Press Release

Date of Release: December 7, 2017

DBRS Confirms Mexico at BBB (high), Stable Trend

Industry: Public Finance--Sovereigns

DBRS Inc. has confirmed Mexico's Long-Term Foreign and Local Currency – Issuer Ratings at BBB (high) and Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (low). The trend on all ratings is Stable.

The rating confirmation reflects gradual improvement in Mexico's credit fundamentals in the context of rising economic and political risks. The Mexican economy has performed well despite a series of negative shocks. Market reforms passed early in the Peña Nieto administration are starting to have a positive impact on growth. The fiscal consolidation plan is also advancing on schedule and underpinned by structural measures. However, uncertainty over the outcome of NAFTA negotiations and Mexico's 2018 general elections present downside risks to the economic outlook.

Mexico's BBB (high) ratings are underpinned by several credit strengths. The strong policy framework – comprised of exchange rate flexibility, prudent fiscal management, and a credible inflation-targeting regime – enhances the resilience of the economy. The banking system is well-capitalized, profitable, and in a strong position to support growth. External accounts do not exhibit any clear imbalances. Furthermore, the implementation of the structural reforms, if sustained through the electoral cycle, is likely to enhance Mexico's medium-term growth prospects.

However, Mexico faces significant structural challenges combined with external and domestic risks. Poor education outcomes, widespread informality, and other governance problems have inhibited productivity growth in Mexico for several decades. Corruption and public security are critical challenges. Although the economic reform agenda should lift productivity growth, realizing its full positive impact over the medium term may depend on Mexico's ability to meaningfully address corruption and strengthen the rule of law. Near-term risks include protectionist measures by the United States, which could adversely affect growth in Mexico through trade, investment, and confidence channels. In addition, the outcome of Mexico's July 2018 elections could result in a less favorable investment climate.

Structural reforms passed during the Peña Nieto administration aim to break Mexico out of its history of lackluster growth. Over the last two decades, Mexico has failed to make progress in converging toward advanced economy income levels. This relative stagnation is explained by Mexico's poor

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labor productivity performance. However, Mexico's supply-side reforms are starting to have a positive impact and help explain the economy's resilience amid a string of adverse shocks. Output expanded 3.3% in 2015 and 2.9% in 2016 despite a sharp decline in oil prices and weak industrial production in the United States. This year the economy faced NAFTA-related uncertainty and natural disasters, including two large earthquakes in September 2017. Nevertheless, several encouraging trends are visible. Formal jobs have been increasing at a robust pace. Telecommunications reform has increased competition and substantially lowered consumer prices. Investment is also up in the electricity sector, which could signal greater generation capacity and more competitive pricing.

Mexico faces both upside and downside risks to growth, which could have an impact on Mexico's ratings over the medium-term. The Mexican economy could outperform growth expectations if the structural reform agenda is fully implemented. In particular, the 2013 energy reform is fundamentally changing the oil and gas sector. After more than a decade of declining output, the upstream sector is positioned to return to growth. The energy reform aims to create a competitive market that is open to private capital. Increased investment should help reverse the decline in shallow-water fields and jumpstart production in deepwater areas.

On the other hand, a potential shift in U.S. trade policy toward protectionism presents a downside risk to Mexico's growth prospects. Mexico and the U.S. are deeply integrated economies with cross-border supply chains in sectors such as automobiles, electronics and textiles. The withdrawal of the U.S. from NAFTA could impact the competitiveness of North American firms, lead to gradual changes in cross-border production, and weaken the investment outlook. However, the overall effect of such a scenario on Mexico would depend on the nature of the post-NAFTA economic relationship between the U.S. and Mexico.

One of Mexico's critical challenges is strengthening the rule of law. According to the Worldwide Governance Indicators, Mexico scores poorly on issues of corruption and rule of law relative to peers in Latin America. Corruption and cronyism are perceived to be entrenched and widespread. By encouraging rent-seeking behavior and misallocating resources, corruption constrains economic growth and erodes trust between citizens and their public institutions. Elevated levels of criminality and violence also weaken the investment climate. However, Mexico's civil society and media have raised public awareness of these issues and propelled political action. Changes to the criminal justice system should result in more efficient courts, multiple high-profile corruption investigations are being pursued, and the National Anti-Corruption System has become operational, although the independent prosecutor has yet to be appointed. Despite the apparent progress, implementation is critical. In DBRS's view, sustainably stronger economic growth could depend on Mexico's ability to meaningfully address corruption and strengthen the rule of law.

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The outcome of Mexico's July 2018 elections could result in a weaker investment climate and less forceful implementation of the structural reform agenda. Andrés Manuel López Obrador, the presidential candidate for the political party Morena, has stated his opposition to the energy reform. Measures to weaken or stall the implementation of the reform could undermine its anticipated growth benefits. Despite this concern, DBRS believes that the basic pillars of Mexico's macroeconomic policy are unlikely to change through the electoral cycle. The frameworks underpinning fiscal and monetary policy benefit from support across the political spectrum. Some recently passed structural reforms, including the energy reform, involved constitutional changes, which would be difficult to reverse. Moreover, whoever wins the presidency would likely need to form alliances in Congress to pass legislation, thereby making radical policy changes unlikely.

Mexico's public finances are improving on the back of reforms and a multi-year consolidation effort. The 2013 tax reform has helped offset the decline in oil-related revenues with higher non-oil tax receipts. Pemex is taking measures to enhance operational efficiency and strengthen its financial position. In addition, the fiscal consolidation plan is advancing on schedule. Even if the one-off dividend transfer from the central bank is excluded, fiscal accounts are expected to meet, if not outperform, the 2017 deficit target of 2.9% of GDP. In DBRS's view, the government is also likely meet its deficit target of 2.5% of GDP in 2018, notwithstanding the electoral pressures. Sustained improvement in the fiscal accounts through the electoral cycle could have positive rating implications.

Although government debt levels have materially increased, overall debt dynamics appear sustainable. From 2012 to 2016, public debt increased from 43% of GDP to an estimated 57%. The 14-point increase was driven by peso depreciation, primary deficits, and the assumption of pension liabilities from state owned enterprises. However, the debt ratio is expected to decline to 54% this year as the fiscal consolidation advances, windfall revenues from the central bank are used to pay down obligations, and the peso appreciates modestly. Debt dynamics appear broadly stable over the medium term. Nevertheless, some additional fiscal tightening could be needed during the next administration in order to put debt dynamics on a firm downward trajectory and rebuild fiscal space.

Mexico benefits from a credible inflation-targeting framework and limited financial stability risks. Inflation climbed well above the central bank's 3.0% target this year due to a series of transitory shocks. The central bank responded by substantially tightening monetary policy in order to anchor inflation expectations and contain second-round effects. Inflation is now starting to trend downward, and peso stabilization and the easing of supply shocks should reinforce the disinflationary process. In addition, the financial system is well-regulated. The banking system is profitable and

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well-capitalized, with low levels of non-performing loans. Exchange rate fluctuations have not adversely affected banks' balance sheets nor have they resulted in a deterioration in asset quality in the corporate sector.

Mexico's external position does not exhibit any clear imbalances. The current account deficit is modest and fully financed by net foreign direct investment. The net international liability position is moderate and relatively stable. While U.S. trade and monetary policies could generate capital flow volatility, Mexico's sound macroeconomic policy framework enhances the economy's resilience to bouts of market turbulence. In addition, the central bank holds substantial reserves and a Flexible Credit Line from the IMF in order to provide foreign exchange liquidity if necessary.

RATING DRIVERS

The Stable trend reflects DBRS's view that risks to the ratings are broadly balanced. If Mexico's underlying economic and fiscal performance continues to improve through the electoral cycle, the ratings could be upgraded. Conversely, if the commitment to sound fiscal management deteriorates in the context of materially weakened medium-term growth prospects, the ratings could experience downward pressure.

RATING COMMITTEE SUMMARY

The DBRS Sovereign Scorecard generates a result in the A to BBB (high) range. The main points of the Rating Committee discussion included: the implications of NAFTA negotiations, the 2018 general elections, Mexico's recent fiscal performance, and an assessment of Mexico's political environment.

KEY INDICATORS
Fiscal Balance (% GDP): -2.8% (2016); -1.4% (2017F); -2.5% (2018F)
Gross Debt (% GDP): 56.8% (2016); 53.8% (2017F); 53.3% (2018F)
Nominal GDP (USD billions): 1,077 (2016); 1,120 (2017F); 1,221 (2018F)
GDP per capita (USD thousands): 8,810 (2016); 9,249 (2017F); 10,021 (2018F)
Real GDP growth (%): 2.9% (2016); 2.1% (2017F); 1.9% (2018F)
Consumer Price Inflation (%, eop): 3.4% (2016); 6.1% (2017F); 3.0% (2018F)
Domestic credit (% GDP): 43.1% (2016); 41.5% (Mar-2017)
Current Account (% GDP): -2.1% (2016); -1.8% (2017F); -2.4% (2018F)
International Investment Position (% GDP): 42.9% (2016); 48.1% (Jun-2017)
Gross External Debt (% GDP): 38.5% (2016); 40.4% (Jun-2017)
Foreign Exchange Reserves (% short-term external debt + current account deficit): 232% (2016);

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219% (Jun-2017)
Governance Indicator (percentile rank): 45.5 (2016)
Human Development Index: 0.762 (2015)

Notes:

All figures are in U.S. dollars (USD) unless otherwise noted. Public finance statistics reported on a public sector basis; this excludes state and local governments but includes state-owned enterprises and public development banks. 2016 Key Indicators incorporate recent revisions to the national accounts (using the 2013 base year). Projections are from the IMF Article IV - Mexico (November 2017). The Fiscal Balance reflects the Public Sector Borrowing Requirement. Governance indicator represents an average percentile rank (0-100) from Rule of Law, Voice and Accountability and Government Effectiveness indicators (all World Bank). Human Development Index (UNDP) ranges from 0-1, with 1 representing a very high level of human development.

The principal applicable methodology is Rating Sovereign Governments, which can be found on the DBRS website www.dbrs.com at http://www.dbrs.com/about/methodologies. The principal applicable rating policies are Commercial Paper and Short-Term Debt, and Short-Term and Long-Term Rating Relationships, which can be found on our website at http://www.dbrs.com/ratingPolicies/list/name/rating+scales.

The sources of information used for this rating include Secretaría de Hacienda y Crédito Público, Banco de México, INEGI, Pemex, IMF, OECD, UNDP, CIA Factbook, The Conference Board Total Economy Database May 2017, Bloomberg, Tullet Prebon Information, World Bank, NRGI, Brookings, Haver Analytics, DBRS. DBRS considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

This rating was not initiated at the request of the rated entity.

The rated entity or its related entities did participate in the rating process for this rating action. DBRS did not have access to the accounts and other relevant internal documents of the rated entity or its related entities in connection with this rating action.

Generally, the conditions that lead to the assignment of a Negative or Positive Trend are resolved within a twelve month period while reviews are generally resolved within 90 days. DBRS's trends and ratings are under constant surveillance.

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Initial Rating Date: 28 July 2006
Last Rating Date: 28 November 2017

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Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
United Mexican States	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (high)	Stb	Dec 7, 2017
United Mexican States	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (high)	Stb	Dec 7, 2017
United Mexican States	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-1 (low)	Stb	Dec 7, 2017
United Mexican States	Short-Term Local Currency - Issuer Rating	Confirmed	R-1 (low)	Stb	Dec 7, 2017

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