Mexico's Credit Profile Under Pressure

Low Growth and Higher Public Debt Burden

Negative Outlook: In December 2016, Fitch revised the Outlooks on Mexico's Foreign- and Local-Currency Long-Term IDRs to Negative from Stable, while affirming the IDRs at 'BBB+'. The Outlook revision reflects increased downside risks to the country's growth outlook (in the context of relative economic underperformance in recent years) and the challenges this could pose for stabilisation of public debt burden.

In addition, the election of Donald Trump as US President has increased economic uncertainty in Mexico, given his allusions to renegotiating the North American Free Trade Agreement (NAFTA) with Mexico and tightening immigration controls.

US-Mexico Links Under Pressure: President Trump has announced that he intends to renegotiate NAFTA with Mexico and Canada. On the trade front, "no change" or the US repeal of NAFTA appear low-probability scenarios, while uncertainty looms on the kind of changes that may be introduced to the existing agreement. Currently, 80% of Mexico's exports are destined for the US. Moreover, overseas workers' remittances amount to over 2% of GDP, over 90% of which originate from the US. Finally, strong foreign direct investment (FDI) flows from the US have facilitated the development of Mexico's manufactured export sector.

Modest Growth, External Challenges: Mexico's growth profile is weaker than its rating peers'. Mexico's five-year growth of 2.5% is weaker than the 'BBB' median of 3.1%. Economic underperformance relative to the peer category could continue in 2017-2018.

The current account deficit has widened in recent years, and any hit to remittances and trade flows could further weigh on external accounts dynamics. At the same time, a dip in FDI could make financing of the current account deficit more dependent on portfolio flows and external borrowing. The high participation of non-residents in the government's securities markets highlights vulnerability to shifts in investor sentiment.

Challenging Debt Dynamics: Primary deficits, weak growth, peso depreciation and one-off issuances to the productive enterprises of the state (eg Pemex and CFE) have led to a steady increase in the public debt burden in recent years. While the government is targeting a public-sector primary surplus to stem the increase in indebtedness, slower growth and peso depreciation could pose risks for debt stabilisation. Mexico's general government debt burden at an estimated 46% of GDP for 2016 has diverged from the 'BBB' median of around 40%.

Downgrade Sensitivities: A deterioration in the economic, trade and financial links between Mexico and the US that dampens Mexico's investment and growth prospects and/or weakens its external balance sheet would be negative for the ratings. Weak economic growth and/or fiscal deterioration leading to a failure to place gross general government debt/GDP on a downward path would be negative as well. Materialisation of contingent liabilities that undermine the sovereign's balance sheet would also weigh on Mexico's credit profile.

Stabilisation of Outlook: Improved growth performance and successful fiscal consolidation that improves the outlook for the public debt trajectory, as well as reduced risks of disruption to trade and financial flows (including FDI) to Mexico, would help stabilise the Outlook.

Related Research

2017 Outlook: Latin America Sovereigns (December 2016)
Global Economic Outlook (March 2017)
Mexico (August 2016)

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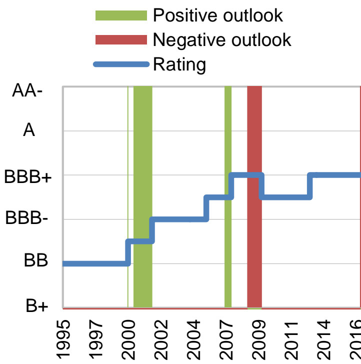
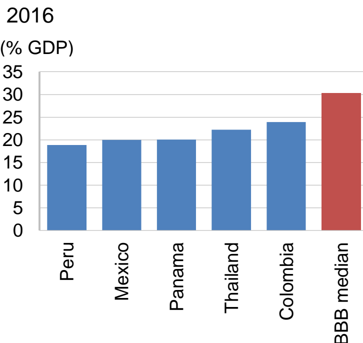
Mexico's Rating History



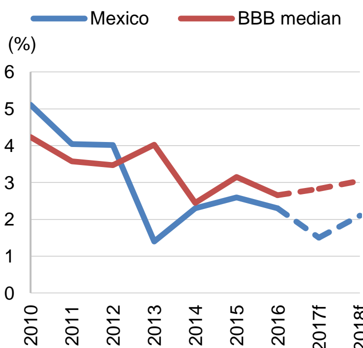
Source: Fitch

GG Revenue
2016



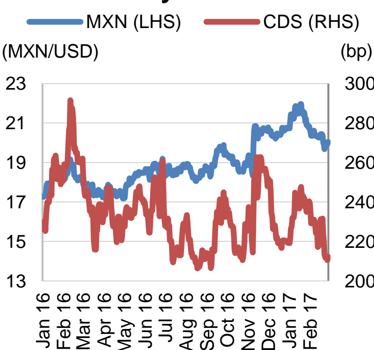
Source: Fitch, National authorities

Real GDP Growth



Source: Fitch, National authorities

MXN and 10y CDS



Source: Bloomberg

Mexico's Credit Rating Trajectory

Fitch has rated Mexico investment grade since 2002. Since then, it was progressively upgraded to 'BBB+' in 2007, reflecting the steady consolidation of its sound economic policy framework, improvement in its external solvency ratio, prudent liability management, efforts to expand the fiscal revenue base, and the public-sector pension reform.

During the global financial crisis, Fitch downgraded Mexico's ratings by one notch to 'BBB'/Stable to reflect increased macroeconomic pressures (an economic contraction of around 5% in 2009), reduced external buffers (due to heavy FX intervention by the central bank amid the unravelling of the corporate derivatives position) as well as increased fiscal vulnerabilities reflecting the steady loss of oil production (given high oil dependence), reduction in the already modest fiscal buffers, and the increase in public debt burden. The tax reform passed at the time was deemed insufficient to materially address the narrow revenue base and reduce the heavy oil dependence of public-sector revenues.

Mexico regained the one notch in May 2013, reflecting the economy's resilience to sluggish US growth, the stabilisation of oil production, improved international reserves buffers and the greater-than-expected commitment of the Peña Nieto administration to implement structural reforms that boded well for Mexico's competiveness, investment and growth outlook.

However, despite the steady implementation of labour, telecom and energy reforms, the economic growth performance of Mexico has not kept up with rating peers. At the same time, while the fiscal reform has been successful in diversifying the revenue base away from oil, the general government revenue base remains narrow (estimated at 20% of GDP for 2016 versus 30% for the 'BBB' median). Moreover, oil production has begun to decline again, reversing the stabilisation trend observed earlier.

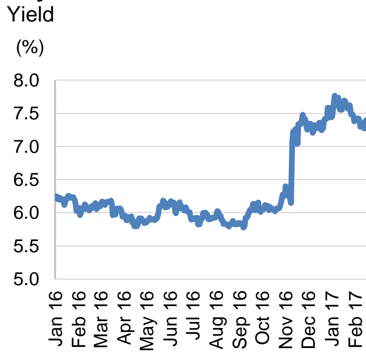
In December 2016, Fitch revised the Outlooks on Mexico's 'BBB+' IDRs to Negative from Stable, reflecting increased downside risks to the country's growth outlook and the challenges this could pose for stabilisation of the public debt burden, which has been steadily increasing in recent years and diverging from rating peers. The election of Donald Trump in November 2016 led to increased peso depreciation and volatility, thereby becoming another source of negative pressure for public debt dynamics. President Trump has alluded to renegotiating or terminating NAFTA and tightening immigration controls, both of which could hit Mexico's economic and social prospects.

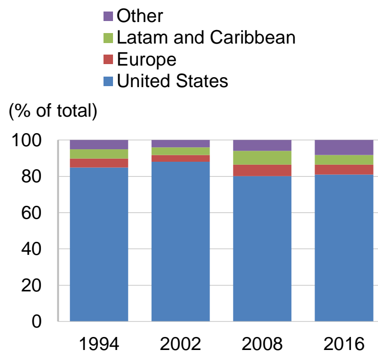
Fitch will monitor the evolution of the negotiations between the US and Mexico on NAFTA and immigration issues as well as the impact increased economic uncertainty would have on Mexico's economy and investment flows. Deterioration in the economic, trade and financial links of Mexico with the US that dampen Mexico's investment and growth prospects and/or weaken its external balance sheet would be negative for the ratings. Weak economic growth and/or fiscal deterioration leading to a failure to place the gross general government debt/GDP ratio on a downward path would be negative as well.

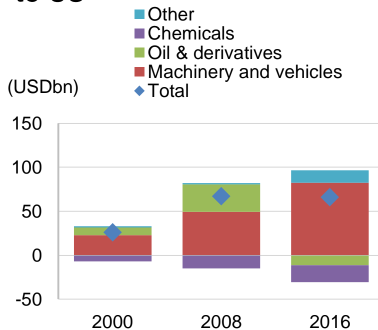
On the other hand, reduced risks of disruption to trade and financial flows (including FDI) to Mexico would be positive. Similarly, improved growth performance and successful fiscal consolidation that improved the outlook for the public debt trajectory would help stabilise the Outlook.

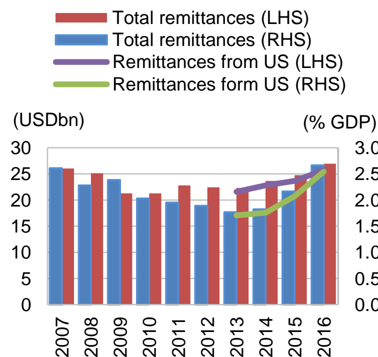
Mexico and Trump Presidency: Channels of Spillovers

The implications of the Trump presidency for Mexico will be felt in both the near and medium terms. The near-term impact has involved increased economic uncertainty, which has hit financial asset prices and increased volatility. The peso weakened following President Trump's November election but has rebounded somewhat. Local bond yields spiked in the election aftermath and CDS spreads widened, although they have narrowed subsequently. Higher uncertainty is likely to reduce appetite for consumption and investment.









Investment, which has already been sluggish, could slump from the "wait and see approach" of local and foreign investors. Consumption growth, which has been a driver of growth in recent years, will likely decelerate in 2017 owing to low consumer confidence (which has plummeted to levels seen around the time of the 2014 tax increases), higher inflation (cutting into real incomes), and slower lending growth as banks adopt a more cautious approach. As a result, Fitch has recently lowered its GDP growth forecasts for Mexico to 1.5% for 2017 and 2.1% for 2018, with risks still skewed to the downside. Mexico's five-year growth average of 2.5% is weaker than the 'BBB' median of over 3%, and Fitch believes this economic underperformance of the peer median will continue during the forecast period.

Over the medium term, the impact of the Trump presidency will depend on the aggressiveness of the administration on trade- and immigration-related issues. Fitch will monitor the following channels through which negative spillovers from US policies could be felt by Mexico and adversely affect its credit profile.

Trade

About 80% of Mexico's exports are destined for the US. The US runs a large trade deficit with Mexico that has grown in recent years. The trade deficit is mainly driven by the transportation sector (eg auto and auto parts). In some industries, the integration of supply chains is quite significant with the US, the most notable being the auto sector. Despite Free Trade Agreements with other countries, Mexico has not achieved much success in diversifying its trading partners, and it will take time to pursue other trade initiatives and effectively diversify export markets.

Regarding renegotiation of NAFTA, there are three possible scenarios. Scenario 1 would be a "no change" scenario, which appears unlikely given the tone of the Trump administration on trade protectionism. Scenario 2 would involve the exit of either country from NAFTA[1]. Fitch currently believes this is a low-probability scenario because of the tight integration of supply chains between the two countries and the extensive investment by the US companies in Mexico. However, should this occur, Mexican manufactured goods would confront moderate average tariffs as per the WTO's most-favoured-nation provisions (and the peso's depreciation should help facilitate the absorption of this). However, higher tariffs on US exports to Mexico could hurt US agricultural producers and some US manufacturers given the high US import content of Mexican exports.

In Scenario 3, changes are made under the NAFTA agreement that restrict the favourable market access of Mexican exports in the US. The range of possible outcomes is wide, and it is difficult to pre-judge the likely impact of such measures. A large unilateral tariff on Mexican exports to the US would be the most damaging, but this could be challenged under the provisions of the WTO and appears unlikely[2].

A more positive scenario would be an upgraded NAFTA that modernises the treaty and includes sectors that were previously excluded (for example, energy), without making substantive changes to the existing favourable market access conditions for Mexican exports to the US. Recent public statements by US Commerce Secretary Wilbur Ross indicate that the two countries may focus on modernising the trade deal, possibly tightening the rules of origin to restrict how many goods can come from nations outside the NAFTA while still receiving the benefits from the agreement's market access provisions.

[1] According to Chapter 22 of NAFTA, any member can withdraw from the agreement after giving six months' written notice to the other parties. Both the US and Mexican governments have made public statements indicating that they could exit NAFTA in case of an impasse.

[2] According to the WTO website, "If a dispute case runs its full course to a first ruling, it should not take more than one year-15 months if the case is appealed. The agreed time limits are flexible, and if the case is considered urgent, it is accelerated as much as possible."

Progress on the domestic tax reform agenda in the US, including the Border Adjustment Tax that has been floated by the House Republicans, would not single out Mexico; however, given the substantial trade deficit of the US with Mexico, it could still hurt Mexican prospects, especially in the context of reduced corporate taxes in the US. A tax reform in the US that leads to a reduction in corporate taxes domestically and implies a less favourable treatment for imports could influence the decisions of US companies to invest and expand abroad, thereby hurting FDI prospects for Mexico.

Remittances

Overseas workers' remittances reached a record USD27 billion (an estimated 2.7% of GDP) in 2016. More than 95% of the remittances originate from the US. Foreign exchange from remittances now exceeds that from oil exports. During the campaign period, Mr Trump stated his intention to tax or block workers' remittances. Since he took office, however, the rhetoric appears to have shifted towards deportation. Any attempt to tax or hinder remittance flows would be negative for Mexico's current account deficit as well as consumption growth as these remittances are largely spent rather than saved.

Even if remittances are not directly taxed or blocked, tighter immigration controls could hurt prospects for such flows. Initial policy statements and actions around deportation suggest that the US administration could be taking a more aggressive stance towards violations related to immigration status. The population of total undocumented immigrants in the US is estimated to be 11 million (of which an estimated 5.5 million are of Mexican origin), although the number subjected to possible deportation risk is uncertain. Return of undocumented Mexican immigrants could have adverse political and social implications given the limited domestic employment opportunities and the loss of foreign remittances flows of such workers.

Foreign Direct Investment

FDI flows have been an important source of funding Mexico's current account deficit, especially in the context of wider deficits in recent years. The current account deficits have nearly doubled compared to the five-year average (2.7% of GDP in 2016 compared with an average of 1.5% during 2010-2014).

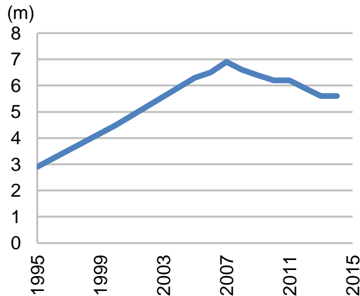
The medium-term impact on FDI from greater US trade protectionism will depend on how far the rules of the game change for trade. Traditionally, Mexico has attracted significant FDI to develop the export sector and buttress the integration of its industrial sector with the supply chains of its northern neighbour. Depending on the year, FDI from the US has been 40%-50% of the total inflows.

Since November, the Trump administration has focused attention on certain companies for outsourcing jobs and activity to Mexico. In this regard, certain US companies have announced plans to alter their expansion plans in Mexico. It is currently difficult to assess how broad-based this trend will become, and as such Fitch will monitor the FDI flows to Mexico in the coming months to assess the potential hit from US policies.

Broader Capital Inflows

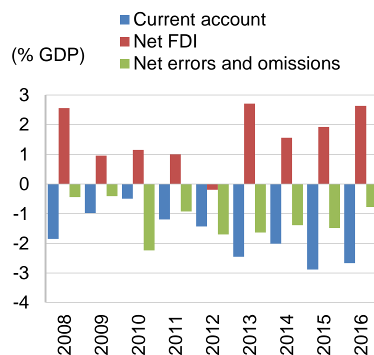
In recent years, Mexico has received substantial portfolio flows. This is reflected in the increased share of foreign ownership of the government's domestic debt market, with over 30% of domestic securities debt held by foreigners. Against the backdrop of US monetary tightening and continued economic uncertainties stemming from the Trump administration's trade policies, portfolio inflows to Mexico could diminish or even reverse. This could complicate the picture for the capital account and the balance of payments, especially in the context of weaker FDI and the large, albeit reduced, negative "errors and omissions". While so far the non-resident ownership of government debt has remained resilient (notwithstanding the significant peso depreciation), Fitch will monitor how these flows evolve in the context of trade renegotiations with the US and the impending Mexican election cycle.

Mexican Unauthorized Immigrant Population in the US



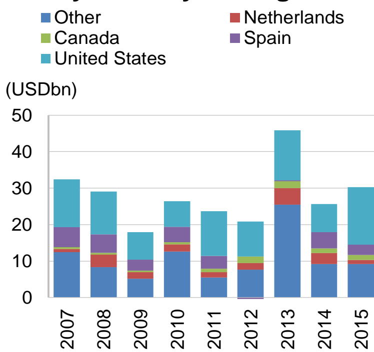
Source: Pew Research Center

Current Account and FDI



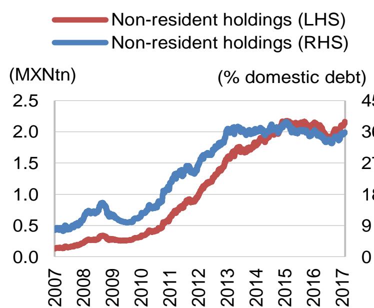
Source: Fitch, Banxico

FDI by Country of Origin



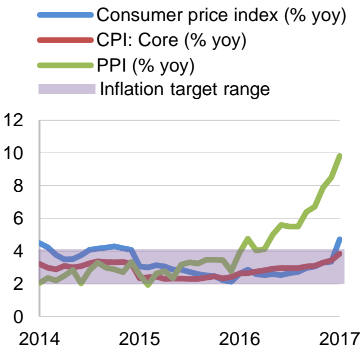
Source: CEPAL

Foreign Participation of Domestic Debt



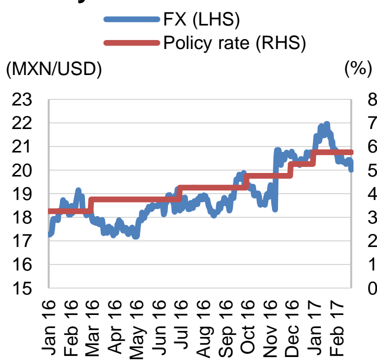
Source: Banxico, Fitch

Increasing Inflation



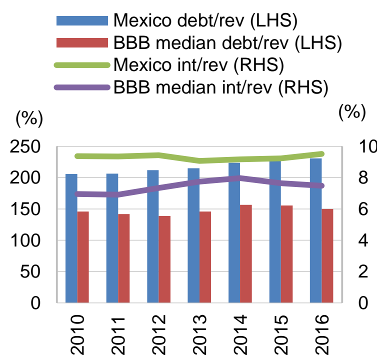
Source: INEGI, Banxico, Fitch

Policy Rate and MXN



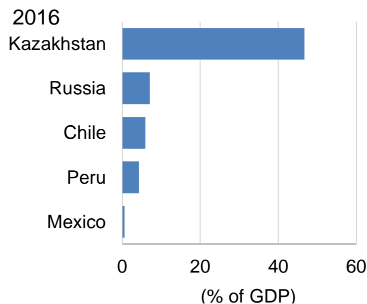
Source: Bloomberg, Banxico

Mexico GG Debt and Interest



Source: Fitch, SHCP

Stabilization Funds



Note: Only includes SWFs explicitly set up to save commodity revenues
Source: National Authorities, Fitch

Increasing Challenges for Economic Policies

Mexico's flexible and credible policy framework is a credit strength and has underpinned macroeconomic stability. However, the space for the authorities to implement counter-cyclical policies to support growth is limited due to currency pressures and the weakening fiscal profile. In contrast, the expected tightening bias of economic policies will weigh on economic growth in 2017.

Monetary policy has been focused on reducing the scope of second-round effects from peso depreciation and anchoring inflation expectations. Inflation reached 3.4% in December 2016 and has increased materially to 4.7% in January. Higher gasoline prices, a hike in minimum wage and the pass-through from peso depreciation will keep inflation under pressure in 2017 despite the expected weakening of domestic demand conditions.

The central bank has been in tightening mode since December 2015 and has delivered 325bp of increases in interest rates despite a sluggish economy and in order to anchor inflation expectations and facilitate inflation convergence with the target of 3%. The central bank has emphasised the relative monetary stance with the US and the exchange rate movements in its decisions. Given continued peso weakness and volatility, Fitch believes that further hikes are likely during 2017, especially in the context of the expected interest rate hikes by the US Fed.

The authorities have prudently allowed the peso to depreciate in the face of external uncertainties and to facilitate external adjustment. Despite the significant depreciation of the currency in 2016-2017, the central bank has refrained from large-scale FX interventions to protect its international reserves buffers given a possible protracted period of economic uncertainty.

In the wake of intense depreciating pressures in January 2017, the central bank made USD2 billion in discretionary sales, which was the second such sale since the suspension of rules-based FX interventions in early 2016. To facilitate a better functioning of the FX market and address peso volatility without intervening through spot sales, the Foreign Exchange Commission recently announced that the central bank would be providing foreign exchange hedges (up to USD20 billion) to the private sector. Mexico also has access to USD88 billion of the IMF's Flexible Credit Line, which it has not tapped yet.

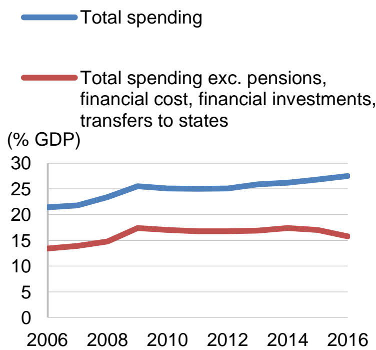
Fiscal Consolidation Not Yet Sufficient for Public Debt Stabilisation

Higher government debt burden is limiting the manoeuvrability of the authorities to confront the economic slowdown. Mexico's debt burden is diverging from the 'BBB' median, while interest/revenue and government debt/revenue ratios remain above the peer medians. Reducing the government debt burden will be important to rebuild fiscal space, especially in the context of limited fiscal buffers.

On the fiscal front, the authorities have been consolidating fiscal accounts according to a pre-determined path despite the shock to oil income and the financial assistance to Pemex. This has been facilitated by the successful implementation of the 2013 tax reform, the execution of an oil hedge, the transfer of one-off central bank profits to the Treasury, and several rounds of downward spending adjustments. Both the federal government and Pemex have shouldered the pain of expenditure adjustment.

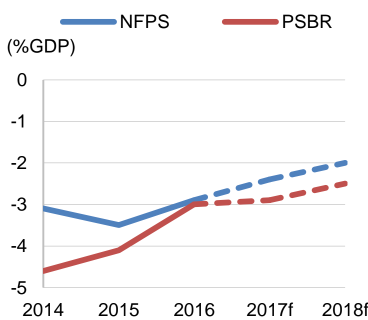
As a result, in 2016, Mexico outperformed its broadest fiscal target measure of PSBR (public sector borrowing requirement) by 0.6% of GDP to reach 2.9%. The decline in public-sector spending (excluding financial investments, financing costs, pensions and federal transfers to states) from 17% of GDP in 2015 to 15.8% in 2016 highlights some positive impact from spending adjustments and prioritisation.

Government Spending



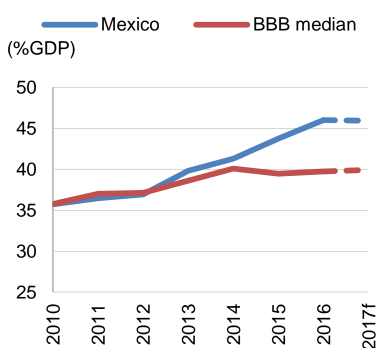
Source: Ministry of Finance, Fitch

Non-Financial Public Sector Balance



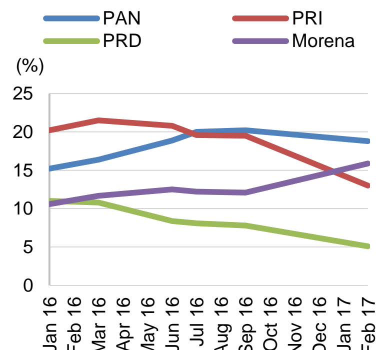
Source: Ministry of Finance, Fitch

Debt Burden



Source: National authorities, Fitch

Presidential Race



Source: Consulta Mitofsky

The 2017 budget has envisioned further spending adjustments to comply with the achievement of the public-sector primary surplus target. The budget assumes that Pemex will make its 2016 MXN100 billion spending adjustment permanent and incorporates a total spending adjustment of MXN70 billion (0.3% of GDP). This will be focused on containing personnel spending, trimming operating spending, prioritising social spending and increasing the participation of the private sector in investment.

Lower economic growth and higher financing costs could test the fiscal consolidation goal for 2017. Given the recent rebound in oil prices, the budget price of USD42 for the Mexican oil mix appears reasonable and is broadly in line with Fitch's assumption[3]. (The authorities have secured an oil hedge at USD38 with the remaining USD4 difference covered by MXN18 billion in a special account of the federal stabilisation fund.) The budget projections also incorporate a nearly 9% decline in oil production.

We expect the authorities to meet their primary surplus target despite our less optimistic growth assumptions. The Mexican budget is long US dollars as oil revenues are earned in foreign currency (and will generate higher pesos) while expenditure is carried out in pesos. This will cushion the impact from depreciation, although this revenue boost will be tempered by the increase in financing costs. Moreover, the significant depreciation of the peso in 2016 will likely lead to additional one-off transfers from the central bank to the Treasury[4], although the exact amount is unknown. The government also has access to 0.6% of GDP in resources in the federal stabilisation fund, which could be used to meet revenue shortfalls. However, achievement of fiscal targets would become more difficult in the event that Mexico faces an economic hard landing and/or Pemex is unable to execute its austerity commitments.

Primary deficits, weak growth, peso depreciation and one-off issuances to the productive enterprises of the state (eg Pemex and CFE) have led to a steady increase in the public debt burden in recent years. While the government is targeting a public-sector primary surplus to stem the increase in indebtedness, slower growth and peso depreciation could pose risks for debt stabilisation. Mexico's general government debt burden at an estimated 46% of GDP for 2016 has diverged from the 'BBB' median of around 40%. Slower growth, FX depreciation and an inability to consolidate fiscal accounts represent chief risks to debt dynamics.

A Competitive Election Cycle Ahead

Mexico's political environment is becoming more challenging against the backdrop of reduced popularity of President Peña Nieto, sluggish economic growth and the impending 2018 presidential election cycle. The popularity of the president has suffered from the perception of increased official corruption as well as higher incidence of crime. The resurgence of the main opposition party PAN in the June 2016 local elections highlighted the public dissatisfaction with some of these issues.

The domestic political environment is also being influenced by the difficult negotiations ahead with the US on NAFTA and immigration-related issues. The cancellation of President Peña Nieto's scheduled trip to the US in late January highlights the challenging terrain of the negotiations. In addition, on the domestic front, the significant increase in gasoline prices in January has raised domestic social and political tensions.

While still early in the cycle, the 2018 election could be a competitive one and could reduce the manoeuvrability of the current government to deal with shocks. The forthcoming June election for Estado de Mexico, the most populous state of the country and a stronghold of President Peña Nieto's PRI party, could provide colour on the presidential race. Some polls are already

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[3] Fitch assumes that Brent oil will average USD52.5 per barrel in 2017. The Mexican oil mix sells at a discount to Brent.

[4] According to pre-set rules, the central bank transfers have to be used to reduce financing needs or buy back debt (70%) and the remaining 30% to increase the federal government's asset position.

showing increasing support for the leftist and anti-establishment candidate Lopez Obrador of Morena. In the past, Mr Obrador has supported higher social spending and expressed strong opposition to some of the reforms implemented during the Peña Nieto administration (especially the energy reform). Increased uncertainty related to the election cycle could represent another domestic headwind for investment and growth outlook in 2017-2018.

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