United Mexican States (Mexico)

Ratings

United Mexican States	
Action: **Affirmed**	6 May 22
Foreign Currency LT	BBB
Local Currency LT	BBB
Action: **Affirmed**	6 May 22
Foreign Currency ST	K2
Local Currency ST	K2

Ratings are based on KBRA's Sovereigns Rating Methodology, published 20 December 2021 and utilise the ESG Global Rating Methodology published 16 June 2021. KBRA's rating scales and definitions are found here.

Outlook/Watch

United Mexican States	
Long-Term Ratings	Stable

Economic Snapshot

	2022 f
Per Capita Income (US$, PPP)	19,028
Real GDP Growth (% Change)	1.8
Inflation Rate (Average %)	6.8
Budget Balance (% GDP)	-3.2
Current Account Balance (% GDP)	-0.6
External Debt (% CAR)	~85.0
Level of Economic Development	medium
Default History	Last episode 1982

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Executive Summary

Kroll Bond Rating Agency (KBRA) affirms Mexico's long-term and short-term issuer ratings.

Ratings Outlook: KBRA has revised the outlook on Mexico's long-term ratings from Negative to Stable. This change reflects reduced post pandemic risks, although high inflation and global slowdown are an evolving concern. The recent congressional vote denying constitutional reform of the energy sector also supports the removal of the Negative Outlook, reducing risks surrounding possible violations of the US Mexico Trade Agreement (USMCA), although negative signals to private and foreign investment persist. Strong oil prices support the beleaguered finances of Petróleos Mexicanos (Pemex).

Key Credit Considerations

The ratings were affirmed because of the following key credit considerations:

- Mexico's economy is generally well managed, with a strong fiscal anchor demonstrated by fiscal restraint even during the pandemic, a flexible exchange rate, and an independent central bank. Minimal fiscal support to the economy produced a deep contraction in 2020 but also a relatively modest deficit. Net public debt stands at 45.4% of GDP, and net federal debt at 36.3% of GDP (1Q22). A low revenue yield, dependence on energy revenues, and weak Pemex finances increase fiscal risks.
- Mexico's considerable geostrategic importance to the U.S. reflects its size, location, commercial linkages, and evidence of financial support. Mexico's ties to a dynamic and resilient economy enhance its economic prospects, and the USMCA provides a framework for Mexico's policy environment. Linkages continue to deepen. Mexico's large, young, relatively well-diversified and competitive economy is attractive to U.S. manufacturing. Supply chains are entrenched and nearshoring momentum continues.
- Mexico has strong access to liquidity, including a $9 billion swap line with the U.S. Treasury and a renewed $50 billion IMF Flexible Credit Line, ample FX reserves (~$200 billion) that exceed immediate external financing needs, a stabilization fund of $25 billion, and strong financial markets access. Sound debt management and fiscal transparency bolster Mexico's credit profile.
- Fixed investment continues to fall and is not sufficient to significantly upgrade the economy's growth potential. The recent Supreme Court decision failed to declare the Electric Power Industry Law unconstitutional and will lead to litigation and continue to dampen private investment in the sector, while intervention in independent institutions underscores shortfalls in rule of law, negative for the investment climate.
- Enduring slow GDP growth in the economy reflects sub-par investment, including limited (and in KBRA's view sometimes inefficient) government capex. High interest rates reflect inflation, exchange rate volatility, and financial markets conditions. Corruption and crime, low levels of educational attainment, and weak productivity also contribute to Mexico's lackluster growth performance. PPP per capita GDP<$20,000 reflects institutional/development weaknesses.

Rating Sensitivities	
Positive rating momentum could arise if private investment strengthens, allowing for stronger dynamism. Energy sector reform that would assist public finances could drive positive momentum.	+
Negative rating pressure could arise if Mexico's longer term growth outlook weakens beyond expectation, or if government finances structurally worsen. A deteriorating international environment – increasingly likely given high global inflation - could meaningfully increase borrowing costs in Mexico, and if sustained could negatively impact government finances.	–

ESG Management

KBRA typically analyses Environmental, Social, and Governance (ESG) factors through the lens of how the sovereign plans for and manages relevant ESG risks and opportunities. More information on KBRA's approach to ESG risk management in sovereign ratings can be found here. Over the medium-term, governments will need to prioritise ESG risk management and disclosure with the likelihood of expansions in global ESG-related regulations, including adherence to the commitments of the Paris Agreement, and rising investor focus on ESG issues.

Environmental Factors

According to USAID, Mexico takes second place in Latin America and the Caribbean in greenhouse gas emissions (GHG). In a 2019 ranking, it ranked 13th globally in terms of GHG. Mexico's energy sector is a large contributor, accounting for > 70% of the total and reflecting the quality of oil production as well as the energy dependency mix (87% of energy needs are met from fossil fuels). The primary sector is also a factor, accounting for ~15% of the total. Mexico is also vulnerable to extreme weather events, such as tropical cyclones and floods, which poses risks to aging infrastructure as well as agriculture (including subsistence farming). Tourism, about 8% of GDP and 9% of employment, is also at risk from extreme weather events and global warming.

Management of environmental risks seems unfocused. In December 2020, the Government of Mexico submitted an updated Nationally Determined Contribution (NDC) to the Paris Agreement, but it has not upgraded its targets since 2015 in a meaningful way. Mexico's NDC targets reducing GHG by 22% and black carbon emissions by 51% by 2030 in a 'business-as-usual' stance. The current policy environment is not inclined towards renewable energy production, and favors increasing production and energy dominance of Pemex in terms of extraction and natural gas generation. KBRA believes there is fiscal bandwidth to address emerging environmental risks should they arise although resources are not infinite.

Social Factors

KBRA focuses on social risk in terms of stakeholder preferences. The current administration's economic program under the Fourth Transformation calls for tackling corruption, organized crime, and poverty. However, it is uncertain if steps being taken will go far towards addressing the shortfalls and reducing stakeholder risk on these social and investor-significant issues. Stakeholder risks also emanate from the administration's management of environmental and climate risks especially related to hesitation toward transitioning towards renewable energy. Violations of Mexico's trade arrangement with the US and Canada (USMCA) is another risk, albeit reduced somewhat due to the lower house of Congress' voting down of the reform of the energy sector. Electoral reform and restructuring of the INE electoral watchdog create rising stakeholder risks.

Mexico was the world's first country to issue a Sustainable Development Goals (SDG) bond internationally and has begun issuing SDG bonds in the local market, which would also be the first such issuance in the emerging markets. It made its first SDG Bondes G issuance earlier this week.

Governance Factors

Mexico's National Cybersecurity Strategy of 2018 is meant to address cybersecurity threats and underscores awareness of this growing risk, especially as modernization of the economy continues.

K-Sov and Rating Methodology Steps

Mexico Sovereign Credit Rating K-Sov	
Rating Determinant	**Equivalent Rating Range**
Macroeconomic Performance	BBB
Government Financial Strength	BBB
External Vulnerability	AA/A
Structural Robustness	BBB
K-Sov Mexico	**A/BBB range**

Determining the K-Sov is the first step of KBRA's Sovereign Ratings Methodology. Supporting Mexico's K-Sov is the economy's relatively moderate external vulnerability. Weighing the K-Sov down are weaknesses in government finances and macroeconomic performance. Structural robustness indicators are mixed and reflect Mexico's geostrategic importance, middle income status, and institutional shortcomings. The second step considers trend analysis, peer comparisons, additional metrics and factors influencing credit risk that may not be included in the K-Sov analytics, as well as willingness to pay. KBRA believes Mexico's willingness to pay its debt is high. In part, this assessment considers the government's commitment to fiscal restraint, and its demonstrated support for state-owned energy company, PEMEX which helps the company honor its debts.

Trend analysis for Mexico is an important rating consideration given the dislocations caused by the pandemic and the dim outlook for longer-term economic growth for this economy due to what KBRA believes are negative signals to private investors as well as its pattern of low growth. Moreover, pandemic risks remain, as evident from the lockdown in China and continued supply chain constraints. The recovery of tourism has been strong even if incomplete but is also vulnerable to virus evolution. Lastly, the global outlook is highly uncertain given geopolitical and inflation risks, for which Mexico is far from immune. Further downward growth revisions for Mexico and its main trading partner, the US, is likely, in KBRA's view.

Macroeconomic Credit Metrics

	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross Domestic Product USD bn	1171.9	1078.5	1158.9	1222.4	1269.4	1087.1	1294.8	1322.7	1322.7
Real GDP Growth	3.3	2.6	2.1	2.2	-0.2	-8.2	4.8	1.8	2.0
Population mns	121.3	122.7	124.0	125.3	126.6	127.8	129.0	130.1	130.1
Total Credit/GDP	74.6	79.8	77.7	77.1	77.2	86.9	82.4	-	-
to Government	0.0	37.0	35.2	35.3	36.1	41.6	41.0	-	-
to Households	15.2	16.0	16.0	16.0	16.0	17.3	16.4	-	-
to Private Corp.	24.5	26.8	26.5	25.7	25.1	27.1	25.0	-	-
Savings/GDP	20.7	21.4	21.2	20.7	20.9	21.6	19.8	21.3	21.3
Investment/GDP	23.3	23.6	22.9	22.7	21.2	19.2	20.2	21.9	21.9
Current Account Balance/GDP	-2.6	-2.2	-1.7	-2.0	-0.3	2.4	-0.4	-0.6	-0.6
External Debt % Exports	97.7	100.6	101.5	90.7	91.5	104.3	84.2	85.0	
Debt Service Ratio	12.7	19.3	14.6	11.8	12.3	15.6	15.8	-	
External Vulnerability Indicator	44.5	58.4	47.6	48.8	52.2	46.1	34.6	-	
ST BIS Liabilities/Assets [2]	39.5	35.4	42.7	47.7	39.3	34.8	30.9	-	-
Total BIS Liabilities/Assets [2]	111.7	97.2	118.1	124.4	116.4	94.1	83.4	-	-
Inflation avg YOY	2.7	2.8	6.0	4.9	3.6	3.4	5.7	6.8	6.8
10-Year Bonds % - Year-end	6.3	7.4	7.7	8.7	6.9	5.6	7.6		
General Government Revenues/GDP	23.5	24.6	24.6	23.5	23.6	24.2	23.3	24.4	24.4
General Government Expenditures/GDP	27.5	27.4	25.7	25.7	26.0	28.7	27.1	27.6	27.6
Fiscal Interest/Revenues	11.9	12.7	14.9	16.1	15.8	16.1	16.3	18.6	18.6
General Government Balance/GDP	-4.0	-2.8	-1.1	-2.2	-2.3	-4.4	-3.8	-3.2	-3.2
General Government Structural Balance/Potential GDP	-4.4	-3.9	-2.0	-2.3	-1.8	-2.1	-2.2	-2.2	-2.2
General Government Cyclically Adjusted Balance/Potential GDP	-4.2	-4.1	-2.6	-2.4	-2.1	-3.1	-2.7	-2.1	-2.1
Primary Balance/GDP	-1.2	0.4	2.6	1.6	1.4	-0.5	0.0	1.3	1.3
Gross Government Debt/GDP	52.8	56.7	54.0	53.6	53.3	60.3	57.6	58.4	58.4
Gross Government Debt/Revenues	253.6	267.4	237.2	238.1	234.9	266.2	242.5	242.2	242.2

Sources: National Sources, IMF, EC, Eurostat, BIS, Bloomberg. [1] as of 3q21 ; [2] 2021 as of 2q21.

Step I: K-Sov Scorecard Analysis

Macroeconomic Performance

Mexico is the 15th largest economy in the world, which leads to meaningful economic diversification. The large size of the domestic market is a point of attraction to investors as its location next to the U.S. and its free trade agreement with the U.S. and Canada (the USMCA, successor to NAFTA). Exports and imports each comprise about 40% of GDP, although they are not very diversified, either in terms of product (auto sector, largely via *maquiladoras*, and oil) or market (over three-quarters of merchandise exports are destined to the U.S.). Consumption is the main driver for the economy (~75% of GDP), and as such, rising income levels are a key variable influencing output. Investment, at ~low-20% of GDP on average, and declining, is low considering Mexico's stage of economic development. Credit intermediation to the nonfinancial corporate sector stands at ~30% of GDP, a low level of monetization that underlies weakness in investment and fosters a reliance on external financing that is generally only available to more sophisticated corporates or those deemed to have sovereign backing. However, the local capital continues to expand. Nonbank financial institution finance has barely grown as highlighted in this recent KBRA research piece, which is also a deterrent to economic growth.

Rating Determinant 1: Macroeconomic Performance (20%)	Equivalent Rating Range
Nominal GDP ($B)	AA/A
Nominal GDP Growth (%)	BB/B
Real GDP Growth (%)	BB/B
Inflation (%)	A/BBB
K-Sov Macroeconomic Performance	**BBB**

Mexico's Pandemic Recovery Stalled by Exogenous Developments

Mexico's economy registered 0.9%q/q balanced growth in 1Q22 fueled by activity in both the industrial and services sectors, and mirroring the buoyant consumption and investment registered for both goods and services in its most important trading partner, the US. This has occurred even as inflation has surged, measuring 7.45%, and as the Bank of Mexico (Banxico) policy rate was hiked by 250 bps to 6.5% starting in June of 2021.The growth slowdown is compounded by rate hikes and inflation that remains well above target. Lack of fiscal support during the pandemic, while preserving government finances, contributed to a deep economic contraction in 2020 of -8.2%, and since then the recovery in output terms has been incomplete, with full recovery of lost output likely only towards the end of this year, or early next year at best. This has been surprising given the pace of US rebound a relationship highlighted in a KBRA research report. Some macro indicators are improving, including production, about ~15% off of full capacity, and employment, with labor force participation in the formal sector just about 1.5 percentage points off pre-pandemic levels. Movement towards producing higher-end cars, Mexico's most important industry, contributed to slow recovery in volumes, and lingering (and deepening in some cases) supply chain woes also contribute to Mexico's more measured growth performance, as has lackluster (and recently contracting) corporate credit growth.

Slowdown in the US dims Mexico's outlook. Heightened inflation globally, and especially in the US, is unlikely to be resolved even with more aggressive interest rate hikes by the Fed. The mix—aggressive hikes and high inflation – could weaken performance and propel the country into recession, with 1Q22 growth in the US already contracting q/q. This situation is expected to have adverse consequences for the US' southern trading partner. The most recent official projections for Mexico were made in the 2023 Preliminary Budget Criteria in early April. The Ministry of Finance (MOF) then announced an expected deceleration in growth to about +3.4% in 2022, but recent global dynamics have caused most private economists to forecast a level below 2% growth for the year. Depending on global dynamics, Mexico's growth performance could continue or even worsen next year, with the official estimate being 3.5% GDP growth in 2023. The MOF's expectations consider fiscal policy that is generally *supportive* of growth in that gas prices are being kept at the level of inflation and the government is about to announce a package of measures to absorb food price inflation. These additional fiscal costs are being financed by higher than anticipated oil revenues. If not for the energy subsidies, the MOF estimates that inflation would be in the range of 1.3-2.0% higher and consumption also lower as well, significantly helping Banxico in keeping forthcoming interest rate hikes more moderate.

Mexico's economy was more resilient than originally anticipated at the outbreak of COVID, especially given the sharp fall in energy prices and tourism, mainstays of the economy. Energy accounts for ~10% of GDP and tourism another 9%. US swap lines (the $60 million pandemic swap line with the Fed expired end 2021), an IMF credit line, along with copious inflows of worker remittances helped the economy weather the challenges. Moreover, social distancing was not as strict. This contributed to very high infections (and mortality in Mexico) but also likely softened the outsized 2020 GDP contraction. Regardless, Mexico experienced one of the most severe economic contractions in the world even compared to several LATAM peers.

Growth Outlook – Structurally Weak

There has been some constructive news on the policy front (from an investors perspective) but some mixed results as well. The June 2021 election did not deliver Andrés Manuel López Obrador (AMLO)'s Morena party a supermajority that would help facilitate the passage of the constitutional reform of the energy sector. Congress recently voted the law down, assuaging investor concerns. However, uncertainties exist about the Supreme Court's ruling on the Electric Power Industry Law. That law gives state electric utility *Comisión Federal de Electricidad* (CFE) priority dispatch over cheaper private companies and creates disincentives for the expansion of renewable energy. The body did not muster enough votes to render the law unconstitutional and as such the injunctions filed will continue to be handled -- with uncertain outcomes -- by the courts. This situation will likely continue to dampen private investment in the energy sector and also present administrative hurdles, such as obtaining permits. Some of these topic have been discussed in this KBRA research report.

The AMLO administration is wedded to the idea of strengthening state influence in the energy sector. The government has been steadily unwinding energy sector reforms (including postponing auctions and farmouts) spearheaded by the last administration under President Peña Nieto. The new refinery in Dos Bocas, Tabasco plus the Maya train in the Yucatan Peninsula are expected to worsen the financial burden on struggling Pemex. The recent (January 2022) purchase of the Deer Park refinery in Texas is not likely to be highly profitable but does improve energy security for the country. Other headline non-investor friendly measures introduced since AMLO's election include a withdrawal from key investment projects such as the Texcoco airport and the fiber optic broadband network, Red Troncal. Gas transportation contracts with CFE were reopened and renegotiated as well.

AMLO continues to attack Mexico's independent electoral body, INE, as an example of infringements on Mexico's independent institutions. Ongoing assaults on the rule of law that aim to increase the role of the state in economic decision-making have also weakened growth in the years leading up to the pandemic. Growth in Mexico has averaged ~1.7% pa since 2000. That's below the US. In 2019, despite a booming U.S. economy, Mexican growth contracted.

Other aspects of the policy environment are favorable from an investor's standpoint. Fiscal restraint is an important anchor for stability in Mexico, and one that helps enhance the investment climate, although without enhancing human and capital infrastructure development because of curbs on public investment spending (and a generally austere fiscal stance). Banxico independence is also supportive. Generally high real interest rates also provide a floor to MXN weakening (in the context of a floating exchange rate regime), a factor considered by investors in MXN securities. Given the weak channels of transmission to the domestic economy, with credit to the nonfinancial sector below 30% of GDP, high interest rates certainly impair economic activity but not in an outsized way.

Government Financial Strength

KBRA uses a broad definition in its analysis of public finances for Mexico, the public sector, which includes all state-owned entities (SOEs). We also refer to the public sector borrowing requirement (PSBR) as well as the conventional fiscal deficit. The PSBR is more comprehensive, including net refinancing needs as well as deficit related borrowing. Mexico's fiscal anchor and assists stability in government debt ratios.

Rating Determinant 2: Government Financial Performance (25%)	Equivalent Rating Range
General Government Revenues % GDP	A/BBB
General Government Balance % GDP	BBB
General Government Debt % Revenue	B and Below
General Government Interest % Revenue	BB/B
Access to Liquidity/Vulnerability to Sell-off	A/BBB
Contingent Liabilities	A/BBB
Fiscal Arrears	AAA/AA
K-Sov Government Financial Performance	**BBB**

Structural Weakness in Revenues, Pemex exposure

A low tax base is one of the more important structural impediments of government finances, although not uncommon to Mexico's peer group. Revenues to GDP amount to around 22%, a ratio that reflects a large informal economy and limitations on revenue mobilization. Tax revenues are in the mid-teens. The government's modest revenue yield is low considering a key government debt solvency indicator, debt to revenues, stands >240%. Net debt to GDP for the public sector is more moderate, at 45.4% as of 1Q22 (and >50% on a gross basis). Revenues from the energy sector, namely Pemex, have trended downwards over the years from 30% of revenues around the time of the GFC, to 17% of revenues in 2019, reflecting production declines, fiscal policy towards taxing the energy concern, as well as energy prices. The importance of energy sector to tax revenues reached a recent low during the height of the pandemic, thanks to the precipitous fall in oil prices, and this year the reverse is underway with energy revenues likely to contribute to almost 25% of the revenue take.

In addition to dependence on Pemex for revenues, the government financially supports the beleaguered company. This support has involved drawing fiscal reserves, tax breaks, direct capital infusions, and specific support for debt repayments (including covering 2021 amortizations), hence hitting public finances through a variety of avenues. The secular decline in production seems to have been arrested only somewhat with expected production for the year of 1,820 mbpd. This compares to 2,548 thousand bpd as recently as 2013, and a peak of 3,380 mbpd in 2004, although new discoveries are hoped for outside of the main oil field Cantarell. Outside of Cantarell, production reached 355 mpd according to Pemex's 1Q22 results. The government's stated goal is to increase production to 2.654 thousand bpd. Pemex debt totalled $108 billion at end-March 2022. As noted, last year's amortizations were paid down by the government. Its 1Q22 results reveal a profit of MXN 123 billion.

Over the past years leading up to the pandemic, Pemex accumulated debt but it did not appear to assist the commercial viability of the company, given falling production volumes. AMLO's investment strategy could further impair Pemex's finances given the focus low-yielding projects including the Dos Bocas refinery (in addition to the investment in Deer Park). In addition, limitations on increasing production are evident, based on recent performance.

In past years, an oil price hedge ('the Hacienda Hedge') has helped insulate the company and government from low oil prices, and the use of these hedges speaks to responsible management of the exposure. However, the combination of hedging costs and high real interest rates swell interest expense to >16% of revenues (>18% expected this year), an outsized level compared to many peers, and results in a significant constraint on expenditures for social and economic development priorities.

Mixed Fiscal Picture Likely for 2022

The fiscal picture is mixed for 2022. In the MOF's early April Preliminary Budget Criteria, it revised down its expected 2022 growth forecast to 3.4% but this is likely still overly optimistic given global developments, although its updated oil price projection of $93/b on average for the year seems reasonable. Based on these assumptions, the government's target of a 0% of GDP primary deficit for the year may be unrealistic. Government coffers will enjoy greater revenues from taxes from Pemex, although this will be offset significantly by subsidies for high energy prices and the slowdown in growth which is also dampening revenues. These subsidies were announced in early March and limit the price of gas at the pump to the rate of inflation. The tax rate on Pemex was reduced last year but rising income thanks to high oil prices should deliver greater income to the public sector accounts. According to MOF estimates, should oil prices stay below $155, federal government accounts would benefit even considering the costs of the subsidies to its balance sheet, although the overall public sector stays positive thanks to the improved financial health of Pemex. There are many unknowns, however, including the impact on revenues from the slowdown in growth. Also, the rising costs to energy supplies to CFE is a concern. Pemex is expected to honor its debt obligations this year, after being supported in the recent past, thanks to oil price developments.

In summary, the PSBR target of 3.7% of GDP and deficit of -3.1% of GDP may not be achievable, with downside risks high thanks to prospects for a faster GDP growth slowdown than expected. Similarly, plans to tighten fiscal policy next year, including a primary balance surplus and falling deficit, may not be achievable.

Government Debt Profile Moderates Risks

The structure of government debt has improved since the Mexican financial crisis in the mid-1990s, when overreliance on *tesobonos* (USD denominated debt instruments) to finance the buildup in foreign exchange reserves was met with a sudden retrenchment of the market. The largess of international creditors and the support of the U.S. Treasury were critical to the rescue of Mexico, and the government avoided restructuring its debts. The government last restructured its debts in the 1980s. Sound debt management and strides in fiscal policy and transparency have been critical factors improving Mexico's debt sustainability.

Mexico's debt is largely local currency denominated, fixed rate and long-term, although large non-resident holdings increase the risk of destabilizing outflows, although to a much lesser extent today given the reduction in holdings during the pandemic. Total public sector debt - foreign currency and MXN denominated - totals ~$680 billion, an estimated 51 % of GDP. MXN debt is mainly (>90%) long-term and fixed rate (76%, largely *Mbonos*).

Public sector foreign currency debt amounts to ~ 22% of total debt. Federal government foreign currency debt totaled ~$120 billion in February 2022 and public company foreign currency debt stands at a slightly lower total. In comparison, FX reserves nearly cover the sum, at $200 billion. The government has begun to rebuild its Stabilization Fund for Budget Revenues (FEIP) and it stands at $24.6 billion as of 1Q22.

Nonresident holdings of MXN debt ($80 billion) has receded and the reliance on the local market has risen. The weighted average maturity of Mexico's foreign currency debt is over 21 years, and debt management has opportunistically taken advantage of the interest rate environment while also lengthening the maturity structure of Mexico's foreign currency debt. The redemption profile is manageable with modest amounts falling due through 2025, roughly $10 billion a year, for example.

Mexican government interest costs are high relative to peers and have been rising, thanks to the layering of shocks over the recent period (oil price shock of 2014-16, Trump immigration policy, and trade shock). Interest to revenues stands at > 18% at present, up substantially over recent years. High domestic interest rates – in spite of Banxico interest rate cuts at the outset on the pandemic - are partly responsible for the high cost of debt relative to revenues, given the reliance on MXN issuance. Pemex debt prices as high yield and this also is captured in interest costs to the public sector.

External Vulnerability

Mexico's sensitivity to external shocks is mitigated by its close commercial ties with a large and stable economy, the U.S. Pemex weaknesses in the context of its status as the top foreign currency indebted oil company globally does add to external risks. Other external risks stem from the holdings of government debt by non-residents. These have contracted significantly since the onset of COVID and non-resident investors now hold about 18% of MXN debt, down from >30% pre-pandemic. As noted, Banxico's independence supports Mexico's external finances. Its demonstrated preparedness to hike interest rates has been an important tool underlying Mexico's external and financial stability. Mexico's external vulnerability is mitigated by its floating exchange rate, the diversification of export receipts, and its balance of payments financing structure, with foreign direct investment covering current account deficits. Reserves stand at about $200 billion, more than ample to cover gross external financing needs for the year ahead. Short term foreign currency debt stood below $33 billion at end-2021.

Moderate current account deficits have averaged around -2% of GDP in the past few years, and the deficit disappeared in 2020 thanks to a larger collapse in domestic demand than exports of goods and services. A small deficit of -0.6% was posted in 2021. Manageable foreign currency indebtedness is another factor alleviating external pressures. The profile of Mexican government debt, with a long-average weighted maturity of foreign currency debt, and the large share of fixed-rate peso debt, helps reduce external risks that tend to be amplified by non-resident investor activity.

As mentioned, the government's $50 billion flexible credit line with the IMF and its swap line with the U.S. Treasury underscore strong liquidity, on top of unfettered market access.

Rating Determinant 3: External Vulnerability (25%)	Equivalent Rating Range
Current Account Balance % GDP	A
External Debt % Current Account Receipts	BBB
Debt Service Ratio	A/BBB
(External ST Debt+ Amortizations+NR Deposits/FX Reserves)	AAA/AA
ST BIS Liabilities % BIS Assets	AAA/AA
BIS Liabilities % BIS Assets	AAA/AA
Dollarization Ratio	AA/A
K-Sov External Vulnerability	**AA/A**

The MXN's position as the second most traded currency in the emerging markets and one of the top traded currencies globally renders the currency particularly vulnerable to risk-off investor behavior (and to homegrown shocks). However, it should be noted that a highly traded currency allows a faster adjustment to fundamentals and generally mitigates the possibility of panic runs on the currency. It also reflects Mexico's sound financial system, open capital markets, market-determined interest and foreign exchange rates, and relatively deep capital market compared to other emerging markets, which are also important considerations for debt sustainability.

Structural Robustness

Mexico is aligned with its peer group on many indicators of structural robustness. KBRA believes sociopolitical risk in Mexico is moderate. Mexico has enjoyed broad political stability, although episodes of protests, violence, riots, and heightened police activity do exist, although Mexico is not unique in this regard. Income inequality is high, as are regional gaps in income and economic performance, and this potentially adds to political risk although heightened activity is thus far quite dormant. AMLO's cuts in the *Progresa* program, a social initiative that combats poverty, has been diluted although measures implemented have avoided extreme protests. Violent crime and corruption, the latter a key focus of the AMLO government, also negatively impacts sociopolitical risk although in Mexico's case manifests itself mostly in sub-par investment rather that distracted public policy. The government has been absorbing the high cost of energy and plans to introduce price controls on 25 items, which does help moderate risks to consumers. In terms of policy continuity, the thrust of policies seems to proceed uninterrupted. In spite of the questionable handling of the pandemic by the government and its severe social consequences, the approval rating of AMLO stands >50% according to most polls.

The large size of the Mexican economy ($1.3 trillion), its diversification and its juxtaposition to, and close relations with, the U.S. are important factors underlying its geopolitical significance. There is a small but nonetheless possible risk of an altered U.S. view towards the U.S.-Mexico relationship should policies related to the energy sector move forward in breach of the USMCA, although that seems to be of lower risk given the recent congressional ruling on constitutional change. Institutional indicators are aligned with many peers but are generally weak and rule of law is deteriorating.

Banking Sector is Resilient and Risks are Manageable

In terms of other structural characteristics, Mexico's financial sector is bank-dominated and relatively small compared to those of other EM peers. Commercial bank assets account for about 40% of GDP. The commercial banking sector is highly concentrated and has a large foreign ownership, but most activity remains local with funding dependent on domestic savings and used for domestic lending and investment in government securities. The country's seven largest commercial banks account for over three-quarters of consolidated sector assets, five of which are majority foreign-owned. The banking system is profitable, adequately capitalized, and mainly deposit-funded, with a low level of nonperforming loans, supported by conservative underwriting standards. As of December 2020, the sector's tier 1 capital ratio stood at over 16% and nonperforming loans (NPLs) (representing 2.4% of the total) were fully provisioned against. Global uncertainty related to the Russian invasion on Ukraine as well as the pandemic will likely pressure banking system profitability and asset quality but the solid health of the banking system at this juncture suggests that systemic problems that could rise due to the weaker economic environment would be manageable for the sovereign's balance sheet. About 20% of system assets are in government debt.

Rating Determinant 4: Structural Robustness (30%)	Equivalent Rating Range
Socio-Political Risk	A/BBB
Security Risk	A/BBB
Geostrategic Importance	A/BBB
Systemic and Economic Risk	A/BBB
Per Capita GDP (PPP Basis)	BBB/BB
Institutional Indicators	BBB/BB
K-Sov Structural Robustness	**BBB**

Step II: Peer Comparatives, Trends, Willingness to Pay

In Step II of the sovereign ratings approach, KBRA evaluates peer comparisons, recent trends and outlook, and its evaluation of willingness to pay. Regarding peer comparisons, Mexico's indicators of structural robustness are broadly in line with economies in its general credit quality neighborhood. European Union (EU) peers have benefited from regulatory and administrative requirements that facilitate their convergence with the bloc. Mexico, like its EU peers, also enjoys support from stronger economies, and in Mexico's case, the U.S. Mexico has somewhat weaker macroeconomic performance and key government debt ratios than several peers. Mexico has received recognition for its strides in fiscal transparency and its control over federal government finances. Mexico's external standing is somewhat stronger than that of many peers with moderate foreign currency debt and manageable current account deficits and coverage by FDI.

Longer-Term Slow Growth, Energy Boon Faces Slowing Global Demand

KBRA's credit ratings of Mexico assigned in 2019 were forward-looking and incorporated the direction of policies – specifically those that dampen private investment and stunt Mexico's growth potential. Elections on June 6, 2022 served to contain risks in that the Morena party lost its supermajority in Congress thereby weakening prospects for the constitutional reform of the energy sector that has been a cornerstone of the AMLO administration's agenda. Indeed, the reform was not passed by Congress last month. There are still uncertainties around the energy sector as referred to earlier in this report, including related to the Supreme Court ruling on the Electric Power Industry law. In addition, the law to nationalize the lithium sector was just passed which provides a signal of lingering policy risks. Upcoming state elections in June could strengthen the resolve of the current government to push ahead with agenda of cementing the government's dominant role in the economy, particularly in areas it views as central to its national security, with negative signals to private investment.

As is the case for all economies, Mexico's near to medium term economic fortunes are largely dependent upon containment of virus variants and the reversal of lockdowns (and supply chain problems) in China as well as energy prices. Growth performance in the US, including the risk of a hard landing, and high global inflation, exacerbated by the Russia Ukraine War, are all risks to Mexico's outlook. While AMLO appointments to Banxico were expected to tilt policy to be more dovish, high inflation of 7.45%, more than double the central bank midpoint target of 3% compounds risks and suggests even faster interest rate hikes. The inflationary environment dulls growth. Prospects for a taper-tantrum in EMs continue to be pronounced as discussed here, especially should global risks heighten and with it global risk aversion. The IMF expects Mexican growth of 2% this year but that seems optimistic, and risks to the economy remain elevated, with inflation risking the dampening of growth even regardless of external dynamics. The medium-term IMF forecast of 2.1% growth through 2026 could also be ambitious, with negative consequences for government debt reduction. IMF forecasts a slight rising in the government's debt ratios alongside of baseline GDP growth of just north of 2%.

In KBRA's view, a GDP growth rate that averaged <2% pre-pandemic and could recede due to the aforementioned macro and policy dynamics, will be an enduring constraint on government financial flexibility and contribute to very slow debt consolidation. However, the cyclical boon to Pemex thanks to high oil prices, should they persist, are an important dynamic to consider as well in calculating fiscal risks.

Macroeconomic Forecasts

Macroeconomic Forecasts (2022-2026 average)				
Trends and Projections	**Mexico**	**Chile**	**Italy**	**Portugal**
GDP Growth	2.1	1.7	1.5	2.5
Inflation	4.0	4.3	2.8	1.9
Current Account Balance % GDP	-0.8	-3.2	2.5	-1.3
Government Revenues % GDP	23.6	25.5	48.0	43.7
Government Balance % GDP	-3.0	-0.6	-3.8	-1.4
Government Primary Balance % GDP	1.3	-0.2	-1.0	0.5
Government Interest Payments % Revenues	18.3	1.5	5.7	4.3
Government Gross Debt % Revenues	242.4	173.0	422.4	286.9
Government Debt % GDP	59.2	38.0	147.3	114.3

Sources: IMF World Economic Outlook and IMF Fiscal Monitor April 2022

Comparative Statistics

Comparative Statistics				
2021 Data	**Mexico**	**Chile**	**Italy**	**Portugal**
Gross Domestic Product (USD bn)	1,294.8	316.9	2,101.3	250.1
Nominal GDP Growth (%)	12.4	20.2	7.2	5.6
Real GDP Growth (%)	4.8	11.7	6.6	4.9
Consumer Price Inflation (%)	5.7	4.5	1.9	0.9
Unemployment Rate - Latest Read	4.1	8.9	9.5	6.6
General Government Revenues % GDP	23.3	25.9	48.3	45.3
General Government Balance % GDP	-3.8	-7.5	-7.2	-2.8
General Government Cyclically Adjusted Balance % Potential GDP	-2.7	-5.4	-6.9	-0.1
General Government Debt % GDP	57.6	36.3	150.9	127.5
General Government Debt % Revenues	242.5	223.0	406.5	303.8
General Government Interest % Revenues	18.0	2.4	7.0	5.1
Current Account Balance % GDP	-0.4	-6.7	3.3	-1.1
Per Capita GDP (PPP) - USD (World Bank)	18,820	24,316	42,018	33,537
Average Institutional Indicators (KBRA Ranking)	BBB	A	BBB	AA/A
Human Development Index (Ranking)	74	43	29	38

Sources: IMF World Economic Outlook and IMF Fiscal Monitor April 2022

Finally, KBRA believes that Mexico has a high willingness to honor its debt obligations.

Step III: Local Currency vs. Foreign Currency Government Bond Ratings

KBRA's unified long term foreign and domestic currency ratings for Mexico reflect our expectation that the government would not differentiate between debt obligations based on currency denomination. Sizeable nonresident holdings of MXN debt (~20%, albeit reduced from pre-pandemic levels) makes it unlikely that one denomination would be significantly immunized against a shock in the other market. The rating alignment also considers that given the indebtedness of the government in MXN, the local currency market could be a source of stress.

Conclusion

Mexico's credit ratings reflect its size, economic diversification, relationship with the U.S., access to liquidity and sound management of the economy as well as longer term uncertainties for growth and rapid sustained fiscal consolidation due to macroeconomic policies.

Summary of Rating Committee

On 03 May 2022, KBRA's Sovereign Rating Committee discussed the rating of Mexico. The main points discussed included the 2021 election results and dulled prospects for constitutional changes in the energy sector, the policy environment that continues to reduce the attractiveness of private investment especially in the renewables sector, the impact of high energy prices on fiscal and Pemex accounts, the inflationary environment and impact on growth, and the slowdown in the US.

Rating History

Mexico Rating History		
Date	**Action**	**Rating/Outlook/Watch Status**
24-Oct-19	Assigned	LT Ratings: BBB (Stable) ST Ratings K2
8-May-20	Affirmed	LT Ratings: BBB (Negative) ST Ratings K2
6-May-21	Affirmed	LT Ratings: BBB (Negative) ST Ratings K2
6-May-22	Affirmed	LT Ratings: BBB (Stable) ST Ratings K2

Further disclosures relating to this rating action are available here. Additional information regarding KBRA policies, methodologies, rating scales and disclosures are available at www.kbra.com.

The ratings of Mexico are unsolicited ratings. The rated entity or related third party did participate in the rating process and KBRA did not have access to the accounts and other relevant internal documents.

Related Publications: (available at www.kbra.com)

- Mexico's Payroll Lending Distress Does Not Create Systemic Risks
- Russia's Invasion of Ukraine: Initial Contours of Credit Risk
- U.S. Stimulus: Uneven Impact on LATAM