United Mexican States (Mexico)

Ratings

United Mexican States	
Action: **Affirmed**	03 May 24
Foreign Currency LT	BBB
Local Currency LT	BBB
Action: **Affirmed**	03 May 24
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

	2023E
Per Capita Income (US$, PPP)	24,980
Real GDP Growth (% Change)	3.2
Inflation Rate (Average %)	5.5
Public Sector Borrowing Req. (% GDP)	-4.3
Current Account Balance (% GDP)	-0.3
External Debt (% CAR)	83.2
Level of Economic Development	medium
Default History	Last episode 1982

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Executive Summary

KBRA affirms the long-term and short-term issuer ratings of the United Mexican States (Mexico).

Ratings Outlook: Mexico's long-term ratings carry a Stable Outlook that rests on expectations for return to fiscal restraint post-election. Petróleos Mexicanos' (Pemex) finances along with high interest rates and sticky inflation continue to be challenges. The Stable Outlook also considers the promise of U.S. nearshoring and onshoring opportunities and the positive impact to be realized on investment, employment, fiscal revenues and GDP growth, and also the uncertainties that persist.

Key Credit Considerations

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

- Mexico's economy is well managed, with a strong fiscal anchor including spending restraint even during COVID-19, a flexible exchange rate, and an independent central bank. The acceleration of project capex and other pre-election spending have led to a pause in post-pandemic fiscal correction. Gross public and Federal debt amount to just 47% and 40% of GDP, respectively. However, a low revenue yield, energy receipts dependence, and generally weak Pemex finances elevate 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 this 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, increasingly higher value-added and competitive economy is attractive to U.S. manufacturing. Supply chains are entrenched. Benefits from near- and onshoring should be enhanced by U.S. industrial policy, including the Inflation Reduction Act (IRA) and continued U.S.-China trade conflict.
- Mexico has strong access to liquidity, including a $9 billion swap line with the U.S. Treasury, a renewed but reduced ~$35 billion IMF Flexible Credit Line, FX reserves (~$217 billion), and fiscal stabilization funds, all ample in face of external financing needs. Mexico enjoys strong financial markets access and active liability management reduces debt risk. Mexico's debt profile and fiscal transparency bolster its credit profile.
- Private investment (except residential construction) and public investment have picked up strongly, even if some of the latter being of questionable economic value, in KBRA's view. More investment, including in the energy sector, is required to upgrade the economy's growth potential of ~2% pa. Private investment in the power sector has been dampened by AMLO's policies, although the Supreme Court's January 2024 ruling and the political transition could lead to improvements.
- Intervention in independent institutions, corruption and crime, low levels of educational attainment and weak productivity contribute to Mexico's lacklustre growth, in KBRA's view. PPP per capita GDP of ~$25,000 reflects institutional/development weaknesses.

Rating Sensitivities	
Positive rating momentum could arise from strengthened private investment and GDP growth 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 that would meaningfully increase the debt servicing burden could negatively impact government finances and creditworthiness.	–

ESG Management

KBRA typically analyzes 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 prioritize 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.

KBRA analyzes many sector- and issuer-specific ESG issues but our analysis is often anchored around three core topics: climate change, with particular focus on greenhouse gas emissions; stakeholder preferences; and cybersecurity. Under environmental, as the effects of climate change evolve and become more severe, issuers are increasingly facing an emerging array of challenges and potential opportunities that can influence financial assets, operations, and capital planning. Under social, the effects of stakeholder preferences on ESG issues can impact the demand for an issuer's product and services, the strength of its global reputation and branding, its relationship with employees, consumers, regulators, and lawmakers, and, importantly, its cost of and access to capital. Under governance, as issuers continue to become more reliant on technology, cybersecurity planning and information management are necessary for most issuers, regardless of size and industry.

Environmental Factors

Management of environmental risks has progressed, although somewhat unevenly. Mexico now aims to reduce greenhouse gas emissions (GHG) by 30% by 2030, up from 22% set in 2020. The reduction of black carbon emissions remains targeted at 51% by 2030. The policy environment is not inclined towards renewable energy 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. ~30% of Pemex output is dirty fuel, much higher than levels in the U.S., although Pemex is addressing this challenge in its sustainability plan, in which in plans to reduce methane emissions by 30% from 2020 levels. Green issuance is also part of its strategy. The Interamerican Development Bank has launched a sovereign guaranteed green bond securitization program for Pemex.

According to US Agency for International Development Mexico takes second place in Latin America and the Caribbean in 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 (88% of energy needs are met from fossil fuels, 10.5% from renewables, and 1.6% from nuclear). The primary sector is a factor, accounting for ~15% of the total. Mexico is however becoming more efficient in its energy use.

Mexico is also vulnerable to extreme weather events, such as tropical cyclones and floods, which pose 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. Mexico has a $255 million Natural Disaster Fund and has issued $485 million of catastrophe bonds with the World Bank.

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 U.S. and Canada (USMCA) is another risk, albeit reduced due to the lower house of Congress' voting down of the reform of the energy sector and the loss of a supermajority in the 2021 election (a situation that is likely to be sustained in the upcoming vote).

Mexico was the world's first country to issue a Sustainable Development Goals (SDG) bond internationally and is also the first emerging markets issuer to issue SDG bonds in the local market. The government of Mexico conducted its first SDG Bondes G issuance in 2022. Mexico issued the largest ever sustainable bond in euros (EUR2 billion) in January 2024. A total of $7 billion in labelled debt has been issued in MXN, as compared to $10 billion in foreign currencies. Mexico's ability to conduct such issuance in MXN reflects the growing sophistication of its capital markets.

Governance Factors

Mexico's National Cybersecurity Strategy of 2017 is meant to address cybersecurity threats and underscores awareness of this growing risk, especially as modernization of the economy continues.

Governance of ESG risks involves tracking 2030 Agenda goals by the Ministry of Finance (Secretaría de Hacienda y Crédito Público, or SHCP) which has made strides in tracking the 2030 Agenda goals through the national government's budget. SHCP incorporates sustainability goals in its budgetary process.

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	A/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 step and balances on the one hand adverse conditions for private investors and pattern of low growth, and on the other, nearshoring opportunities. While the upcoming election looks likely to deliver a Morena victory and a simple majority in Congress, this political construct would be insufficient to achieve constitutional reform. That bodes well for policy stability. However, the extent to which President Andrés Manuel López Obrador's (AMLO) statist agenda will be continued under his successor may impact the outlook for investment, in KBRA's view. Moreover, whether this year's fiscal derailment will be sustained is another trend to monitor. The global outlook remains uncertain given geopolitical and lingering inflation risks, for which Mexico is far from immune. A U.S. hard landing, increasingly improbable and in any event likely to be short-lived, could also mar near-to-medium term forecasts.

Macroeconomic Credit Metrics

	2017	2018	2019	2020	2021	2022	2023e	2024f	2025f
Gross Domestic Product USD bn	1,190.7	1,256.3	1,305.2	1,120.8	1,313.1	1,463.3	1,788.9	2,017.0	2,128.1
Real GDP Growth	1.9	2.0	-0.2	-8.8	6.0	3.9	3.2	2.4	1.4
Population mns	124.8	126.0	127.2	128.2	129.0	130.0	131.1	132.3	133.4
Total Credit/GDP*	77.7	77.1	77.3	85.7	83.2	81.0	78.4	-	-
to Government	35.2	35.3	36.1	41.4	41.4	40.8	41.0	-	-
to Households	16.0	16.0	16.0	17.2	16.5	16.6	16.3	-	-
to Private Corp.	26.5	25.7	25.1	27.0	25.2	23.6	21.1	-	-
Savings/GDP	22.1	21.4	21.8	22.6	21.3	21.5	24.4	23.9	23.4
Investment/GDP	23.9	23.5	22.1	20.2	21.6	22.7	24.8	24.6	24.1
Current Account Balance/GDP	-1.8	-2.1	-0.3	2.4	-0.3	-1.2	-0.3	-0.8	-0.8
Inflation (HICP) YoY	6.0	4.9	3.6	3.4	5.7	7.9	5.5	4.0	3.3
Unemployment Rate	3.4	3.3	3.5	4.4	4.1	3.3	2.8	2.8	3.2
10-Year Bonds % - Year-end	7.7	8.7	6.9	5.6	7.6	9.0	9.0	-	-
General Government Revenues/GDP	24.0	22.8	23.0	23.5	23.0	24.3	24.4	24.4	24.1
General Government Expenditures/GDP	25.0	25.0	25.2	27.8	26.8	28.6	28.7	30.3	27.1
Fiscal Interest/Revenues	3.6	3.7	3.6	3.8	3.7	5.0	5.8	5.0	4.3
General Government Balance/GDP	-1.0	-2.1	-2.3	-4.3	-3.8	-4.3	-4.3	-5.9	-3.0
General Government Cyclically Adjusted Balance/Potential GDP	-2.7	-2.7	-2.8	-3.6	-3.3	-4.2	-4.5	-6.2	-3.1
Primary Balance/GDP	2.5	1.5	1.4	-0.5	0.0	0.7	1.5	-0.9	1.3
Gross Government Debt/GDP	52.5	52.2	51.9	58.5	56.9	54.2	53.1	55.6	55.4
Gross Government Debt/Revenues	219.0	228.6	225.7	249.0	247.4	222.9	217.9	228.1	230.3
Net Government Debt/GDP	44.5	43.6	43.3	50.2	49.3	48.1	47.9	50.3	50.2
Net Government Debt/Revenues	185.6	191.2	188.3	213.7	214.3	197.8	196.5	206.7	208.7
Debt Service % of Exports (GSPI)*	13.2	10.7	12.0	14.1	13.0	6.6	5.7	-	-
External Debt / CAR	120.4	112.7	112.3	127.4	101.5	83.1	83.2	-	-
External Debt / GSPI	128.5	120.3	120.2	138.8	111.1	90.5	91.5	-	-
EVI* : [Principal Payments Due + ST Debt]/ Official Reserves	48.2	56.0	59.4	47.4	50.7	38.2	40.8	-	-

Sources: National Sources, IMF World Economic Outlook, IMF Fiscal Monitor, UN, World Bank, World Economic Forum, EC, Eurostat, BIS, Bloomberg

** Most recent data available*

***Numerator includes non-resident deposits where available*

Step I: K-Sov Scorecard Analysis

Macroeconomic Performance

Mexico is the 14th largest economy in the world, which leads to meaningful economic diversification. At the current exchange rate, the Mexican economy may exceed $2 trillion in size this year. To put this in context, the Brazilian economy is $2.3 trillion in size with a population of 205 million, compared to Mexico's 132 million residents. The scale of Mexico's domestic market is a point of attraction to investors, as are both its location next to the U.S. and its free trade agreement (FTA) with the U.S. and Canada (the USMCA, successor to NAFTA). The FTA has had a tremendous role in enhancing growth and investment in Mexico, although these gains have not extended to the southern region of the country. Investment in Mexico is rising; it has settled in 2023 >24% of GDP due to a large rise in private investment as well as public investment, although still remains short of development needs. Private consumption is the main driver for the economy (~70% of GDP), and as such, rising income levels are a key variable influencing performance. Exports and imports each comprise ~35%-40% of GDP, and concentration exists both in terms of product (auto sector, largely via *maquiladoras*, and oil) and market (over three-quarters of merchandise exports are destined to the U.S.). Mexico now the U.S.' largest trading partner, partly reflecting trade diversion from China.

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**

GDP growth outperformed in 2022 and the economy fully recovered lost GDP due to the pandemic in 2Q of that year. The momentum has broadly been sustained for 2023 with growth registered of 3.2%, although dipping in 4Q. That is a rate well above potential growth of ~2% pa. Mexican GDP growth has outperformed historical performance despite incredibly restrictive monetary policy (the real Banxico interest rate is currently estimated around 7%) and reflects, in part, the strong performance of the U.S. and also investment in advance of nearshoring opportunities. Banxico started a rate cutting cycle this past March, lowering the base rate by 25 bps to 11%, after holding it at 11.25% for a year. The speed of Fed rate cuts is likely to influence future Banxico rate cuts, along with the performance of inflation, U.S. growth momentum, oil price dynamics, U.S. trade tensions with China and global malaise due to rising geopolitical conflict. At the current visibility, growth for 2024 is likely in the 2.5%-3.5% range (MOF expectations), which is broadly in line with Banxico's 2.8% forecasts and slightly above the IMF's 2.4% projection. The 1Q24 GDP print (1.6% growth y/y) may suggest some optimism in these forecasts. The 'no-landing' scenario in the U.S. could lend Mexico towards the higher end of the MOF's forecast bracket. Core inflation of 4.4% in mid-April 2024 is now below headline inflation of 4.6%. While generally declining, inflation is outside of Banxico's target band of 3% +/- 1%. Remittance inflows continue to post records, sustaining economic momentum.

Nearshoring Potential Expands

An improved outlook for nearshoring opportunities is promising as KBRA highlighted in a KBRA research report. Rules of Origin specifications in the USMCA should allow Mexico to be the beneficiary of new investment related to the U.S. IRA and to a lesser extent the CHIPS and Science Act (whether because of nearshoring investment or investments related to onshoring in the U.S). Post-pandemic concern over supply chain rigidities has also made strengthening linkages with Mexico more attractive.

Investment appears to be still very much in the planning stage despite announcements for committed funds (around >$90 billion). FDI has not increased meaningfully yet although reached a height of >$36 billion in 2023. New investments have generally been a feature of the inflows, although last year the overwhelming share was reinvestments. Official estimates are for FDI to reach $41 billion a year by 2025. Investments announced are in the automotive sector (Tesla, BMW, Volkswagen, and Solarever (car batteries)) totalling $23 billion and another $32 billion in energy and public services (Pacific Ltd, Copenhagen IP, HDF Energy). Beyond FDI there has been a marked pickup in non-residential construction, albeit including public investment, as well as increased demand for industrial parks, indicating increased preparedness for nearshoring. Machinery and equipment investment is about 25% above pre-pandemic levels in real terms. Surveys of Mexican companies reveal that nearshoring momentum is well underway. Surveys of banks indicate the same expectation.

Government Financial Strength

KBRA uses a several definitions of public finances for its fiscal analysis of Mexico. We review the public sector borrowing requirement (PSBR), the conventional fiscal deficit, and also study the federal government accounts. The PSBR is the most comprehensive fiscal indicators and includes the finances of state-owned entities (SOEs), net refinancing needs as well as deficit related borrowing. Mexico's longstanding commitment to fiscal restraint – notwithstanding the deterioration this year in advance of the election -- assists stability in government debt ratios. Pemex beleaguered finances and the federal government's dependence on Pemex for revenues are important considerations.

Rating Determinant 2: Government Financial Performance (25%)	Equivalent Rating Range
General Government Revenues % GDP	BBB/BB
General Government Balance % GDP	BBB/BB
General Government Debt % Revenue	B and Below
General Government Interest % Revenue	B and Below
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. Concerted effort to mobilize revenues has lifted the public sector revenue yield to a solid 24% of GDP. Still low, considering the spending demands, the ratio reflects a large informal economy and tax compliance shortfalls. Tax revenues are in the mid-teens.

The weak financial situation of Pemex is an important credit rating consideration as well as the government's dependence on the company for government revenues. Government finances have historically had an outsized dependence on Pemex and oil revenues mainly through the Derecho de Utilidad Compartida (DUC) royalty. For context, pre-COVID, oil revenues were responsible for 16%-20% of revenues pa, and since then the level has fluctuated wildly from 11% to 22%, given oil price volatility as well as reductions in the DUC. The DUC was 65% in 2019 and has been lowered by the AMLO administration to improve the company's financial viability. Still, excessive taxation is one of the many reasons behind Pemex's troubled finances. Government financial support for the company has been ongoing in the form of drawing fiscal reserves, tax breaks, direct capital infusions, and specific assistance with debt payments, hence hitting public finances through a variety of avenues.

An oil price hedge ('the Hacienda Hedge') helps insulate the company and government from the risk of 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 have swelled fiscal interest expense. Interest to revenues is outsized compared to peers and acts as a significant constraint on expenditures for social and economic development priorities.

Election Year Fiscal Expansion and Explicit Pemex Support

The PSBR narrowed to -4.3% of GDP last year, compared to expectations for a level of -4.1% of GDP. The SHCP projects the PSBR will widen to -5.4% of GDP in the current fiscal year (although the initial PSBR expectation was -3.2% of GDP) due in part to the acceleration of capex on pet projects and the widening of social transfers in advance of the election. The revisions also reflect less buoyant nominal GDP growth due to a sharper fall in inflation than expected and higher-than-expected financing costs. In the 2024 fiscal plan the DUC royalty payment from Pemex was lowered to 30% from 40% and the government also explicitly earmarked $8.3 billion financing that supports debt service coverage, that together will facilitate repayment of peak amortizations of $8.8 billion falling due for the company this year.

KBRA believes the real GDP growth assumption of 2.5%-3.5% and the average oil price of $71.3/bbl (Mexican crude is currently ~$75/bbl) appear generally reasonable, suggesting likely attainment of this forecast, although uncertainties exist. The public sector debt ratio (net) is now expected at 50.2% of GDP (55.6% of GDP as calculated by the IMF, which is gross debt). Debt to revenues is set to rise to 228% of GDP this year, after falling below 218% of GDP last year. Federal debt (net) is markedly lower than public sector debt, thanks primarily to the exclusion of Pemex's large external liabilities. It stood at 39.4% of GDP at Q1 2024. For reference, Pemex external debt amounts to $101.5 billion vs. ~$128 billion for the federal government.

While improving the financial fortunes of Pemex has been a goal of the AMLO administration, shortcomings exist. The company has lifted production to 1.882 million bpd, a level not seen since 2018. But this compares to production of 2.548 million bpd as recently as 2012, and a peak of 3.383 million bpd in 2004. AMLO's investment strategy could impair Pemex's finances given the focus on low-yielding projects including the Dos Bocas refinery. The Deer Park investment has produced profits.

Government Debt Profile Moderates Risks

The structure of government debt has improved meaningfully over several decades and active debt management and contained deficits support continued improvement. Sound debt management and strides in fiscal policy and transparency have been critical factors improving Mexico's debt sustainability.

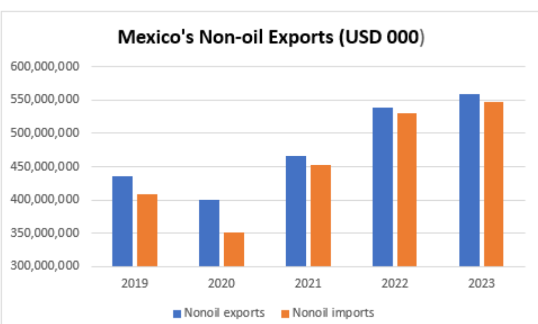
Mexico's government debt is largely local currency denominated, fixed rate and long-term, and the lower share of non-resident holdings of MXN debt (since COVID) reduces the risk of destabilizing outflows. Total public sector debt (foreign currency and MXN denominated, gross) totaled ~$954 billion at 1Q 2024. MXN debt (76% of the total) is mainly long-term and fixed rate. Public sector foreign currency debt amounts to ~ 24% of total debt.

At the end of 2023, public sector external debt amortizations totalled ~$16.5 billion for 2024 and hover in the range of $12 billion-$16 billion a year for 2025-2029 (compared to official reserves of $217 billion). For the Federal government, for 2024, the sum that has not yet been refinanced for 2024 is under $500 million. Liability management has significantly smoothed peaks in the government's debt service profile, greatly facilitating the post-AMLO transition. Federal government amortizations due are usually well under <$5 billion a year, a goal of the Hacienda. The weighted average maturity (WAM) of federal external debt stands at ~20 years. The WAM of local currency debt is ~8 years.

The government has also rebuilt its various oil and stabilization funds to the aggregated tune of MXN78 billion. The Mexican Congress recently approved new financing sources for Mexico's stabilization fund (Estabilización de los Ingresos Presupuestarios) to include savings in financing costs for the government (as compared to what's been budgeted) on top of hedging gains, fiscal surpluses and Banxico surpluses.

External Vulnerability

Mexico's sensitivity to external shocks is mitigated by its close commercial ties with a large, stable, dynamic economy, the U.S. Pemex financial weaknesses in the context of its status as the world's most externally indebted oil company does add to external risks. Other external risks stem from the holdings of government debt by non-residents, although this exposure has fallen considerably. Non-resident holdings of local currency debt are estimated at < 17% of the total and <6% of GDP. Mexico's external vulnerability is mitigated by its floating exchange rate, the ongoing diversification of export receipts, and its balance of payments financing structure, with foreign direct investment covering current account deficits. As noted, reserves of $217 billion are more than ample to cover gross external financing needs for the year ahead. Economy-wide external short-term debt is ~10% of total external debt.



Source: Banxico, KBRA.

Current account deficits have averaged around -2% of GDP pre-2019 but have narrowed significantly since then, save for during the height of the pandemic in 2020. A negligible deficit of -0.3% was posted in 2023, and the imbalance is not expected to meaningfully widen over the forecast period through 2029. Non-oil exports also continue to expand, reflecting the integration of supply chains and capital import demands.

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. Mexico's debt service ratio stands at about 8% for the entire economy and its external vulnerability indicator[1] is estimated ~40%. Notwithstanding these strengths, it is important to note that of the current account, only the secondary income account is in surplus, thanks to remittances. The trade, services and primary income accounts are all in deficit reflecting, in part, a negative oil balance and interest expense.

Rating Determinant 3: External Vulnerability (25%)	Equivalent Rating Range
Current Account Balance % GDP	A
External Debt % Current Account Receipts	BBB/BB
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**

[1] A KBRA ratio defined as the ratio of currently maturity long-term debt, ST debt + Nonresident deposits (where available) as a % of FX reserves.

In November 2023 Mexico reduced its flexible credit line with the IMF to ~$35 billion (USD value is a rough estimate, fluctuates with value of SDR) thanks to its proven external resilience. Its swap line with the U.S. Treasury further strengthens its external liquidity, on top of unfettered market access.

The MXN's position as the third most traded currency in the emerging markets (behind the Chinese Yuan and Indian Rupee, although the later ascension may be linked to Russian energy payments) 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 may mitigate the possibility of panic runs on the currency. It also reflects Mexico's sound financial system, open capital account, 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.

Recent strengthening of the MXN is generally constructive to credit risk, although gains from exports in local currency are reduced by the large import component of exports related to supply chain integration. The super peso is also helpful in combatting inflation.

Structural Robustness

Mexico is aligned with its peer group on many indicators of structural robustness. KBRA believes socio-political risk in Mexico is moderate. Mexico has enjoyed broad political stability, although episodes of protests, riots, and heightened police activity do exist, even if Mexico is not unique in this regard. Income inequality is high, as are regional gaps in income and economic performance. This situation potentially adds to political risk although heightened activity is thus far quite dormant. The ramp up in capex spending this year in the run up to elections has been constructive to the South, although sustaining the momentum could provide for added risks. Violent crime and corruption negatively impact socio-political risk and hinders investment. The government absorbed the high cost of energy in the aftermath of Russia's invasion of Ukraine which helped moderate purchasing power deterioration (and political risk). Real wage growth (average, for formal workers) of ~25% since 2018, likely also manifesting in the informal sector, helps contain political risks and dull inequality. Institutional indicators are aligned with many peers but are generally weak and rule of law is deteriorating, as noted, although not out of step with some peers.

The large size of the Mexican economy (almost $2 trillion at the current exchange rate), its diversification and its juxtaposition to, and close relations with, the U.S. are important factors underlying its geopolitical significance as well as manageable systemic/economic risk. There is a small but nonetheless possible risk of an altered U.S. view towards the U.S.-Mexico relationship. Claims of Mexican violations of USMCA, including those related to the treatment of private renewables investors, are unresolved. The review of the USMCA in 2026 is not expected to involve fundamental changes, especially given the growing reliance of U.S. corporations on Mexico.

Resilient Banking Sector Despite Challenging Geopolitical Environment

Mexico's financial sector has a sound regulatory framework, is dominated by banks and is relatively small compared to those of other EM peers. Commercial banks account for about 40% of GDP. The banking sector is highly concentrated, with the six largest domestically systemically important banks (D-SIBs) comprising about 75% of banking sector assets. The sector has a large foreign ownership, with five D-SIBs being foreign subsidiaries, although noting Citigroup's plan to exit consumer banking in Mexico. Most banking activity remains local with funding dependent on domestic savings and used for domestic lending and investment in government securities. The banking system is profitable, adequately capitalized and has sound asset quality with a low level of nonperforming loans (NPLs), supported by conservative underwriting standards. The sector has ample liquidity and is mainly deposit-funded, although some smaller banks have lower liquidity buffers than D-SIBs. As of November 2023, the sector's core equity tier 1 (CET1) capital ratio stood at 16.8% (as per IMF Financial Stability Indicators) while NPLs represented 2.2% of the total loans (as per IMF) and were fully provisioned against. Profitability and asset quality are expected to weaken over the coming quarters, albeit from very strong levels, due to challenges coming from high interest rates, inflationary pressures, and subdued economic activity. That said, the health of the Mexican sovereign balance sheet is not expected to be put at risk by any challenges in the banking system. A low level of monetization of the economy also dampens financial risks, even if also reducing investment.

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)	A/BBB
Institutional Indicators	BBB/BB
K-Sov Structural Robustness	**A/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. Mexico has somewhat weaker key government debt ratios than several peers, although it has received recognition for its strides in fiscal transparency and control over federal government finances. Mexico's external standing is somewhat stronger than that of many peers with moderate external and foreign currency debt, and manageable current account deficits and ample coverage by FDI.

In KBRA's view, Mexico's credit outlook depends upon the conduct of policies in the post-AMLO environment and the extent of gains from nearshoring. On the former, elections are scheduled for June 2, 2024. The next government looks likely to be led by Claudia Sheinbaum of Morena, and her party and its allies are likely to win a simple majority in Congress, a situation that would significantly encumber bold policy changes that would involve a recrafting of the Constitution. The next government will be challenged by inheriting a record fiscal deficit for 2024 (marked by the largest primary deficit seen in recent years even including during the peak of COVID in 2020). Moreover, structurally speaking, the challenges amplify: the uptick in revenues is largely based on nonrecurring revenues and could be difficult to sustain especially should the macro environment worsen. On the expenditures side, large-scale investment projects in the South are a big part of the expenditure blowout, and while temporary, should these projects prove not financially viable, further fiscal support could be needed. Larger fiscal social transfers will also be difficult to pare by the new President, especially as some were passed into law at the Constitutional level by AMLO's administration. It should be noted that the windfall gains from higher revenues have not been earmarked yet and it could be that expenditures end up lower than expected for 2024.

The Hacienda's Precriterios plan are for the PSBR to be reduced from -5.9% of GDP expected for 2024 (which is itself already higher than originally planned) to -3.0% of GDP in 2025. However, the actual fiscal plan for 2025 will be revealed by the new administration by November 15 and the present forecasts are just hopeful projections. KBRA expects that the new government will respect the country's strong fiscal anchor but recognizes risks to this view. Debt management efforts to smooth the redemption profile position Mexico well going into this period of uncertainty. The pension reform and expansion of assets under management and the home (and regulatory) bias supports the local debt market.

Turning to nearshoring, investors still are in the planning stages. FDI has not increased much since 2018 levels despite the IRA and geostrategic risks surrounding supply chain fragilities post-COVID. Curiously, export-oriented, and FDI-recipient corporates are reporting investment explicitly linked to nearshoring, even though it has yet to show up in FDI statistics. And as noted, the ramp up in non-residential investment in the north, especially related to industrial parks, is yet another manifestation of financing made available to accommodate nearshoring. By some estimates, nearshoring could lift real GDP by upwards of 50 bps per year – or a 25% improvement above current estimates of potential growth -- with important spill-over effects to the rest of the economy even if regional income gaps may persist. Tax receipts would benefit not only from improved economic activity, but because the activity is in the formal economy and within the government's tax purview. As more production moves onshore to the U.S., a development well-underway, Mexico should also benefit thanks to its supply chain linkages.

KBRA also notes that Mexico's near to medium term outlook is very much coloured by the outcome of the upcoming U.S. election and U.S. macro prospects due to the importance of this northern trading partner to Mexico's economy. For example, a Trump victory could result in a blanket tariff applied to countries, including Mexico. Not only would there be a direct negative impact on Mexico via the trade route, but there could be a more indirect impact due to the inflationary impulse on the U.S. economy. Tight restrictions on illegal immigration – a goal that is broadly shared by both U.S. political parties - would also be inflationary. Such shifts would be growth dulling and could interfere with the path of Fed cuts, and also, in turn, affect Banxico's ability to meaningfully reduce interest rates. The upcoming review of the USMCA in 2026 is another risk, although a wholesale revamp is unlikely.

Banxico interest rate policy weighs heavily on Mexico's growth outlook. While the economy has been resilient thus far given the weak pass through to the local economy, at the current very high real rate levels the cost to government finances is measurable. At very high real rates – in the neighborhood of Brazil and Türkiye, for example - the peso could stay strong to the detriment of traditional exports. The gains from a strong peso are less acute for companies that are highly integrated into the U.S. economy because of the large import component of operations. A strong MXN generally supports government finances through the value impact in pesos on oil receipts.

The next President is also inheriting other choices related to the investment environment. One of AMLO's most troublesome policies for foreign investors has been his energy policy which favors SOEs including Pemex and the state electric utility *Comisión Federal de Electricidad* (CFE) over private actors and creates disincentives for the expansion of renewable energy. Some of these topic have been discussed in a [KBRA research report](). Transition to clean energy is made more urgent by Mexico's large-scale dependence on the U.S. for natural gas, a vulnerability that was exposed a few years ago upon the extreme weather events in Texas. Moreover, the expansion of the power sector is critical to optimizing nearshoring opportunities. Morena candidate Claudia Sheinbaum, as a climate scientist, has expressed support for transitioning to renewables and clean energy but whether that goal will be fulfilled while she also balances party demands to follow through with her predecessor's agenda (and undo the administrative and regulatory hurdles to private investment) remains to be seen.

Measures to curb and defund INE (Mexico's independent election agency), failure to address crime, giving the military control of public security, and energy disputes with the U.S. and Canada under the USMCA all dampen investor confidence in KBRA's view. Other headline non-investor friendly measures introduced since AMLO took office include a withdrawal from key investment projects, the most high-profile of which was the Texcoco airport. Gas transportation contracts with CFE have been reopened and renegotiated. By many assessments, rule of law has deteriorated, and lack of judicial reform is seen as a bottleneck. AMLO's 20-point plan released in February, likely as a means to frame what he hopes will be the Morena agenda in the future, could make it difficult for Ms. Sheinbaum to deviate strongly from his platform given his popularity. The next President will be tasked with selecting a Supreme Court Justice and appointing a new Banxico Board member by year-end, revealing the likely complexion of policy pretty soon, including as it relates to the independence of these institutions.

Macroeconomic Forecasts

Macroeconomic Forecasts (2024-2029 average)				
Trends and Projections	**Mexico**	**Chile**	**Indonesia**	**Colombia**
GDP Growth	2.0	2.3	5.0	2.6
Inflation	3.2	3.0	2.5	3.7
Current Account Balance % GDP	-0.9	-3.5	-1.2	-3.4
Government Revenues % GDP	23.8	26.0	15.4	29.8
Government Balance % GDP	-3.3	-0.5	-2.5	-2.7
Government Primary Balance % GDP	0.9	0.4	-0.3	0.9
Government Interest Payments % Revenues	17.6	3.5	14.0	12.0
Government Gross Debt % Revenues	233.4	158.9	254.5	185.1
Government Gross Debt % GDP	55.6	41.2	39.1	55.1
Government Net Debt % Revenues	211.5	91.1	241.0	165.0
Government Net Debt % GDP	50.4	23.6	37.1	49.1

Comparative Statistics

Comparative Statistics				
2023e Data*	**Mexico**	**Chile**	**Indonesia**	**Colombia**
Gross Domestic Product (USD bn)	1,788.9	335.7	1,371.2	363.6
Nominal GDP Growth (%)	7.9	6.8	6.7	7.0
Real GDP Growth (%)	3.2	0.2	5.0	0.6
Consumer Price Inflation (%)	5.5	7.6	3.7	11.7
Unemployment Rate - Latest Read	2.8	8.8	5.3	10.1
General Government Revenues % GDP	24.4	24.7	15.0	32.3
General Government Balance % GDP	-4.3	-2.2	-1.6	-2.7
General Government Cyclically Adjusted Balance % Potential GDP	-4.5	-3.6	-1.6	-2.6
General Government Gross Debt % GDP	53.1	39.4	39.9	52.5
General Government Gross Debt % Revenues	217.9	159.5	266.2	162.5
General Government Interest % Revenues	23.9	1.4	14.0	11.8
General Government Net Debt % GDP	47.9	22.8	37.2	44.4
General Government Net Debt % Revenues	196.5	92.2	248.3	137.4
Current Account Balance % GDP	-0.3	-3.5	-0.1	-2.7
ST BIS Liabilities/Assets	42	101	166	68
Total BIS Liabilities/Assets	89.53	231.30	369.86	147.42
External Debt / GSPI ratio	116	--	152	367
Debt Service % of Exports (GSPI)	3.83	--	11.06	11.14
EVI** : Principal Payments Due + ST Debt / Official Reserves	41	-	79	68
Per Capita GDP (PPP) - USD (World Bank)	24980	29873	15829	19283
Average Institutional Indicators (KBRA Ranking)	4	3	4	4
Average Institutional Indicators (KBRA Ranking)	BBB/BB	A	BBB	BBB/BB
Human Development Index (Ranking)	86	42	114	88

Sources: IMF World Economic Outlook, IMF Fiscal Monitor, UN, World Bank, World Economic Forum
** 2022 data for BIS, External Debt and EVI Indicators*
***Numerator Includes Non-Resident Deposits Where Available*

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. Non-resident holdings of MXN debt (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.

Mexico Ratings History		
Date	Action	Rating/Outlook/Watch Status
24 Oct 2019	Assigned	LT Ratings: BBB (Stable) - ST Ratings: K2
8 May 2020	Affirmed	LT Ratings: BBB (Negative) - ST Ratings: K2
6 May 2021	Affirmed	LT Ratings: BBB (Negative) - ST Ratings: K2
6 May 2022	Affirmed	LT Ratings: BBB (Stable) - ST Ratings: K2
4 May 2023	Affirmed	LT Ratings: BBB (Stable) - ST Ratings: K2
3 May 2024	Affirmed	LT Ratings: BBB (Stable) - ST Ratings: K2

Disclosures

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 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
- U.S. Stimulus: Uneven Impact on LATAM
- Mexico: Governance Threatens to Impair Post-Pandemic Recovery