% in 2020.

The 2022 budget proposal extends Mexico's limited fiscal impulse into next year, targeting a small NFPS primary deficit of 0.3% of GDP. This target is a moderate fiscal relaxation compared to the previous guideline published in April 2021, accommodating higher health-related spending while maintaining the administration's priority projects (infrastructure projects along the south of Mexico and transfers to the elder population).

The budget maintains the government pledge not to increase taxes but includes tax measures to incentivise small businesses to join the formal sector. The finance ministry does not assume these will raise tax collection in the near term. Low government revenues coupled with fast rising pension costs signal narrowing medium-term fiscal space. Fiscal buffers (such as FEIP, Budgetary Revenues Stabilization Fund), while not fully depleted, are no longer available to compensate for material revenue losses.

Fiscal policy remains consistent with a relatively stable debt to GDP ratio. Fitch projects general government debt (Federal Government & Social Security plus State and Municipalities plus IPAB but excluding PEMEX and CFE) to remain around 48% of GDP through 2023, before resuming a gradual increase at the end of our five-year forecast horizon, albeit remaining below the 2022 'BBB' rating category forecast median of 54%. Weak potential growth estimates place the onus on fiscal policy to maintain a stable debt to GDP ratio over the medium term.

Fitch views the debt of state oil company Pemex (equivalent to 9% of GDP) as a contingent liability of the sovereign. Fitch expects the federal government will continue to financially support PEMEX (BB-/Stable) as a priority of this administration has been to strengthen the role of Mexico's state-owned energy companies. The 2022 budget reduces PEMEX profit-sharing tax, (DUC, derecho de utilidad compartida) to 40% from 54%, reducing Pemex's tax burden by approximately MXN80 billion (0.3% of GDP).

A negative notching in the qualitative overlay to our model-implied rating reflects Fitch's view that the government will continue to support Pemex financially through tax benefits and capitalizations on an ad hoc basis, weighing on the government's own finances. The government will meet Pemex's external debt amortizations in 2021 but has made no formal commitment to do this in the future.

Fitch expects real GDP growth of 5.9% in 2021 and 2.8% in 2022. Economic recovery is underway although at divergent speeds and recent data signals the fragility of recovery prospects. Manufacturing production (excluding autos) recovered to pre-pandemic levels supported by the US economic recovery while construction and services consumption lag behind. Real GDP contracted 0.2% quarter-over-quarter (preliminary estimate) in Q3 2021 because of lingering pandemic effects, input scarcity and temporary effects of the recently approved labour outsourcing reform. Mexico's vaccination drive mitigates further pandemic risks as the economy continues to fully reopen; 58% of the population has received one dose, while 47% is fully vaccinated. Post-pandemic medium-term growth, which Fitch estimates at 2%, continues to be hampered primarily by investment unease due to political noise, weak governance quality and low productivity growth.

Rising U.S. demand for goods has resulted in input supply-demand imbalances (most importantly semiconductors) delaying industrial production recovery, particularly in Mexico's auto sector. Mexico's auto industry (21% of manufacturing production, 3.3% of GDP in 2019) has been forced to carry out technical stoppages through the year due to input scarcity, which Fitch expects to affect GDP growth by 1 percentage point. Supply shortages are likely to continue through the first half of 2022.

Inflation rose through 2021 reaching 6.2% in October 2021 as rising manufactured goods prices coincided with higher agricultural and energy prices. Fitch believes these effects are transitory, but higher prices are feeding into short-term inflation expectations. This prompted Banxico to raise its monetary policy rate by 100bps since June 2021. Longer-than-expected supply shocks will constrain monetary policy space and will likely result in further rate hikes in 2022.

Mexico held mid-term congressional elections in June along with state elections. The elections resulted in Morena's (ruling party) loss of the two-thirds majority in the lower chamber 'Camara de Diputados' it held along with its coalition allies. The new political landscape diminishes President Lopez Obrador's (AMLO) capacity to pass any constitutional reform, including the recently announced electricity reform. Amendments to the Constitution require approval from two-thirds majority in the Chamber of Deputies and the senate and a simple majority from half of the state legislatures.

A cornerstone of AMLO's political agenda has been the reversal of reforms allowing private participation in the energy and electricity market. The latest effort is a constitutional reform modifying the electricity sector presented to Congress in September 2021. The reform intends to transform CFE (Mexico's state-owned electricity company) into an autonomous state entity, limit private sector participation and grant CFE and the Ministry of Energy full regulatory and dispatch authority.

If approved, Fitch expects the reform would lead to underinvestment in the electricity sector and non-competitive electricity pricing and would weaken Mexico's regulatory quality. The reform would also likely result in higher investment needs on the part of CFE and higher generation costs, which could increase pressure on CFE's finances and public finances. The debate on the reform was moved to April 2022; Fitch does not anticipate it will be approved in its current form given the mid-term congressional results, but a version of the proposals could be approved.

A pattern of microeconomic policy intervention in markets and distrust in autonomous regulatory entities continues to affect Mexico's investment climate and governance quality, although the main focus continues to be the energy sector. While many proposals have been shelved, suspended by the courts and/or modified after private sector consultation, there have been initiatives with negative implications for investment prospects (e.g. Mexico City airport cancelation) and those yet to be implemented (e.g. electricity reform).

The government has also continuously criticized autonomous regulatory institutions, including energy regulators and the electoral authority. Regulatory quality, one of the six pillars of the World Bank Worldwide Governance Indicators, has consistently deteriorated through this administration.

ESG - Governance: Mexico has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Mexico has a medium WBGI ranking at 35 reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Macro: A weakening in the consistency and credibility of the macroeconomic policy framework, for example if unorthodox policy interventions become more widespread, negatively affecting growth prospects and/or leading to a reassessment of the upward notching in our rating adjustment for this factor;

- Public Finances: A trend increase in the government debt burden, evidenced by an upward trajectory in the gross general government debt/GDP ratio;

- Structural: Deterioration in governance indicators that widens the gap further to the scores of 'BBB' category peers and further undermines the business climate.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Macro: Improvement in growth prospects to a level closer to the BBB median, underpinned by credible macroeconomic policies.

- Structural: Improvement in governance indicators to a level closer to the rating category median.

- Public Finances: Addressing weaknesses in public finances via revenue-enhancing reforms that would increase confidence in a stable or declining government debt path, and a reduction in contingent liability risks related to Pemex.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Mexico a score equivalent to a rating of 'BBB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: + 1 notch, to reflect Mexico's track record under successive administrations of prudent, credible and consistent macroeconomic policies, which is not captured by the weak governance indicator score included in the SRM. The authorities continue to emphasize macroeconomic stability in both fiscal and monetary policy, which has contained macroeconomic imbalances. The long-term sustainability of this positive notch adjustment could be threatened by a prolonged pattern of microeconomic interventions by the government, potentially weakening governance quality and impacting macroeconomic outturns.

- Public Finances: -1 notch, to reflect our expectation that ongoing sovereign support for Pemex will result in a lower tax take and/or higher general government debt burden, negatively impacting public finances.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Mexico has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Mexico has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Mexico has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Mexico has a percentile rank below 50 for the respective Governance Indicators, this has a negative impact on the credit profile.

Mexico has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Mexico has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Mexico has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Mexico, as for all sovereigns. As Mexico has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Mexico	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	LC ST IDR	F3	Affirmed	F3
	Country Ceiling	BBB+	Affirmed	BBB+

senior unsecured	LT	BBB-	Affirmed	BBB-
senior unsecured	ST	F3	Affirmed	F3

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Sovereigns Latin America Mexico
