MOODY'S RATINGS

Rating Action: Moody's Ratings changes Mexico's outlook to negative from stable, affirms Baa2 ratings

14 Nov 2024

New York, November 14, 2024 -- Moody's Ratings (Moody's) has today changed the outlook on the Government of Mexico's ratings to negative from stable and affirmed the issuer ratings, senior unsecured long-term ratings at Baa2, and the senior unsecured MTN program and senior unsecured shelf long-term ratings at (P)Baa2.

The outlook change is driven by our view of a weakening in the policymaking and institutional settings that risks undermining fiscal and economic outcomes. Deteriorating debt affordability and further government spending rigidity make fiscal consolidation challenging, following this year's widening in the government deficit – a deviation from a longstanding track record of low deficits regardless of economic pressures. At the same time, the constitutional overhaul risks eroding checks and balances of the country's judiciary system, with potential negative impact to Mexico's economic and fiscal strength. Finally, we consider there is an increased likelihood that contingent liabilities stemming from Petroleos Mexicanos (PEMEX, B3 negative) could materialize onto the government's balance sheet, while at the same time not restoring long-term debt sustainability for PEMEX and therefore maintaining fiscal risks for the government.

The affirmation of the rating reflects our view that Mexico's credit profile continues to benefit from robust economic strength that will continue to be supported by the diversity of the economy, as well as by potential benefits of nearshoring. Modest macroeconomic imbalances thanks to a history of relatively prudent fiscal and monetary policies support the rating.

Mexico's local-currency (LC) and foreign-currency (FC) ceilings remain unchanged at A1. The four-notch gap between the LC ceiling and the issuer rating reflects the government's moderate role in the economy, a track record of predictable and reliable macroeconomic policymaking, moderate political and low external vulnerability risks. The lack of a gap between LC and FC ceilings reflects the absence of transfer and convertibility risks, itself anchored in a history of strong economic institutions supporting currency convertibility and open capital accounts.

RATINGS RATIONALE

RATIONALE FOR THE NEGATIVE OUTLOOK

The government has approved reforms to the country's institutional framework, including the judiciary, that have the potential to materially alter the checks and balances and the business operating environment in the country. While our assessment of the quality of institutions in Mexico is already low compared to rating peers, particularly when it comes to rule of law and control of corruption, we will assess whether a further deterioration in the policymaking framework and the independence of the judicial system could limit the government's ability to address rising credit challenges.

In particular, notwithstanding fiscal authorities' commitment to reduce the fiscal deficit over the coming years, we consider that their ability to achieve material fiscal consolidation will be constrained as a consequence of a series of reforms implemented or announced. In turn, beyond the weakening in 2024-25 in the sovereign's debt metrics, fiscal strength could decrease more than what we currently anticipate and weigh on Mexico's credit profile.

The government's fiscal position has weakened in 2024 as the deficit widened to more than 5% of GDP. The authorities' capacity to adjust the fiscal accounts is limited by an increasingly rigid spending structure, a reduction in financial buffers and a narrow revenue base. Our current baseline considers that after the fiscal slippage in 2024, the government will only gradually narrow the deficit in coming years. Under this scenario, Mexico's general government debt burden will increase above 45% of GDP by 2025 from 40% in 2023 and could continue to climb towards 50% by 2027-28 absent more material consolidation.

While the debt burden remains relatively moderate, debt affordability has also weakened in recent years, with the interest/revenue ratio reaching 15% in 2023, compared to 10% pre-pandemic, and we forecast it will remain between 15% and 16% over the coming years.

Although we continue to expect that Mexico will benefit from nearshoring-related investments in the coming years, the constitutional reforms may dampen investors' confidence, which risks materializing in lower investment and economic growth that underperforms vis-à-vis our expectations of medium-term growth of about 2%. Additional downside risks to investment dynamics could emerge ahead of the revision of United States-Mexico-Canada Agreement (USMCA) in 2026, particularly if modifications to the agreement's rule of origins, labor specifications and other US trade policies towards Mexico changed in a way that durably limit the country's exports. Lower economic growth and, consequently, government revenue would undermine fiscal consolidation efforts.

The new administration has also announced that it will introduce a series of reforms that could result in codifying some types of spending within the constitution, potentially leading to an increase in mandatory expenditure. Other measures, including a universal old-age transfer, could have an effect on expected increases in pensions in absolute terms and in the government's budget. As the authorities appear more likely to focus on spending restraint to reduce the deficit, additional spending commitments reduce the scope of effective expenditure containment.

The government has also emphasized that it will maintain its support for PEMEX given the company's liquidity challenges, as it remains a key instrument for its energy sovereignty policy priority. We expect that the government will continue to provide the company with resources to cover its debt amortization obligations in a timely manner. However, there is an increased probability that the sovereign will absorb part or all of PEMEX's financial obligations. While the way that the authorities may carry out this transaction is unclear at this time, it may result in a further increase in the federal government's debt and interest burdens. Importantly, in the likely scenario that the company's business model remains relatively unchanged, we forecast that the government support will also need to cover increasing cash flow needs given PEMEX's recurrent losses.

RATIONALE FOR AFFIRMATION AT Baa2

Mexico's economic strength is comparatively high on account of the diversified economy, able to recover from large shocks. This is balanced by relatively subdued long-term growth of about 2% for the past three decades and our expectation that a similar trend continues.

The ongoing shifts in global supply chains and geopolitical tensions between the US and China have improved the prospects that Mexico will benefit from the nearshoring process. Over the past two years, there have been large investment announcements that, depending on implementation, have the potential to boost the Mexican economy's growth performance in years to come. Mexico's geographical location next to the very large US market, its long-established trade and financial ties, still-favorable labor costs, are among several factors that support the relocation of supply chains to the country, notwithstanding the risks mentioned above that could limit the upside of the nearshoring process.

Mexico's long-established track record of prudent policymaking related to fiscal and monetary issues contribute to a relative absence of macroeconomic imbalances that could exacerbate the credit impact of future shocks, another source of credit strength. Historically, the effectiveness of policymaking institutions has represented a counterweight to a relatively weak institutional framework. While Mexico is not exempt of facing inflationary shocks, the central bank benefits from a relatively high degree of credibility as exemplified by anchored inflation expectations.

The susceptibility of Mexico to banking sector or external risks is also low. The country has a robust regulatory framework, and the banking system is comparatively strong and currently faces favorable conditions. Meanwhile, external risks are mitigated by a current account deficit that is mostly financed by FDI, a floating exchange rate and large foreign reserve buffers.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Mexico's credit impact score of CIS-3 reflects heightened social risks, primarily stemming from health and safety concerns, partly mitigated by financial and institutional capacity to respond to them, although there are downside risks to the latter.

Mexico's E-3 exposure to environmental risks relates to the country's vulnerability to physical climate risks, such as extreme weather conditions, which could potentially affect the financial stability of its sub-national governments. These effects might be seen through diminished tourism, as well as increased expenditure on disaster relief and preparedness. However, the impact at the sovereign level is somewhat mitigated due to the size and diversity of Mexico's economy. Moreover, the interconnectedness between the government and the state-owned oil enterprise exposes Mexico to carbon transition risks over the medium to long term.

Mexico's exposure to social risks is S-4, reflecting material challenges related to health and safety. For over a decade, escalating violence has been threatening the physical security of several states within the country. This has undermined security conditions across the country, weighing on the operating environment and imposing additional economic costs for investments in Mexico. Furthermore, the country grapples with moderate challenges in delivering and maintaining the quality of essential services such as education, and housing. In the upcoming decades, Mexico is also expected to face additional risks associated with an aging population. This demographic shift, set against the backdrop of an underfunded social security system, is likely to result in increased social demands.

Mexico's governance issuer profile is scored at G-3. The Mexican government has consistently demonstrated effective fiscal and monetary policymaking. However, recent deterioration in the decision-making process has resulted in economic policies that negatively impact investment prospects and restrict the government's capacity to respond to economic shocks. Despite these challenges, the strength of key institutions like the central bank continues to underpin macroeconomic stability. Conversely, Mexico has consistently received low scores on institutional factors for several decades, with corruption control and rule of law emerging as its most significant areas of weakness.

GDP per capita (PPP basis, US$): 24,249 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 3.2% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.7% (2023)

Gen. Gov. Financial Balance/GDP: -3.6% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.3% (2023) (also known as External Balance)

External debt/GDP: 38.6% (2023)

Economic resiliency: baa2

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

On 11 November 2024, a rating committee was called to discuss the rating of the Mexico, Government of. The main points raised during the discussion were: The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased.

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

Given the negative outlook, an upgrade is unlikely. The outlook could return to stable if we were to assess that the authorities' fiscal consolidation efforts are likely to contribute to a rapid stabilization of the debt burden and an improvement in debt affordability metrics even in the context of more difficult economic and financial conditions. Given the increased likelihood that contingent liabilities stemming from PEMEX will materialize onto the government's balance sheet, a stabilization of the outlook would be consistent with our assessment that the impact of the sovereign's support to the company will not exacerbate a potential weakening of its fiscal strength beyond our current expectations and, importantly, that the company's financial standing improves materially to reduce its dependence on government support over the coming years.

A continued deviation from a track record of prudent fiscal policy management that undermines the effectiveness and credibility of macroeconomic policymaking would lead to downward rating pressure. Relatedly, downward pressure on the rating would emerge if government debt and debt affordability metrics worsened significantly because of wider-than-expected fiscal deficits or the materialization of contingent liabilities. Given Mexico's more constrained fiscal capacity to respond to shocks, potential economic disruptions – including from changes in trade relations with the US – could contribute to a weakening of its credit profile. More generally, indications that medium term growth will be lower than we currently expect in the context of worsening regulatory and investment conditions would also put downward pressure on the rating.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

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

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

At least one ESG consideration was material to the credit rating action(s) announced and described above. Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824 .

The Global Scale Credit Rating(s) discussed in this Credit Rating Announcement was(were) issued by one of Moody's affiliates outside the EU and UK and is(are) endorsed for use in the EU and UK in accordance with the EU and UK CRA Regulation.

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