AUG 08.26.2016

ECONOMICS: LATIN AMERICA PERSPECTIVES

MEXICO: YET ANOTHER RATINGS YELLOW CARD

+ Fernando J. Losada, Senior Economist—Latin America Research, fernando.losada@abglobal.com

In March, Moody's placed Mexico's sovereign rating on negative outlook. Now, Standard and Poor's has followed suit, while indicating a one-in-three chance of a downgrade within the next two years. At this juncture, however, we don't expect one.

Fiscal and Growth Concerns

On August 23, S&P affirmed Mexico's sovereign long-term foreign-currency rating of BBB+, but the ratings agency did change the outlook to negative from stable. Moody's had made the same move on March 31, affirming Mexico's rating at A3 and shifting the outlook to negative. Fitch's rating, meanwhile, remains at BBB+ with a stable outlook.

S&P's press release indicated that the negative outlook reflects a one-in-three chance of a ratings downgrade for Mexico within two years "if either the government's debt or interest burden deteriorates beyond our current expectations." S&P based its action on the perceived deterioration of fiscal risk—all other key rating factors remained unchanged.

Based on S&P's projection, net general government debt will climb from 45% of gross domestic product (GDP) this year to 46.3% in 2017 (*Display 1*) and 48% by 2019, mainly from large fiscal deficits and low economic growth. Interestingly, S&P's forecast calls for GDP to grow by 3% from 2017 to 2019. That's not an overly pessimistic scenario, and it's slightly more constructive than is market consensus.

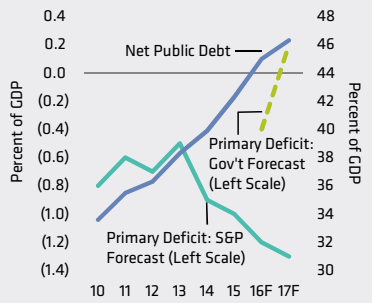
This estimate leaves the door open for disappointment and, if the press release is taken at face value, a negative rating action.

The agency acknowledged that Mexico's debt burden is moderate, though highlighting that the country's debt has increased steadily from 28% of GDP in 2005. The agency zeroed in on soft GDP growth in recent years, suggesting that the impressive record of structural reforms was offset by weak governance, weak rule of law and the perception of corruption that has deterred investment (*Display 2*).

S&P expects that the general government interest burden will remain below 10% of revenues, although it also mentioned risk factors, such as potentially larger fiscal deficits, peso depreciation and the cost of periodic financial assistance to the state-owned oil company PEMEX and electricity company CFE. S&P expects the current-account deficit to be near 2.7% of GDP this year, averaging 2.2% in 2017–2019 as foreign direct investment into the energy sector gradually increases—almost fully funding the country's external gap in the next few years.

Display 1
Fiscal Concerns for Mexico

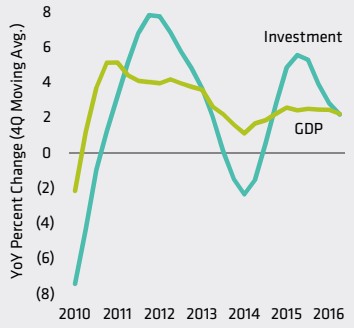
Widening Primary Deficit and Deteriorating Debt Ratio



As of August 25, 2016
Source: Finance Ministry and S&P

Display 2
Steady but Modest GDP Growth

GDP and Gross Fixed Capital Formation



Through August 25, 2016
Source: Instituto Nacional de Estadística y Geografía

Actual Downgrade Not Imminent

All in all, the press release doesn't suggest S&P is in a hurry to downgrade Mexico's sovereign debt, but rather to raise a yellow flag about the negative impact of subdued growth on the fiscal bottom line and on debt ratios. This approach is similar to what Moody's did.

This situation means that Mexico will need more fiscal consolidation to avoid a downgrade over the next couple of years—a rather tall order, given the upcoming 2018 presidential election and the financial support PEMEX will likely require. The good news? S&P made its announcement at the same time the government unveiled a unilateral plan to tighten its fiscal stance further.

This plan is expected to lower public sector borrowing requirements by half a percentage point, moving it toward 3% of GDP, and the plan targets a small primary fiscal surplus of 0.2% of GDP in 2017. S&P appears to have made its decision on the outlook change before the government announced the new fiscal targets. For instance, the rating agency's press release projects a primary fiscal deficit that's 1.2% of GDP for next year. So, if the Mexican government fulfills its new fiscal projections, it's likely to avoid a downgrade.

Focus on Fiscal Discipline Expected

We expect the authorities to focus on fiscal discipline through the end of the current presidential term—especially in the wake of S&P's announcement. S&P also highlighted the need to speed up the execution of reforms as a way to stabilize ratings. This stance puts progress on energy deregulation, including the December auction of deep-water crude areas, on the radar screen.

We don't think one-notch downgrades are likely to occur in the near term, especially in the case of S&P and Fitch. If Moody's were to downgrade Mexico's sovereign debt, this action would merely leave Moody's rating in line with those of the other two agencies—still two notches above the minimum level for investment-grade status. As a result, we don't believe the loss of investment-grade status is on the horizon. Besides, chances are very good that if there's a single-notch downgrade, the government will react by tightening its fiscal bottom line even further.

S&P's announcement on Mexico's credit outlook spurred an initial sell-off in the peso, with the spot exchange rate weakening by 27 centavos to MXN18.56/USD. After the initial shock, which suggests the news was unexpected, the currency strengthened back to MXN18.43/USD.

We still believe that the peso is slightly undervalued in inflation-adjusted terms, and we expect a gradual, mild appreciation toward sub-MXN18/USD by year end. That expectation assumes that we don't see a major hiccup in oil prices, and that the US and Europe maintain a still-accommodative monetary policy stance until then. ■