

## Press Release

# DBRS Morningstar Changes Trend on Mexico to Stable; Confirms at BBB

## Sovereigns

May 06, 2021

DBRS Inc. (DBRS Morningstar) confirmed the United Mexican States' (Mexico) Long-Term Foreign and Local Currency – Issuer Ratings at BBB. At the same time, DBRS Morningstar confirmed the United Mexican States' Short-Term Foreign and Local Currency – Issuer Ratings at R-2 (high). The trend on all ratings has been changed to Stable from Negative.

### KEY RATING CONSIDERATIONS

The change in trend to Stable from Negative reflects DBRS Morningstar's expectation that the Mexican economy will recover in 2021 and 2022 following a powerful shock in 2020, and that the government's commitment to sustainable public finances will continue to support macroeconomic stability. Relative to our last review in May 2020, we now view the risks to Mexico's sovereign credit profile as more balanced.

The pandemic has had a severe impact on Mexico in terms of health and economic outcomes. The economy contracted 8.2% in 2020, the worst annual hit to GDP since the 1930s. While activity rebounded in the second half of the year, growth momentum slowed at the start of 2021 due to tightened pandemic-related restrictions, a global shortage in semiconductors, and weather-related energy supply disruptions. However, activity is expected to pick up over the next few quarters, supported by the reopening of the economy and strong demand from the United States. The IMF expects GDP growth of 5.0% in 2021 and 3.0% in 2022. We think the risks to this near-term forecast are skewed to the upside, although further outbreaks of the virus

## Issuers

United Mexican States

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and potential delays in the vaccine rollout present downside risks.

The deterioration in public finance metrics last year was broadly in line with our expectations when we downgraded Mexico's ratings to BBB from BBB (high) last year. Government debt-to-GDP increased an estimated 8 percentage points in 2020, but tight fiscal policy is expected to keep the debt ratio on a stable trajectory over the next five years. While we remain concerned about the quality of public spending, the government's commitment to fiscal sustainability should help preserve stable macroeconomic conditions.

The BBB ratings balance Mexico's track record of sound macroeconomic policymaking with the country's deep governance and growth challenges. The economy has demonstrated a high degree of resilience, due in large part to its strong policy framework – comprised of exchange rate flexibility, prudent fiscal management, and a credible inflation-targeting regime. The financial system has also demonstrated resilience amid the pandemic, and the country's external position appears broadly consistent with economic fundamentals.

However, significant structural challenges weigh on the credit profile. Poor education outcomes, widespread informality, and far-reaching governance problems have led to decades of weak economic growth. We expect Mexico's relatively poor growth performance to continue over the medium term, due in large part to policy actions by the López Obrador (AMLO) administration. Poorly-targeted infrastructure spending, reduced reliance on private capital in the energy sector, and less predictable policymaking will likely end up constraining investment and dampening productivity growth. Over time, weak economic growth could increasingly weigh on public finances.

#### RATING DRIVERS

The rating could be upgraded if (1) the government reorients economic policy in a manner that materially strengthens Mexico's investment outlook and (2) public debt dynamics are put on a firm downward trajectory over the medium term.

The ratings could be downgraded if (1) there is a material deterioration in Mexico's medium-term growth prospects, or (2) a weakening in the country's macroeconomic policy framework.

#### RATING RATIONALE

Mexico's Lackluster Growth Record Is Unlikely To Improve With AMLO's Policy Mix

Mexico's growth performance over the last three decades has been poor. From 1989 to 2019, the economy grew at an average rate of just 2.5%. Due to policy actions by the AMLO administration, we think Mexico's growth trajectory is unlikely to improve. The government's decisions to postpone energy auctions, limit cooperation between Pemex and private firms, cancel a partially-built airport in Mexico City, renegotiate private contracts related to several natural gas pipelines, and revoke permits to build a beer manufacturing plant, have damaged business confidence. More recently, the government has taken steps to strengthen the market power of state-owned energy companies, a move that will likely lead to more expensive and carbon-intensive energy production. All of this points to lower and poorer-quality investment, which will adversely impact medium-term growth prospects.

On the other hand, the passage of the United States-Mexico-Canada trade agreement in 2020 reduces a major source of uncertainty about the future of the North American relationship, and Mexico appears well-positioned to take advantage of potential shifts in global value chains: Mexico is located next to the US market, connected to the US with well-developed transport infrastructure, open to international trade and investment, and cost competitive. However, deepening participation in global value chains could depend on Mexico's ability to upgrade worker skills and training, increase competition in network industries, and strengthen the rule of law.

#### Mexico's Fiscal Strategy Allays Sustainability Concerns But Raises Allocation Concerns

The government's fiscal response to the pandemic has been a mix of targeted support and fiscal austerity. Compared to other countries, the scale of the response has been small. Additional spending and foregone revenue totaled just 0.7% of GDP last year; measures included accelerating some social transfer payments, extending low-interest credit to SMEs and households, and moving ahead with previously announced large infrastructure projects. At the same time, changes to the tax regime and stepped-up tax collection efforts contributed to positive real revenue growth, even as there was a sharp decline in economic activity. As a result, the deficit only increased from 2.3% of GDP in 2019 to 3.9% in 2020. The government's muted fiscal response is expected to continue this year and next year. The deficit is set to narrow to 3.3% of GDP in 2021 and 2.9% in 2022, supported by a recovery in activity and higher oil prices. We think the government's commitment to fiscal sustainability should help foster a stable macroeconomic environment as the economy recovers.

However, low and poorly-targeted public investment raises concerns about future economic growth. Of key concern is Pemex's business strategy, which in DBRS Morningstar's view, is unlikely to improve operational efficiency or

DBRS Morningstar's view, is unlikely to improve operational efficiency or rebuild its reserve portfolio. Consequently, Pemex could increasingly weigh on public finances, either by crowding out other higher-yielding investment or contributing to higher deficits.

Tight fiscal policy will keep the government debt ratio on a stable trajectory over the outlook period, albeit at a higher level than before the pandemic. General government debt increased from 53% of GDP in 2019 to 61% in 2020. The increase was largely due to the recession, although exchange rate depreciation also contributed. The composition of the public debt mitigates risks stemming from global market volatility. Rising interest rates and peso depreciation would adversely affect debt dynamics, but the impact would likely be modest due to the relatively long average maturity of the debt and the high share of debt that is denominated in local currency.

### Strengthening The Rule Of Law Is A Critical Challenge

The most significant challenge facing Mexico's credit profile relates to governance. According to the Worldwide Governance Indicators, Mexico scores poorly on the rule of law relative to emerging market peers, both globally and in Latin America. Corruption and cronyism, which are perceived to be entrenched and widespread, constrain economic growth by encouraging rent-seeking behavior and misallocating resources. Elevated levels of criminality, combined with perceived deficiencies in the judicial system and law enforcement, also weaken the investment climate.

Efforts by the AMLO administration to address corruption and improve public security have focused on poverty alleviation schemes, budgetary cuts for programs perceived to be subject to graft, and the creation of a National Guard to replace the Federal Police. Although it may be early to draw conclusions, it is not clear, in DBRS Morningstar's view, that the strategy will yield any benefits in terms of strengthening the rule of law or improving the country's institutional quality.

The results of the June 6th mid-term elections will influence AMLO's ability to implement his agenda in the second half of his presidency, especially as it relates to the energy sector. The election will determine all 500 seats in the lower house, 15 governors, and 30 of 32 state legislatures. If AMLO's coalition wins two-thirds of the seats in the lower house, it would still need support from the opposition in the Senate to pass constitutional amendments. In our view, one source of credit strength has been the broad political support through the electoral cycle for Mexico's sound fiscal and monetary policy frameworks. This has enhanced the economy's resilience to shocks and influences positively our "Political Environment" building block assessment.

## Strong Policy Frameworks Support The Economy's Resiliency

Mexico benefits from a credible inflation-targeting framework and a well-regulated financial system. In the 12 months following the COVID-19 outbreak, the central bank cut the policy rate by 300 basis points cumulatively from 7.0% to 4.0%. The cut in the policy rate shifted the monetary policy stance from restrictive to moderately expansionary. Easing policy has helped to mitigate the shock and support the recovery, with most of the rate cuts being passed on to individual and corporate borrowers. However, further rate cuts do not seem likely, despite the output gap, as headline and core inflation have remained above the 3% target for the last 10 months. The central bank also has noted that the highly uncertain economic outlook and that recent volatility in financial markets warrant a cautious approach to monetary policy. According to the median forecast in the Survey of Expectations of Private Sector Economists, headline inflation is expected to converge toward the target in the first half of 2022, with the first rate increase in late 2022.

The financial system appears well-positioned to weather the recession and support the recovery as demand returns. Firms tapped credit lines in the first two months of the pandemic when domestic financing conditions tightened. However, outstanding commercial loans have declined since May 2020 as precautionary liquidity needs have diminished and local capital market conditions have improved. The financial regulator allowed banks to provide temporary forbearance to borrowers impacted by the shock. Increased provisioning contributed to lower profitability in 2020, but the banking system remains well-capitalized, with adequate buffers to absorb unexpected losses. In addition, exchange rate fluctuations have not adversely affected banks' balance sheets nor do they appear to have adversely affected asset quality in the corporate sector. Household leverage is also low, with limited foreign exchange exposure.

External accounts have demonstrated resilience amid the pandemic. The current account shifted from a deficit of 0.3% of GDP in 2019 to a surplus of 2.4% in 2020. Exports recovered faster than imports in the second half of the year and remittances increased 11% year-over-year in dollar terms. We expect the current account to move back to a modest deficit position over the next few years, in line with strengthening domestic demand. Mexico's sound macroeconomic policy framework – including a credible inflation-targeting regime and exchange rate flexibility – enhances the economy's resilience to bouts of market turbulence. In addition, the central bank holds \$202 billion in net reserves, a \$60 billion swap line with the Federal Reserve, and a \$61 billion Flexible Credit Line from the IMF, which provide some protection against global tail risks. Notwithstanding these buffers, the large stock of foreign portfolio liabilities leaves the economy exposed to capital flow

volatility.

## ESG CONSIDERATIONS

Resource & Energy Management (E), Human Capital & Human Rights (S), Bribery, Corruption & Political Risks (G), Institutional Strength, Governance & Transparency (G), and Peace & Security (G) were among key drivers behind this rating action. Management of the energy sector remains a potential vulnerability to Mexican public finances, with oil-related revenues accounting for 10-20% of government revenue. Similar to other emerging market economies and many of its regional peers, per capita GDP is relatively low, at US\$8.4k (US\$19.1k on a PPP basis). According to World Bank Governance Indicators, Mexico ranks in the 22nd percentile for Control of Corruption, the 45th percentile for Voice & Accountability, the 27th percentile for Rule of Law, and the 45th percentile for Government Effectiveness. Mexico is trying to address violence and criminality issues through reform, but still ranks low (20th percentile) on Political Stability and the Absence of Violence/Terrorism. These considerations have been taken into account within the following Building Blocks: Fiscal Management and Policy, Economic Structure and Performance, and Political Environment.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at <https://www.dbrsmorningstar.com/research/373262>.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments: <https://www.dbrsmorningstar.com/research/378059>.

### Notes:

For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: <https://www.dbrsmorningstar.com/research/357883>

All figures are in U.S. dollars unless otherwise noted. Public finance statistics reported on a public sector basis; this excludes state and local governments but includes state-owned enterprises and public development banks. The fiscal balance is the Public Sector Borrowing Requirement.

The principal methodology is the Global Methodology for Rating Sovereign Governments <https://www.dbrsmorningstar.com/research/364527/global-methodology-for-rating-sovereign-governments> (July 27, 2020). Other

applicable methodologies include the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings <https://www.dbrsmorningstar.com/research/373262/dbrs-morningstarcriteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings> (February 3, 2021).

Generally, the conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are monitored.

The primary sources of information used for this rating include the Secretaría de Hacienda y Crédito Público, Banco de México, INEGI, BIS, OECD, IMF, World Bank, UN, Tullet Prebon Information, and Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing this rating was of satisfactory quality.

This rating was not initiated at the request of the rated entity.

The rated entity or its related entities did participate in the rating process for this rating action. DBRS Morningstar did not have access to the accounts and other relevant internal documents of the rated entity or its related entities in connection with this rating action.

For more information on this credit or on this industry, visit [www.dbrsmorningstar.com](http://www.dbrsmorningstar.com).

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## Ratings

| Date Issued | Debt Rated   | Action              | Rating        | Trend        | Attributes       |
|-------------|--|---------------------|---------------|--------------|------------------|
| 06-May-21   | Long-Term Foreign Currency - Issuer Rating             | Confirmed           | BBB           | Neg          | US               |
| 06-May-21   | Long-Term Foreign Currency - Issuer Rating             | Trend Change        | BBB           | Stb          | US               |
| 06-May-21   | Long-Term Local Currency - Issuer Rating<br>Debt Rated | Confirmed<br>Action | BBB<br>Rating | Neg<br>Trend | US<br>Attributes |

|           |   |              |            |     |    |
|-----------|---|--------------|------------|-----|----|
| 06-May-21 | Long-Term Local Currency - Issuer Rating    | Trend Change | BBB        | Stb | US |
| 06-May-21 | Short-Term Foreign Currency - Issuer Rating | Confirmed    | R-2 (high) | Neg | US |
| 06-May-21 | Short-Term Foreign Currency - Issuer Rating | Trend Change | R-2 (high) | Stb | US |
| 06-May-21 | Short-Term Local Currency - Issuer Rating   | Confirmed    | R-2 (high) | Neg | US |
| 06-May-21 | Short-Term Local Currency - Issuer Rating   | Trend Change | R-2 (high) | Stb | US |

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## Related Documents

### Methodology Used:

Global Methodology for Rating Sovereign Governments / July 27, 2020

DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings / February 3, 2021

### Other:

United Mexican States - 17g-7 Disclosure Report

United Mexican States - Scorecard Indicators and Building Block Assessments

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