JCR

ISSUER REPORT

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12049

Mexico

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Long-term Rating	A-
Outlook*	Stable
Short-term Rating	-

*Long-term Rating refers to Foreign Currency Long-term Issuer Rating in principle.

1. Overview

Mexico is a major regional economy with a population of about 120 million and a nominal GDP of approximately USD 1.2 trillion, both of which are the second-largest in Latin America after Brazil. Its per capita GDP totaled approximately USD 9,800 in 2018. Its land area is about 1.96 million square kilometers, about five times that of Japan.

In terms of ethnic composition, Mestizo, a mixed blood of European (Spanish, etc.) and indigenous people, accounted for about 60%, indigenous people for about 30%, and European (Spanish, etc.) approximately 9% of the total population. The official language is Spanish and 90% of its population is Catholic. Such population composition, language and religion reflect the influence of the era of Spanish colony.

2. Social and political bases

Mexico started an independent war against Spain, the former suzerain country, in 1810 and won independence in 1821. It is currently a federal republic headed by president and based on constitutional democracy. The president is elected by popular vote and the term of the president's tenure is one term of six years, with reelection prohibited under the constitution. Its legislature is a bicameral Congress composed of the chamber of senators and the chamber of representatives.

Partido Revolucionario Institucional or the Institutional Revolutionary Party (PRI), founded in 1929, had been in power for 70 years since the Mexican Revolution. In 2000, Partido Accion Nacional or the National Action Party (PAN) took over power for the first time and stayed at the helm until 2012. In December 2012, PRI returned to power when its candidate Pena Nieto was elected president. During his presidency, Pena Nieto pursued structural reforms in a variety of fields, including energy, finance, banking, communications, labor and education, and gained support from the domestic business community and foreign investors. On the other hand, he was unable to enforce effective measures to stem the spread of corruption amid disclosure of corruption scandals involving himself and his wife. In addition, public security has deteriorated as the murder rate hit a record high in 2018. The approval rate of his government plunged due to its inability to effectively tackle with these issues.

The latest presidential election was held in July 2018, and Andrés Manuel López Obrador, widely known as AMLO, from emerging left-wing political party MORENA (Movimiento Regeneración Nacional or the National Regeneration Movement) was elected by garnering 53.2% of the votes cast. In the congressional election held on the same day, a leftist coalition led by MORENA won a majority in both houses. In contrast, José Antonio Meade, who ran on the center right-wing PRI ticket, won only 16.4% of the votes to rank third, with PRI's share of seats in Congress falling sharply from about 50% to some 12%. AMLO officially launched his administration upon assuming the presidency in December that year.

The new administration has identified eradication of corruption as one of its top priorities. In Mexico, productivity has remained sluggish for many years due to rampant corruption and the existence of large-scale informal labor, but successive governments had failed to find effective solutions to those problems. Against this backdrop, Mexican people seemed to have pinned hopes on the freshness of the new AMLO administration backed by the emerging left-wing MORENA.

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On the other hand, the administration has been revising the main policies pursued by its predecessor. Even before assuming office in October 2018, AMLO said his administration would suspend the construction of a new international airport in Mexico City. In December 2018, he suspended the oil bidding process for private-sector companies, which had been part of the previous administration's energy-sector reforms, and announced plans aimed for self-sufficiency in petroleum products through a renovation of existing refineries and the construction of a new refinery. These decisions made stock prices and exchange rates temporarily volatile, an indication that investors both at home and abroad had turned wary about growing future uncertainty.

In his inaugural address in December 2018, however, AMLO also expressed his willingness to pay certain consideration to domestic and overseas investors, such as maintaining fiscal discipline and respecting the independence of the central bank. JCR will watch whether his administration will be able to push ahead with necessary reforms such as suppression of corruption over the medium to long term while giving consideration to investors' concerns about the future and reducing uncertainty about imminent governmental policies.

On the diplomatic front, since the conclusion of the North American Free Trade Agreement (NAFTA) with the United States and Canada, Mexico has strengthened its economic interdependence with the United States in particular. On the other hand, the Trump Administration inaugurated in January 2017 has made a spate of hardline assertions against Mexico, including renegotiation of NAFTA (concluded in September 2018), the construction of walls along the Mexican-American borders and the repatriation of illegal immigrants. The bilateral relations have since remained politically tense.

In May 2019, US President Trump branded the measures taken so far by the Mexican government on illegal immigrants as insufficient and announced a plan to impose a 5% tariff on all goods imported from Mexico. The tariff would be raised in stages to a maximum of 25% if Mexico's response was not improved, Mr. Trump added. Following the conclusion of the negotiations between the two countries, the United States eventually announced an indefinite suspension of tariff imposition on Mexico in June. It was also agreed that an interim assessment of Mexico's response would be carried out 45 days later and a final conclusion including the invocation of a higher tariff would be drawn within 90 days by the US administration. According to media, Mexican side received a certain level of appreciation for the progress that has been made from the US side in the meeting of ministers held after the 90 days passed. JCR will closely monitor the future development of the bilateral talks between the US and Mexico for this issue.

3. Economic base

Since the conclusion of the NAFTA, Mexico has established a solid export base for automobiles and home appliances mainly bound for North America by accepting a large amount of direct investments. The share of industrial products in exports reached 88% in 2018. The country is also open to other countries, and the ratios of goods exports and imports to GDP are the highest among the top five countries in Latin America in nominal GDP terms. Goods exports (on a balance of payments basis) in 2018 accounted for 36.8% of GDP and goods imports for 38.0% of GDP, both of which have been on a moderate upward trend. Approximately 90% of the goods exports are manufactured goods, with some 80% of them bound for the United States. In particular, the automobile industry has been growing remarkably, and the automobile production reached 4.067 million units in 2018 (INEGI), the sixth largest in the world.

Blessed with abundant mineral resources such as oil, silver and lead, Mexico ranks 19th in the world (third in Latin America) in terms of proved oil reserves at 7.7 billion barrels per day at the end of 2018 according to BP statistics, and 12th in the world (second in Latin America) in terms of oil production at 1.85 million barrels per day in 2018 according to BP statistics and the Ministry of Finance of Mexico. The country's oil production peaked at 3.38 million barrels per day in 2004, and the declining trend has not been halted. Behind this is the fact that the state-owned petroleum company PEMEX (Petróleos Mexicanos), which solely undertakes oil production, has not been able to make investments necessary to recover production due to the financial deterioration stemming from its heavy burden of payments to the government. While the real sector's dependence on mineral resources is low at around 4%, with crude oil accounting for only 6.8% of total exports, the government continues to rely on oil-related revenues for its finance. Since oil production affects government finance via PEMEX, it needs to take effective measures to restore its production.

The new AMLO administration announced a three-year suspension of the oil bidding process, saying that

the current private-sector participation in the oil sector had no clear effect in recovering oil production. The administration looks to reinforce PEMEX's production capacity through a renovation of existing refineries and the construction of a new refinery. To this end, it is revising the previous administration's policy to utilize the private sector in favor of greater priority on reforms of PEMEX itself. It should be carefully noted that the efforts to boost PEMEX's production capacity made by the successive governments in the past have not been successful, and there remains much uncertainty about whether domestically produced petroleum products can beat US-produced products to ensure self-sufficiency. Given this situation, JCR will monitor whether the new administration's PEMEX modifications will lead up to improving the petroleum sector’s performance.

One of the focal points about the Mexican economy in recent years has been whether the central bank can stabilize the high inflation rate mainly brought by rising import prices and a spike of international crude oil prices amid the Mexican peso’s depreciation against the US dollar caused by the US interest rate hikes.

The CPI (headline) inflation rate began rising sharply since January 2017 due mainly to the peso’s depreciation and the liberalization of energy prices, reaching 6.8% year-on-year in December that year. In 2018, the impact of liberalized energy prices was removed, but the inflation rate remained high due to the impact of rising import prices and crude oil prices. It averaged higher than 4% in 2018, exceeding the central bank's inflation target (3 ± 1%).

The central bank resolutely raised its policy interest rate by a cumulative 525 basis points between December 2015 and December 2018, bringing it to 8.25%, the highest since 2008. Thanks to the bank’s swift policy responses, the peso has generally stabilized since the beginning of 2019 and the CPI inflation rate fell to 3.2% year-on-year in August 2019, coming closer to the central bank’s inflation target. Amid the growing speculation of an interest rate cut by the US Federal Reserve, the pressure on domestic and international financial conditions is likely to weaken for the time being. JCR holds that the central bank may shift its stance in favor of lower interest rates in the second half of 2019 at the earliest to support growth amid an outlook of price stabilization.

The Mexican economy grew 2.0% in real GDP terms in 2018, slowing for the third consecutive year on stagnant domestic and foreign demand. Private consumption was sluggish as higher prices persisted and private-sector capital investment was also bleak amid the uncertainty over the country’s trade relations with the US and the new administration's economic policies. External demand made a negative contribution for the second consecutive year amid the global economic slowdown. In 2019, the contribution of government spending and public investment to growth is expected to decline due to the new administration's curtailment of budget expenditures. Corporate activities may also stay cautious from the viewpoint of assessing the administration’s economic policies. JCR expects that the growth rate will be lower than 2% in 2019 and around 2% in 2020 although the central bank may have some room for monetary easing to support growth in the near future against the backdrop of a halt to US interest rate hikes and weakening inflation pressures.

4. Fiscal base

Oil-related revenues including those from PEMEX accounted for 19.1% of the total public-sector revenues in 2018. Compared to the most recent peak 39.4% in 2012, the decline was largely due to a significant fall of crude oil prices since 2014 and a continuing downtrend of domestic oil production. The expansion of the tax base for non-oil tax revenues and the establishment of a framework to reduce the impact of fluctuations in oil prices promoted by the former Peña Nieto administration also contributed to the reduced dependence on oil-related revenues. Yet the country’s fiscal dependence on oil remains high. While the real economy's reliance on the oil sector is not so high, Mexico's public finance remains structurally susceptible to the impact of the entire oil sector, including PEMEX.

Under these circumstances, the Fiscal Responsibility Act was amended in 2014 under the former Peña Nieto administration, requiring the government to set an annual target for Public Sector Borrowing Requirement (PSBR), the broadest-based budget deficit. PSBR in 2018 settled at 2.2% of GDP for a significant increase in the deficit from 1.1% (including the transfer of the Bank of Mexico’s operating surplus) in the previous year. However, the government's target of 2.5% was achieved and the cumulative PSBR fell from 45.8% to 44.9% in 2018, indicating that fiscal discipline has been largely maintained.

Even before assuming the presidency, AMLO had pledged that his administration would enhance expenditures on social policies, infrastructure development and energy investments while securing

financial resources solely by reducing current expenditures, such as salary cuts for the highest paid civil servants, without resorting to tax increases. How these would be reflected on budget proposals had been seen as crucial in predicting the fiscal policy of the new administration. The 2019 budget submitted by the new administration in December 2018 shortly after the presidential inauguration proved to be one that would not impair fiscal discipline. That was clear from two points that the budget was based on conservative economic forecasts and that PSBR target was to be kept retrained at 2.5% of GDP.

A breakdown of the budget shows that total revenues have been projected to decline in GDP terms due mainly to a prospective fall of non-tax revenues whereas on the expenditure side, the growth of various expenses have been curbed such as proposed salary cuts for public servants. The budget has incorporated AMLO's public pledges to a discernible extent.

The 2020 budget submitted by the government in September 2019 also shows its continued adherence to fiscal discipline as the PSBR is to remain at 2.6% of GDP and the primary balance is to be secured a surplus of 0.7% of GDP.

The Mid-Term Economic Outlook (2020-25), made public along with the budget, projects an annual average economic growth rate of 2.5% for 2020-2025, which can be seen as quite realistic in light of IMF's outlook (an average growth rate of 2.5% for 2020-2024). It is actually a conservative outlook that falls short of a 4% growth pledged by AMLO. The fiscal outlook predicts that annual revenues will stay at around 21% of GDP throughout 2025 and that while pension expenditures will increase, current expenditures such as personnel expenses and capital spending will be curbed to deliver PSBR to restrain within the level of 2.5% of GDP. The cumulative PSBR is planned to be reduced from 45.3% of GDP at the end of 2019 to 44.7% of GDP at the end of 2025. It deserves recognition that the new administration's adherence to fiscal soundness has been shown in terms of specific figures. However, the projected PSBR reduction in the medium-term outlook is planned to be achieved mainly through restrained expenditures. Given that most of the administration's priority policy measures require increased spending, it is unclear if it can restrain budget expenditures as planned. This needs to be closely monitored going forward.

With regard to PEMEX, while its EBITDA has been in surplus, it has been obliged to pay about 80% of the surplus to the government. Therefore, it has been in chronic deficit, staying in excess liabilities since 2009. This has left PEMEX unable to make necessary capital investments to recover production, which has kept falling since the 2004. Its EBIDTA in 2018 was 2.3% of GDP and profit before tax was 1.3% of GDP, but it had a net loss equivalent to 0.6% of GDP because its payments to the government reached 1.9% of GDP. Its balance of financial liabilities reached 8.8% of GDP at the end of 2018. In February 2019, the new administration announced relief measures worth about 0.3% of GDP for PEMEX. Restoring PEMEX production is essential to fundamentally improve its financial conditions and, consequently, to reduce its burden on the government finance. The new administration has temporarily suspended the opening of mining areas to the private sector which had been promoted by the previous administration in a policy shift in favor of increasing PEMEX's oil production capacity. JCR will closely monitor whether it would be possible to recover PEMEX's oil production without relying on the private sector.

5. External position

Mexico's current account deficit mainly stemming from a trade deficit and interest payments on foreign direct investment has stayed in the range of 1-2% of GDP in recent years. The current account deficit in 2018 was equivalent to 1.8% of GDP, little changed from 1.7% in the previous year. Mexico is easier to draw foreign direct investment due to its proximity to the United States under NAFTA, with its net inflow remaining stable at around 2% of GDP in recent years. Therefore, the current account deficit has been stably financed by foreign direct investment and the impact of volatile portfolio investment on the overall external balance has been kept mitigated. In fact, the net inflow of foreign direct investment in 2018 was equivalent to 2.0% of GDP, enough to cover the current account deficit in that year.

Portfolio investment in Mexico is characterized by a large portion of nonresidents’ investments concentrating on debt securities issued by the government and state-owned corporations. However, nonresidents’ investments in those instruments declined significantly in the third and fourth quarters of 2018. One of the factors behind the fall was the growing concerns among foreign investors over AMLO's election as president in July 2018 and forthcoming economic policies to be taken by his administration.

The growth of Mexico’s external debt has been restrained since 2015, and the debt totaled USD 446.1

billion in 2018, up 2.2% from the previous year. The debt in GDP terms has been on a declining trend since peaking at 38.3% in 2016. In 2018, the rate stood at 36.4%, which is lower among the countries rated in the A-range by JCR. Looking at its composition by period, the share of short-term debt has remained lower at around 10% in recent years. The country's foreign currency reserves have been staying flat at around USD 177 billion since 2015. The total reserves including gold stood at USD 176.4 billion at the end of 2018, or 2.8 times of the short-term debt and 4.2 months of imports of goods and services. In addition, Mexico had a SDR 53.5 billion (approximately USD 73.6 billion) Flexible Credit Line (FCL) with the IMF as of the end of October 2018 and is therefore highly resistant to external shocks.

The NAFTA renegotiations initiated by the United States, Mexico and Canada in August 2017 were concluded in September 2018. The new agreement, renamed USMCA (United States-Mexico-Canada Agreement), was signed by the leaders of the three countries at the end of November 2018. USMCA included stricter rules of origin for automobiles. Specifically, the US assertion to increase the ratio of procurement from the United States was reflected to a certain extent in the agreement as follows: (1) raising in stages the regional value content (RVC) of completed vehicles from the current 62.5% to 75% in 2023; (2) introducing a so-called wage clause that a certain percentage or more of the value-added must be put in regions with hourly pay of USD 16 or more; and (3) requiring that the steel and aluminum purchased by completed vehicle manufacturers should meet 70% of local value content.

However, the most-favored-nation (MFN) tariff rate for US-bound passenger cars and SUVs is low at 2.5% even when the rules are not met. Some automakers thus may find it more rational to pay the tariff than making major changes in their production and parts procurement systems.

The Side Letter attached to USMCA stipulated a limit on Mexican automobile exports to the United States. The meaning of this export quota is that Mexican automobile exports to the US will be exempt from Article 232 tariff when Washington invokes the higher tariff under Article 232 of the Trade Expansion Act. The cap on passenger car and SUV exports has been set at 2.60 million units. Given that such exports in 2018 totaled approximately 1.70 million units and considering the rate of growth in recent years, actual exports are unlikely to exceed the limit for at least several years to come. Therefore, the export quota could be considered to have a stronger significance as an insurance to avoid Article 232 tariff than a quantity export control.

For these reasons, JCR holds that Mexican auto exports to the United States and direct investments related to auto production in Mexico are unlikely to be significantly restrained by USMCA.

6. Financial system

The Mexican commercial banking sector is characterized by the strong presence of foreign banks following the currency crisis in the 1990s and subsequent financial restructuring. Foreign banks now account for about 70% of the total assets held by commercial banks.

Despite the Mexican peso's depreciation from 2015 to 2017 and the substantial rate hikes by the central bank, the Mexican banking sector has generally been retaining its high profitability and soundness. The ROA of the banking sector as a whole remained relatively high at 2.2% at the end of 2018. The capital adequacy ratio has been rising since 2016, reaching 15.9% at the end of 2018. The NPL ratio has been declining continuously since 2014. It stood at 2.1% at the end of 2018. The loan-to-deposit ratio has been staying stable at around 90% in recent years.

The limited impact of the major rate hikes by the central bank on the banking sector is due to the fact that financial deepening in the country is still in the development process and, therefore, the impact of monetary policy on the real economy is not so large. In fact, domestic claims stood at 54.4% of GDP at the end of 2018, the lowest among the countries rated in the A-range by JCR. The intermediation function of the banking system as a whole has not sufficiently deepened in comparison to the size of the economy and the domestic financial sector alone can hardly supply enough funds to finance growth. Riding on a stable loan-deposit ratio, the banking sector kept its balance of external borrowings low at 2.6% of GDP at the end of 2018 whereas the corresponding ratio for non-financial corporations stayed relatively high at 17.5%. This surely proves that Mexican firms have good access to international financial markets. However, it is important to promote financial deepening in the medium- to long term in order to enhance the stability of the financial system against external shocks although the external debt-GDP ratio itself is low among the A-rated countries.

7. Overall assessment and rating outlook

The ratings are supported by the country's solid export-oriented industrial base, its adherence to fiscal discipline, flexible and swift management of monetary and exchange rate policy, and resilience to external shocks. On the other hand, the ratings are constrained by the necessity of modernization of Mexican oil industries, and prevalent corruption and large-scale informal labor which impedes economic efficiency. Andrés Manuel López Obrador (AMLO), from the leftist party MORENA, was elected in the presidential election in July 2018 and took office as president in December that year. His new administration advocates eradication of corruption, which had worsened under the previous administration, as its top priority. On the fiscal front, it presented a 2019 budget which attached great importance to maintaining fiscal discipline with an expected surplus in the primary balance of 1.0% of GDP. JCR holds that a further increase of the fiscal deficit and public debt may continue to be restrained under its policy. On the other hand, NAFTA renegotiations were concluded in September 2018, and the new agreement (United States–Mexico–Canada Agreement, USMCA) is aimed to come into effect in 2020. While USMCA has tightened rules of origin for automobiles, JCR sees little likelihood of a substantial decline in Mexican auto exports to the US and direct investments related to automobiles in Mexico. Based on the above, JCR has affirmed its ratings with Stable outlook. It has also maintained its "A+" country ceiling.

If concerns arise about the government's commitment to fiscal discipline when increased expenditures in excess of its fiscal outlook are required for its priority policy measures, the ratings will come under downward pressure. In addition, if the new administration continues to implement policies that may significantly dampen the medium- to long-term investment predictability, such as the one seen in the suspension of the new airport construction project, the instability of the external balance may grow amid heightened concerns among foreign investors over its policy management. That will also bring downward pressure on the ratings. Moreover, continued attention needs to be paid to the impact that future US economic, monetary and trade policies and its policy toward Mexico may have on the country's external sector.

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Major Economic Indicators

		2014	2015	2016	2017	2018
Nominal GDP per capita	USD	11,014	9,691	8,826	9,392	9,808
Real GDP growth	%	2.8	3.3	2.9	2.1	2.0
CPI inflation (annual average)	%	4.0	2.7	2.8	6.0	4.9
Public sector primary balance to GDP	%	-1.1	-1.2	-0.1	1.4	0.6
Public sector fiscal balance to GDP	%	-3.1	-3.4	-2.5	-1.1	-2.1
Public sector borrowing requirement (PSBR) to GDP	%	-4.5	-4.0	-2.8	-1.1	-2.3
Public sector historical PSBR to GDP	%	42.6	46.5	48.7	45.8	44.9
Current account balance to GDP	%	-1.9	-2.6	-2.3	-1.7	-1.8
Trade balance to GDP	%	-0.2	-1.2	-1.2	-0.9	-1.1
Financial account balance to GDP	%	-4.4	-2.3	-3.3	-2.1	-3.0
Official reserve assets	bn USD	195.7	177.6	178.0	175.4	176.4
Official reserve assets to imports of goods and services	months	5.4	5.0	5.1	4.6	4.2
Official reserve assets to short-term external debt	x	2.1	2.5	3.2	3.2	3.3
External debt to GDP	%	32.4	35.6	38.3	37.7	36.9
Foreign exchange rate (annual average)	MXN/USD	13.3	15.9	18.7	18.9	19.2
Capital Adequacy Ratio (domestic deposit-taking institutions)	%	15.8	15.0	14.9	15.6	15.9
NPL Ratio (domestic deposit-taking institutions)	%	3.0	2.5	2.1	2.1	2.1
Domestic claims to GDP	%	49.1	52.5	54.7	54.8	54.4

* Figures for the most recent period could be indicators based on preliminary figures.
Source: National Institute of Statistics and Geography (INEGI), Central Bank, Secretariat of Finance and Public Credit (SHCP), IMF and CEIC

Ratings

(millions of yen)

	Rating	Outlook*	Amount	Rate (%)	Issue Date	Maturity Date	Release
Japanese Yen Bonds 19th Series (2014)	A-	-	13,900	1.44	2014.07.24	2024.07.24	2019.03.26
Japanese Yen Bonds 20th Series (2014)	A-	-	12,300	2.57	2014.07.24	2034.07.24	2019.03.26
Japanese Yen Bonds 22th Series (2016)	A-	-	50,900	0.70	2016.06.16	2021.06.16	2019.03.26
Japanese Yen Bonds 23th Series (2016)	A-	-	16,300	1.09	2016.06.16	2026.06.16	2019.03.26
Japanese Yen Bonds 24th Series (2016)	A-	-	21,900	2.40	2016.06.16	2036.06.16	2019.03.26
Japanese Yen Bonds 25th Series (2018)	A-	-	57,200	0.60	2018.04.20	2023.04.20	2019.03.26
Japanese Yen Bonds 26th Series (2018)	A-	-	24,100	0.85	2018.04.20	2025.04.18	2019.03.26
Japanese Yen Bonds 27th Series (2018)	A-	-	38,700	1.05	2018.04.20	2028.04.20	2019.03.26
Japanese Yen Bonds 28th Series (2018)	A-	-	15,000	2.00	2018.04.20	2038.04.20	2019.03.26
Japanese Yen Bonds 29th Series (2019)	A-	-	65,500	0.62	2019.07.05	2022.07.05	2019.06.27
Japanese Yen Bonds 30th Series (2019)	A-	-	41,200	0.83	2019.07.05	2024.07.05	2019.06.27
Japanese Yen Bonds 31th Series (2019)	A-	-	27,300	1.05	2019.07.05	2026.07.05	2019.06.27
Japanese Yen Bonds 32th Series (2019)	A-	-	31,000	1.30	2019.07.05	2029.07.05	2019.06.27
Foreign Currency Long-term Issuer Rating	A-	Stable	-	-	-	-	2019.03.26
Local Currency Long-term Issuer Rating	A+	Stable	-	-	-	-	2019.03.26

History of Long-term Issuer Rating (Foreign Currency Long-term Issuer Rating or its equivalent)

Date	Rating	Outlook*	Issuer Name
1998.06.17	BB+	-	Mexico
2000.11.02	BBB	-	Mexico
2005.01.26	BBB	Stable	Mexico
2006.01.20	BBB+	Stable	Mexico
2008.01.28	A-	Stable	Mexico

*Outlook for Foreign Currency long-term issuer rating, or direction in case of Credit Monitor

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