Fitch Upgrades Mexico's FCY Rating to 'BBB', Pemex Remains at 'BBB-'

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Fitch Upgrades Mexico's FCY Rating to 'BBB', Pemex Remains at 'BBB-' 07 Dec 2005 12:19 PM (EST) Fitch Ratings-New York-07 December 2005: Fitch Ratings has upgraded Mexico's foreign currency rating (FCY) to 'BBB' from 'BBB-' and local currency (Mexican Peso) rating to 'BBB+' from 'BBB'. The short-term foreign currency rating remains at 'F3'. The Rating Outlook is Stable. Fitch also upgraded the country ceiling for Mexico to 'BBB+' from 'BBB'. At the same time, Fitch maintains the foreign currency and local currency ratings of Pemex (the state oil company) at 'BBB-'and 'BBB', respectively. 'The upgrade is underpinned by the consolidation of macroeconomic stability in Mexico, the continued improvement in its external accounts and international liquidity, and a further decline in its external debt burden. All these factors have enhanced the resilience of Mexico to external shocks,' said Shelly Shetty, Senior Director in Fitch's Sovereign Group. Mexico's external indicators continue to improve and are converging with that of the 'BBB' median. The country's current account deficit (% GDP) is lower than the 'BBB' median and is fully covered by foreign direct investment (FDI). The decline in the current account deficit is attributable to higher current external receipts (CXR), partly related to high oil prices and strong growth in overseas workers' remittances. Net external debt as a percentage of CXR has declined significantly since 2002 when Mexico's ratings were last upgraded and is expected to reach 37%, which is in line with the 'BBB' median. The improvement in Mexico's financial ratios reflects higher growth of broad exports as well as the refinancing of external debt in the domestic market by the private and public sectors. Fitch also expects net public sector external debt (% CXR) to decline steadily in 2006 and 2007 on the back of prudent liability management efforts of the federal government and greater local financing of Pemex's PIDIREGAS projects. The upgrade recognizes the continued improvement in Mexico's macroeconomic policy framework. The credibility of the central bank's inflation-targeting regime was boosted further last year, as it continued to tighten monetary policy conditions to combat inflationary pressures notwithstanding the impact of this measure on the nascent economic recovery. With inflation on a downward path, the central bank is gradually unwinding the monetary tightening, which should support economic growth next year. Mexico's consistent compliance with fiscal targets, combined with its lower inflation rate has reinforced investor confidence in the country. Consequently, the government has been able to fully finance its fiscal deficit in the domestic markets. Good liability management efforts have reduced the vulnerability of the federal government's debt to exchange rate and interest rate movements. Owing to asset and liability management efforts, Fitch believes that the federal government's foreign currency denominated debt is likely to decline further over the next two years, as the government has drawn down its local currency assets to fully pre-fund 2006 and partly pre-fund 2007 external bond amortizations. Mexico's ratings are constrained by structural weaknesses in public finances, such as a heavy dependence on oil revenue and a low tax intake. A revenue-enhancing reform will be required to cope with medium term pressures emanating from higher pension costs and PIDIREGAS debt service and lower nonrecurrent revenues. However, the current high oil price environment accords some additional flexibility to the Mexican government. Finally, Mexico needs to implement structural reforms in the areas of energy and labor sectors to improve its competitiveness, growth potential, and the flexibility of its factor markets. In this regard, the recent approval of the new Securities Market Law by the Lower House, if passed by the Senate, will be a positive development for the domestic capital markets. Although the recently approved change in Pemex's tax regime will lead to additional tax relief for Pemex, Fitch believes that this is not sufficient to strengthen the company's operating and financial profile nor to mitigate the challenges that continue to be faced by the energy sector. Without further energy reform, Fitch believes Pemex may have difficulty achieving its long-term exploration, development, and production targets. In Fitch's opinion, owing to the lack of an explicit sovereign guarantee on Pemex's debt and the company's ballooning debt burden in an environment of higher oil prices, a rating distinction between Pemex and the Mexican government is warranted. Fitch will hold a teleconference to explain the rationale behind the upgrade of Mexico and affirmation of Pemex's ratings at 10 a.m. EST on Thursday, Dec. 8. A further teleconference notice will have additional information. Contact: Shelly Shetty +1-212-908-0324, New York; David Riley +44-207-417-6338 or Brian Coulton +44-207-862-4097, London. Media Relations: Christopher Kimble, New York, Tel: +1 212-908-0226. Fitch's rating definitions and the terms of use of such ratings are available on the agency's public site, 'www.fitchratings.com'. Published ratings, criteria and methodologies are available from this site, at all times. 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