United Mexican States (Mexico)

Ratings

United Mexican States	
Action: **Affirmed**	06 May 21
Foreign Currency LT	BBB
Local Currency LT	BBB
Action: **Affirmed**	06 May 21
Foreign Currency ST	K2
Local Currency ST	K2

Ratings are based on KBRA's Sovereigns Rating Methodology, published 11 May 2017. KBRA's rating scales and definitions are found here.

Outlook/Watch

United Mexican States	
Long-Term Ratings	Negative

Economic Snapshot

	2020e
Per Capita Income (US$, PPP)	19,130
Real GDP Growth (% Change)	-8.2
Inflation Rate (Average %)	3.4
Budget Balance (% GDP)	-4.6
Current Account Balance (% GDP)	+2.5
External Debt (% GSPI)	104.3
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 issuer ratings. KBRA also affirms the short-term issuer ratings of the sovereign. The ratings remain on Outlook Negative.

Ratings Outlook: The Negative Outlook on Mexico's ratings reflects continued concerns about the policy environment that dampens investment and growth with negative implications for longer-term fiscal flexibility. KBRA continues to monitor the direct and indirect impacts of the COVID-19 virus on Sovereigns. Please refer to KBRA's COVID-19 research page for more details.

Key Credit Considerations

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

- Mexico's stable policy environment is underpinned by fiscal restraint and overperformance even during the pandemic, a flexible exchange rate, and an independent central bank. The pandemic caused a GDP contraction of -8.2% in 2020. Measured fiscal support to the economy produced a public sector borrowing requirement of -3.9% of GDP, among the smallest fiscal gaps posted globally in 2020.
- 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.
- Mexico's large, young, relatively well-diversified and competitive economy is attractive to U.S. manufacturing, and supply chains are entrenched.
- Mexico has strong access to liquidity due to a $60 billion swap line with the Federal Reserve Bank, a $9 billion line with the U.S. Treasury and a ~$64 billion IMF Flexible Credit Line, ample foreign exchange reserves ($195 billion) that exceed immediate external financing needs, and strong financial markets access. Sound debt management and strides in fiscal policy and transparency have bolstered Mexico's debt profile.
- KBRA is concerned that some measures such as the new hydrocarbons and electricity laws do not send an encouraging signal to private investors in those sectors, possibly to the detriment of longer-term growth. June 6 elections could bolster the government's mandate for constitutional changes that could be construed negatively by the investor community.
- Enduring slow GDP growth in the economy reflects sub-par investment, including limited government capex. High interest rates reflect exchange rate volatility and financial markets conditions. Corruption and crime, low levels of educational attainment, and weak productivity also contribute to Mexico's relatively lackluster growth performance, although dedication to correcting weaknesses is present and in some cases delivering improvements. Institutional weakness exists in KBRA's view.
- A policy thrust that may not sufficiently bolster the financial viability of Petróleos Mexicanos (Pemex) contributes to fiscal risks. A low relative revenue yield, dependence on energy revenues, and weak longer-term GDP growth negatively impact government finances. Reliance on foreign investors in the government debt market potentially adds to risk.

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 pandemic related scarring is meaningful and the growth outlook weakens, or if government finances structurally worsen. Constitutional changes that would threaten the USMCA or further erode the investment environment could be rating triggers.	–

ESG Management

KBRA's ratings incorporate all material credit factors including those that relate to Environmental, Social and Governance (ESG) factors. While ESG factors may influence ratings, it is important to underscore that KBRA's ratings do not incorporate value-based judgments. Throughout our analysis, KBRA captures the impact of ESG factors in the same manner as all other credit-relevant factors. More information on ESG Considerations for the Sovereigns sector can be found here.

Environmental Factors

Management of environmental risks seems uneven. Mexico issued a Sustainable Development Goals (SDG) bond last Autumn which indicates commitment to investment in SDG. At the same time, commitment to reducing emissions appears to take a back seat compared to other policy priorities in the energy sector. The current policy environment does not appear inclined towards renewable energy production. KBRA believes there is sufficient fiscal bandwidth to address emerging environmental (or cybersecurity) risks should they arrive although resources are not infinite.

Social Factors

Crime, corruption, and weaknesses in the social safety net are credit considerations. The current administration's economic program under the Fourth Transformation calls for tackling corruption, organized crime, and poverty. Improvements have been recorded, including in some measures of corruption, and successive minimum wage hikes do help households.

Governance Factors

Weaknesses in rule of law, including a policy thrust that includes renegotiating contracts with private investors and what KBRA views as signs of interference with or discrediting of independent institutions, are credit considerations. Statements against electoral watchdog INE and the extension in term of the head of the Supreme Court are among several examples that could be construed as interference in independent institutions.

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	A
Structural Robustness	BBB
K-Sov Mexico	**BBB**

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 somewhat dim outlook for longer-term economic growth. The latter expectation reflects KBRA's concerns about private investment especially in the energy sector and is also based on the recent low growth platform of the country. On the other hand, the USMCA is an important conduit for positive investment trends. In addition, limited COVID-19 related spending in 2020 could mean that permanent post pandemic scarring will be more severe than would otherwise be the case. The recovery of tourism is still uncertain both in terms of timing and breadth, although the rebound in energy prices, should it be sustained, is constructive to Mexico's outlook and will help reduce Pemex-related risks. Near term growth is being supported by the robust, policy-inspired U.S. recovery.

Macroeconomic Credit Metrics

	2015	2016	2017	2018	2019	2020e[1]	2021f	2022f
Gross Domestic Product $B	1,172	1,078	1,159	1,222	1,269	1,076	1,433	1,510
Real GDP Growth	2.6	2.9	2.1	2.2	-0.1	-8.2	6.1	4.5
Population	121.3	122.7	124.0	125.3	126.6	127.8	129.0	130.1
Total Credit/GDP[1]	74.6	79.8	77.7	77.1	77.2	89.1	-	-
Investment/GDP	22.4	22.8	22.1	22.0	20.7	18.8	20.9	21.8
Current Account Balance/GDP	-2.5	-2.3	-1.8	-1.9	-0.3	2.5	1.8	1.0
Foreign Currency Debt/Current Account Receipts (GSPI)[2]	69.6	76.6	77.5	69.5	70.1	84.1	-	-
External Debt /Current Account Receipts (GSPI)	97.7	100.6	101.5	90.7	91.4	104.3	-	-
Foreign Currency Debt Service Ratio	12.7	19.3	14.6	11.8	12.3	15.6	--	--
(Foreign Currency ST Debt+Amortizations due+ NR deposits)/Reserves	44.5	58.4	47.6	48.8	52.1	34.9	--	--
ST Liabilities/Assets in BIS Banks	39.5	35.4	42.7	43.3	44.0	45.0	46.0	47.0
Inflation (avg)	2.7	2.8	6.0	4.9	3.6	3.4	4.0	3.3
Banxico Target Rate	3.3	5.8	7.3	8.3	7.3	4.0	-	-
10-Year Bonds	6.3	7.4	7.7	8.7	6.9	5.6	-	-
Federal Government Debt % GDP			33.7	34.6	36.9	45.2	44.0	43.0
Public Sector Debt % GDP	46.5	48.7	45.8	46.8	46.8	53.8	51.0	50.0
Public Sector Borrowing Requirement % GDP	-4.0	-2.8	-1.1	-2.2	-2.3	-3.9	-3.3	-2.9
General Government Revenues/GDP	23.5	24.6	24.6	23.5	23.6	24.6	24.0	24.0
General Government Interest/Revenues	11.9	12.7	14.9	16.1	15.8	16.1	15.5	14.0
General Government Primary Balance/GDP	-1.2	0.4	2.6	1.6	1.4	0.1	0.0	0.4
General Government Debt/GDP	56.7	54.0	53.6	53.3	60.6	60.5	59.0	58.0
General Government Debt/Revenues	224.6	230.7	219.0	228.5	225.5	246.7	245.8	241.7

Source: IMF WEO,BIS, Bloomberg, national sources, KBRA. [1] Estimate or latest.

[2] Nonresident holdings of government peso debt amount to about $95 billion and resident holdings of Mexican FX government bonds amount to about $7 billion as of 12/20.

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 GDP and fosters reliance on external financing that is generally only available to more sophisticated corporates or those deemed to have sovereign backing. Sound banking system fundamentals (p. 7) however do support credit intermediation, and reliance on external financing has been reduced over the years.

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

Mexico's Pandemic and Policy-Driven Recession Heightens Fiscal Risks

The coronavirus (COVID-19) pandemic caused an -8.2% GDP contraction of the Mexican economy in 2020. Mexico experienced one of the most severe economic contractions in the world even compared to several LATAM peers. To dimension the extent of the decline, the IMF estimates that LATAM and the Caribbean region as a whole contracted by -7% in 2020 on average, and this includes economies that are extremely dependent on tourism which was the worst impacted sector. Lockdown and social distancing, the collapse of tourism, which accounts for as much as 9% of GDP in direct terms, and significantly reduced energy demand (energy accounts for ~10% of GDP) also contributed to the economic contraction. However, at the same time, a less restrictive policy environment towards social distancing (compared to many advanced economies, for example) and meagre fiscal support to the economy to ride out the dislocation encouraged the return to work (and also contributed to extensive virus contagion). Handouts have been estimated at 0.7% of GDP, a miniscule fraction of what has been spent across the globe, including in emerging market economies. Total fiscal support is estimated at 2% of GDP by the IMF. Remittances at record levels (4% of GDP), a normal pattern of behavior during crisis in destination economies, also softened the contraction. As a reference point for the scale of the pandemic's impact on Mexico, GDP declined -6.3% in 1995 due to the Tequila Crisis and -5.3% in 2009 during the Global Financial Crisis (GFC). KBRA anticipates the economy to make a rebound >6% in 2021, although the most recent April IMF forecasts expects GDP growth of 5.3% this year.

Extensive stimulus in the U.S. underpins KBRA's constructive expectations for growth in Mexico. KBRA authored a research report that highlights the unique commercial relationship between Mexico and the U.S. in the LATAM region and its strong position to benefit from a strong economic rebound in the U.S. KBRA expects that Mexico is likely to recoup lost output in the first half of 2022. 1Q21 GDP growth is estimated at +0.4% q/q, and expected to accelerate as the U.S. growth momentum gains steam. However, Mexico is still technically in recession with growth contracting -2.9% y/y thanks in part to dislocation in natural gas imports due to the weather emergency in Texas in February. Strides in vaccine rollout in the U.S., and less vaccine availability Mexico (a situation common to many countries) is an important metric underpinning economic recovery, as are vaccine resistance to new variants and consumer behavior post pandemic – all still very much unknown. Pent-up demand in the U.S. and Mexico are unleashing near term growth, as is indicated by both countries' trade data.

The policy environment provides a very mixed picture but one that discourages Mexico's longer-term growth momentum. Fiscal restraint (and overperformance) is an important anchor for stability in Mexico, and one that helps enhance the investment climate. However, it is also accompanied by weaker spending than otherwise on human and capital infrastructure development because of limitations on public investment spending, although the policy environment is focused on greater focus on infrastructure spending. A 2.3% of GDP infrastructure package is under discussion. Banxico policy improves Mexico's prospects because of the control over inflation and demonstrated independence of central bank monetary policy, even as high interest rates create friction for growth. Compromises regarding the treatment of remittances and the appointment of more dovish MPC members have not successfully challenged the independence of the institution. Generally high real interest rates also provide a floor to MXN weakening, 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 do not have an outsized role in dampening economic activity, even if they do influence the government's borrowing profile.

Other aspects of the policy environment are detrimental to Mexico's longer term growth prospects and have impeded investment as discussed in this research report. The government of Andrés Manuel López Obrador (AMLO) has been steadily unwinding energy sector reforms (including postponing auctions and farmouts) spearheaded by the last administration that were hoped to lead to greater financial stability of Pemex. The new refinery in Dos Bocas, Tabasco plus the Maya train in the Yucatan Peninsula are not expected to meaningfully improve the financial burden on struggling Pemex. Other measures what KBRA considers to be construed as non-investment friendly introduced since AMLO's election include a withdrawal from key investment projects such as the Texcoco airport, the fiber optic broadband network, Red Troncal, and the Constellation Brewery project that was hoped to be a signal of greater openness to private investment. Gas transportation contracts with state electric utility *Comisión Federal de Electricidad* (CFE) were reopened and renegotiated as well.

In KBRA's view, a anti-private investor agenda has continued, despite the challenges of COVID-19. Under the new Hydrocarbons Law the government has actively suspended permits granted to private companies; it has the ability to do so on the full vertical of activities in the sector. A new Electricity Industry Law gives *CFE* priority dispatch over cheaper private companies and creates disincentives for the expansion of renewable energy. The Mexican Congress (controlled by AMLO's Morena party alliance) voted to extend the term of the chief supreme court justice in a bid that is widely considered a breach of the constitution. This move could ensure for sufficient votes to block moves against the Electricity Law and discredit the wave of injunctions filed to the detriment of private investors. AMLO has attacked Mexico's independent electoral body, INE, discrediting its findings in advance of the June 6 vote, in one of the latest 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. In 2019, despite a booming U.S. economy, Mexican growth contracted.

Government Financial Strength

KBRA uses a broad definition for public finances for Mexico, the public sector, which includes all state-owned entities (SOEs) and is a more comprehensive definition than general government. 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.

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. Revenues from the energy sector, namely Pemex, have fallen considerably over the years from 30% of revenues around the time of the GFC, to 17% of revenues in 2019. In 2020, COVID-19 related record oil price weakness and OPEC+ negotiated production cuts have reduced the ratio to 11%. The government's modest revenue yield is low considering a key government debt solvency indicator, debt to revenues, stands at well over 250%. Debt to GDP for the public sector is more moderate, at around 54% at YE2020, even if up 10 percentage points over the year due to the pandemic (the IMF estimates it at ~60% using general government accounting).

In addition to dependence on Pemex for revenues, the government financially supports the beleaguered company on several occasions. 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 has been arrested, now stabilizing after having fallen by 4.2% pa in the period 2005-2018. According to the company, production would have been over 1,700 thousand bpd in 2020 if not for the OPEC+ supply curb agreement), although compared to 2,548 thousand bpd as recently as 2013, and a peak of 3,380 thousand bpd in 2004, the shortfalls are still extreme. This performance is thanks to contracting production in Mexico's main oil field Cantarell, no new relevant field discoveries, and under or misdirected investment. Pemex's goal is to increase production to 2.055 thousand bpd. Pemex debt totals about ~$100 billion and the indebtedness has not gone towards improving the commercial viability of the company. AMLO's investment strategy that focuses on what KBRA believes to be unproductive projects that will not likely yield profits (the Dos Bocas refinery) is not expected to meaningfully help its financial situation even as the Hydrocarbons Law and Electricity Industry Law favor Pemex. An oil price hedge has helped insulate the company and government from low oil prices. However, the combination of hedging costs and high real interest rates swell interest expense to ~16% of revenues, an outsized level compared to many peers, and results in a significant constraint on expenditures for social and economic development priorities.

COVID-19 Fiscal Deterioration Contained

As noted, fiscal restraint is a grounding pillar of the government's policy agenda. Even in 2020 during the ravages of COVID-19, government spending increased by a mere 3.6 percentage points of GDP, compared to the double digit climb in many other economies. The overall deficit registered -4.6% of GDP for 2020, up from -2.3% in 2019, one of the smallest deficits recorded in the world and especially small considering the extensive virus contagion in Mexico. The government's successful attempts to mobilize tax revenues also contained the size of the deficit. An oil hedge, known as the Hacienda Hedge, protected government finances during 2020 when oil prices were at record lows. Normally this expense does not yield such benefits to government finances, but represents a very prudent and conservative approach to fiscal policymaking.

Government Debt Profile Moderates Risks

The structure of government debt has improved since the Mexican financial crisis in the mid-1990s, when overreliance on *tesebonos* (USD denominated debt instruments) to finance the buildup in foreign exchange reserves was met with a sudden pull out from 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 (albeit reduced over the past year and some to about 20% of the total) increase the risk of destabilizing outflows. Total public sector debt - foreign currency and MXN denominated - totals $630.5 billion as of March 2021, an estimated 51.4% of GDP according to national sources. About 90% of government debt is long-term. MXN debt is mainly (81.2%) long-term and fixed rate (largely *Mbonos*), and the average maturity on outstanding MXN debt stands at 7.4 years. The *Afores* pension funds hold about 20% of government domestic debt.

Public sector foreign currency debt amounts to ~ 36% of total debt. Federal government foreign currency debt totaled ~$115 billion in March 2021 and public company foreign currency debt totaled another ~$115. In comparison, FX reserves nearly cover the sum, at $195 billion as of end-April.

Large nonresident holdings of MXN debt ($95 billion) means that external investors hold ~50% of government debt of all currency denominations. Nonresidents hold about 40% of the fixed rate *Mbonos*, the main long-term financing instrument. They pared their holdings of peso debt by over $20 billion over the pandemic, but there has been a gradual return to the market. 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.

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 ~ 16%. 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 that about 70% of government debt is MXN denominated. Pemex debt prices as high yield and this also is captured in interest costs to the public sector.

Rating Determinant 2: Government Financial Performance (25%)[1]	Equivalent Rating Range
General Government Revenues % GDP	A to BBB
General Government Balance % GDP	BBB
General Government Debt % Revenue	B
General Government Interest % Revenue	BB to B
Access to Liquidity/Vulnerability to Sell-off	A to BBB
Contingent Liabilities	A to BBB
Fiscal Arrears	AAA
K-Sov Government Financial Performance	**BBB**

[1]Public Sector Data for Mexico

External Vulnerability

Access to Liquidity, Manageable Current Account Deficits, and External Debt Structure Minimize External Risks

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 substantial holdings of government debt by nonresidents. 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 $40 billion at end-2020.

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. The current account balance recorded in 2020 was +2.5% and strong performance of the external accounts should be facilitated by the U.S. recovery. Record remittances have also helped. 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 given the substantial MXN holding by foreigners who could have heightened sensitively to fiscal stability.

The government's ~$64 billion flexible credit line with the IMF, access to swap lines from the Federal Reserve Bank ($60 billion) and U.S. Treasury ($9 billion) 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/CAR (%)	BBB
Debt Service Ratio (%)	A to BBB
(STD + CMLTD + NR Deposits)/Reserves (%)	AA
ST BIS Liabilities/BIS Assets (%)	AAA
BIS Liabilities/BIS Assets (%)	AAA
Dollarisation	A
K-Sov External Vulnerability	**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 in emerging markets (and to homegrown shocks). However, it should be noted that a highly traded currency allows a faster adjustment to fundamentals and 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

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

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. In terms of policy continuity, the thrust of policies seems to proceed uninterrupted. Even the economic and social dislocation caused by COVID-19 has not really altered the path of fiscal or economic policy meaningfully. In spite of the questionable handling of the pandemic by the government and its severe social consequences, the approval rating of AMLO stands >60%.

The large size of the Mexican economy ($1.2 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, although heighted should policies related to the energy sector move forward in breach of the USMCA. 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 2.3% of the total) were fully provisioned against. NPLs have barely climbed over the last quarter and stand at 2.4% as of 1Q21. The pandemic will continue to pressure banking system profitability and asset quality but the solid health of the banking system going into the crisis suggests that systemic problems that could rise due to the effects of the pandemic would be manageable for the sovereign's balance sheet.

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. 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. For Mexico, the broadest definition of government finances is used, the public sector, so the data is not directly comparable to peers. Mexico has received recognition for its strides in fiscal transparency and its control over federal government accounts is very strong as illustrated from the fiscal performance over the pandemic year of 2020. 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, Near-Term Fortunes Buoyed by U.S. Recovery

KBRA's credit ratings of Mexico assigned in 2019 were forward-looking and incorporated the direction of policies – specifically those that we believe could dampen private investment and stunt Mexico's growth potential, despite the incentives to investment provided for by the USMCA.

As is the case for all economies, Mexico's near to medium term economic fortunes are largely dependent upon the successful rollout of COVID-19 vaccines and the development of therapies that fight the virus, as well as the ability of scientific advancements to reduce the risk of virus variants. Banxico's ability to sustain a low real interest rate environment would be stimulative and assist Mexico's recovery. Its ability to do so is partly dependent on global interest rates in an environment of accelerating inflation, although this may be temporary. Inflation in Mexico is running at >6% compared to a Banxico target of 3%, although likely to also reflect base effects and temporary factors. Banxico appointments by AMLO could tilt the balance of the MPC to become more dovish. KBRA has recently authored a research report discussing the uncertain outlook for inflation beyond the current surge. It also discussed prospects for a taper-tantrum in EMs in a podcast here. As noted, massive U.S. fiscal stimulus and an imminent multi-year infrastructure package will be favorable to Mexico (see here). An expected strong U.S. growth performance over the near to medium term, and strong prospects for continued strength over the long term would be beneficial to Mexico also due to the positive impacts on tourism and remittances which are also important sources of FX revenues for the economy, especially the SME and micro SME sector and households. Trade divergence from China could also assist Mexican exporters.

In KBRA's view, a GDP growth rate that averaged <2% pre-pandemic, and which may structurally recede thanks to a the policy environment that in our view dampens investment, will be an enduring constraint on government financial flexibility and contribute to very slow debt consolidation. Additional risks could stem from ESG stakeholder sentiment related to environmental and climate risk concerns, considering likely slow progress in transitioning towards renewable energy. Violations of Mexico's trade arrangement with the US and Canada (USMCA) is another risk. Fiscal flexibility is likely to continue to be constrained by Pemex, as policies do not appear to meaningfully improve the company's sources of revenues through increasing production. A tax reform that likely awaits until after the upcoming elections in June 2021 will be monitored to assess its impact on both Pemex financials and government finances. Oil price uncertainty is another risk, although the recent strengthening of prices is constructive and Mexico's use of hedges helps insulate it from such risks. Concerns exist that without bolder initiatives including substantial private investment, Pemex will continue to weigh on government finances. A possible incomplete recovery of tourism to pre-pandemic levels is another risk to Mexico's outlook.

Fiscal Policy Anchors Risks

Commitment to tight fiscal policy is expected to continue to anchor economic policy. KBRA believes government's macro assumptions are reasonable and will enable Mexico to achieve its MT fiscal targets. These assumptions are GDP growth of 5.3% in 2021 and 3.6% in 2022, and average oil prices of $55/b and $53.1/b, respectively. The expected increase in oil production – to 1794 bpd and 1867 bpd - appears optimistic, and that is also the case for the interest rate assumptions of 3.8% and 4.3% for 28-day cetes at YE. First quarter results suggest that the government could perhaps overperform targets. Fiscal buffers have been rebuilt over the last quarter to $67.7 billion. Receding deficits and debt accumulation, along with active debt management, should contribute to a gradual consolidation of the government's key ratios, according to KBRA's expectations.

Elections May Further Test Investor Sentiment

Upcoming election on June 6 could contribute to an even more concerted thrust of AMLO-style populist policies over the next few years. The upcoming election is the most extensive vote in recent years with the entire lower house of congress being voted in, nearly half of gubernatorial seats up for vote, and many state and mayoral seats being contested across the country. Morena and allies currently hold 60% of Senate seats and 65% of house seats. AMLO's popularity rate is >60%, although the popularity of his party, Morena, lags that of the leader. Should AMLO's Morena party command a supermajority (>66% of seats) in the two chambers of congress as a result of the elections, constitutional reforms and/or more aggressive initiatives could be forthcoming, likely along the lines of the populist and interventionist policy tilt since AMLO took office in 2018.

At the current vantage point, the most likely outcome is a loss of some seats and a divided congress, which would dilute the current policy stance, although the improving outlook could tip the vote towards a Morena supermajority. Many recent initiatives, such as the energy sector laws and a recent vote to extend the term of the head of the supreme court, have been pushed ahead to take advantage of the Morena alliance hold on Congress and because of election uncertainties.

Macroeconomic Forecasts

Forecasts (2021-2026 average)						
Trends and Projections	**Mexico**	**Poland**	**Hungary**	**Colombia**	**Peru**	**Portugal**
GDP Growth	2.7	3.4	3.7	4.0	4.7	2.8
Inflation	3.1	2.6	3.3	2.7	2.0	1.3
Current Account Balance % GDP	0.3	0.8	-0.3	-3.9	-1.2	0.2
Government Revenues % GDP	23.2	40.1	43.0	28.9	19.0	43.3
Government Balance % GDP	-2.7	-3.1	-3.2	-3.3	-2.6	-1.2
Government Primary Balance % GDP	0.6	-2.1	-1.0	-0.5	-1.3	1.0
Government Interest Payments % Revenues	14.0	2.4	5.1	10.0	7.0	5.0
Government Gross Debt % Revenues	262.0	136.6	175.0	213.7	193.7	277.2

Source: IMF WEO and Fiscal Monitor April 2021

Comparative Statistics

Comparative Statistics						
2019 Data	**Mexico**	**Poland**	**Hungary**	**Colombia**	**Peru**	**Portugal**
Gross Domestic Product ($ B)	1269.0	596.0	163.0	323.0	231.0	240.0
Nominal GDP Growth (%)	3.9	7.8	9.6	7.4	4.0	4.3
Real GDP Growth (%)	-0.1	4.5	4.6	3.3	2.2	2.5
CPI Inflation (%)	3.6	2.3	3.4	3.5	2.1	0.3
General Government Revenues % GDP	23.6	41.0	43.3	29.4	19.9	42.6
General Government Balance % GDP	-2.3	-0.7	-2.0	-2.5	-1.4	0.1
General Government Debt % Revenues	225.5	111.3	151.0	178.1	135.9	274.2
General Government Interest % Revenues	15.8	3.3	5.0	8.4	5.9	6.6
Current Account Balance % GDP	-0.3	0.5	-0.2	-4.4	-1.5	0.4
External Debt/GSPI	92.6			233.5	115.0	
Debt Service Ratio	12.3			32.3	11.5	
External Vulnerability Indicator	54.1			53.0	19.0	
Liabilities due within 1 year/Assets in BIS banks	39.3	67.7	53.0	85.7	72.4	90.5
Liabilities/Assets in BIS banks	116.4	287.2	159.0	177.2	148.5	218.7
Per Capita GDP (PPP) - USD	20,868	33,890	34,046	15,541	14,719	33,665
Average Institutional Indicators (KBRA Ranking)	BBB	A	BBB	BBB	BB	A
Human Development Index	0.77	0.87	0.84	0.76	0.76	0.84

Source: *European Commission, Eurostat, World Bank, IMF WEO, United Nations Development Programme, national sources.*

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 both MXN and foreign currency government debt make 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 uncertainties for growth and fiscal consolidation due to macroeconomic policies.

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

Further disclosures relating to this rating action are available in the Information Disclosure Form. Additional information regarding KBRA policies, methodologies, rating scales and disclosures are available at www.kbra.com.

The ratings of the 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)

- Sovereigns Rating Methodology
- U.S. Stimulus: Uneven Impact on LATAM
- Sovereign Credit Risk: Taking Stock Mid-Pandemic
- Sovereign Podcast: USD, UST and Sovereign Risk
- Mexico: Governance Threatens to Impair Post-Pandemic Recovery