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Fitch Affirms Mexico at 'BBB-'; Outlook Stable

Fitch Ratings - New York - 18 Nov 2022: Fitch Ratings has affirmed Mexico's Long-Term Local-Currency and Foreign-Currency Issuer Default Rating (IDR) at 'BBB-' with a Stable Rating Outlook.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

Credit Fundamentals: Mexico's rating is supported by a prudent macroeconomic policy framework, stable and robust external finances, and government debt/GDP projected to remain stable at levels below the 'BBB' median. The rating is constrained by weak governance indicators, muted long-term growth performance, micro policy intervention affecting investment prospects in Fitch's view, and the potential contingent liabilities from Pemex.

The Stable Outlook is supported by stable public finances and the priority policymakers attach to this and broader macroeconomic stability, notwithstanding challenges from subdued economic growth prospects. This supports our assessment of macro policy credibility as a rating strength despite continued microeconomic policy interventions and governance challenges.

Commitment to Debt Stability: The government continues to show commitment to a stable debt/GDP ratio, by maintaining moderate fiscal deficits. Sustained tax revenue growth due to administrative measures, such as tackling tax evasion, has helped Mexico's fiscal position. We forecast general government deficits (including federal government and social security, an approximation used by Fitch for comparison purposes) of 3.1% of GDP in 2022 and 3.8% in 2023, compared to 3.0% in 2021. The 2023 budget projects a non-financial public sector deficit of 3.6% of GDP, up from 3.0% in 2022.

Higher Expenditure Pressures: Government expenditure is budgeted to increase by 11.6% in real terms in 2023 versus the 2022 budget due to higher interest costs and increased capital expenditure because of higher input costs. The AMLO administration seeks to complete its priority infrastructure projects (the Maya and Isthmus trains and the Dos Bocas refinery) before elections are held in July 2024. The budget, therefore, projects a sharp fall in capex in 2024. A large increase in pensions (up 8.4% in real terms) and the administration's priority social transfer program to older people (Pensión para el Bienestar de las Personas Adultas Mayores, up 34.3% in real terms), coupled with low government revenue, signal narrowing medium-term fiscal space in Fitch's view.

Reform to Rebuild Fiscal Buffers: The government recently reformed the rules surrounding its Revenue Stabilization Fund (FEIP) to facilitate its build-up (pending Senate approval), including via use of other financial assets and budgetary savings derived from lower borrowing costs. While not fully depleted, fiscal buffers have declined in recent years and are no longer available to compensate material revenue losses, which could force the government to resort to spending cuts (primarily investment) to meet the fiscal deficit target. The FEIP currently has MXN25 billion (0.1% of GDP), and the government anticipates increasing the fund's assets to MXN75 billion (0.26% of GDP) by year-end.

Continued Pemex Support: Fitch expects the government will remain committed to financially supporting Pemex, as part of its priority of strengthening the role of state-owned companies in the energy sector. We anticipate the government will continue to provide ad hoc support but stop short of a firm commitment of sustained financial support. Such support will be dependent on Pemex's financial position (and thus has been less in the context of higher oil prices) and the fiscal position of the federal government. Fitch does not expect the government will guarantee Pemex's debt given current legislation that restricts this.

Economic Growth Continues to Lag: Fitch forecasts real GDP growth to reach 2.5% in 2022 and slow to 1.4% in 2023. Growth continues to be hindered by sluggish investment, partly related to ongoing political noise and regulatory uncertainty, particularly in the energy sector. External demand remains supportive in the near term but the economy will face challenges from the expected slowdown of the U.S. economy. A mild U.S. economic recession in mid-2023 is now Fitch's central scenario. Consumption benefits from continued labor-market improvement and strong remittances. Mexico's real GDP growth will continue to lag behind both rating and regional peers. A sharper-than-expected U.S. recession is a key downside risk for the Mexican economy.

External Buffers: In the context of increased global financial and economic uncertainty, external risks appear contained by Mexico's free-floating exchange rate, narrow current account deficit which is funded by foreign direct investment flows, adequate international reserve levels, and prudent monetary policy. Mexico continues to benefit from the IMF's Flexible Credit Line (about USD47 billion, one fourth of international reserves) although treats the facility as precautionary.

Near-Shoring Economic Opportunity: Increasingly, evidence points towards higher demand for Mexico's production (though this has yet to translate into higher aggregate investment) as a result of U.S.-China trade tensions and manufacturers' desire for shorter and more resilient supply chains. Further reliance of the U.S. on Mexico's goods may improve the latter's resilience despite the expected economic slowdown. Asian countries seem to have benefited from the supply chain reallocation out of China in the short term, but rising shipping costs may tip the scale more in favor of Mexico.

Continued Inflationary Pressures: Inflation declined slightly to 8.4% in October following its peak of 8.7% in September. Pandemic-related demand distortions, supply-chain disruptions and elevated commodity prices lifted inflation to levels not seen in the past two decades. The government's intention of increasing the minimum wage could moderately add to inflationary pressures and may result in higher labor informality. High inflation may increase its persistence outside the central bank's (Banxico) range and affect inflation expectations. Banxico began to tighten its monetary policy in June 2021, raising the policy rate by 600bp to 10% as of November. We anticipate Banxico will continue its policy tightening to avoid further de-anchoring of inflation expectations against the backdrop of stubbornly high inflation. We project policy rate will reach 10.75% by end-2022.

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 low WBGI ranking at the 32th percentile reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity but relatively weak rule of law and control 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 marked upward trajectory in the gross general government debt/GDP ratio, for example due to fiscal deterioration or weaker economic growth;

--Structural: Deterioration in governance that results in political instability or undermines policy-making and 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;

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

--Structural: Improvement in governance, for example, reflected in convergence in governance indicators closer to the rating category median.

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 centered 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(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Mexico	LT IDR	BBB-	Affirmed		BBB-
	ST IDR	F3	Affirmed		F3

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	LC LT IDR	BBB-	Affirmed		BBB-
	LC ST IDR	F3	Affirmed		F3
	Country Ceiling	BBB+	Affirmed		BBB+
• senior unsecured	LT	BBB-	Affirmed		BBB-
• senior unsecured	ST	F3	Affirmed		F3

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Country Ceilings Criteria (pub.01 Jul 2020)

Sovereign Rating Criteria (pub.11 Jul 2022) (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, v3.13.1 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Mexico	EU Endorsed, UK Endorsed

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