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Statement by Mr. O'Brolchain and Ms. Cunningham on Mexico
(Preliminary)
Executive Board Meeting
November 3, 2021

Thank you to staff for their insightful report and to Mr. Guerra and Ms. Arevalo Arroyo for their helpful Buff statement. Authorities have successfully maintained economic and financial stability during the pandemic, and macroeconomic and institutional policy frameworks are very strong. Mexico has suffered unusually high excess mortality as well as other severe humanitarian, social, and economic impacts from the pandemic. We broadly agree with staff's appraisal that Mexico's response to the COVID-19 crisis has been conservative, and we generally support the staff's policy recommendations.

The economy is currently rebounding from the deep, pandemic-driven recession, but the risks of economic scarring are high. *We note that staff's forecast is stronger than that of consensus and the Bank of Mexico. Is this mainly due to different paths for monetary policy?* Although manufacturing employment is above pre-pandemic levels, services employment is subdued, underemployment is elevated, and there is considerable slack in the economy (estimated by staff to be around four percent of potential output in 2021). Poverty also remains high and above pre-pandemic levels. The pandemic has exacerbated long-standing concerns about weak productivity and slow growth, and worsened gaps in spending on education and health in Mexico compared to other EMs and OECD countries.[1]

We support staff's proposal to increase government spending in the near term by 1.5 percentage points of GDP in 2022, rising to three percent of GDP over the medium term. This spending would support education, health, and social programs. Mexico has significant

[1] We appreciate the very useful analysis in the Annexes on social needs, labor market and trade.

fiscal space and increased spending is appropriate to reduce scarring effects, address poverty challenges, and protect the vulnerable. Reversing the decline in healthcare access during the pandemic could be one key priority. Staff also emphasis the need for credible medium-term tax reforms to finance the proposed spending increases. While important progress has been made in increasing tax revenue collection, Mexico's revenue collection remains well-below its Latin American peers. We agree with staff's view that there is scope to gradually implement reforms to increase some tax rates and reduce exemptions over a range of tax policy instruments.

Fiscal reforms to contain costs from pensions and Pemex's business losses are also needed. While authorities are rightly concerned about poverty among the elderly, reforms to the pension system should nevertheless aim to contain rising costs such that the level of social noncontributory pensions are kept constant in real terms. PEMEX's substantial burden on taxpayers also needs to be reduced. Staff argue that its financial viability can be improved through increased exploration investment, cuts to investment in new refineries, and encouraging greater private sector participation. We agree with these suggestions.

We share staff's concerns over energy policies that provide preferential treatment to state-owned energy producers and subsidies for fossil fuels such as liquefied natural gas. These polices can distort energy prices, crowd out private investment, and delay carbon emission reductions. We encourage the authorities to consider alternative measures such as targeted income transfers to help vulnerable households safeguard against energy price volatility. We also support staff's call for gradually increasing carbon pricing to incentivize emissions reductions, while recognizing the need to counteract the impact of these taxes on vulnerable populations. Carbon pricing measures should be supported by a public information campaign. Leveraging Mexico's renewable resources and allowing for greater private sector involvement could improve energy sector competitiveness, reliability, and sustainability.

Structural reforms outside the energy sector are also required to tackle impediments to potential output growth. Authorities plan to implement the USMCA trade deal and increase public investment and infrastructure spending. Staff identify Mexico's widespread labor informality as a key impediment to increasing Mexico's growth potential. They emphasize that recent increases in the minimum wage and employer social security contributions far exceed productivity growth and could discourage formalization. While staff focus on minimum wages, some discussion of other ways to encourage greater formalization would have been welcome (e.g., effective enforcement of tax laws and labor standards in the informal sector). We appreciate staff's focus on gender issues and are concerned about worsening conditions for women in Mexico. We strongly support the recommendations to

urgently address violence against women, large gender pay gaps, and low labor female force participation rates. The authorities should also continue efforts to increase investment and make growth more inclusive by improving governance, transparency, and institutional quality. This includes building on progress in tackling corruption and strengthening their AML/CFT framework.

Monetary policy faces challenges in supporting the recovery amid elevated inflation pressures. Monetary policy has been tightened since June to address inflation risks and keep inflation expectations anchored. *While inflation pressures are expected to be transitory, staff suggest that supply disruptions for intermediate goods could persist through 2022. It would be useful if staff could provide further details about their expectations for input shortages and the effects on inflation.* We support staff's recommendation to gradually normalize monetary policy rates and increase the transparency of communications about the central bank's outlook and reaction function. Mexico's monetary policy framework has successfully delivered credible monetary policy and low inflation with a floating exchange rate. We welcome the authorities' openness to conducting a strategic review of their monetary framework.