MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Mexico's Baa1 rating, maintains negative outlook

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New York, April 29, 2021 -- Moody's Investors Service, ("Moody's") has today affirmed the Government of Mexico's long-term foreign-currency and local-currency issuer ratings at Baa1. The outlook remains negative.

The decision to affirm the credit rating despite evidence of erosion in some of Mexico's credit metrics reflects two key drivers. First, the deterioration in the fiscal accounts has been contained, and is most likely to remain so, in part as a consequence of the austere fiscal stance adopted during the crisis. Second, the significant economic contraction -- itself also partly a consequence of the government's austere fiscal stance -- is likely to be reversed, with medium-term growth returning to its pre-crisis trend, supported over the near term by strong growth in the US.

The decision to maintain the negative outlook reflects ongoing downside risks to those outcomes, in part as a consequence of what Moody's considers to be a weaker policy framework. Additionally, the rating agency considers heighten risk that medium-term growth will be weighed down by sluggish domestic demand, weak investment prospects and limited productivity growth, failing to recover as Moody's expects. Fiscal accounts are exposed both to the risk of lower-than-expected growth and to the possibility that financial support for Pemex exceeds Moody's expectations, as the rating agency believes the current strategy is unlikely to successfully address the company's strategic challenges and those facing the broader energy sector.

The rating affirmation applies to Mexico's foreign-currency and local-currency senior unsecured Baa1 ratings, the foreign-currency and local currency MTN senior unsecured program (P)Baa1 ratings, and the foreign-currency senior unsecured shelf (P)Baa1 rating.

Mexico's local-currency (LC) and foreign-currency (FC) ceilings are Aa3. The four-notch gap between the LC ceilings and the issuer rating reflects the government's relatively limited role in the economy and a track record of predictable and reliable macroeconomic policymaking. The lack of a gap between LC and FC ceilings reflects the absence of transfer and convertibility risks, itself anchored in a history of strong economic institutions supporting currency convertibility and open capital accounts.

RATINGS RATIONALE

RATIONALE FOR RATINGS AFFIRMATION AT Baa1

LIMITED DETERIORATION IN FISCAL AND DEBT METRICS

While Mexico's fiscal and debt metrics have deteriorated over the past year, the deterioration has been broadly in line with the rating agency's expectation when it downgraded the rating to Baa1 from A3 last year, and relatively limited on a global comparative basis in the context of the pandemic. Even though the economy contracted by 8.2%, compared to Moody's forecast of a 3.7% real GDP contraction at the beginning of the pandemic, debt at the federal government level only increased by around six percentage points of GDP, in line with the rating agency's expectation at that time. Resilient government revenue resulting from enhanced tax enforcement efforts, alongside lower current expenditures, led to a relatively small increase in the fiscal deficit to 2.4% of GDP from 1.8% of GDP in 2019. The decision to provide support to Pemex by securitizing assets rather than using transfers also helped to contain the increase in government debt.

Looking ahead, Moody's expects the conservative fiscal stance that has characterized the current administration to continue during the second part of its term in office. Relatedly, the rating agency expects financial support to Pemex via transfers or tax breaks to remain contained, at around 1% of GDP per year. While there remains little prospect of a material improvement in the sovereign's low revenue base, government revenue is expected to remain broadly resilient, in part reflecting the tax authority's efforts to fight tax evasion and improve collection. Moody's expects the tax reform planned for 2022 to be largely administrative in nature.

Overall, Moody's expects Mexico's fiscal strength to remain a positive feature of the sovereign credit profile relative to Baa peers. Moderate increases in government debt, of around one percentage point a year, will be driven by small primary deficits at the federal government level. The government's debt burden will remain below the median for Baa-rated sovereigns, although debt affordability (as measured by interest payments as a percentage of revenue) will remain weaker than that of most rated peers.

STRONG US GROWTH WILL SUPPORT AN ECONOMIC RECOVERY IN MEXICO

Moody's believes Mexico's conservative fiscal response exacerbated the economic impact of the crisis. After GDP fell by over 8% in 2020, Moody's expects only a somewhat muted recovery of 5.6% growth in 2021 and 2.7% growth in 2022. However, over the medium term Moody's projects economic growth to return to broadly the same potential, of close to 2% per annum, as expected prior to the crisis. Overall, the impact of the pandemic on Mexico's economic strength is not expected to be fundamentally different than for most sovereigns, with the pandemic leaving a significant scar on the level of GDP, but not necessarily on post-pandemic trend growth.

That forecast is subject to both headwinds and tailwinds. On the negative side, Moody's expects investment to remain around four percentage points lower than it was five years ago, with negative implications for already very low productivity growth. Low investment reflects negative sentiment and persistent private sector concerns about additional regulatory and legal changes that could negatively impact business conditions, due to both bill proposals and recurrent confrontations with the private sector, notwithstanding agreements on some areas. While the government recognizes the need to stimulate investment, its success in doing so, or conversely the persistence of the problem into the next administration, remains to be seen. On the positive side, growth this year and next is likely to benefit from the very strong recovery Moody's expects in the US, which will lead to higher manufacturing exports and production in Mexico, coupled with a post-pandemic rebound on consumption. Improving US growth prospects have been the key driver of the material increase in Moody's 2021-22 growth estimates for Mexico since January this year.

In addition, Moody's expects a more constructive relationship to develop between the US and Mexico under the Biden administration, as the new administration sees Mexico as a North American partner that can benefit from further development of regional integrated production chains, in the context of the USMCA trade agreement signed by the US, Mexico and Canada, which took effect on 1 July 2020. That said, Mexico will likely experience a "two-speed" recovery, with sectors connected to the US expanding at a faster pace than those driven by domestic demand.

RATIONALE FOR A NEGATIVE OUTLOOK

Moody's decision to maintain the negative outlook primarily reflects the downside risks to growth and the potential fiscal risks related to the need for recurring financial support to Pemex.

In addition, weak investment prospects could lower medium-term growth beyond Moody's current expectations. Moody's expects growth to trend back to 2% after 2022. However, policy decisions and private sector concerns related to future changes in the legal and regulatory environment, particularly in the energy sector, can further undermine business sentiment and could have a lasting negative impact on medium-term growth.

Persistently weak investment and a weak labor market continue to pose downside risk to domestic demand. While the unemployment rate has fallen from its 2020 peak, it remains above the level seen in December 2019 and the quality of employment has continued to lag: the underemployed represented 14% of the employed population in December 2020 (compared to an average 7% over 2019), and those earning an equivalent of less than double the minimum wage accounted for 57.2% of those employed (compared to 51% in the last quarter of 2019).

Lack of a comprehensive recovery strategy for Pemex poses a further downside risk to public finances. Moody's currently expects 1% of GDP per year in recurrent government support to Pemex for the next few years. Following a continuous decline in production over the past decade and lower oil prices since 2014, Pemex's net revenue contribution to the sovereign had narrowed to around 2% of GDP by 2017/18. Going forward, Moody's expects Pemex's net revenue contribution to hover around zero, given lower production and the need to support the company to meet its debt amortizations and capital expenditure needs.

On the fiscal front, Moody's anticipates a gradual but persistent shift toward an increasingly rigid expenditure structure, a condition that will limit policy flexibility in the coming years, making it harder for the authorities to respond to shocks without a negative impact on the debt burden. Government pension spending, which includes social security and state-owned companies contractual pension obligations, has been growing annually at a 7.5% real rate for the last fifteen years (2006-20), consistently above real GDP growth, which averaged 1.4% in the same period. The government's pension-related spending now amounts to 4% of GDP compared to 2% in 2006. Total public investment, which currently stands at only 3.4% of GDP, has fallen to 13% of total expenditures in 2018-20 from 20% in 2014-16, severely limiting the scope for further cuts in the future.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Mexico's ESG Credit Impact Score is moderately negative (CIS-3) reflecting its moderate exposure to environmental risks balanced by higher social risks, driven mostly by safety and health concerns, and rising governance risks due to the deterioration in the quality of institutions, notwithstanding the strength of its macroeconomic framework.

Mexico's exposure to environmental risks is moderately negative (E-3 issuer profile score) given the country's exposure to physical climate risk in the form of extreme weather events that may impact the finances of sub-sovereign states (not as much at the sovereign level) via reduced tourism and higher disaster relief and preparedness expenditures. The size and diversity of the economy helps mitigate the impact at the sovereign level. Additionally, given the interdependence between the state-owned oil enterprise and the government, Mexico is exposed to carbon transition risks over the medium to long term.

Exposure to social risks is moderately negative (S-3 issuer profile score) reflecting several factors. Mexico faces moderate challenges in the provision and quality of education, housing and, most importantly, health and safety and access to basic services. Mexico has had rising levels of violence that threaten physical security in several states of the country for at least a decade. Additional risks are related to an aging population in the coming decades. This aging, in the context of a social security system that is significantly underfunded, will result in social demands that future administrations will have to contend with.

Governance poses moderately negative risks (G-3 issuer profile score). The government of Mexico maintains a strong track record of effective fiscal and monetary policymaking. However, a deterioration in the decision-making process is leading to economic policies that affect investment prospects and limit the government's ability to respond to shocks. While the strength of key institutions such as the central bank supports macroeconomic stability, Mexico has scored poorly on institutional factors for many decades, with control of corruption and rule of law among its weakest areas.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Sustained economic growth above current baseline scenario could lead to a return to a stable outlook. A material strengthening of the government's balance sheet, particularly reflected in particular in debt affordability metrics via a stronger revenue base, could add positive pressure to the rating. A sustained strengthening of the governance and institutional framework could lead to an upgrade.

Indications that medium-term growth will likely plateau at a level below 2% would put downward pressure on the rating. A heightened likelihood that higher-than-expected fiscal deficits will lead to a more pronounced upward increase in government debt trajectory, whether due to financial support to Pemex above and beyond what is already captured in our Moody's baseline scenario or driven by a decline in government revenue, could also lead to a downgrade. Similarly, an increase in contingent liabilities, via structured vehicles or off-balance sheet operations, could further impact the sovereign's overall fiscal strength and could lead to a negative rating action.

GDP per capita (PPP basis, US$): 20,796 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -0.1% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.8% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -1.8% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.3% (2019 Actual) (also known as External Balance)

External debt/GDP: 36.6% (2019 Actual)

Economic resiliency: baa2

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 27 April 2021, a rating committee was called to discuss the rating of the Mexico, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. Other views raised included: The issuer's institutions and governance strength, have decreased.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

NATIONAL SCALE RATINGS

Moody's National Scale Rating (NSR) map to Mexico's Baa1 Global Scale Ratings (GSRs) maps to a range of Aaa.mx to Aa1.mx. Moody's NSRs are ordinal rankings of creditworthiness relative to other credits within a given country, which offer enhanced credit differentiation among local credits. NSRs are generated from GSRs through correspondences, or maps, specific to each country. However, unlike GSRs, Moody's NSRs are not intended to rank credits across multiple countries. Instead, they provide a measure of relative creditworthiness within a single country. The full maps can be accessed through the "Index of Current and Superseded Compendia of National Scale Rating Maps by Country".

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in May 2016 entitled "Mapping National Scale Ratings from Global Scale Ratings". While NSRs have no inherent absolute meaning in terms of default risk or expected loss, a historical probability of default consistent with a given NSR can be inferred from the GSR to which it maps back at that particular point in time. For information on the historical default rates associated with different global scale rating categories over different investment horizons, please see https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1216309 .

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1263068 .

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Ariane Ortiz-Bollin
Vice President - Senior Analyst
Sovereign Risk Group
Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
U.S.A.
JOURNALISTS: 1 212 553 0376
Client Service: 1 212 553 1653

Alejandro Olivo
Managing Director
Sovereign Risk Group
JOURNALISTS: 1 212 553 0376
Client Service: 1 212 553 1653

Releasing Office:
Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
U.S.A.
JOURNALISTS: 1 212 553 0376
Client Service: 1 212 553 1653

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