May 19, 2020
Approval: 5/27/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/90-2

9:33 a.m., November 4, 2019

2. Mexico—2019 Article IV Consultation

Documents: SM/19/242 and Correction 1; and Supplement 1; SM/19/243

Staff: Christou, WHD; Haksar, SPR

Length: 1 hour, 28 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	**Alternate Executive Directors**
	O. Odonye (AE), Temporary
	T. Nguema-Affane (AF), Temporary
G. Lopetegui (AG)	
	C. White (AP)
	B. Saraiva (BR)
Z. Jin (CC)	
	A. Guerra (CE)
L. Levonian (CO)	
R. Kaya (EC)	
	P. Rozan (FF)
R. von Kleist (GR)	
	Indraratna (IN)
	M. Psalidopoulos (IT)
T. Tanaka (JA)	
	C. Sassanpour (MD), Temporary
H. Beblawi (MI)	
	R. Doornbosch (NE)
	J. Damgaard (NO), Temporary
	L. Palei (RU)
	R. Alkhareif (SA)
	K.Tan (ST)
P. Inderbinen (SZ)	
S. Riach (UK)	
	P. Pollard (US), Temporary

C. McDonald, Acting Secretary
K. Hviding, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: P. Morra. Fiscal Affairs Department: M. Raissi, S. Thomas. Finance Department: D. Moore, M. Nkusu-Mulumba, E. Zoli. Legal Department: C. El Khoury, K. Kwak, N. Rendak. Monetary and Capital Markets Department: D. Drakopoulos. Research Department: U. Wiriadinata. Strategy, Policy, and Review Department: B. Csonto, V. Haksar, M. Perks. World Bank Group: S. Curto. Western Hemisphere Department:

2. MEXICO—2019 ARTICLE IV CONSULTATION

Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank Staff for the comprehensive report and accompanying selected issues papers, and for the extensive and constructive discussions with the authorities during their visit to Mexico.

The Mexican economy had a slowdown in the first half of the year that reflected subdued domestic and external demand in a context of higher uncertainty. Regarding performance of domestic demand, private consumption has already started to register a moderate recovery, with retail sales going up, supported by increased wages and remittances, and high consumer confidence. While activity in the primary sector has recovered, industrial production and services are still showing signs of weakness. Manufacturing exports, particularly related to the automotive sector, continued to recover despite the weakening of global trade and the escalation of trade tensions worldwide.

Risks to the Mexican Economy

Undoubtedly, there have been significant benefits from the increased integration of emerging markets into the global economy and international financial markets. Nevertheless, augmented interconnectedness entails additional policy challenges due to the stronger transmission of economic and financial shocks. While financial conditions in general have eased on the back of prolonged accommodative monetary policy in advanced economies, there have been more frequent spikes in volatility and exchange rate pressures in emerging markets, reflecting increased uncertainty in the global economic outlook, and entrenched trade and geopolitical tensions. Going forward, the search for yield will only accentuate these risks.

Among emerging market economies, Mexico is notably one of the more open economies in both trade and financial markets, and the Mexican peso is one of the most actively traded currencies. In particular, the heightened trade-related uncertainty is already taking a toll on growth and investment. Furthermore, tariffs pose an impending threat, and the negative effects could have lasting repercussions –particularly on the global value chains on which Mexico’s automotive exports are based. Thus, the ratification of the USMCA would significantly contribute to reduce trade uncertainty and boost investment in Mexico.

The Policy Framework

The Mexican authorities are fully committed to very strong policies and institutional policy frameworks. Fiscal discipline in recent years has maintained a stable debt-to-GDP ratio. The prudent monetary policy stance has been successful in reducing inflation and has been instrumental, together with a robust financial supervisory framework, to maintain financial stability. A flexible exchange rate regime has played a key role in making the economy more resilient to external shocks and to assure that no major external imbalances materialize.

In line with the commitment to very strong policies and institutional policy frameworks, the guiding principles for the 2020 Economic Program are: maintaining macroeconomic stability and certainty; fiscal discipline and a stable debt-to-GDP ratio; austerity and efficiency in expenditure execution; and, strengthening tax collection, and combating tax fraud and evasion. Commitment to sound public finances is reflected in the primary surplus of 1 percent of GDP that will be reached in 2019 and a target of 0.7 percent of GDP for 2020. Furthermore, the Economic Program for 2020 is based on conservative assumptions of GDP growth, and oil prices and production.

On tax policy, new measures will be put in place to strengthen public revenues, focusing on simplifying the tax framework and narrowing the scope for fiscal evasion and avoidance. In particular, the authorities are eliminating tax amnesty, increasing sanctions and strengthening enforcement to reduce fiscal fraud. Furthermore, in order to increase the taxpayer base, new measures are being put in place, including VAT withholding to labor outsourcing firms and income tax retention to independent sellers.

Public expenditure is guided by the principles of austerity and reorienting the budget towards programs aimed at reducing inequality. There are enormous disparities in Mexico, with municipalities at the top of the Human Development Index while others being similar to that of low-income countries. In this regard, social programs will aim at reducing economic and regional inequalities. Priority will be given to expenditure in regions with higher infrastructure lags. In this regard, the authorities appreciated the staff's analysis on the important role of investment in road construction for potentiating economic activity (Selected Issues on Road Construction and Firm Productivity). The authorities have published more than 870 public tenders (8.7 billion pesos) for private sector involvement in road conservation by end-October and have announced a new ambitious road construction program with a total investment of 18.8 billion pesos.

The government is implementing a strategy to stop and revert the fall of PEMEX oil production and make its finances sustainable in the short and medium term. For the first time in many years, oil production has stabilized and is expected to increase from 1.7 million barrels per day in 2019 to 1.95 million in 2020, with private production accounting for about a third of this increase. Additionally, PEMEX recently carried out the largest financial operation in its history to refinance its obligations for 2020-2023, substantially alleviating short-term liquidity pressures and without increasing its total financial debt.

The government is following a strategy to shield public finances from adverse shocks. It will continue a public debt management framework that will ensure access to capital markets at favorable conditions. Around 78 percent of the Federal Government's debt is in domestic currency, and 82 percent of domestic debt is at a fixed rate and of long-term maturity. Mexico will continue to hedge oil revenues and protect against natural disasters using catastrophe risk insurance. This strategy will also ensure a primary fiscal surplus even in adverse-shocks scenarios of lower oil prices and economic slowdown.

The staff analysis concurs with the authorities' assessment that the current fiscal rules framework has not been effective in controlling public debt growth. In this area, the authorities are working on a new fiscal rule with main elements to include: maximum debt limit for the non-financial public sector; an operational rule for expenditures growth; a countercyclical fund; minimization of the escape clause activation; and an independent advisory fiscal board. The authorities will engage with the IMF to establish this new framework. Last, but not least, Mexico's tax revenue is below Latin America's average, and is one of the lowest among OECD countries. This points to the need of a fiscal reform. The authorities will also seek Fund advice in this regard.

Monetary Policy

Although annual headline inflation increased in the first half of 2019, it has shown a downward trend more recently, reaching 3.01 percent in the first fortnight of October. The downward trajectory followed by headline inflation has essentially reflected the development of the non-core component, which decreased from 3.64 percent to 0.99 percent, as result of the lower increases of energy, agricultural and livestock product prices. Core inflation has remained persistent around 3.7 percent. Short-term expectations from

surveys have trailed observed inflation, while longer-term expectations have remained relatively stable, although above 3 percent.

To guide its monetary policy actions, Banco de México closely follows the development of inflation vis-à-vis its forecasted trajectory. Monetary policy must act prudently if, for any reason, the uncertainty faced by the economy increases significantly. To consolidate low and stable inflation in an environment in which price formation and slack conditions in the economy are subject to risks, the central bank will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook, and will take the required actions based on incoming information, so that the policy rate is consistent with headline inflation, achieving Banco de México's target within the time frame in which monetary policy operates.

As to monetary policy decisions, at August and September meetings, the policy rate was lowered by 25 basis points to a level of 8 percent and 7.75 percent, respectively.

Going forward, Banco de México will maintain a prudent monetary policy stance, and under the current environment of uncertainty will follow closely the potential pass-through of exchange rate fluctuations to prices, Mexico's monetary policy stance relative to that of the U.S.–in an external environment that it is still subject to risks–, and the behavior of slack conditions and cost-related pressures in the economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve its 3 percent target and to strengthen the anchoring of medium- and long-term inflation expectations.

The free-floating exchange rate regime will continue to serve as a shock absorber to external developments. Despite the significant depreciation of the Mexican peso over the last years, the exchange-rate pass-through remains low, thus reflecting the good functioning of the economy's nominal system. The authorities will continue to ensure that FX adjustments take place in an orderly manner, thus avoiding undesirable impacts on the price formation process. Furthermore, the authorities believe that an open capital account can be instrumental to attract the necessary financial resources for growth and development, while contributing to the development of local markets, and be crucial in assuring that FX markets are deeper, more liquid and efficient.

Financial Stability

Despite the uncertainty that the economy has faced, Mexico's financial system has remained solid and well capitalized with reasonable liquidity and capital levels to withstand potential stress scenarios. In fact, stress test results confirm that the banking system is in good shape to face adverse events. The authorities continue working to implement macroprudential policies that reduce the likelihood of risks materializing and mitigate their impact if they occur.

Regarding FinTech, although this sector is at an early stage in Mexico and represents a limited risk for the system, the significant growth of some participants could create future financial stability risks. These and other considerations motivated the authorities to implement specific regulation for this sector, seeking to strike a right balance between development opportunities and risk mitigation.

Financial Deepening and Inclusion

The authorities have announced several measures to deepen the financial system. These measures include: i) Portability of payroll credits; ii) Modify the pension funds investment regime to incentivize voluntary savings; iii) Tax scheme changes for IPOs and corporate bond purchases; iv) Initiatives for development banks to cater to the financing needs of the unbanked population; and, v) Launch a retail payment platform, known as CoDi, to allow instant mobile-to-mobile transactions using QR code technology.

Moreover, the authorities are working on a new national policy for financial inclusion to expand access and the use of financial products and services while improving infrastructure for the provision of financial services. The aim is to reduce the use of cash and promote digital payments, enhance consumer protection, increase financial literacy, and promote financial inclusion of women and financially vulnerable groups, among other objectives.

Labor Reform

A labor reform was approved in May 2019 to enhance workers' rights and clarify the legal framework to bargain collectively through independent unions, among other changes. The authorities are now focusing on the implementation phase of this law, with the necessary resources for its execution already included in the 2020 budget.

Social Policy

The authorities are directing their social policy to address groups that have been left behind on education, health, and social protection. In this sense, the objective of social programs is to reduce economic, social and regional inequalities. These programs include benefits for the elderly, marginalized rural populations, the disabled, and scholarships for youngsters and interns, among others. In addition, to increase participation of the recipients in the financial system, benefits of previous and new programs will be disbursed through transactional accounts. Moreover, the authorities are working on policies to boost participation of women in the labor force, which they regard as a priority.

Corruption and AML/CFT Reforms

The authorities have a strong commitment to tackle corruption and impunity, as well as to strengthen the rule of law. There are several concrete policy actions put in place recently, including the implementation of the National Anti-Corruption System (NACS), the execution of a strategy to address fuel theft, the establishment of corruption as a severe criminal offense, the appointment of the General and the Anticorruption Prosecutors, the Asset Recovery Law, and the increased number of money laundering cases detected by the Financial Intelligence Unit.

Mr. Rosen, Mr. Farber, Ms. Pollard and Mr. Shenai submitted the following statement:

We thank staff for their well-written staff report and Mr. Guerra and Ms. Arevalo Arroyo for their informative and thorough buff statement.

Mexico has a track record of sound macroeconomic policies. Strong fiscal and monetary policy, coupled with the easing of global financial conditions this year, have stabilized the peso, reduced risk premia, enhanced market access, and anchored expectations. The Flexible Credit Line provides the authorities an additional buffer against tail risks.

Yet as the staff report makes clear, the current policy mix is insufficient to address Mexico’s long-term challenges, including reducing poverty and informality, tackling persistent governance weakness, closing infrastructure and regional disparity gaps, and boosting economic growth. In this context, we urge the authorities to continue to improve fiscal capacity, advance the structural reform agenda including by renewing their commitment

to increasing private sector participation in the economy, and use all tools available to tackle Mexico's long-standing challenges of corruption, crime, and insecurity.

Fiscal Policy

While we support the authorities' continued targeting of primary surpluses over the medium term, we foresee potential budgetary underperformance given large increases in unfunded social programs, the overestimation of Pemex's support for the budget, and projected use of the FEIP stabilization fund to meet near-term financing needs. We welcome the authorities' plans to revamp the fiscal framework, as detailed in Annex IV of the staff report and in Mr. Guerra and Ms. Arevalo Arroyo's statement. We agree with staff that building a medium-term budgeting framework and an adequately-sourced fiscal council can help safeguard against fiscal risk and enhance spending efficiency. Staff's suggestion of moving toward a market-determined retail gasoline price and ending border tax expenditures seem sensible in the context of limited fiscal space. We look forward to learning more about the authorities' plans to strengthen enforcement to reduce fiscal fraud while broadening the tax base.

Energy Sector

We strongly believe that greater involvement by the private sector can improve Pemex's viability, boost productivity, and mitigate fiscal risks. Staff's analysis of Pemex's business plan paints a worrying picture of the direction of energy policy in Mexico. Long-term dollar bond yields remain elevated, highlighting market skepticism of planned policies. We agree with staff that that Dos Bocas refinery may be more costly than initially estimated and will likely crowd out upstream investment. We urge the authorities to re-examine the viability of this project considering their need for more private sector upstream investment. Given the optimism of the authorities' energy production estimates, we strongly welcome a renewed commitment to existing and future private sector participation in the energy sector that would support a sustained rebound in oil production. Additional steps to streamline costs at Pemex, including pension expenses and selling non-core assets, can help improve free cash flow and reduce implicit fiscal risks.

Governance

We commend President Lopez Obrador's administration for making the eradication of corruption and enhancing financial transparency a top

priority. Box 6 in the staff report provides helpful detail on the National Anti-Corruption System, though we note that this program has yet to yield results. We urge the authorities focus on implementation. Making further progress on strengthening Mexico's AML/CFT regime is also needed. Does staff have more specific recommendations to the authorities to bolster their anti-corruption agenda?

Monetary Policy

The Bank of Mexico ("Banxico") remains a pillar of macroeconomic stability in Mexico, and we commend the authorities for recent improvements in communication and commitment to the inflation target and floating exchange rate. While we agree there may be scope for additional monetary easing as headline inflation falls toward target, we urge the authorities to remain data driven and err on the side of caution given the large foreign ownership share of government securities and ongoing fiscal risks.

External Sector

We believe that the United States-Mexico-Canada (USMCA) trade agreement can help enhance regional integration and competitiveness. We welcome the authorities' implementation of labor reforms consistent with the USMCA's objectives. We also believe that continued economic integration between Mexico and Central America, particularly in El Salvador, Honduras, and Guatemala, can improve Mexico's external position and mitigate regional disparities, in line with the authorities' development strategy.

Financial Sector

We welcome the authorities' efforts to strengthen financial deepening and inclusion with a focus on women and rural populations. At the same time, we urge the authorities to remain vigilant of fiscal and asset quality risks. We agree with staff that the development banks should target financial inclusion metrics and align selection of senior management and boards with international best practices.

Finally, we would like to commend the authorities for consenting to the publication of staff's mission concluding statement.

Mr. Mahlinza and Mr. Odonye submitted the following statement:

We thank staff for a detailed report and welcome Mr. Guerra and Ms. Arevalo Arroyo's informative buff statement. We broadly agree with the staff assessment and policy recommendations.

Mexico has maintained strong fiscal and monetary policies which helped weather external and domestic challenges over the years. Nonetheless, economic growth has continued to decline, and fiscal pressures are rising. At the same time, policy uncertainty and new government priorities have weakened investor confidence and dampened the growth outlook. Against this background, we welcome the authorities' full commitment to a strong policy framework as highlighted in Mr. Guerra and Ms. Arevalo Arroyo's buff Statement and urge them to strictly adhere to fiscal prudence, continue their prudent monetary stance, and advance structural reform measures.

Maintaining a prudent fiscal stance as an anchor for stability remains important. In this respect, we welcome the authorities' medium-term fiscal targets, which will keep debt broadly stable at around 55 percent of GDP. Like staff, we would urge the authorities to consider a more ambitious fiscal effort over the medium term to place debt on a downward path, while rebuilding buffers. Further, we welcome the authorities plan to improve the fiscal framework including through a new fiscal rule targeting debt limits for the non-financial public sector, an operational rule for expenditure growth, a countercyclical fund and an independent fiscal board. Given the low revenue levels compared to regional peers, we welcome the envisaged tax reforms aimed at rationalizing regressive tax expenditures, broadening the tax base, lowering the threshold for the top PIT bracket, abolishing border incentives and fuel price support, as well as raising subnational property and vehicle registration taxes.

We agree with staff that Mexico has scope for further monetary easing in the context of the large negative output gap. That said, we would urge the authorities to remain data dependent, taking into account all factors and elements of uncertainty. We would appreciate staff's comment on the factors behind the persistently high core inflation and its implications for monetary policy. Further, we see scope for enhancing financial sector resilience by closing the gaps in the regulatory and supervisory framework. This will require increasing the operational independence, budget autonomy and legal protection of the banking and securities supervisor, and extending oversight authority over financial holding companies, among others. Strengthening financial sector should continue, including through prioritizing a multi-pronged strategic approach to boost lending and increasing competition and inclusion.

Finally, reinvigorating structural reforms is central to promoting strong, sustainable and inclusive growth. We support restarting energy auctions and risk-sharing arrangements between Pemex and private firms to attract needed private investment and technical know-how. We also encourage lowering participation barriers for women and removing constraints to trade in services, especially in the transportation and logistics sector. Reducing high levels of informal sector activity to improve access to finance by firms, strengthening enforcement, and replacing hiring and firing restrictions with an unemployment insurance scheme, is pertinent in Mexico. Further, we encourage continued concrete policy action to fight corruption and strengthen the rule of law that is vital for effective implementation of the National Anti-Corruption System. Enhancing the effectiveness and quality of law enforcement and the prosecution, as well as addressing the shortcomings identified in the AML/CFT assessment, remain crucial in this respect.

Mr. Fanizza and Ms. Quaglierini submitted the following statement:

We thank staff for the concise and well-focused papers and Mr. Guerra and Ms. Arevalo Arroyo for their insightful buff statement.

We agree with the main recommendations of the staff papers and highlight a few comments, particularly on communication. We concur on the need to focus on a stronger and more inclusive growth path for Mexico's economy, given the recent slowdown and the contained medium-term prospects. Overall, the differences with staff's views seem to be limited to specific areas; in some instances, like on tax reform, the key change is on the timeline, with staff calling for a quicker action. More fundamental differences in opinions appear on PEMEX business plans. In the external communication, we would suggest identifying more clearly the policy areas where there is agreement between the authorities and staff, to gain more traction to staff's policy advice, and clarify the underlying reasons where opinions diverge.

We would also like to add some more specific comments:

We agree that public investment program is crucial to address a higher growth performance and social inclusion. We appreciate the selected issue paper on road construction, infrastructure and firm productivity (one of the Selected Issue Papers) and the analysis on PIMA in Annex V of the staff report.

We welcome the staff analysis on improving the fiscal framework and the intention of the authorities to act in this area through the engagement with the Fund.

We support the aim of a higher women participation in the Mexican labor force stated by the authorities and appreciate the analysis on gender parity conducted by staff in Box 7 of the staff report.

We also found very interesting the Box 5 on regional disparities and poverty trends in different Mexican regions, and the analysis on high labor market informality in Mexico, which remains an issue to be addressed.

We are glad of the ongoing work aimed at strengthening of the rule of law, as indicated in Box 6 of the staff report on corruption and AML/CFT reforms. We encourage the authorities to pursue their reform efforts in this area as highlighted in the buff statement.

Mr. Doornbosch and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. We broadly share the thrust of the staff's appraisal and with the remarks below look forward to discussing the authorities' request for a successor FCL arrangement during the forthcoming session to engage.

Despite the authorities' strong macroeconomic policies and policy frameworks, Mexico remains prone to shocks. Economic growth has recently decelerated and increasing uncertainty weighs on the near-term outlook. We welcome President Obrador's administration's strong commitment to fiscal prudence and robust financial sector regulation. The central bank's proactive and flexible monetary policy has also been helpful to contain inflation and preserve macroeconomic stability. The interrupted large-scale public investment projects and needed social transfers, together with the commitment to not raise taxes and stabilize the state-owned oil gas company Pemex, should be better reconciled with the immediate fiscal targets and the medium-term budgetary objectives. Several important structural reforms are yet to be implemented. Thus, we encourage the authorities to better sequence the policy mix and reforms, especially through strengthening the rule of law, institutional capacity and public finance management, improving business environment, accelerating financial inclusion and implementing the 2018 IMF AML/CFT recommendations. In this regard, staff's analyses in the Selected Issues Papers are helpful.

Fiscal Policy

Mexico's main fiscal challenge is to enhance investments in infrastructure and human capital to facilitate growth, while retaining fiscal discipline. Strong and predictable fiscal policies with reasonable fiscal targets are also critical to limit uncertainty and put public debt on a downward trajectory. We agree with staff that Mexico's fiscal framework should be further strengthened and urge the authorities to fully implement the recommendations provided in para 23 and Annex IV. Going forward, the further revenue mobilization will be essential to guarantee public spending and create the necessary fiscal buffers against shocks. We note the authorities' evolving views on the need to increase the progressivity of the tax system and boost tax revenues. In addition, we welcome staff's strong engagement to facilitate the optimal mix and encourage the authorities to launch the revenue reform package as part of the 2021 budget. The SIP on Pemex's taxation provides helpful suggestions on how Mexico can strengthen the petroleum sector's fiscal regime. Measures to sizably improve the administrative capacity at various levels for effective tax collection and incentives to substantially narrow the informal sector should also become an integral part of the next revenue mobilization reform package.

Further strengthening of the expenditure efficiency and better targeting of social spending will help alleviate the budgetary pressures and facilitate a return to a sustainable and inclusive growth path. The SIP analyzing the budgetary spending pressures only highlights the main reform avenues. Bold actions on the part of the authorities are needed to regain control over the public sector recruitments and wage bill through establishing a central payroll and payroll-audit systems, accompanied by stricter job standards and greater transparency of the personal mobility.

Macro-Structural Policies

Although politically difficult, key structural reforms should be reinvigorated to lift growth and increase inclusiveness. We welcome that staff and the authorities agree that priority should be given to the key labor market reforms and measures to strengthen competition, combat corruption and money laundering. President Obrador's approach to establish a long-term crime-prevention stimulus should be combined with firm measures to strengthen the rule of law and efficiency and quality of the law-enforcement and juridical institutions. We also urge the authorities to swiftly implement the recommendations from the 2018 Fund-staff led AML/CFT assessment against the FATF standard. Further reduction of Mexico's labor informality can only

be achieved through well-integrated policies to increase inclusion, enhance financial education, improve financial infrastructure and strengthen competition in the banking sector. We also encourage the Mexican authorities to ensure reliable official data on vacancies to further improve the analysis of demand for labor in the economy.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

Since our last discussion, the Mexican economy remained resilient, owing to prudent policies and strong frameworks, although growth slowed markedly. We welcome the authorities' continued commitment to very strong macroeconomic policies and policy frameworks, as reiterated by Mr. Guerra and Ms. Arevalo Arroyo in their helpful buff statement. Policy uncertainty and emerging policy priorities have, however, created some economic challenges, against the background of an unsettled trade-related external environment, as indicated by staff in their interesting reports. The Flexible Credit Line remains an important complement to Mexico's reserve buffers, providing insurance against tail risks. We broadly agree with the staff appraisal and would like to turn in what follows to policy issues in the fiscal and monetary areas.

Staff acknowledges that the announced fiscal targets remain prudent but considers that medium-term targets need to be more ambitious to put public debt on a downward path. At the same time, the authorities indicate that their projections do point to a decline in the debt path. Can staff elaborate on the reasons for the divergent medium-term debt projections? Fiscal discipline and a stable debt to GDP ratio are commendable objectives for 2020. To that effect, the authorities have announced new tax measures aimed at increasing revenue by simplifying the tax system and narrowing the scope for fiscal evasion and avoidance. These measures include eliminating the tax amnesty, broadening the taxpayer base, as well strengthening sanctions and enforcement to reduce fiscal fraud.

On the expenditure side, the authorities and staff agree on the need to achieve efficiency gains while striving to reduce inequality and addressing social needs. We found staff's work on the positive impact of government spending on road infrastructure helpful and take positive note of the authorities' intention to prioritize regions with large infrastructure gaps. We would appreciate staff's comments on the expected yield of the new revenue and expenditure measures envisaged, as well as the timeframe for their implementation. We concur with staff that Pemex's business plan should be

reformulated with a view to strengthening the company and reducing risks to the budget

The Bank of Mexico's tight monetary policy stance in the past year contributed to bringing headline inflation to the 3 percent target, which prompted a monetary policy easing. Given the still tight policy stance and the large negative output gap, staff recommends further easing, so long as inflation stays close to the target and inflation expectations remain anchored. Can staff further elaborate on the timing of their recommended monetary easing? We note indeed that commercial bank credit growth to the non-financial corporate sector has slowed over the past year but remains healthy at 9 percent y-o-y in August, while consumer credit growth has remained stable at 7.2 percent. We also share the authorities' view that caution is needed regarding further monetary easing as domestic and external risk remain elevated. Continued clear central bank communication remains important to guide market expectations.

Mr. Saraiva and Mr. Fuentes submitted the following statement:

We thank staff for the papers and Mr. Guerra and Ms. Arevalo for their insightful statement. The Mexican economy continues to be supported by prudent policies and a strong policy framework. Fiscal discipline has ensured a stable debt-to-GDP ratio over the past few years. Banco de Mexico (Banxico) has successfully brought headline inflation back to target, the banking system remains liquid and well-capitalized, and the flexible exchange rate regime has efficiently operated as a buffer against external shocks avoiding large macroeconomic imbalances. Nevertheless, in the context of a slowing world economy and persistent trade tensions that risk disrupting exports, private sector investment and global value chains, the Mexican economy has stagnated facing serious headwinds from the external environment and important structural challenges. In the near term, we expect a more accommodative policy mix and sustained reform efforts, bolstering economic activity and gradually closing the output gap.

External risks will continue to challenge the growth outlook. Mexico has greatly benefited from increasing trade openness and integration into global financial markets. In that vein, the United States-Mexico-Canada Agreement (USMCA) was ratified last June by the Mexican parliament. When it becomes effective, after approval by the US and Canada legislatures, it is expected to moderate uncertainty, increase FDI, and strengthen confidence and the investment climate. Yet, as a highly open economy, uncertainty emanating from heightened financial market volatility and global trade

tensions could still negatively impact the recovery in Mexico. In this context, authorities have indicated that trade diversion effects may partially and temporarily mitigate the adverse impact of global trade tensions. Could staff further elaborate on whether such trade diversion has taken place and the order of magnitude of potential trade diversion effects in favor of Mexico at the current juncture?

While budget execution is expected to accelerate, authorities' commitment to fiscal discipline should result in a balanced effort to support recovery and address social needs without causing significant deviations from the targeted deficit. While fiscal deficit is projected to increase slightly above the target of 2.5 percent this year, this is fully explained by the shortfall in revenues, impacted by the slowdown in the economy. That said, both the government and staff agree on the need to strengthen the existing fiscal framework fostering a comprehensive reform aimed at increasing the tax-to-GDP ratio, particularly by reducing exemptions and tax expenditures, intensifying the progressivity of the tax system and enhancing spending efficiency. Regarding debt sustainability, staff recommends more ambitious fiscal targets over the medium term with lower deficits to rebuild buffers and set public debt on a downward path. On this subject, we welcome the ongoing work of the government towards designing a new fiscal rule to strengthen debt sustainability by restricting non-financial public sector debt, limiting expenditures growth and bolstering transparency and accountability. In addition, restoring PEMEX financial health is a critical element for medium-term fiscal sustainability.

Monetary policy has succeeded in returning headline inflation to target and anchor inflation expectations. The tight monetary conditions fostered by Banxico have been instrumental to bolster resilience under heightened external uncertainty. Despite the sustained weakening of real output and a more accommodative monetary policy stance in the US, further monetary easing in Mexico may be warranted, but will depend on inflation continuing close to target and inflation expectations remaining anchored. Recently, the high persistence of core inflation has fueled the discussion about targeting this rate to remove any downward rigidity to headline inflation. Monetary authorities, however, expect core inflation to converge to target as the indirect effect from energy prices wanes, the output gap closes and the exchange rate pass-through remains low. Moreover, overreacting to the persistency of core inflation may unduly jeopardize the speed of recovery.

The financial sector remains profitable and resilient. Capitalization levels of most banks will remain above the regulatory minimum capital ratios

under stress scenarios and the debt-at-risk of large corporations would remain manageable even under severe exchange rate and earnings shocks. Furthermore, once ratified by all parties, the USMCA will considerably lessen trade protectionism-related uncertainties for Mexican banks. Nevertheless, the banking system remains subject to concentration risk given that most banks are exposed to a handful of large corporates. The measures aimed at deepening the financial system should contribute to boost financial inclusion, promote competition and expand the use of financial technology.

Building on the recent progress in labor reform, we encourage authorities to push forward in the implementation of the structural reform agenda to boost potential growth and reduce poverty and inequality. Further actions are warranted to reinvigorate productivity growth and address the rising dispersion in productivity across regions, sectors, and firms. Reforms are also needed to reduce informality, which constrains productivity growth and the government capacity to provide public services. In this regard, actions directed to cutting the cost of doing business for SMEs are key to any strategy geared towards tackling informality. All in all, we commend the Mexican government for its strong commitment to tackle corruption and strengthen the rule of law by implementing several initiatives to address this issue, including: the National Anti-Corruption System (NACS), the appointment of Anticorruption Prosecutors and the Asset Recovery Law, among others.

Mr. Sigurgeirsson and Mr. Damgaard submitted the following statement:

We thank staff for the useful set of papers and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. We welcome the authorities' firm commitment to a strong policy framework and their focus to build fiscal buffers and reduce inequality. Nevertheless, elevated domestic and external uncertainty has clouded economic developments, and output growth is expected to fall to a mere 0.4 percent this year. We broadly agree with staff's appraisal and offer the following points for emphasis.

We welcome the authorities' focus on fiscal discipline, but more could be done to lift tax revenues. The authorities remain committed to their fiscal targets and have been forced to cut the budget due to the commitment not to raise taxes until 2021. We are concerned that drastic cuts to important regulatory institutions could have long-term effects on their human capital and the ability to effectively pursue their mandates. Given the very low tax revenues compared to peer countries, we encourage the authorities to implement an ambitious tax reform that serves to deliver substantially higher revenues. Such revenues could be used to close the fiscal gap that will emerge

in the coming years, while protecting social spending and key government institutions. In this context, could staff provide an estimate of the effect on GDP growth as well as fiscal projections if the USMCA is not ratified by next year as assumed in the baseline scenario?

The monetary policy stance is appropriate. We agree with the authorities that there could be scope for further easing, while considering elevated risks and the sticky above-target core inflation. Flexible exchange rates have served Mexico well and been an important shock absorber. International reserves are adequate at the current juncture, based on traditional measurements, but the authorities will have to assess if higher reserves will be necessary when the Flexible Credit Line is reduced.

The vulnerabilities in the financial sector remain limited, but continued close monitoring is critical. We welcome the results of the stress tests, which confirm the resilience of the banking sector to various shocks. At the same time, we encourage the authorities to reconsider the 2016 FSAP recommendations, including the governance structure of supervisory institutions. We would be interested to hear from staff where views differ with the authorities regarding the integration of prudential supervision under one authority. We agree with staff that a multi-pronged strategy to enhance financial deepening and inclusion should be a policy priority. Financially vulnerable groups, particularly women and the rural population, should be prioritized.

Structural reforms are necessary to boost productivity and potential growth. We strongly encourage the authorities to open the economy up for more private sector participation, particularly in the energy sector. In addition, we call for more infrastructure investments, which will lead to higher productivity for both small and large firms as laid out in the SIP. To that end, we welcome the increased private involvement in road conservation and the new ambitious road construction program described in the buff statement. Reforms to address labor participation and payment gender gaps, as well as competition, could also enhance potential growth and reduce inequality. Finally, we strongly encourage the authorities to prioritize an effective enforcement of the National Anticorruption System (NACS) and a swift enactment of pending legislation related to the 2018 Fund-led AML/CFT assessment.

Mr. Tan and Mr. Chea submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement.

We commend the Mexican authorities for their firm commitment to strong policies and reforms aimed at ensuring macroeconomic stability and resilience in the face of persistent internal and external challenges. While economic activity is projected to recover over the medium-term, Mexico's near-term growth is weighed down by policy uncertainty, tight monetary conditions, fragile fiscal position and unsettled external environment. In this context, steadfast efforts are needed to enhance fiscal consolidation, strengthen financial sector soundness and reinvigorate structural reforms to preserve macroeconomic stability as well as to promote inclusive and sustainable growth in the longer term. We agree with the broad thrust of the staff appraisal and offer the following comments for emphasis.

Staying the course for fiscal consolidation will create needed space for priority spending, particularly in social and infrastructure developments. We welcome the announced fiscal targets, which remain prudent and should help safeguard fiscal sustainability. Given the understanding between the authorities and staff that the current fiscal rules framework has not been effective in controlling public debt growth, we agree that more ambitious fiscal measures will help rebuild buffers and put the public debt ratio on a downward trajectory. To this end, we encourage the authorities to further enhance the credibility of its fiscal framework by strengthening tax compliance, enhancing progressivity of the tax system and improving expenditure efficiency. This will also help to create fiscal space for needed investments in healthcare and education, among others. We would appreciate staff's assessment on the feasibility of the authorities' plans to cut spending – including capital expenditure – or take revenue-enhancing measures in the event of shortfalls too. We also note the difference in views on reformulating Pemex's business plan. Staff's comments are welcome on this and the implications on the government budget.

Continuing efforts to foster credible inflation-targeting framework and flexible exchange rate regime are crucial in safeguarding monetary stability. We commend the Banco de México's continued efforts in improving the credibility of its communication strategy, which will help provide greater clarity and effectiveness to monetary policy. We also agree that exchange rate flexibility has been and should continue to serve as the primary shock absorber. We note the views of the authorities and staff on the potential scope for monetary easing given the tight policy stance in the context of a large negative output gap. We further agree with the authorities on maintaining a

prudent stance and see merit in approaching any further easing with caution given heightened uncertainties in a highly complex external environment.

Maintaining effective supervisory oversight will further strengthen financial sector resilience to shocks. In line with staff's multi-pronged strategy, we welcome the authorities' announced measures to boost financial deepening and inclusion, and the agreement to prioritize the financially vulnerable groups such as women and the rural population in particular. Although the financial sector remains profitable and resilient, we encourage the authorities to continue to be vigilant and close the remaining gaps in the supervisory and regulatory frameworks. In this regard, we would appreciate further details from staff on any observed deficiencies/issues with the current governance structure for prudential supervision to justify the need to merge regulators.

Advancing structural reforms is essential to spur productivity growth, business competitiveness and private investment for strong, sustainable and inclusive growth. While some progress has been made to boost participation of women in the labor force, more robust implementation of the labor market reforms will help create better employment opportunities and contribute to the reduction of poverty and inequality. We welcome the authorities' strong commitment in combating corruption and strengthening the rule of law as stated in the buff statement. Going forward, we encourage the authorities to ensure effective implementation of the National Anti-Corruption System and give top priority to the structural reform agenda, particularly in addressing the three key drivers – corruption, labor informality and crime. This will promote a more business-friendly environment and boost productivity and inclusiveness.

We wish the Mexican authorities' success in their future endeavors.

Mr. White, Mr. Kim and Ms. Park submitted the following statement:

We thank staff for their comprehensive report and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. Economic growth in Mexico has slowed sharply and Mexico is vulnerable to the risk of increased financial market volatility prompted by capital outflows and uncertainty about trade relationships. More broadly, real GDP growth has been insufficient to narrow the income gaps with the US and other advanced economies or generate substantial improvements in poverty and inequality. The authorities' commitment to very strong policies and policy and institutional frameworks is welcome. We agree that priorities include achieving fiscal targets with a more

growth friendly and inclusive policy mix, maintaining a prudent monetary policy stance and progressing structural reforms to lift medium term growth.

We welcome the authorities' commitment to fiscal consolidation but agree that a more growth-friendly and inclusive policy mix would be desirable. This would include greater attention to revenue mobilization to support growth-enhancing spending while putting public debt on a downward path. We note the authorities' openness to tax reform and plan to seek Fund advice in this area. On the expenditure side, the agreement between staff and the authorities on the need to enhance spending efficiency is welcome but emphasis should also be placed on potential gains to growth from productivity enhancing investment. And we would be concerned if efficiency measures jeopardized the ability of regulatory agencies and autonomous institutions to fulfil their mandates. Could staff expand on the concerns raised in this area?

Monetary policy should continue to be guided by a credible inflation-targeting framework and a flexible exchange rate remains a key shock absorber. We welcome the Banco de Mexico's cautious approach in balancing the case for further monetary easing against elevated domestic and external risks. We note staff and the authorities' view that the flexible exchange rate has played an important role in the shift from net oil exporter to net oil importer and agree that exchange rate intervention should be limited to disorderly market conditions.

Continued resilience in the financial sector is welcome and further progress in closing regulatory and supervisory gaps is desirable. We note the authorities' view that the current prudential governance structure has worked well and that there is no need to merge regulators. While we see the value of ensuring that current shared arrangements do not lead to gaps in coverage or impede inclusive and effective policymaking or transparency, we would caution against changing arrangements that are seen to be working well.

Low and uneven growth remains a key medium-term policy challenge. In this context, the Article IV appropriately emphasizes the need to reinvigorate productivity enhancing reforms. Combatting corruption is a particular priority, with key measures including effective implementation of the National Anti-Corruption System and measures to address shortcomings in the recent AML/CFT assessment.

Mr. Siriwardana and Mr. Singh submitted the following statement:

We thank staff for their analytical reports and Mr. Guerra and Ms. Arevalo Arroyo for their insightful buff statement.

We agree with the staff assessment that the authorities' commitment to fiscal prudence is strong, monetary policy remains judicious and has succeeded in bringing inflation to target, and financial sector supervision and regulation are robust. Also, the flexible exchange rate is playing an important role in helping the economy adjust to external shocks, while Mexico's external position remains broadly consistent with medium-term fundamentals. We welcome the authorities' medium-term fiscal targets, which will keep public debt broadly stable. Nevertheless, a relatively low tax-GDP ratio compared to its emerging market peers, poses significant challenge for Mexico, which remains crucial not only for maintaining prudent fiscal path over the medium term but also for preserving the quality of public spending. We agree with the staff assessment that revenue administration could be strengthened by adopting a comprehensive strategy to tackle VAT non-compliance. The tail risks from trade uncertainty remain considerable. Could staff clarify whether they see any progress on the new trilateral trade agreement (USMCA) which Canada and the U.S. have yet to ratify? Once ratified, to what extent is it going to reduce the downside risks emanating from trade-related uncertainty?

In our view, a key challenge for restoring growth trajectory arises from contractionary trend in investment. Despite a positive mix of healthy and well capitalized financial sector and a low/moderately leveraged non-financial corporate sector, the long-awaited investment recovery has been elusive. The staff assessment reveals that ex-ante real rate of around 5 percent is much above the staff's and Bank of Mexico's estimates of the neutral rate of 2.0–2.5 and 1.8–3.4 percent, respectively. The staff findings in the Selected Issues paper also reveal that programmable spending envelope has been cut and the composition of spending has shifted away from capital spending and based on functions of government, out of health, education, housing and community services. Further, the paper finds that the planned fiscal adjustment under the authorities' medium-term fiscal framework would reinforce these trends. Can staff explain as to what extent the fiscal consolidation achieved by way of cutting back on productive public investment vis-à-vis other factors may have contributed to the current slowdown of overall investment activity in the economy?

While the authorities have taken several legislative initiatives to strengthen financial deepening and inclusion, we concur with the staff view that the authorities' solid mandate presents an opportunity to address longstanding structural challenges viz., reducing labour market informality and improving the security situation. We believe that reducing the labour market informality will contribute to higher productivity and would help accelerate growth when the investment cycle kicks in.

Mr. von Kleist and Mrs. Koh submitted the following statement:

We thank staff for its informative set of reports and Mr. Guerra and Ms. Arevalo Arroyo for their buff statement. Despite Mexico's notable economic transformation and strengthened resilience, the Mexican economy has contracted sharply, and the medium-term outlook has weakened. This is to a great extent due to policy uncertainty, both domestic and external, which weighs on domestic demand and employment. While we appreciate the authorities' strong commitment to macroeconomic stability and fiscal prudence, we agree with staff that additional measures are needed to enhance the credibility of policies and tackle long-standing structural challenges.

Judicious policies continue to support external stability, even if risks to the outlook remain elevated and the investment climate has deteriorated. The cushion of foreign exchange reserves seems to be adequate and the current account deficit to be in check. The flexible exchange rate has played a key role in helping the economy adjust to external shocks and macro-financial policies have been instrumental in navigating the economy amidst a complex external environment. However, ratings downgrades and widened spreads on sovereigns should remind the authorities that markets are sensitive particularly towards policy decisions in Mexico. We therefore encourage authorities to remain on the path of macro stability and step up efforts to enhance productivity growth.

While we commend authorities for striking a balance between fiscal prudence and public spending, we believe that more ambitious medium-term fiscal targets are needed to put public debt on a clear downward path and to rebuild buffers against future shocks and structural spending pressures. In this vein, we welcome authorities' proposal to include a well-calibrated debt anchor into the fiscal budget.

We encourage authorities to undertake additional efforts, particularly on the revenue side, to preserve the prudent fiscal stance, reduce dependency on oil revenues while enabling a move towards a more growth-friendly and

inclusive policy mix. We strongly support the authorities' ambitions to seek Fund advice on curbing tax evasion and avoidance and to work towards enhancing the progressivity of the tax system. We encourage the authorities to implement the targeted reforms in a timely manner.

We take positive note that Banxico has succeeded in returning inflation to target. On scope for further easing, we agree with the authorities on the need to tread carefully, given domestic and external risks and persistent core inflation. While recognizing that Mexico's financial sector remains profitable and well capitalized, we echo staff's call for closing gaps in the regulatory and supervisory framework.

We reiterate our call to reinvigorate productivity-enhancing reforms. In this context, we share staff's concern with respect to the high level of capital spending on PEMEX which forces government to carry the burden of stabilizing PEMEX. We encourage authorities to redirect focus on measures that boost firm productivity via enhanced market-based competition and private sector involvement.

Corruption, informality and crime remain major obstacles to increase economic prosperity and reduce regional disparities. We strongly encourage authorities to deliver on their commitments to strengthen the rule of law to increase security, fight corruption and reduce informality.

Mr. Sylla, Mr. Diakite and Mr. Lopes Varela submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement.

We welcome the Mexican authorities for their commitment to sound policies aimed at sustaining macroeconomic stability. Inflation has been reduced close to the target, the financial sector continues to be healthy with a low level of NPLs underpinned by broadly adequate regulation and supervision, while the external position remains generally in line with medium-term fundamentals. However, we note that growth has weakened and that Mexico's economy continues to face downside risks from both external and domestic factors, including global trade uncertainty and potential downgrade of Pemex credit rating. Going forward, a recalibration to a more growth-friendly and inclusive policy mix while pursuing structural reforms that promote the business environment would be critical to preserving the progress made in recent years.

We broadly agree with the staff's assessment and policy advice and would like to highlight the following points for emphasis.

The authorities appropriately pursue prudent fiscal policy while avoiding a contractionary stance at the time of a negative output gap. In this regard, the overall fiscal deficit is projected to reach 2.6 percent of GDP in 2020 against 2.8 percent this year. In addition, we take positive note of the authorities' intention to further reduce the Public Sector Borrowing Requirement (PSBR) to 2.2-2.4 percent of GDP over the medium-term with a view to keep the public debt in a sustainable footing. In this regard, we stress the importance of additional revenue measures to help achieve this objective. The new actions being considered by the authorities to boost non-oil tax revenues are welcome, and we encourage their swift implementation. These include rationalizing regressive tax expenditures, lowering the threshold for the top bracket of personal income tax, eliminating the border tax incentives and fuel price support, and increasing property and vehicle registration taxes. Besides, proposals to improve spending efficiency through the streamlining of the government's wage bill, social spending, and the pension system are also needed to recalibrate spending to other areas that are more inclusive and pro-growth.

Banco de Mexico's current policy stance remains appropriate and has contributed to bringing inflation back to its target. Nevertheless, we see merit in further easing the stance to address the still large negative output gap while inflation remains on or close to the target. The authorities are to be commended for improvements in communication that have supported their monetary transmission mechanism. Regarding the staff's recommendation for strong forward guidance to further enhance the efficiency of monetary policy transmission, we note the authorities' view that the country's complex risk environment is a constraint on engaging in such forward guidance. We would appreciate staff elaboration on this issue.

We welcome staff assessment that Mexico's financial system remains resilient, well-capitalized, and profitable. While we take positive note of the recent stress test that confirms the resilience of the banking system to shocks, we concur on the need to further strengthen the regulatory and supervisory framework through the implementation of 2016 FSAP recommendations to enhancing financial stability. Moreover, additional efforts to improve financial inclusion, especially in favor of small and medium enterprises, should be one of the authorities' main priorities to support the private sector.

Structural reforms to promote employment and foster more active private sector participation are essential to achieving sustainable and inclusive growth. We welcome continued efforts by the authorities to reduce impediments to productivity growth and promote a more conducive business climate, including firm commitment to fight corruption and labor informality. In this regard, the authorities should put emphasis on further advancing the energy sector reform by allowing more private investment in Pemex, diminishing barriers to trade in services, and narrowing the gender gaps in the transportation and logistics sector. Decreasing the cost of entry for formal firms and replacing hiring and firing restrictions with an employment insurance scheme will also be paramount to buttress inclusive growth. The recommendations laid out in the Selected Issues paper on policies to promote productivity and competition in Mexico are pertinent and deserve consideration by the authorities. Moreover, further efforts to fighting corruption and addressing the shortcomings identified in the recent AML/CFT assessment will help improve the business environment.

With these remarks, we wish the authorities of Mexico success in their reform agenda.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We commend staff for a set of well-written papers and thank Mr. Guerra and Ms. Arevalo Arroyo for their candid buff statement. The authorities' prudent macroeconomic policies and strong policy frameworks have served Mexico well. But, more recently, growth has come under pressure as policy uncertainty has worsened the already-weak investment climate and tepid consumption growth, clouding the near-term outlook. While rising global trade tensions continue to be a major risk for Mexico—an open economy well-established in the global supply chains—the impact of weakening US demand on Mexico has been so far tempered by trade diversification, although potential US tariffs continue to pose a threat. The major challenges facing Mexico are to preserve its hard-earned fiscal and debt sustainability; increase productivity and potential growth through higher investment and structural reforms; and address its poverty and wide gender and regional disparities.

The authorities' expansionary fiscal position in support of growth this year is appropriate, especially given the very tight monetary policy. We are encouraged by their continued commitment to fiscal discipline, as spelled out in their 2020 Economic Program, and further welcome their intention to institute tight fiscal rules to anchor fiscal policy. Going forward, fiscal policy

should be tight enough to put the debt ratio on a downward track and build buffers given potential external shocks. As for the mix of measures, we welcome the authorities' efforts to boost tax revenues and increase the progressivity of the tax system, and encourage them to begin enacting measures as soon as possible, preferably in the context of the 2020 budget, since the medium-term deficit targets are likely to be exceeded based on staff assumptions. Rationalizing expenditures is also important. A better expenditure mix with higher non-oil public investment—especially on roads and social sectors—would help boost productivity in the longer run. A comprehensive review of myriad of social protection programs with a view to increase their efficiency and improve their targeting would also be warranted. We welcome the authorities' emphasis on social policy as stressed by Mr. Guerra and Ms. Arevalo Arroyo.

As regards monetary policy, given the balance of risks, the stickiness of core inflation and cost pressures, we tend to support the Banxico's cautious approach, as long as domestic demand and growth could be adequately safeguarded by calibrated fiscal policy. We commend the authorities' commitment to continued exchange rate flexibility that has contributed to an improvement in the non-oil external current balance in the face of declining oil production and prices.

Mexico is facing politically challenging issues arising from corruption, crime and labor informality that are constraining its growth and impeding wider prosperity. We welcome the authorities' efforts in combating corruption and money laundering, and improving the security situation. The early implementation of the new labor law with emphasis on protection of workers' rights is welcome, keeping in mind that reducing labor informality calls for a holistic approach to increase the flexibility and efficiency of the labor market. While the recent sharp increases in minimum wage have helped reduce inequality, it could have adverse implications on employment growth in the formal market, and on cost competitiveness, as long as productivity growth is lagging behind nominal wage growth. In any event, the macro and structural policies should always have in focus the need to address Mexico's poverty, and income and gender inequalities and their spatial aspects.

We wish the authorities all the success.

Mr. Tanaka, Mr. Chikada and Mr. Kuretani submitted the following statement:

We thank staff for comprehensive papers and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. Mexico has very

strong policies and policy frameworks, and we welcome that the new president and his government's commitment to fiscal prudence and an independent central bank. However, we share staff's concern that new policy initiatives, such as drastic budget cuts and cancelations or reversals of the previous engagements, have weakened policy predictability and further added uncertainties surrounding Mexico. This in turn, has contributed in weakening Mexico's economic outlook and its investment climate. As we broadly agree with the thrust of the staff's appraisal, we would like to offer the following remarks for emphasis:

Alleviating policy uncertainties should give more room for further monetary easing and support the economy. We note with concern that policy uncertainty has weakened the investment climate and will weigh on the near-term economic outlook. However, risk of capital flow reversal and significant currency depreciation, which could be realized by heightened policy uncertainties, could limit the scope of further monetary policy easing. In this light, we caution the authorities to carefully plan and implement policy initiatives so as not to increase policy uncertainty further.

We support staff's view that the authorities need to specify additional measures to underpin their fiscal targets and to boost tax revenues and increase the tax system's progressivity. Given Mexico's low tax revenue to GDP ratio compared to peer Latin American countries, it is welcoming that the new tax policy measures will be put in place to strengthen public revenues, focusing on simplifying the tax framework and narrowing the scope for fiscal evasion and avoidance. In this context, we concur with staff that the authorities should consider rationalizing regressive tax expenditures, broadening the tax base, lowering the threshold for the top PIT bracket, abolishing border incentives and fuel price support, as well as raising subnational property and vehicle registration taxes.

Given macro-critical characteristics and strong fiscal linkage of the oil sector in Mexico, we agree with staff's view that Pemex needs more cooperation with private firms and a stronger focus on its upstream business to support a significant increase in production and reserves. Mexico's oil production has decreased significantly following the halt of foreign private investment into this sector. Clearly, reexaminations of polices are warranted to reinvigorate the oil production and reduce fiscal risks.

Perseverance with structural reforms, including energy reform, governance, security and the rule of law, competition and AML/CFT, is central to boost growth and reduce poverty and inequality. In this regard, we

encourage the authorities to restart energy auctions and risk-sharing arrangements between Pemex and private firms. According to Box 6, a majority of the recommendations from a 2018 Fund staff-led AML/CFT assessment against the FATF standards have yet to be implemented, due to a range of shortcomings related to the effectiveness of law enforcement and prosecution. We also noted that corresponding legislation prepared is pending in Congress. In this regard, we encourage the authorities to implement the recommendations and make significant progress in this area.

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

We thank staff for their valuable set of papers, and Mr. Guerra and Ms. Arevalo Arroyo for their insightful buff statement. Mexico's policy frameworks remain strong, but shifting policy priorities have clouded the outlook, and external risks remain elevated. Growth came to a stand-still in 2019 amid weak domestic demand and slowing manufacturing. The growth outlook is negatively affected by policy uncertainties, an energy policy that limits the role of the private sector, and the salient structural challenges. The latter include corruption, informality and crime. External risks remain elevated, compounded by trade-related uncertainties, weaker-than-projected global growth, and volatility in global financial markets.

Maintaining prudent policies remains imperative. We concur with staff that policy predictability should be improved. Maintaining very strong policies and policy frameworks is indispensable to maintain the resilience of the Mexican economy and ensure that hard-won achievements are not compromised.

Fiscal consolidation is called for. More ambitious medium-term fiscal targets would help replenish buffers, put the public debt ratio on a downward trend and preserve policy credibility. The public sector fiscal deficit is likely to reach 2.8 percent of GDP in 2019 instead of the 2.5 percent target. The deviation implies a notable fiscal expansion and, if this trend continues a fiscal gap of up to 1.5 percent of GDP would emerge. This would bring the debt ratio on an upward path.

Strong commitment to fiscal responsibility and credible measures to close the fiscal gap are imperative. Fiscal policy should be geared toward non-oil revenue mobilization. This would be key to closing fiscal gap, given Mexico's low ratio of tax revenue to GDP. In this context effort to reduce informality should be stepped-up. To minimize Pemex-related fiscal risks, it would be of utmost importance to re-orient its business strategy and

strengthen its cost efficiency and financial position, in line with staff's suggestions. We welcome authorities' plans to strengthen the fiscal framework along the outlined potential avenues for reform.

Exchange rate flexibility should be maintained. Weak economic activity has kept price pressure low and inflation close to target. Inflation expectations appear well anchored. Against this background, there is scope for lower policy rates as the ex-ante real rate is currently well above the neutral rate based on estimates by staff and Banxico. This said, we welcome the authorities' commitment to exchange rate flexibility as the key shock absorber.

Structural reform efforts should be renewed. Relaunching the reform effort in the energy sector would help attract private investment and foster growth. Reforms to address informality, security, corruption, and the rule of law are needed to increase productivity and ensure more inclusive growth. In this context, could staff elaborate on whether the "Pacto por México" remains valid? We note that most elements of the National Anticorruption System are in place, and the authorities should focus on its implementation and enforcement. Furthermore, we note that regional differences remain significant with regard to poverty, income inequality, and the share of informal employment. Rectifying this would require better targeting policies to vulnerable groups and regions.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the reports and Mr. Guerra and Ms. Arevalo Arroyo for their comprehensive buff statement.

We are encouraged by the authorities' commitment to macroeconomic stability, which is the necessary condition to fulfill their plausible objectives, especially those related to significantly boosting social conditions, particularly for the most vulnerable sectors of society. As a general view, we take positive note of the authorities' commitment to a strong policy framework, including to central bank independence, exchange rate flexibility, fiscal prudence, and respect of private property rights, which are essential to successfully face Mexico's challenges. Moreover, the financial sector is strong and well regulated, providing a very good starting point to develop on a sound basis.

We note that the staff report may appear more critical than warranted in some areas. In paragraph 12 of the staff report, staff emphasizes a "notable" fiscal expansion, with the PSBR reaching 2.8 percent of GDP in 2019 from

2.2 percent of GDP in 2018. Is this description appropriate to refer to a fiscal expansion that could be justified amid a complex situation in the world economy, cyclical conditions, and tight monetary policy? Are political economy factors taken into account, given relevant social developments experienced in Latin America? Staff's comments are welcome. Similarly, staff argues that policy predictability has increased in light of decisions to cancel energy auctions and the airport construction. Besides whether these have been good or bad policy decisions, we have the sense that the authorities have been consistent with their electoral pledges. On spending cuts, the concerns of staff on their sustainability may be warranted, but they could also be read as decisive policy choices. We would welcome staff's elaboration on these matters.

On the fiscal front, we welcome the authorities' policies aimed at maintaining fiscal prudence. The fiscal effort that has led to a decline in the debt ratio in recent years needs to be maintained, and further progress to enhance revenue mobilization and sustainable expenditure restraint would be important to generate the fiscal space necessary to expand much needed investment. The staff report underscores that the authorities' medium-term fiscal projections target would keep debt broadly stable at around 55 percent of GDP over the medium term. Still, staff's assessment that there is a gap to achieve this objective is worrisome. Could staff further elaborate on their different views with respect to the authorities' fiscal projections? We are also encouraged by the authorities' determination to make important reforms to the tax system and revenue administration with the objective of boosting the tax revenue-to-GDP ratio, which is currently low and insufficient to meet Mexico's demands, and to increase the progressivity of the system. We also note the authorities' willingness to strengthen the fiscal framework.

We understand the authorities' concerns generated by a sticky core inflation, which is above the target, and agree that there could be scope for further easing of monetary policy, provided that risks to inflation abate. It is useful to remember that in last year's Article IV discussion, we sided with Banxico on the need to avoid premature easing of monetary conditions, which appears to have been the correct approach. Like staff, we commend Banxico for recent improvements in its communication and share the comments that exchange rate flexibility should remain the key shock absorber.

One of the issues that has been creating more political and economic instability in the region is related to inequality. The staff report underlines that poverty and inequality in Mexico have improved only modestly, with persistent regional inequalities. Paragraph 10 presents some of the reforms

that aim to address this vulnerability. The staff report calls for gradual adjustment in the minimum wage to avoid short-term disruptions and adverse formal employment effects. Nevertheless, we must remember that Mexico's labor informality has been very high even when the minimum wage has been low. Moreover, Box 5 shows that labor market informality and underemployment are also highest in the south, where wages have increase less than in the north. The issue of productivity growth should be addressed in other ways, including strengthening competition and easing product market regulations, as mentioned in the report. Furthermore, the several measures aimed at enhancing financial inclusion will contribute to reinforce social objectives. On other issues, we share Mr. Guerra and Ms. Arevalo Arroyo's remarks that the ratification of the USMCA would significantly contribute to reduce trade uncertainty and boost investment in Mexico.

The staff report points out that corruption, labor informality, and crime are key drivers of Mexico's disappointing productivity growth. Therefore, we welcome the agreement between staff and the authorities that priority should be given to addressing these key challenges. Building on the progress of recent years, it will be important to focus on continuing the implementation of the NACS, fighting crime against property, and strengthening AML/CFT regime.

With these comments, we wish Mexico and its people every success in their future endeavors.

Mr. Kaya and Mr. Bayar submitted the following statement:

We thank staff for their comprehensive set of reports, and Mr. Guerra and Ms. Arevalo Arroyo for their helpful buff statement. As an open, emerging market economy, Mexico has recently been tested by additional policy challenges emanating from elevated trade-related tensions, as well as intermittent bouts of financial volatility. Nevertheless, with the help of the authorities' strong policy frameworks, the country has managed to safeguard macroeconomic and financial stability, and register positive growth. While the macroeconomic imbalances are contained at a manageable level, some of the long-standing impediments to growth, stemming particularly from the persistent security and governance challenges, and compounded by the recent rise in policy uncertainty, continue to beset the growth outlook, as well as the efforts to tackle regional disparities and poverty. Going forward, we agree that preserving macro stability and redoubling structural reform efforts remain essential to buttress growth and achieve more inclusive development

outcomes. On that note, we agree with the thrust of the staff appraisal and would like to provide the following comments for emphasis.

While public debt appears sustainable, a more ambitious fiscal consolidation path would help build buffers by putting debt firmly on a downward trajectory. We welcome the authorities' commitment to a disciplined fiscal policy line, which has kept the debt-to-GDP ratio on a stable path at around 55 percent levels. However, should the realizations of major macro or fiscal aggregates fall short of the underlying projections, there is a risk that the debt-to-GDP ratio could rise toward 60-percent levels. We therefore concur with staff's advice for identifying additional administrative and policy measures, primarily relying upon Mexico's large tax revenue potential to buttress fiscal policy credibility. To that effect, priority should be given to the rationalization of regressive tax expenditures and broadening the base of non-oil taxes. Specifically, on staff's advice to phase out the fuel price support, we tend to see economic merit in revoking the current scheme, which provides regressive subsidies to fuel consumption. Nonetheless, given the latest developments in several Latin American countries, we are somewhat concerned about the social acceptability of such initiatives in a weak growth environment. We would therefore appreciate staff's further elaboration on the pros and cons of revoking the fuel subsidies, including from a political-economy angle, and whether the most vulnerable will be protected. We also support the ongoing efforts to improve public expenditure efficiency, as well as restructure Pemex's business plan, in order to ensure a sustainable production path while containing risks to the budget.

The tight monetary policy stance has been effective in containing inflationary pressures and anchoring expectations. Going forward, we believe that monetary policy should continue to be guided by the price stability objective and remain data-dependent. While the relative stability of the peso, overall demand conditions, and the renewed cycle of monetary expansion in advanced countries support a further easing of the monetary policy, core inflation – which remained persistent at around 3.7 percent – instills some caution. Taking these into account, like staff, we tend see some scope for gradual monetary easing, which together with a tighter fiscal policy stance, could generate a better macro policy mix. Nonetheless, we are assured by the Banco de México's flexible and cautious approach and thus, confident that the authorities will steer towards the right policy path, duly reflecting all factors. We fully agree that the flexible exchange rate system has served the Mexican economy well, including by inducing a gradual strengthening of the non-oil balance, as the country shifts from a net oil exporter to net oil importer. We also commend the Banco de México for the recent improvements in their

communication, which have enhanced transparency and the credibility of the central bank against a complex risk environment.

The financial sector is well-capitalized and profitable, and has a sound asset structure. We take positive note of the authorities' stress tests, confirming that the banking system as well as the largest non-financial corporates are able to withstand adverse shocks. That being said, the regulatory and supervisory framework could further be strengthened through closing the gaps identified in the 2016 Financial Sector Assessment Program (FSAP). Regarding the specific FSAP recommendation for integrating prudential supervision under one authority, we tend to concur with toward the authorities' view and believe that countries – in principle – should be able to design their supervisory governance structures reflecting their own circumstances. Given the still low credit utilization rates in Mexico, we support the ongoing efforts to facilitate financial inclusion and deepening.

The authorities need to redouble their structural reform efforts to foster strong, sustainable, and more inclusive growth. Mexico's growth outcomes are far from sufficient to facilitate income convergence with advanced economies, or tackle pervasive poverty and inequality. In this vein, we agree that reinvigorating productivity is the key to raising growth rates in a meaningful and durable manner, and the current administration has a strong mandate to tackle the most challenging impediments as such: corruption, crime, and informality. We take positive note of the series of reform actions that have been initiated and encourage the authorities to further their steps, particularly in strengthening rule of law, fighting against corruption and organized crime, and addressing labor market informality. It remains critical to enact the legislation closing the gaps identified in the recent Fund-led AML/CFT assessment, as well as to ensure its effective implementation and enforcement.

Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for a set of well-written reports and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. Output growth in Mexico is projected to slow down to 0.4 percent in 2019, due to elevated uncertainties and negative domestic and external shocks. Once again staff revised their estimates of potential growth, recognizing the slow pace of structural reforms and persistently unfavorable investment and productivity trends. As highlighted in the report, some recent decisions by the authorities have weakened policy predictability, while the newly announced policy priorities have created fiscal challenges.

Over the past ten years since the approval of the first FCL in 2009, the Mexican economy exhibited relative resilience to a variety of shocks. The credibility of the inflation targeting framework is manifested in well-anchored inflation expectations and limited pass-through from currency depreciations. Flexible exchange rate regime, well-capitalized banking sector, and natural and financial hedging of private and public balance sheets contribute to macro-financial stability. Overall, the monetary policy and debt management frameworks are very strong.

At the same time, the progress in raising living standards remains rather elusive. The report highlighted a broad number of challenges that remain to be addressed by the authorities, including poverty, inequality, corruption, crime, labor informality, lack of competition, and poor human capital. Policy uncertainty, trade risks and concerns about Pemex also weigh on growth, exports, and sovereign spreads.

One of the key challenges in addressing these lingering economic and social issues is the weak fiscal framework in Mexico. Staff's characterization of the fiscal framework as being very strong in the executive summary and the concluding appraisal, in our opinion, contradicts the in-depth analysis in the main text of the report and in the SIP. Staff's comments would be appreciated.

The fiscal position in Mexico remains fragile, including weak revenue collection and multiple tax exemptions. The current fiscal rules have not been effective in reducing public debt and accumulating buffers against future shocks. Under these circumstances, the authorities have embarked on reorienting the budget towards social programs and several large infrastructure projects. The financing of this shift remains uncertain as staff highlighted the need for additional fiscal measures of about 1.5 percent of GDP to meet the authorities' medium-term fiscal targets. Staff have also raised concerns about the quality and sustainability of the fiscal adjustment due to the sustained reduction of the same spending items. In this context, we continue to encourage the Mexican authorities to advance the necessary tax reform, improve tax administration, and broaden the tax base. Given the low C-efficiency ratio in Mexico, one of the key areas for further improvements remains the VAT collection and administration. On the expenditure side, we broadly support staff's recommendations presented in paragraph 21 of the report.

We also welcome the authorities' plans to revamp the fiscal framework as part of the 2021 budget. The framework should have a strong nominal anchor in the form of an explicit and well-calibrated permanent debt

ceiling and cover a broader expenditure envelope. As we have argued on several previous occasions, the creation of an independent fiscal council can help mitigate fiscal risks and enhance spending efficiency, and we welcome the authorities' intention to create such a council. The authorities should also be more proactive in accumulating fiscal buffers against future shocks.

The weak financial situation in Pemex adds to the list of risks to Mexico's public finances. According to staff, the company's business plan relies on optimistic production and reserve projections and envisages large investments in the loss-making refining business. Market uncertainty remains elevated, and rating agencies retain their negative rating outlook. As highlighted in Box 2, a downgrade by Moody's to below IG rating could lead to a substantial selling pressure. Against this background, we encourage the authorities to consider staff's recommendations on how to strengthen the business plan in order to address Pemex's structural problems, as well as broader recommendations in the SIP on changes in taxation of the oil sector.

Given the reduction of headline inflation and the estimated slack in the economy, we agree with staff that there may be some scope for additional monetary easing. At the same time, we encourage Banco de Mexico to remain vigilant and cautious in the current environment of uncertainty and increasing vulnerabilities.

According to the report, Mexico remains exposed to the shifts in global investors' sentiment toward emerging markets. Indeed, this factor features prominently in the justifications for Mexico's continuing reliance on the FCL. In this respect, it seems to us that the long-standing nature of these vulnerabilities may call for a much more ambitious foreign exchange reserves accumulation by the authorities. Do staff see benefits from increasing foreign exchange reserves in Mexico? Would it be helpful for the authorities' exit strategy from the FCL?

We welcome the authorities' efforts to reinvigorate structural reforms in Mexico. Given the striking differences between the productive maquiladora sector and the rest of the Mexican economy, reducing resource misallocation would be key to boosting aggregate productivity. In this context, the authorities are rightly focused on strengthening governance and reducing corruption. As Mr. Guerra and Ms. Arevalo Arroyo pointed out, the authorities have already started the implementation of the National Anti-Corruption System (NACS) and the strategy to address fuel theft. We also agree with staff that pending legislation to address recommendations from the recent AML/CFT assessment should be enacted in a timely manner. Could

staff elaborate on how the Fund supports the authorities' efforts to address corruption problems in Mexico? What would be growth effects if the authorities were able to improve the quality of governance, as well as the country's perceptions of corruption?

Ms. Levonian, Ms. McKiernan and Mr. Weil submitted the following statement:

Thank you to staff for the insightful set of reports and to Mr. Guerra and Ms. Arevalo Arroyo for their helpful buff statement in which they emphasized Mexico's commitment to a strong policy framework in the face of significant risks.

We support the staff appraisal, which highlights the strength of Mexico's policies, policy frameworks, and macroeconomic fundamentals. In particular, the authorities' commitment to fiscal prudence, responsive monetary policy, and robust financial sector supervision and regulation have served them well in a challenging environment.

Mexico's growth has declined sharply over the past year and the recovery is expected to be modest. Very weak growth in 2019 was driven by slowing domestic demand, policy uncertainty, tight monetary conditions, a substantial decrease in public expenditure, as well as slowing global manufacturing activity. We agree that a modest pick-up in the medium-term would be supported by increased domestic demand, easier monetary conditions and more predictable domestic policy.

The balance of risks is tilted to the downside, and both domestic and external risks have increased. Domestically, the main risk is ongoing policy uncertainty given prior contentious policy decisions (e.g., airport project cancellation, pipeline contracts, suspension of Pemex private partnerships), which would hurt market confidence and deter investment. Externally, the growth path of the US economy and a sudden capital flow reversal are key risks. Whereas escalating trade tensions are a risk for Mexico as an integrated open economy, there are also upside trade risks from trade diversion that should be acknowledged. A still-unratified USMCA is a risk to the outlook, but the authorities are committed to the ambitious labor reforms that will help secure ratification.

New revenue measures may be required in the near term to achieve fiscal targets amid declining oil revenues. We welcome the current administration's commitment to fiscal prudence as an anchor of stability. However, we share staff's view that additional measures are needed to meet

announced fiscal targets. The authorities' contemplated tax policy reform package, including broadening the top personal income tax bracket, eliminating regressive tax expenditures and broadening the VAT base, is most welcome in that regard. We support staff's recommendation to implement these reforms in the 2021 budget, provided that necessary measures to offset impacts on the poor are in place (i.e., in relation to the elimination of the zero-rating of the VAT on food).

Spending efficiency should increase to address fiscal pressures and meet SDGs. The burden of Mexico's fiscal consolidation has come at the expense of inclusive growth via cuts to capital spending, wages, and transfers in education, health and community services. These same areas are expected to see further spending reductions under the medium-term fiscal framework. Social spending needs to be more efficient, including by streamlining and better targeting social protection programs to make room for additional priority spending, including to meet health and education SDGs among others. We also encourage the authorities to prioritize productivity-enhancing capital projects such as improvements to the road network, as staff have suggested in their excellent selected issues paper.

There is scope for further monetary easing in the baseline outlook. We agree with staff's view that the authorities have room for monetary easing so long as inflation remains aligned with the target and expectations remain well anchored. The authorities should consider domestic and external risks in making monetary policy decisions.

Energy sector reforms should reduce budget risk and support increased oil revenues. Pemex's business plan, while limiting new debt, also increases budget risk by limiting the participation of private firms and prioritizing less profitable downstream operations. The authorities should consider incorporating joint ventures and risk sharing agreements with the private sector into Pemex's business plan to reduce fiscal risks and focus on upstream operations to increase oil reserves and production.

We encourage the authorities to complete and implement education and labor market reforms. Only 20 percent of the population over age 25 has completed secondary education, and over one-third of youth are not in school, in training, or working. There will be significant benefits to investing in this under-educated and under-employed segment of the population. We also echo staff's view that female labour force participation should be supported by better policies for childcare and parental benefits. These reforms would not

only raise competitiveness of Mexico, but also contribute to supporting inclusive growth.

The authorities should take concrete policy action to tackle corruption, informality and crime and to improve the AML/CFT framework. Such steps could include the implementation of the National Anticorruption System and the enactment of pending AML legislation.

Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Guerra and Ms. Arevalo Arroyo for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

Benefiting from very strong policies and policy frameworks, the Mexican economy has remained resilient in a complex external environment, but growth has declined sharply. Notably, strong fiscal prudence has helped maintain a stable debt-to-GDP ratio, prudent monetary policy has succeeded in bringing inflation to target, and the financial sector remains profitable and well capitalized. That said, growth has declined sharply. Indeed, we note in today's press that GDP has contracted for the second consecutive quarter on an annual basis by 0.4 percent y/y, according to preliminary estimates and that services growth, which had been a bright spot in previous quarters, has also slowed. We however take positive note of staff's assessment that growth is expected to recover in 2020 on the back of a modest recovery in domestic demand.

In addition to low growth in the short-term, Mexico remains confronted with other important risks and challenges. As reiterated in the staff report, structural challenges such as high poverty and informality, corruption, and crime continue. In this context, priorities include pursuing growth-friendly and inclusive policy mix while maintaining fiscal discipline. Efforts should also continue to improve financial deepening and inclusion while safeguarding financial stability. In addition, reinvigorating the structural reform agenda remains a priority. We also agree with the view expressed in the buff statement that the ratification of the new trilateral trade agreement (USMCA) would significantly contribute to reduce trade uncertainty and boost investment.

We welcome the authorities' continued commitment to fiscal prudence and the plan to strengthen the current fiscal framework. In this context, we

take positive note of the projected primary surplus of 1 percent of GDP in 2019 and a target of 0.7 percent of GDP for1 2020. Notably, we are encouraged by the authorities' willingness to cut spending, including capital spending, or take revenue-enhancing measures in the event of shortfalls. Considering the modest tax revenue-to-GDP ratio, the authorities should develop concrete measures to achieve the envisaged increase in additional tax revenues of at least 2 percent of GDP. To this end, priorities include broadening the tax base, rationalizing tax expenditures, and strengthening revenue administration. We also echo staff recommendation to focus on enhancing public expenditure efficiency to help shift spending toward a more growth-friendly and inclusive mix. Annex IV on strengthening the current fiscal framework provides useful analysis on the authorities' proposals to guide the design of a new framework and we look forward to the authorities' work in this area in the period ahead.

We commend the Bank of Mexico (Banxico) for the progress in reducing inflation and we see merit in staff's recommendation to continue easing monetary policy so long as inflation stays close to the target and inflation expectations remain anchored. We welcome Banxico's recent improvements in its communication, detailed in ¶25. While the FCL continues to provide a complement to Mexico's international reserves, we encourage the authorities to further strengthen reserves. As shown in Figure 5, the level of reserves in percent of ARA metric at end-2018 is essentially the same as the end-2009 level.

On the financial sector, we welcome the staff's assessment that it remains resilient to various shocks. In this context, we agree that the resilience could be reinforced by closing gaps in the regulatory and supervisory framework. We also welcome the authorities' focus on boosting financial deepening and inclusion especially of women and the rural population.

Finally, we welcome the authorities' resolve to reinvigorate the structural reform agenda to support growth and inclusion and combat poverty. In this connection, we are particularly encouraged to note in the buff statement that the authorities have a strong commitment to tackle corruption and impunity, as well as to strengthen the rule of law. Box 6 provides useful details on corruption and AML/CFT reforms and the authorities should continue their efforts to ensure effective implementation of the recommended measures.

With these comments, we wish the authorities continued success.

Ms. Riach and Mr. Chrimes submitted the following statement:

We thank staff for the informative set of papers, and Mr. Guerra and Ms. Arevalo Arroyo for their helpful and detailed buff statement. We also welcome the authorities consenting to the publication of staff's Concluding Statement following completion of the mission.

Mexico's growth has slowed in 2019, but we agree that strong policy frameworks have contributed to its ability to manage a challenging external environment. Staff's projected pickup in growth over the next few years seems optimistic but consistent with the IMF's baseline case for the global economy. Delivering growth as per the forecast is contingent on an easing in external factors – and on domestic policy choices. As in last year's report, all risks highlighted in the Risk Assessment Matrix are negative shocks, emphasizing the case for further strengthening the current policy framework in Mexico. A balanced and prudent fiscal approach, a robust monetary policy framework, a flexible exchange rate and continued structural reform are all key tools for managing the risks Mexico faces.

We agree that Mexico derives benefits from its position as one of the more open emerging market economies in terms of trade and financial markets, but that it is also exposed to global trade and policy uncertainty (despite diversion effects which may have offered recent support to exports). In line with the recent flagship reports, we reiterate the importance for all countries of a durable resolution to trade tensions. Ratification of the USMCA by all signatories should also be significant for Mexico. We highlight staff's assessment that the flexible exchange rate has played – and continues to play – a key role in helping the Mexican economy adjust to external shocks. We also note the agreement between staff and the authorities that foreign exchange reserves are adequate, with the FCL providing an effective complement.

We recognize the competing fiscal objectives the authorities are trying to balance, commend the authorities' continued commitment to fiscal responsibility, and encourage them to carefully consider the options for delivering fiscal objectives in a way which supports inclusive and sustainable long-run growth. It is positive that staff and the authorities agree that the fiscal framework should be strengthened and have engaged in constructive discussions on this. We also welcome the authorities' intention to strengthen public revenues. However, we share staff's concerns about sustainability of

adjustments required to meet announced fiscal targets, given current policies (e.g. a commitment not to raise taxes until 2021) and budgetary constraints: the Budgetary Spending Pressures Selected Issues Paper highlights that legally-manded expenditures represent two-thirds of the budget, with a further 20 percent of expenditures "technically discretionary but inflexible". Capital investment and education spending – both crucial to long-run growth prospects – are among priority areas likely to see further spending squeezes. Staff conclude that putting the public debt ratio on a downward path could require stronger medium-term fiscal targets, while also stating that additional measures are needed to meet those targets already announced, further illustrating the challenges facing the authorities.

Broadening the revenue base and delivering targeted, growth-friendly efficiency gains in public spending could both help square this circle and support sustainable and inclusive long-run growth. The low level of revenue as a share of GDP is striking compared to regional and OECD peers; timely and well-communicated reforms to broaden the tax base and make the system more progressive will be important.

This set of papers and previous reports have suggested many potential structural reforms. We are concerned by staff's assessment that – despite pockets of progress – productivity-enhancing reforms have largely stalled. We encourage the authorities to consider all of staff's proposals. We also believe, as per our statement in 2018, that more detail from staff on suggested prioritization and sequencing might be useful. Concrete steps to enhance good governance and the rule of law, and to advance productivity-enhancing structural reforms – including on labor and product markets – would boost growth prospects. This productivity focus also applies to PEMEX: we appreciate that there are different approaches to managing natural resources effectively for the public good and acknowledge that country circumstances matter. Nevertheless, we share some of staff's worries. Operating profitability projections for PEMEX seem optimistic, with further fiscal risks if these are not met. Meanwhile, the investment in the Dos Bacos refinery could come at the expense of much-needed investments elsewhere in the business. Finally, we note that recent reports on Mexico have not referenced climate change, and we encourage staff to consider this in their thinking going forward.

Mr. Jin and Ms. Zhao submitted the following statement:

We thank staff for the insightful set of papers, and Mr. Guerra and Ms. Arevalo Arroyo for the informative buff statement. Supported by strong policies and policy frameworks, the Mexican economy has continued to show

resilience in the context of a complex external environment. Going forward, uncertainties surrounding both the global economic environment and domestic policy decisions will weigh on the outlook, calling for sustained fiscal prudence, well-calibrated monetary policy, and productivity-enhancing structural reforms. We broadly concur with the thrust of staff's appraisal and would like to make the following comments for emphasis.

Continued fiscal prudence is needed to create fiscal space and enhance tax progressivity. Given the budget projections are based on more optimistic assumptions for nominal GDP growth, oil production, and tax revenue, additional efforts are needed to put public debt ratio on a downward path. We welcome the recent cancelation of the universal tax offset as well as proposed measures to strengthen tax collection. Given the low revenue levels compared to regional peers, we welcome the envisaged tax reforms aimed at rationalizing regressive tax expenditures, broadening the tax base, and widening the top personal income tax bracket. We also take note of the different views between staff and the authorities regarding the Pemex's business plan and encourage more private sector participation in the energy sector.

Monetary and financial policies should be geared to further strengthen stability. We agree with staff that there is room for monetary easing as long as inflation remains close to the target and inflation expectations are anchored. We commend the authorities for recent improvements in its communication. The flexible exchange rate has served Mexico well and should continue to remain the key shock absorber. Although the financial sector remains resilient to various risks, we encourage the authorities to continue to monitor financial risks and close regulatory gaps.

A new wave of structural reforms is instrumental to raise productivity and increase investments. We welcome staff's analysis of factors holding back Mexico's productivity growth. For structural reforms to translate into higher growth, we encourage the authorities to steadfastly press ahead with the reform agenda to lift growth potentials and promote inclusiveness, focusing on mitigating corruption, reducing labor informality, and combatting crime. We welcome the ratification of the Mexican authorities on the new trilateral trade agreement with the U.S. and Canada (USMCA). Since Mexico is a highly open economy that is deeply integrated into the global value chain, we encourage the authorities to continue to diversify its trading partners.

Mr. Rozan and Ms. Albert submitted the following statement:

We thank staff for their interesting and detailed set of reports and Mr. Guerra and Ms. Arevalo Arroyo for their informative buff statement. We commend the authorities for their robust macroeconomic framework, with the commitment to fiscal and monetary prudence, and to the flexible exchange rate. We encourage the authorities to take significant measures to boost growth, through a strong structural reform agenda, to further ease monetary policy, and to fight corruption and criminality. We see the reduction of poverty and inequalities as an important priority. Going forward, enhancing the quality of the fiscal adjustment will be necessary, through a more redistributive tax system. Pemex represents a very sizable fiscal risk for the country, and we encourage the authorities to work closely with the Fund to develop a viable strategy. the FCL arrangement sends a strong signal about the country's institutions and policies and has allowed to weather episodes of volatility and reinforced market confidence, and we look forward to discussing a new arrangement. We share staff's analysis and would like to add a few comments for emphasis:

We welcome the authorities' commitment to a strong framework and prudent policy mix but note that the growth performance remains lackluster. In addition, GDP per capita could even decrease by 0.5 percent this year. We note that growth should rebound to 1.3 percent in 2020. However, the poor performance of US manufacturing sector, the lack of dynamism of private consumption despite the wage increases and the persistent uncertainty (Pemex, trade issues) make such a rebound subject to significant uncertainty. Preliminary results for the third quarter show that GDP decreased by 0.4 percent on a year on year basis. We also note the 11.8 percent growth of US imports due to trade diversion effects. Could staff detail the magnitude of trade diversion effects in Mexico compared to its peers in the region? On the long-term trajectory, we note the downward revision of the medium-term growth from 2.9 to 2.4 percent comparing to the last Article IV review, which echoes past discussions at the Board on the country's growth performance.

Improving the quality of the adjustment appears important. We encourage the government to focus on the efficiency gains, by rationalizing the existing taxes, fighting fraud, better targeting social benefits, and to develop a more redistributive strategy, to further entrench social buy-in. The chart on page 11 makes clear the possibility to significantly decrease the threshold for the top PIT bracket. The authorities' willingness to work on these issues is very much welcome. On the expenditures side, the significant cuts in capital, education and health spending made to further support Pemex

should be reversed. Given Pemex's role in the economy and in the fiscal framework, and its impact on the sovereign risk, we are concerned by the divergence of views between the authorities and staff about Pemex management. We encourage the authorities to find a viable solution for Pemex to avoid the materialization of an adverse scenario in this regard. Could staff provide some elements to define a strategy to balance fiscal sustainability, ensure a Pemex balance sheet adjustment while limiting the detrimental impact on public capital, education and health spending? Finally, we commend the authorities for their willingness to revamp the fiscal framework in 2021 to improve fiscal credibility.

We welcome the first steps towards a more accommodative monetary policy and encourage the authorities to go further in this direction. Indeed, a gradual monetary easing is appropriate as the inflation has come back on the 3 percent target range, the real interest rate is far above its ex-ante real neutral rate, inflation expectations remain anchored and the high core inflation should soften. Could staff detail its core inflation's forecast and its components? We agree that the flexible exchange rate is the appropriate tool to help the economy to adjust in case of external shock and we underline the very positive role the FCL, as a contributor to the country's economic resilience.

Financial sector resilience is a strength and we support initiatives to boost financial inclusion. We welcome the soundness of the financial system, and its overall resilience to shocks. We also strongly support the authorities' initiatives to tackle financial inclusion, which can have a significant impact on informality. In particular, regarding the predominant use of cash, we welcome the initiatives such as CoDi to mainstream the use of bank accounts.

Going forward, sustaining stronger level of growth requires reinvigorating productivity-enhancing reforms, as highlighted by staff. We support the authorities' strong commitment to fight corruption and money laundering and encourage the authorities to focus on implementation and enforcement. We commend staff for the very useful analysis of the impact of the security situation on growth, which shows the sizable gains to be triggered by improvements in this regard, on the population's well-being and on the business climate.

The Acting Chair (Mr. Lipton) made the following statement:

We turn to our first agenda item, Mexico. We will be starting with the Article IV consultation as our first order of business. Bank staff is attending our meeting.

Mr. Doornbosch made the following statement:

The markets are very sensitive, particularly towards Mexico's policies, as evident from the recent ratings downgrades and widened spreads on sovereigns. We welcome the authorities' commitment to very strong policies and institutional frameworks. This commitment is welcome and needed especially to sustainably address the fiscal challenges and strengthen public financial management.

I acknowledge the authorities' satisfaction with the current prudential government structure and welcome their recent initiatives to increase financial inclusions. Like Mr. Tan and Mr. Sigurgeirsson, I urge the authorities to remain vigilant. They should expeditiously implement the recent Fund anti-money laundering / combating the financing of terrorism (AML/CFT) recommendations to boost credibility.

Mr. Lopetegui made the following statement:

We are encouraged by the authorities' commitment to macroeconomic stability, which is a necessary condition to successfully address Mexico's challenges, especially those related to a need to reinvigorate growth and strengthen social conditions. We especially welcome the authorities' commitment to the very strong policy framework in place, including central bank independence, exchange rate flexibility, fiscal prudence, and respect of property rights. The financial sector is strong and well regulated, providing a very good starting point to develop on a sound basis.

On the fiscal front, we welcome the authorities' policies aimed at maintaining fiscal prudence. The fiscal effort that has led to a decline in the debt ratio over the last years needs to be maintained, and further progress to enhance revenue mobilization and sustainable expenditure strength would be important to generate the fiscal space necessary to expand much-needed investment. We believe that the short-term fiscal policy has been appropriate in light of the complex external environment, cyclical conditions, and a tight monetary policy. This could have been reflected in the staff report more clearly.

We are encouraged by the authorities' determination to make important reforms to the tax system and revenue administration with the objective of boosting the tax-to-GDP ratio and increasing the progressivity of the system. We appreciate the authorities' willingness to strengthen the fiscal framework.

Mexico has implemented an effective monetary policy to bring inflation back to target. While we see scope for further easing as risks to inflation abate, we agree that monetary policy should remain prudent. We commend recent improvements in communication.

A pressing challenge, both in Mexico and the region, is related to inequality. The staff report underlines that poverty and inequality in Mexico have improved only modestly with persistent regional inequalities. We encourage policy directives to strengthening competition and easing product market regulations, as mentioned in the report. Several measures aimed at enhancing financial inclusion will contribute to reinforce social objectives. The ratification of the USMCA will significantly contribute to reduce trade uncertainty and boost investment.

Corruption, labor informality, and crime are assessed to be key drivers of Mexico's disappointing productivity growth. We welcome the agreement between staff and the authorities that priority should be given to addressing these challenges. Building on the progress of recent years, it will be important to focus on continuing the implementation of the NACS, fighting crime against property, and strengthening the AML/CFT regime.

Ms. Levonian made the following statement:

On balance, it has been a challenging first year for the new administration. Growth has been disappointing, and the risk environment has clearly worsened. However, Mexico's very strong policies and policy frameworks have enabled it to weather the slowdown. Looking ahead with so much policy-induced uncertainty in the world, Mexico should avoid undermining its growth prospects with domestic policy uncertainty. We agree with staff's overall assessment that the composition and efficiency of spending should help Mexico address fiscal pressures and to support inclusive growth.

The authorities' tax policy agenda seems to be well calibrated in that regard, and new non-oil revenue-raising measures will help fill a potential fiscal gap and reduce public sector debt requirements. Energy sector reforms should be prioritized, as markets have sent a clear signal that Pemex's business plan is not moving in the right direction. We encourage the authorities to heed that advice in order to stave off further downgrades, which would trigger sell-offs.

With regard to the financial sector, the authorities should continue efforts to promote competition and improve financial inclusion. We would welcome the articulation of an integrated competition and inclusion strategy that pulls together existing plans in the area of open banking, fintech, and digital payments. Structural policy priorities should be those reforms targeting governance, security, the rule of law, and labor informality. We would also underscore the importance of reforms that support inclusive growth, including addressing gaps in female labor force participation.

Two very quick observations on the report itself. First, we found the Selected Issues Paper (SIP) on the firm productivity gains from road improvements to be fascinating and commend staff for that paper. Second, on the Risk Assessment Matrix (RAM), a flexible exchange rate is the policy to manage four of the seven risks identified in the Risk Assessment Matrix, which does not provide much depth of advice. Export market diversification could be added as a policy response to manage the risk of weaker-than-expected growth in the US, and changes to Pemex's business plan should be added as a response to lower oil revenues, particularly if the bottleneck is private sector participation in exploration and production.

More generally, we would like to see the Fund pay more attention to the Risk Assessment Matrix (RAM) and the review stages to improve traction with authorities.

Ms. Pollard made the following statement:

We strongly agree with staff's assessment that Mexico has a history of very strong macroeconomic policies, and that continues. We think the currency and credit markets have reflected Mexico's fiscal and monetary discipline as the peso and sovereign credit default swap (CDS) spreads have been relatively resilient despite credit rating downgrades and negative outlooks for sovereign and Pemex ratings. We would particularly like to commend the Bank of Mexico for remaining a pillar of macroeconomic stability in Mexico, and we encourage the authorities to continue along their path of data-driven monetary policy, keeping exchange rate flexibility as a key shock absorber while focusing on inflation targeting.

Despite these strengths of the economy, the staff report makes clear that the current policy mix is insufficient to address the long-term challenges, including reducing poverty and informality, tackling persistent weaknesses, and fostering strong, sustainable, and inclusive economic growth. The focus

needs to be on structural reforms, as the macro framework seems to be very strong.

We strongly believe that greater involvement by the private sector would improve Pemex's viability and boost productivity and, as a result, reduce Mexico's fiscal dependence on oil prices and revenues. We are also concerned about the optimism of the authorities' energy production estimates and would like to see Pemex streamline costs to improve the free cash flow and reduce implicit fiscal risks. We also support moving toward a market-determined retail gasoline price and restarting energy auctions.

Finally, we commend the administration for making eradication of corruption and enhancing financial transparency a top priority. We highlight the need to turn priorities into concrete actions and the need to improve governance and corruption and AML/CFT compliance and enforcement, as well as strengthening the rule of law.

We look forward to staff's recommendations and monitoring and reporting of these efforts in the coming months and years.

Mr. Saraiva made the following statement:

Mexico has been navigating well a difficult, delicate transition, and it is important to highlight that Mexico has a proven track record of sound macroeconomic policies and has a very strong policy framework, which has helped over time to sustain important shocks suffered by the Mexican economy. It is very much welcome the fact that the authorities are committed to preserve the strong policy framework moving forward.

Regarding fiscal policy, the authorities' plan to improve the framework is a step in the right direction, having highlighted first that it is already a strong framework. I think the focus on mobilization of domestic resources is an important one. If we compare Mexico with peer economies, it still lags behind in terms of fiscal revenue. This direction is very much welcome.

On the monetary policy framework, as Mr. Lopetegui has mentioned this morning, Mexico has been very effective in bringing the inflation down towards the target. As Mr. Rosen has said in his written statement, monetary policy should continue to be data-dependent and approach cautiously to this very complex environment that the Mexican economy continues to face. I see no merit in pre-committing to a specific easing path for monetary policy. If

conditions allow, the central bank should continue to ease the monetary policy. The monetary stance is very tight at this point, but easing should continue to be data-dependent, especially given the complex challenges that the Mexican economy is still facing.

Finally, the focus on reducing poverty and inequality is very auspicious. As we have seen in other cases, it is absolutely critical to move towards better income distribution and greater ownership by the population to ensure sustainability of good macroeconomic policies.

Mr. Inderbinen made the following statement:

We acknowledge Mexico's proven track record of sound policy implementation and the strength of its policy framework. We also note the authorities' continued commitment to flexible exchange rate and the benefits of Mexico's exchange rate regime in easing the external adjustment following the drop in oil prices and production over the last years. Also, I would like to underline the authorities' commitment to an open capital account, as mentioned in the statement by Mr. Guerra and Ms. Arevalo Arroyo.

We encourage further fiscal consolidation to replenish the fiscal buffers and ensure that public debt is on a downward trend. This said, we note the authorities' ambition to improve the fiscal framework and the readiness to take on Fund advice in achieving this. We note staff sees scope on the monetary side for further easing beyond the cuts in the policy rates that were made in August and September of this year. In our gray statement, we emphasize the difference between the ex ante real rate and the estimates of the natural rate of interest in Mexico, but at the same time we do sympathize with the authorities' concern with the stickiness of core inflation and the need to strengthen the anchoring of medium- and long-term inflation expectations going forward.

Finally, like others, we very much welcome the authorities' commitment to improve governance, reduce informality, and combat corruption. One area that is helpfully highlighted in the staff report is the AML/CFT regime, and we join other Directors in encouraging the authorities to speed up action in addressing the shortcomings that have been identified in the 2018 assessment with the view to exit the enhanced follow-up process of the Financial Action Task Force (FATF).

Mr. Rozan made the following statement:

The authorities have had a good track record on reinforcing the credibility and the resilience of the country, which leads the country to have a sound and strong macro framework overall, and this is particularly useful in a risky environment. Downside risks are significant today, and as mentioned in the World Economic Outlook (WEO) and more recently, with a more difficult social context in several countries of the sub-region. This is why it is important to preserve this resilience and confidence, especially in a context of sluggish growth.

Second, the quality of fiscal adjustment remains an issue, and we would like to reiterate our view regarding the need to more substantially fund human development needs and targeted capital spending. We thought the selected issues paper on this topic was very useful and informative.

GDP per capita growth has been low since 2008, and we would like to echo the points raised by Mr. Saraiva on inequality and the need to have more distributive policies. Reforms about property taxes could be positive approaches. In this regard, we support the authorities' intention to deliver at least 2 percent of GDP in additional tax revenues through efficiency measures and enhanced progressivity as very welcome step. Moreover, we see the minimum wage increase this year as very positive to reduce inequalities.

Finally, we see productivity-enhancing structural reforms as key to boost potential growth. We see useful reforms in the field of informality, market power, and concentrated industries, as well as improved financial access, and we think that the government's approach on these issues is very useful.

Finally, we commend the authorities for their strategies on reducing corruption and would like to emphasize the need to implement the new framework.

Mr. Sassanpour made the following statement:

When I read this year's report, I went back and also read last year's report, and I noticed there was a change from an upbeat tone of last year to a more subdued tone of this year. I am not exactly sure what the underlying reasons are. The external conditions are broadly unchanged and, if anything, probably slightly favorable. The financial conditions in the US have eased, and the impact of global trade tensions on Mexico appears to be slightly positive, at least this year. On the domestic front, the new government has indicated its commitment to fiscal prudence and flexible exchange rate policy

and strong policy framework. Could staff elaborate what could explain the slight tilt in the assessment?

On trade tensions, as indicated by staff answers, the net impact of the US-China trade conflict on Mexico is likely to be slightly positive in 2019 this year and possibly negative in 2020 and beyond, as indirect impacts, for example, on confidence are expected to dominate. In staff's view, regarding trade diversion from which Mexico benefited and possible rerouting of supply channels that you also referred to in your written answers, how likely are they to be permanent even if the trade tensions are to end soon? We raised the same questions in the Board discussion on the WEO, and the staff assessment at that time was that the confidence factor was likely to be durable.

On monetary policy, like Mr. Saraiva and Mr. Inderbinen, we are among the chairs that supported the Bank of Mexico's cautious approach to monetary easing given the balance of risks and the stickiness of core inflation. In staff's medium-term scenario, I am not sure what the underlying assumption about monetary easing is. But if the tight monetary conditions were to continue longer, how would the fiscal policy be calibrated to support demand and growth?

Mr. Kaya made the following statement:

Mexico is an open emerging market economy which is well integrated into the regional and global supply chains. While the economy has benefited from trade and openness in the last few years, the elevated trade tensions, as well as the intermittent bouts of market stress, have been possible additional challenges. Thanks to the authorities' sound policy framework, the Mexican economy has managed to withstand these external shocks and preserve macroeconomic and financial stability. Nevertheless, challenges remain with particular respect to the weaker growth outlook, calling for decisive steps in the structural reform area. We believe priority should be given to tackle the most challenging impediments in this regard, namely, corruption, climate, and informality.

On the overall macro policy mix, we commend the authorities for broadly keeping the fiscal position in order as inflation has successfully been brought back to target and the non-oil external balances are registering a healthy improvement. We believe that some tweaks to this policy mix through a tighter fiscal and easier monetary policy stance could help the authorities to consolidate their stability gains and yield further buffers. To this effect, tapping on the large tax revenue potential and instilling more progressivity in

the tax policy design could be the first avenue to explore. We also welcome the authorities' efforts to improve the public financial management framework and take positive note of the broad agreement between staff and the authorities on the recipe to be followed.

Finally, on Pemex, like many other Directors, we note the differences between the authorities' and staff's view on how to approach the business plan of the company. We agree that the authorities should continue to review the business model of Pemex to ensure financial viability and oil production sustainability while containing quasi-fiscal risks. We also support the greater involvement by the private sector within a well-designed framework. We are concerned about one particular aspect of this debate, namely the disagreement about the downstream investment of Pemex in the Dos Bocas refinery. We note that staff has cautioned against a possible extension of the construction schedule and significant cost overruns, which could lead inter alia to the crowding out of the upstream investments. This would be a worrisome development. On the other hand, we also try to understand why the authorities are so keen on refined rate investment. Could it be because of concerns about energy supply, which could come to the fore in a possible new episode of trade tantrum?

We would appreciate if staff could elaborate on the import dependency of Mexico with respect to refined oil products and to what extent the new refinery will be a solution in this regard.

Mr. Von Kleist made the following statement:

We note that Mexico has a well-proven track record of policies that support macroeconomic stability, and we strongly welcome and support that. At the same time, the economy has contracted sharply, and the medium-term outlook has weakened. This is due to domestic and external policy uncertainty to a great extent. Now, the authorities obviously probably cannot do that much about external uncertainties; but on the domestic policy uncertainty, we feel that there are some more steps that can be taken. Therefore, we encourage the authorities to redirect their focus on measures that enhance the credibility of policies and tackle longstanding structural challenges. Enhancing security, reducing inequality, and fighting corruption bear a significant economic and social dividend. Enhanced market-based competition and private sector involvement will boost firm-level productivity and enhance Mexico's resilience against external headwinds.

We commend the authorities for striking a balance between fiscal prudence and public spending. We do, however, believe that more ambitious medium-term fiscal targets are needed to put public debt on a clear downward path and to rebuild buffers against future shocks and structural spending pressures. We welcome the authorities' proposal to include a well-calibrated debt anchor into the fiscal budget.

Lastly, we encourage the authorities to undertake efforts on the revenue side to reduce dependency on oil revenues and enhance the progressivity of the tax system that will enable a move towards a more growth-friendly and inclusive policy mix.

Mr. Tanaka made the following statement:

Mexico has very strong policies and policy framework, and we welcome that the new President and his government would make a commitment to fiscal prudence and tight monetary policy based upon the independence of the central bank. However, we share staff's concern that new policy initiatives have weakened policy predictability and further added uncertainty surrounding Mexico.

On the fiscal sector, we support staff's view that the authorities need to specify additional measures to underpin their fiscal targets and to strengthen tax collection and increase the tax system's progressivity, rather than drastic budget cuts. It is welcome that the new tax policy measures will be put in place to strengthen public revenues, focusing on simplifying the tax framework and narrowing the scope for fiscal evasion and avoidance.

On the oil sector, given macrocritical characteristics and the strong fiscal linkage of the oil sector in Mexico, we agree with staff's view that Pemex needs more cooperation with private firms and a stronger focus on its upstream business to support a significant increase in production and reserves. A re-examination of policies is warranted to reinvigorate the oil production and reduce fiscal risks.

Perseverance with structural reforms, including energy reform, governance, security, and the rule of law, competition, and AML/CFT is central to boost growth and reduce poverty and inequality. We encourage the authorities to implement the recommendation from 2018 Fund staff-led AML/CFT assessment against FATF standards and make significant progress in this area.

Mr. Palei made the following statement:

We certainly support the authorities' efforts to improve the macroeconomic policy frameworks, to strengthen the fight for improving governance against corruption, also to improve the security situation in the country. In my intervention, I will address several issues. One would be a group of questions related to the fiscal policy framework; then a question on structural reforms, and finally, a question on the governance issues.

In the fiscal area, in our gray statement, we questioned the conclusion made in the introduction to the staff report and the staff appraisal that the fiscal policy framework is very strong. When you read the report, the fiscal deficit is higher than advised by staff. Then without 1.2 percent of GDP in additional measures, the debt trajectory will be unfavorable as well. Today the public-debt-to-GDP is 55 percent, and in five years it is likely to be 63 percent if there are no policy measures taken.

We see that staff disagree with the authorities' estimates that the improvements in tax administration will deliver very large benefits. The tax revenues overall are very low compared to the peers. There is a special paper on the expenditure cuts, and staff questioned whether those are well targeted and well thought through, and staff believe that these expenditure cuts may be growth-impairing, so there is a significant disagreement in this area.

Then we look at the energy sector, which is also very important for Mexico, and here there is a major disagreement between staff and the authorities on the role of energy subsidies. Staff would prefer to address those in a more expeditious manner. The Pemex business plan also remains to be improved. So, there are many issues were there are significant disagreements between staff and the authorities. Importantly, staff also say that the current fiscal rules do not seem to provide a very strong fiscal framework, and staff propose a new reform to the fiscal framework based on adjusted fiscal rules.

We certainly are siding on many of these issues with staff. When you look at the selected issues papers, one on the Pemex business plan and oil taxation in general, we are very supportive of staff views. We are also supportive of another chapter in the selected issues paper on expenditures. We believe there is a disconnect between the conclusion in the appraisal and the fact that the fiscal framework remains relatively weak. Mexico is a user of the Flexible Credit Line (FCL) for ten years, and still we have many unresolved issues.

Another point I wanted to make is on structural reforms. I recall there was a time when Mexico was praised for significant structural reforms and staff expected them to contribute significantly to potential growth, and the growth estimates of potential GDP were close to 4 percent a year. Today, staff went down to 2.4 percent of GDP potential growth. Could you reflect on the several years of evolution in views and the reasons you believe that potential growth is much lower than it was seen a few years ago?

Finally, on the governance and corruption, we know that the new administration won its position on the platform of improving governance and fighting against corruption, so the administration certainly recognizes the severity of these problems. We applaud the authorities' intention to move in many areas here, for example, to introduce a fiscal council, improve fiscal transparency, and introduce many other measures that would be helpful in improving governance. However, since staff frequently use these quantitative estimates of third-party indicators, the Corruption Perception Index or governance quality, we would like to hear from staff what could be the explanation for the deteriorating position in these ratings for Mexico. In 2015, Mexico was ranked 95 in the Corruption Perception Index, and today, it is ranked 138; we are in the same place here, sharing 138 in this particular indicator. What would be the quantitative effect of moving from 95 to 138? You probably know our skepticism of all of these regressions and numbers, but it would be instructive just to hear what kind of changes we are talking about and whether we should take them seriously. Maybe Mexico did improve in the area of governance and fighting corruption over the past ten years while it was a FCL user. If there were any significant achievements, maybe you could remind us about them.

Mr. Singh made the following statement:

We complement the Mexican authorities for maintaining macroeconomic stability and implementing reforms, which have provided the economy much-needed resilience against an adverse external environment. As highlighted in the staff report and also in the statement by Mr. Guerra and Ms. Arevalo Arroyo, fiscal discipline, a reverse monetary policy focused on price stability and a flexible exchange rate regime to absorb external shocks have been important landmarks towards attaining macroeconomic stability in the recent period. However, there are two important challenges that may shape up the growth and stability going forward. First is the external challenge emanating from threat of trade and tariff frictions, which may get magnified in the event of an adverse global financial market shock given the high trade and financial openness of the Mexican economy. While diversification of trade

direction can help contain such risks, these measures can yield dividends only over the medium to long run. Another important challenge is the balance between the policy choices of reducing the debt-to-GDP ratio on a sustainable path and maintaining the quality of public spending.

While we welcome the authorities' medium-term fiscal targets, which will keep the debt-to-GDP ratio on a downward trajectory, the cutback in productive spending has adversely affected the investment cycle, which is an important domestic driver of growth. A relatively low tax-to-GDP ratio compared to its emerging market peers provides a window of opportunity for augmenting tax revenue efforts through simultaneously augment public spending and stabilize debt.

We agree with the staff assessment that revenue administration could be strengthened by adopting a comprehensive strategy to tackle VAT noncompliance. Simultaneously, efforts can be made to reduce labor market informality, which will contribute to higher productivity and will help accelerate growth when the investment cycle kicks in.

Mr. Alkhareif made the following statement:

I would like to commend the authorities for their strong macroeconomic policies and policy framework. We welcome the authorities' continued commitment to fiscal prudence and the plan to strength the current fiscal framework. We echo staff's recommendation to focus on enhancing public expenditure efficiency to help shift spending toward a more growth-friendly and inclusive mix. We commend the Bank of Mexico for the progress in reducing inflation, and we see merit in staff recommendation to continue easing monetary policy, as long as inflation stays close to target and inflation expectations remain anchored. We welcome the central bank's recent improvement in its communication.

On the financial sector, we welcome the staff assessment that it remains resilient to various shocks. We agree that resilience could be reinforced by closing gaps in the regulatory and supervisory framework. Indeed, we welcome the authorities' focus on boosting financial deepening and inclusion, especially of women and the rural population.

Finally, we welcome the authorities' resolve to reinvigorate the structural reform agenda to support growth and inclusion and combat and poverty. In this connection, we are particularly encouraged by Mr. Guerra and Ms. Arevalo Arroyo's statement on the authorities' strong commitment to

tackle corruption. Like Ms. Pollard, Mr. Tanaka, and Mr. Inderbinen, we encourage the authorities to continue their efforts to strengthen the AML/CFT framework.

Mr. Fanizza made the following statement:

I would like to say at the outset I tend to agree with some of my colleagues, particularly Mr. Lopetegui and Mr. Sassanpour, on the fact that the staff report sounds a bit overcritical. Let me be concrete in what I mean by that. I tend to sympathize with the authorities' view on monetary policy in particular. We cannot say that we should ease more because the output gap is large and negative. The important thing is that core inflation, which is the target of the authorities, is not on target. That is the main point. The output gap, which is in the diametrically opposite situation, is not a sufficiently relevant piece of information to guide monetary policy choice. The target for inflation is concrete. We know that the other measure is fraught with flaws.

On fiscal policy, I do not understand how we could argue that in a situation with a large negative output gap, we should reduce the structural balance. I would argue more in favor of a neutral fiscal policy stance, at least in the short period. I am not saying that there are no long-term problems or issues to be addressed, to the contrary. The reason is not to further criticize the output gap measure, but because Mexico, like many emerging markets at the moment, faces great opportunities. They need to accelerate structural reforms, because in this juncture with very low interest rates worldwide, particularly in the advanced world, the benefit from structural reforms can translate in concrete results and attracting large amount of capital. So, implementing structural reforms that improve the investment climate, you let great benefits, natural benefits. The fact that fiscal policy should not take a restricted stance that makes implementation of structural reforms more difficult and may create political difficulties is something that we should consider.

Finally, I liked the recommendations of the staff on reducing informality, which were not recommendations that tended to replace informality, but to the contrary, to reduce the incentives to informality.

Mr. Jin made the following statement:

Supported by strong policies and policy frameworks, the Mexican economy has continued to show continued resilience in the context of a complex external environment. Monetary and financial policies should be geared to further strengthen stability. We agree with staff that there is room

for monetary easing as long as inflation and inflation expectations are anchored. In light of the heightened external risk, the flexible exchange rate should continue to remain the key shock absorber.

A new round of structural reforms is instrumental to raise productivity and increase investment. We encourage the authorities to steadfastly press ahead with the reform agenda to lift growth potential and promote inclusiveness, focusing on mitigating corruption, reducing labor informality, and combating crime.

The ratification by the Mexican authorities of the new trilateral trade agreement with the US and Canada will promote regional economic integration on one hand. On the other hand, we hope this will not reduce Mexico's degree of freedom and flexibility in exploring a more diversified economic cooperation with other parts of the world under any multilateral and bilateral framework.

Mr. Odonye made the following statement:

Thank you, Chair. We fully acknowledge the Mexican authorities for their commitment to a strong policy environment but also noted the slowing growth amidst policy uncertainty and weak investment environment. We acknowledge the full details that were put out in the staff report, as well as the response by the authorities. We also want to acknowledge the fact that staff has responded to the questions we raised in our gray statement, which settled our concern. We just have an additional comment and would ask for staff comment with regard to that.

To this extent, we have noted that Mexico does shadow the US economy in several respects despite different economic fundamentals. We would like to ask for staff's view on policy steps during economic decoupling, as witnessed during the recent US fiscal impulse implemented through the general tax cuts.

The staff representative from the Western Hemisphere Department (Mr. Christou), in response to questions and comments from Executive Directors, made the following statement:[1]

> Before addressing a few of the broad issues on the policy mix, and the tone of the report, let me update you about the flash GDP estimate for the third quarter of the year, which was released last week. The Mexican economy in the third quarter of this year shrunk by 0.4 percent year-on-year, and this in seasonally adjusted terms is 0.1 percent quarter-on-quarter. That comes following a contraction of 0.3 percent in the first quarter and then a flat second quarter. What does that mean for our annual projection? It means that probably the 0.4 percent projection we have for real growth this year is not feasible, so we now expect no growth this year. That does not affect our forecast for 2020, which remains unchanged at 1.3 percent.
>
> This revision does not affect our staff appraisal, but actually reinforces our recommendation to continue the easing of monetary policy and reinvigorate structural reforms, and also the point that fiscal policy was appropriately expansionary this year.
>
> Let me now turn to the main themes that were addressed both in the gray statements and in this morning's discussion, starting with the tone of the report and whether it was overly critical compared to last year. In our assessment, Mexico's policies are very strong. The fundamentals are also very strong. The authorities' commitment to fiscal prudence is there. The independent central bank is there. Moreover, the inflation targeting framework is very robust. Nothing has changed in all these compared to last year. What has changed is policy predictability, and we highlight in the report that some of the decisions that were made since the government took office have indeed created uncertainty. It is true that perhaps some of these decisions were already part of the pre-election campaign. However, the public consultation about the construction of the new airport and the recent reopening of the contracts for the gas pipelines have generated uncertainty. Investors are worried, for example, about whether there will be other public consultations. So it is that concern that we have about policy unpredictability.
>
> Another concern pertains to the drastic budget cuts. We do support fiscal prudence, but at the same time, with a very limited revenue envelope, cutting expenditures substantially will at some point start hurting human

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

capital and the provision of services. It is in that sense, as well, that the report is somewhat different than last year. On the same topic, and related to the Pemex plan, it is very clear that there are certain elements of the business plan of Pemex that we recommend to be revisited. Having said all that, these actions have not undermined the institutional framework or the very strong policies that Mexico continues to have.

Turning to the fiscal and monetary policy mix, we have supported the easing of fiscal policy this year and a neutral stance for next year, but over the medium term, we see the need to continue the fiscal prudence and to make sure that public debt goes down as a share of GDP. Our recommendations on fiscal policy are not so much about what to do with the fiscal stance this year but are rather more like medium- and long-term recommendations. Even if the authorities were to say for next year, for example, that if the economy continues to be weak, they would be willing to accommodate more spending, staff could perhaps support this as long as the authorities had a medium-term plan to increase revenues and put together the recommended enhancements of the fiscal framework.

On monetary policy, it has been data-driven, and we do recommend that it remains data-driven; but it is the case that the ex ante real rate is very high and the headline inflation is on target. Core inflation is indeed high, but the target of the authorities is headline inflation. Both staff and the authorities expect that core inflation will go down over the medium term. The recently released weak GDP data further support the recommendation for further easing. Finally, the US Federal Reserve also has eased monetary policy, so all of these factors together point to the need to continue the easing path.

There was a question about our advice over the medium term. Over the medium term, the advice is that monetary policy moves toward the neutral rate within the next 18 months or so, and fiscal policy remains prudent. With fiscal policy remaining prudent, you can have a slightly looser monetary policy. So, it is in that setting that we recommend the continued easing of monetary policy.

Turning to fiscal policy, there were questions about our differences of views with the authorities. We do agree on the objective of bringing the public-debt-to-GDP ratio down over the medium term, but the current deficit targets only stabilize that ratio; while we advise to be slightly more ambitious. We are not saying to bring the debt-to-GDP ratio down very abruptly in the context of this weak economy, but to do so gradually over time. Thus, I would

not say there is difference in view; it is more the way that we see the fiscal policy over the medium term.

Another area that we have discussed at length with the authorities is tax reform, and this was brought up in the grays statements and this morning's discussion. You have seen in the report that Mexico's non-oil tax revenue is 15 percent of GDP, which is extremely low. What we see is a tension between low revenues and the administration's objectives to increase infrastructure and social spending. Therefore, we see merit in bringing forward the tax reform and we have been discussing that with the authorities. One sticking point in the timeline is that the President has pledged not to do the tax reform before 2022. On our side and on the side of the Ministry of Finance, we are working very closely on the blueprint of the tax reform and there will be a tax policy/technical assistance mission probably early in the next fiscal year.

There was also a question about whether the fiscal framework is still strong. The fiscal framework is indeed strong. However, every country reviews the framework every few years, and makes steps to enhance the fiscal framework. It is in that context that earlier this year we started discussions with the authorities and the Fiscal Affairs Department about the fiscal rule, the countercyclical fiscal buffer, and the fiscal council. This is work that has been in train for some time, and the idea is to make enhancements in the framework.

On the fiscal council, which you may remember has been a longstanding recommendation of the staff, we see now a possibility for progress. We still need to discuss the institutional setup of the council. I think the authorities are of the view that the council should not to be a physically independent fiscal council, but rather be part of Congress. So, we are going to discuss in the coming months different models of setting up a fiscal council, but the authorities do agree with the main objective of the council being a decision-making body and independent in terms of funding. On the fiscal framework, these are indeed some differences in view with the authorities, but the fiscal framework is very strong. What we recommend is some more enhancements.

Let me turn now to a few of the questions that were brought up this morning. On potential growth, back in 2013 when Mexico adopted the very ambitious structural reform plan, everybody was very optimistic about its impact; and our projection of 4 percent potential growth was, in fact, on the low end of the range of projections. What we have seen since then are the following. First, probably this projection was overly optimistic. Moreover,

another important consideration is that many of these reforms, especially in the energy sector, take a long time to materialize and have an impact on growth. And this is excluding the recent cancellation of the auctions. Even before that, it took really a long time for the reforms to materialize, and by the time you see really the output, it would be another five or seven years. That is another factor, and that also relates to the synergies between different reforms and the corruption and governance. Many of these reforms are interlinked with reforms in the financial sector and in the real economy, and governance issues are very much relevant there. That reinforces our recommendation to proceed with the national anti-corruption plan in the coming months and years. Finally, we have to also realize that, especially on governance, effective implementation is much more difficult than the approval of the reform, so that could also take time.

On the revision of growth, these were some reasons that made us revise our potential growth forecast, and, more recently, the revision compared to last year's Article IV was driven by two things. First, the cancellation of the energy auctions, and second, it is the fact that this year is the third year of very weak investment; so persistently very low investment does not bode well for medium-term potential growth.

There was a question on gasoline imports and trade diversion. First, on gasoline imports, this is another of the promises of the new government. The President said they would like to ensure fuel self-sufficiency. In our view, and by talking to many experts, it is much more efficient to import gasoline, i.e., export crude oil and import gasoline from across the border. This is in line with our recommendation to shift investment from downstream to upstream, where Pemex now is making profits, while the downstream is losing money.

Talking about energy sufficiency, a bigger concern of the authorities is the gas dependency, because Mexico depends 100 percent on imports from the US. It is a very cheap source, so this is one other area that the authorities are considering on how to boost gas production.

On trade diversion, we have indeed seen some trade diversion. In our baseline scenario, however, we have not assumed a permanent trade diversion, and we have not done any analysis to see the impact of that. Having said that, anecdotal evidence that we have by talking to the automotive industry, suggests that the main issue is the USMCA and how fast the USMCA will be approved, because as you may recall from last year, the USMCA includes a number of changes in the rules of origin and also in the wage component. So, for the automotive industries, this is the main consideration. Of course, trade

diversion helps in the short-term, but recalibrating the supply chains to the new rules of origin is a more important factor for the auto industry.

Mr. Palei made the following statement:

Indeed, as I said in my previous intervention and as we mentioned in our gray, we are very much in line with staff recommendations for Mexico, specific recommendations, but we still have trouble reconciling the notion of a strong fiscal framework with the facts presented in the body of the report. For example, there is an annex to the report, Annex IV, and that is devoted to fiscal framework. I am reading here that over the past ten years, fiscal deficit was around 4 percent of GDP, and it was OK during the global financial crisis. Then, from 2011-2015, the authorities had to build up fiscal buffers, and they did not do it, so the fiscal framework did not stimulate them to build fiscal buffers. And then, since 2015, the only reason the average fiscal deficit declined to 2.5 were the extraordinary revenues from oil hedging, from Banxico, the transfer of revenues of around 1.5 percent. I read this in paragraph 7 on page 67.

If we understand that over the past 13 years, the authorities complied with the fiscal rules framework only for about 5 years, 5 out of 13 years, then there are certainly issues with the strength of the fiscal framework; and here I think we need to take another look at how we appraise or praise the authorities for their fiscal reforms.

I think there is also a link to the projections of potential GDP. If the authorities believe they can draw at around 4 percent of GDP as the IMF told them four or five years ago, then they can afford somewhat higher fiscal deficit. But if they grow to 2.4 percent annually, then the story is different, and the fiscal challenges are much more severe for the country. So here, for me, the lesson is we should take another look at the effects from structural reforms, and I think in May there will be major discussion on this new structural reforms data set the Fund created. Maybe this would be an appropriate occasion to look back at our advice and our views over the past several years on the effects from structural reforms. When we put this large effect into the baseline forecast, then when we may have a problem. It is too optimistic. I think Mexico is not the only case. I am just raising a broader issue here, but for Mexico we did have this situation with a very optimistic forecast and weaknesses in the fiscal area in particular.

Mr. Saraiva made the following statement:

I beg Mr. Palei, I will disagree with his view on the strength of Mexico's fiscal framework. We need to certainly account for the magnitude of the shocks that the Mexican economy has faced in the past several years, and a less-than-strong fiscal framework would certainly lead to a situation where the public debt would be much higher at this point and probably in a much more difficult situation in terms of managing the economy as a whole. There are improvements to be made. This is the view of the authorities, of staff, but this is a normal process of making a framework that already works, that serves the economy well, to assimilate those important shocks to be preserved and be perfected moving forward.

In this point, I disagree with what staff has just said here. I may be wrong, but when I listened to forward guidance, what I think is some kind of ex ante commitment to a specific path for a substantial long period so that it can impact expectations and anchor it in a way that your normal communication would not do, and I think that the situation in Mexico right now is one in which Banxico has reacted to the conditions of the Mexican economy, to the circumstances in which it has this uncertainty in the external environment, and it has proven that it is loosening the stance, and it should continue to loosen the stance as conditions continue to favor the policy that has been taken by Banxico. So, I just do not see the need for that kind of pre-commitment to a specific path moving forward.

My perception here is that a clear communication and remaining data-dependent will suffice to keep expectations anchored and make the policy stance more accommodative and more in line with the current circumstances but also ready to react to changes that are still can possibly affect the Mexican economy.

The staff representative from the Western Hemisphere Department (Mr. Christou), in response to further questions and comments from Executive Directors, made the following additional statement:

The fiscal framework has over the past few years undergone many changes. At the same time, fiscal policy has been very proactive in terms of responding to challenges, for example, back in 2013 when a very comprehensive tax reform was adopted. In this regard, what we saw in 2015-2016—i.e. the deficit being reduced—is not only due to one-off factors, but it is also because of the dividends to the tax reform. A similar example also back in 2015-2016 was when Pemex was in a difficult financial situation, thus

raising questions about the impact on the budget. At that point, the authorities came out very strongly with a very ambitious reform plan for Pemex, changing the management team, opening the sector as part of the energy reform, and inviting joint ventures. In other words, what we have seen is that the authorities over time have been trying to address many of the fiscal weaknesses. We understand there are still weaknesses, but the question is how to make the fiscal framework stronger, so it is in that direction that our advice is relevant.

Finally, on potential growth, our medium-term estimate is the same with the authorities. The authorities are thinking also in the range of 2 1/2 to 3 percent. So, the whole fiscal and monetary policy mix is calibrated on that basis.

The Acting Chair (Mr. Lipton) made the following statement:

Just to come back on the potential growth — and you correct me if I'm wrong — this is a puzzle, and it is not just about the increase that might have come from reforms. Some years ago, when we thought potential growth was about 3, we thought the reforms might add 0.9 to that. That is how you got close to 4, but now we are below 3, so there is a question about what the return to those reforms were; but there is also a question about why the potential growth slowed apart from the reforms, and I think we have got to be looking at the effectiveness of particular reforms. We need to be looking also at other factors that may have affected potential growth. Mr. Guerra can comment on this. We may be learning that whatever your fiscal framework, whatever your reforms, there may be other matters, whether it is about education, about corruption, about rule of law, and other factors that may undermine growth. It may be about the external environment. It is hard to know. To be fair, we should consider that Mexico's growth situation is a puzzle, but I think it is a more complicated puzzle than just the question about whether those reforms have the effect that we had anticipated. You tell me if that is a fair way to put it.

Mr. Guerra made the following concluding remarks:

Let me thank staff for the very candid report. Also, we thank Directors for their thoughtful comments and recommendations. I will convey them fully to my authorities.

Let me just begin by underscoring the fruitful and constructive relationship that Mexico has with the Fund. Mexico sees in the IMF a trusted

advisor and partner in their objective to secure strong, sustainable, and inclusive growth.

Mexico's strong fundamentals have been crucial to allow the economy to be resilient in a context of heightened external risks. As one of the more open emerging market economies in both trade and financial markets, Mexico will continue to be subject to uncertainty and volatility. In this regard, I would like to underscore the commitment of my Mexican authorities to very strong policies and institutional policy frameworks.

Fiscal discipline in recent years has maintained a stable debt-to-GDP ratio, and improving monetary policy stance has been instrumental in hand with our regional supervisory framework and a flexible exchange rate regime that has served well as a first line of defense. The authorities are mindful that in order to continue to be resilient and withstand shocks, building buffers and securing strong growth is required.

The authorities recognize that the challenge is to secure higher growth. As Mr. Lipton was saying, we have found out that this not only has to do with strong fiscal and monetary policy framework; it has to do also with issues of governance and also the difficulty that Mexico encounters as having a country that is basically riding between the north that has been growing fast and the south part of the country that is growing at a much slower rate. So two comments on the strategy to address the challenge.

The authorities believe that it will be necessary to both increase private and public investment. In this regard, the authorities are working with the private sector on a national infrastructure plan that would over the next five years include around 1,600 projects with a particular emphasis on developing the southeastern part of the country.

The authorities consider that in order to have sustainable growth, it is crucial in the current juncture to address the pervasive social disparities in order to assure that the proven policy framework delivers its objective in a sustainable manner.

On public finances, the recent data at the end of the third quarter of 2019 ratifies the commitment to help the public finances. The primary fiscal surplus remains on track to achieve 1 percent of GDP at the end of 2019, as established in the economic program for 2020. Public expenditure will continue to be guided by principles of austerity and reorienting the budget towards the program aim of reducing inequality.

The government is implementing strategy to stop and revert the fall of Pemex oil production and make its finances sustainable in the short and medium term. For the first time in many years, oil production has stabilized and is expected to increase, with bilateral auction accounting for a third of this increase. Additionally, Pemex recently carried out the largest financial operation in its history to refinance its obligations from 2020 to 2023, substantially alleviating the short-term liquidity pressures and without increasing its total financial debt.

Although there might be a different view on the timing, my authorities agree with staff that it is crucial to revamp the fiscal framework. In this regard, the authorities are working on a new fiscal rule that will have debt-to-GDP as the main anchor. Additionally, low tax revenue even in comparison to peers, points to the need for a fiscal reform. To enhance the fiscal framework, Mexico is engaging and seeks technical assistance from the Fund.

On monetary policy, Mexico will continue to act prudently, follow closely all factors that have an impact on inflation and its outlook, and will take the required actions based on incoming information. While the central bank considers there could be a scope for further easing, my authorities hold the view that caution in policy decisions is required since domestic and external risks remain elevated. Moreover, a sticky core inflation above the target remains a concern.

The authorities are also determined to maintain the flexible exchange rate regime that will continue to serve as a key shock absorber. Foreign exchange interventions will be limited to smooth exit volatility and prevent disorderly market conditions. The Mexican government is also committed to deepening the financial system, increase financial inclusion, while safeguarding financial stability. Also, very important in the current administration, the authorities are directing the social policy to address groups that have been left behind on education, health, and social protection. In this sense, the objective of social programs is to review economic, social, and regional inequalities. A specific priority of this government is boosting participation of women in the labor force.

Mexico will continue to work towards tackling corruption, impunity, and criminality. It is the administration’s strategy, and in the view of the authorities, this issue acts as significant obstacles to growth and productivity.

Finally, on confirmation of my authorities’ commitment. We confirm the authorities’ commitment to pursue a strong transparency policy. Let me

end up, Mr. Chairman, thanking the whole team, with the excellent leadership of the mission chief, Mr. Christou. We thank them for the candid and constructive dialogue and the excellent work during this Article IV consultation.

The Acting Chair (Mr. Lipton). Mexico is an Article VIII member, and no decision is proposed. The 2019 Article IV consultation with Mexico is concluded.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the continued maintenance of a very strong policy framework and policies, which contributed to the resilience of the Mexican economy in the face of elevated uncertainty. Noting these risks and the recent slowdown in growth, they highlighted the need for steadfast implementation of sound macroeconomic policies combined with an acceleration of structural policy reforms to foster strong, sustainable, and inclusive growth.

Directors welcomed the authorities' resolve to maintain fiscal discipline. They stressed, however, that additional measures were needed to reach the announced fiscal targets and that even more ambitious targets were necessary to put the public debt ratio on a downward path. In this context, they underscored the need to increase non-oil tax revenues. They saw scope for, strengthening revenue administration, rationalizing tax expenditures, raising subnational taxes, and making the tax system more progressive, while also enhancing public expenditure efficiency. In this regard, Directors also saw merit in establishing a fiscal council to support the administration's commitment to fiscal responsibility.

Directors urged the authorities to revise Pemex's business plan to strengthen its financial position and reduce risks to the budget. Directors underscored the need for Pemex to make progress in selling non-core assets and provide credible plans to reduce operating costs to strengthen profitability. Increased cooperation with private firms could also bolster production and diversify risks.

While being mindful of risks, Directors saw scope for easing of monetary policy, as long as inflation stays close to the target and inflation expectations remain anchored. They commended the Banco de México's continued efforts in improving its communication strategy, which would help provide greater clarity and effectiveness to monetary policy. They noted that

exchange rate flexibility should remain a key absorber of shocks and that foreign exchange intervention should be limited to incidences of disorderly market conditions.

Directors noted that the financial sector remained sound and emphasized that resilience could be further enhanced by closing gaps in the regulatory and supervisory framework. They welcomed efforts to boost financial sector competition and inclusion and considered that a multi-pronged strategy to further boost competition and inclusion should be a policy priority going forward.

Directors underscored that reinvigorating the structural reform agenda is an imperative to foster strong, sustainable and inclusive growth. They emphasized the need to reduce corruption, labor informality, and enhance the rule of law by strengthening the AML/CFT framework and implementing the National Anti-Corruption System (NACS). Lowering participation barriers for women and removing constraints to trade in services could narrow the gender gap and boost activity. Directors considered that, in general, labor informality could be addressed by reducing entry costs, strengthening enforcement, and replacing hiring and firing restrictions with an unemployment insurance scheme.

It is expected that the next Article IV consultation with Mexico will be held on the standard 12-month cycle.

APPROVAL: May 27, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Could staff further elaborate on whether such trade diversion has taken place and the order of magnitude of potential trade diversion effects in favor of Mexico at the current juncture?***

2. ***Could staff detail the magnitude of trade diversion effects in Mexico compared to its peers in the region?***

- Given the relatively short time since the introduction of U.S. tariffs on Chinese imports, there is a high degree of uncertainty around the extent to which Mexico might have benefited from trade diversion. The presence of such effects, however, seems to be supported by bilateral trade data, model simulations and anecdotal evidence. As indicated in Box 3 of the Staff Report, the introduction of U.S. tariffs in mid-2018 was followed by robust growth of imports from Mexico (even against the backdrop of decelerating manufacturing activity in the U.S.) and a sharp decline in imports from China, especially in 2019:H1. Also, recent model simulations suggest that the overall impact of trade tensions on economic activity in Mexico would be slightly positive in 2019, with a positive direct impact on trade (i.e., trade diversion) partially offset by indirect effects (e.g., confidence). Going forward, model simulations suggest that indirect effects would dominate, resulting in a negative overall impact. Finally, several counterparts of the Article IV mission highlighted the substitution of U.S. imports from China with imports from Mexico as well as growing interest by Chinese companies to relocate part of their production to Mexico in case trade tensions are prolonged.
- Staff has not performed an analysis to compare trade diversion effects across all countries in the region. Mexico's close ties to the U.S. (including its membership in NAFTA), however, would suggest that U.S. import diversion effects (i.e., the substitution of U.S. imports from China) would be stronger in Mexico compared to its peers.

3. ***In this context, could staff provide an estimate of the effect on GDP growth as well as fiscal projections if the USMCA is not ratified by next year as assumed in the baseline scenario?***

- If ratification of the USMCA is delayed beyond 2020, it would prolong the uncertainty and further delay the pick-up in private investment, thereby weakening

the recovery in economic activity. This would have a negative impact on fiscal revenue. Staff has not quantified the impact of such a downside scenario.

4. ***Could staff clarify whether they see any progress on the new trilateral trade agreement (USMCA) which Canada and the U.S. have yet to ratify? Once ratified, to what extent is it going to reduce the downside risks emanating from trade-related uncertainty?***

- The Mexican authorities have been working closely with their U.S. counterparts to address remaining concerns surrounding the new trade agreement, such as the implementation of the new labor laws in Mexico. Ratification of the USMCA will significantly reduce uncertainty regarding North-American trade relations.

Fiscal Policy and Debt Sustainability

5. ***In paragraph 12 of the staff report, staff emphasizes a "notable" fiscal expansion, with the PSBR reaching 2.8 percent of GDP in 2019 from 2.2 percent of GDP in 2018. Is this description appropriate to refer to a fiscal expansion that could be justified amid a complex situation in the world economy, cyclical conditions, and tight monetary policy? Are political economy factors taken into account, given relevant social developments experienced in Latin America? Staff's comments are welcome.***

- The reference to a "notable" fiscal expansion is not a judgment on the appropriateness of the policy action but is a factual statement about the size of the fiscal impulse (0.6 percent of GDP; as shown in Table 3). Staff has supported a PSBR target of 2.5 percent of GDP for 2019 which would also have implied a fiscal expansion relative to 2018, albeit a smaller one. This expansion could be justified based on domestic demand weaknesses, low inflation and still tight monetary policy.

6. ***Can staff elaborate on the reasons for the divergent medium-term debt projections?***

7. ***The staff report underscores that the authorities' medium-term fiscal projections target would keep debt broadly stable at around 55 percent of GDP over the medium term. Still, staff's assessment that there is a gap to achieve this objective is worrisome. Could staff further elaborate on their different views with respect to the authorities' fiscal projections?***

- The gap between staff's and the authorities' projections arises from the following factors: (i) different nominal growth assumptions; (ii) staff does not concur with the authorities' expectations of a significant rebound in oil production given Pemex's business plan; (iii) based on current policies, staff does not concur with the revenue

administration payoffs over the medium term assumed by the authorities; and (iv) staff does not consider that the further sharp reductions in goods and services spending projected by the authorities over the medium-term are desirable, feasible and sustainable.

8. ***We would appreciate staff's comments on the expected yield of the new revenue and expenditure measures envisaged, as well as the timeframe for their implementation.***

9. ***We would appreciate staff's assessment on the feasibility of the authorities' plans to cut spending – including capital expenditure – or take revenue-enhancing measures in the event of shortfalls too.***

- The authorities envisage a tax reform that could deliver about 2 percent of GDP in additional revenues. It would center on rationalizing inefficient and regressive income tax expenditures, broadening the income tax and VAT bases, and evaluating the structure of the income tax brackets and their progressivity. The reform would also revisit fiscal incentives in special economic zones and digital taxation. Revenue administration measures are also contemplated.
- Staff concurs that there is scope to achieve the intended increased in tax revenues. As discussed in the staff report, tax expenditures on VAT and incomes taxes amount to some 3 percent of GDP, many of which are either regressive or not well targeted. Abolishing the gasoline price support could generate an additional 0.2 percent of GDP in revenue. Moreover, property tax revenues in Mexico are some 1.5 percentage points of GDP lower than in regional peers. A comprehensive strategy to strengthen tax administration could further boost tax revenues. There is also scope for strengthening expenditure efficiency with significant potential for savings (partly quantified in the selected issues paper).

10. ***On spending cuts, the concerns of staff on their sustainability may be warranted, but they could also be read as decisive policy choices. We would welcome staff's elaboration on these matters.***

- Staff welcomes the authorities' continued commitment to fiscal prudence and efforts to adhere to the fiscal targets. Nevertheless, as outlined in the selected issues paper, sizable and durable expenditure savings can best be achieved by reforms and efficiency improvements while safeguarding social objectives as a policy choice. At the same time, Mexico's tax revenue as a share of GDP is very low compared to both regional and emerging market peers. Staff, thus, sees significant scope for increasing tax revenues to bolster fiscal space and deliver on social objectives, while caution should be exerted in seeking additional expenditure cuts in areas that are detrimental to long-term growth. That said, staff does see scope for targeted improvements in

expenditure efficiency in some areas including social protection (see selected issues paper).

11. ***We would be concerned if efficiency measures jeopardized the ability of regulatory agencies and autonomous institutions to fulfil their mandates. Could staff expand on the concerns raised in this area?***

- Staff has no evidence at this stage that the administration's efficiency measures jeopardize the ability of regulatory agencies and autonomous institutions to fulfill their mandates. Nevertheless, the budget cuts for many important agencies (e.g., the judicial branch, the hydrocarbons commission, and the competition authority) have been significant, while wage cuts for staff in managerial positions have reportedly made it difficult to retain highly trained staff in specialized agencies. Staff thus sees reason for caution and to closely monitor whether the cuts may have unintended or larger-than-expected effects.

12. ***Can staff explain as to what extent the fiscal consolidation achieved by way of cutting back on productive public investment vis-à-vis other factors may have contributed to the current slowdown of overall investment activity in the economy?***

- Staff is concerned about the fall in public investment in recent years considering that productivity in the Mexican economy has yet to fully break with its decades-long declining trend. To the extent that public investment, for example in road infrastructure, can have important synergies in incentivizing private investment, it is conceivable that even private investment was held back by the decline in public investment. That said, staff has not done any analytical work to support this hypothesis.

13. ***We would therefore appreciate staff's further elaboration on the pros and cons of revoking the fuel subsidies, including from a political-economy angle, and whether the most vulnerable will be protected.***

- The current formula guarantees that retail fuel price growth will not exceed CPI inflation in cumulative terms from November 30, 2018. The gasoline excise tax is reduced as needed to achieve this objective on any given day. Staff is of the view that supporting fuel prices is likely to disproportionately benefit the rich who tend to consume larger quantities of fuel. Abolishing the practice, while increasing targeted benefits to the poor, would thus be a better use of scarce fiscal resources in supporting the poor. A well-conceived strategy of abolishing fuel price support, complemented by good communication, would go a long way in engendering political and public support.

14. ***We also note the difference in views on reformulating Pemex's business plan. Staff's comments are welcome on this and the implications on the government budget.***

- The new business plan limits cooperation with private firms in Pemex's upstream business to service contracts, envisages investing heavily in its downstream business, does not focus on selling non-core assets, and lacks credible measures to reduce operating and legacy costs. Staff considers that these decisions are problematic given that Pemex's downstream business is not profitable and that, in the absence of higher private participation, cost-cutting measures or asset sales, the burden of supporting the company falls squarely on the government. Support, both in the form of capital injections and tax reductions this year has already been sizable, and additional support may be needed in the coming years (Box 2).

15. ***Could staff provide some elements to define a strategy to balance fiscal sustainability, ensure a Pemex balance sheet adjustment while limiting the detrimental impact on public capital, education and health spending?***

- Elements of such a strategy would include focusing Pemex's resources on its profitable upstream business and ensuring that the company has enough resources to service its debt and invest in exploration and extraction activities. To safeguard the government from bearing the full burden of supporting Pemex's balance sheet, staff would recommend expanding cooperation with the private sector in Pemex's upstream business, cutting operating and legacy costs, selling non-core assets and limiting investment in the company's loss-making downstream business.

16. ***Staff's characterization of the fiscal framework as being very strong in the executive summary and the concluding appraisal, in our opinion, contradicts the in-depth analysis in the main text of the report and in the SIP. Staff's comments would be appreciated.***

- Staff believes that Mexico's fiscal framework is strong but sees room for improvements in certain areas in line with the evolving evidence on international best practice (see 2018 SDN on Second Generation Fiscal Rules). Periodic reviews of fiscal frameworks are common across countries and are advised. In this context, staff considers that any changes to the current framework should be based on a holistic and in-depth analysis, coupled with extensive consultations with all stakeholders.

Monetary, Exchange Rate, and Financial Sector Policies

17. ***We would appreciate staff's comment on the factors behind the persistently high core inflation and its implications for monetary policy.***

- Mexico's persistently high core inflation is not easy to explain in the current environment of low aggregate demand. Staff considers increasing wage growth likely played an important role while lingering pass-through effects from past energy price increases to core may be part of the explanation as well. Weak economic activity and a widening output gap should have a delayed moderating impact going forward.

18. ***Could staff detail its core inflation's forecast and its components?***

- Staff projects core inflation to gradually decline and reach the 3-percent headline inflation target in 2020. This decline would be supported by the delayed impact of weak economic activity and the dissipation of past shocks affecting core components.

19. ***Can staff further elaborate on the timing of their recommended monetary easing? We note indeed that commercial bank credit growth to the non-financial corporate sector has slowed over the past year but remains healthy at 9 percent y-o-y in August, while consumer credit growth has remained stable at 7.2 percent.***

- Staff considers that monetary policy is currently very tight given headline inflation is at the target, the ex-ante real rate of almost 5 percent far exceeds the neutral rate of 2.0-2.5 percent, and the output gap is negative. In this environment, staff believes that the authorities can continue easing as long as inflation expectations remain stable.

20. ***Regarding the staff's recommendation for strong forward guidance to further enhance the efficiency of monetary policy transmission, we note the authorities' view that the country's complex risk environment is a constraint on engaging in such forward guidance. We would appreciate staff elaboration on this issue.***

- Staff sees value in forward guidance as it can provide a guidepost for the expected path of interest rates. Staff has also heard from various financial market interlocutors that the absence of such guidance is a problem in financial decision making. Staff concurs that forward guidance is more challenging in an economy facing significant external and domestic risks but would highlight that such guidance is not meant to predetermine a path for policy but rather to explain how future policy decisions are likely to be taken, taking into account whether or not risks materialize.

21. ***We would be interested to hear from staff where views differ with the authorities regarding the integration of prudential supervision under one authority.***

22. ***We would appreciate further details from staff on any observed deficiencies/issues with the current governance structure for prudential supervision to justify the need to merge regulators.***

- In the context of Mexico's increasingly complex financial sector and the dominant role played by large financial conglomerates, a integrating the different supervisory authorities under one authority would be more effective in ensuring the soundness of the financial system and mitigating risks. Staff's view is that an integrated supervisor would be able to pool the expertise needed to supervise a rapidly evolving and more complex financial system, carry out effective consolidated supervision as barriers to information sharing and cooperation from different line supervisors come down, and could limit regulatory arbitrage.
- An integrated and more independent supervisor should also have more influence in implementing policies and be able to make better contributions to the financial stability assessment and macroprudential policy setting within the Financial System Stability Council (CESF). Additionally, the multiplicity of communication channels could affect the clarity of the message. For example, there is considerable overlap between the CESF Annual Report and reports published by its members (e.g. Banxico and CNBV). Please note that this policy advice is in line with 2016 FSAP recommendations.
- The authorities noted that the current governance structure can be complex and cumbersome at times, but it has worked well and did not see the need to merge regulators at this point.

23. ***Do staff see benefits from increasing foreign exchange reserves in Mexico? Would it be helpful for the authorities' exit strategy from the FCL?***

- Staff considers Mexico's reserves as being adequate. Reserves would also remain adequate in staff's projections over the medium-term. The FCL provides an important complementary buffer.

Structural Reforms

24. ***Does staff have more specific recommendations to the authorities to bolster their anti-corruption agenda?***

- Staff considers that, while the legal anti-corruption framework is generally in place, there is a need to focus on effective implementation. Paragraph 31a of the staff report contains an ambitious list of specific anti-corruption measures, designed to improve the effectiveness of Mexico's anti-corruption system. The main focus of these measures is on effective implementation through domestic cooperation, creating inter-agency peer pressure and accountability, ensuring that sufficient resources are available, and improved follow-up to FIU disseminations. Other measures relate to transparency of beneficial ownership and criminal liability for legal persons.
- Reference is also made to the need to implement the recommendations from the recent AML/CFT assessment. The staff report indeed does not provide further detail on AML/CFT recommendations, but these can also be beneficial for combatting corruption, notably because corruption is one of the main risks for money laundering in Mexico. For example, the key findings of the assessment report note the need to prioritize ML investigations, improve customer due diligence measures (also in relation to politically-exposed-persons), improve supervision of financial institutions and other businesses as well as financial institution's risk understanding, and an improved framework for international cooperation.

25. ***Could staff elaborate on how the Fund supports the authorities' efforts to address corruption problems in Mexico? What would be growth effects if the authorities were able to improve the quality of governance, as well as the country's perceptions of corruption?***

- Staff has allocated significant resources to background work on corruption-related issues since the 2017 Article IV consultation, including by bringing a corruption and AML/CFT expert along on each of the Article IV missions since then. The Fund has also taken the lead in the recent FATF assessment.
- Staff has not made a quantitative assessment of the growth effects of improving the quality of governance in general, which would be challenging. However, as noted in the 2017 staff report, based on estimates in the literature, a reduction in the perception of corruption could have very large economic effects. Ugur and Dasgupta (2011) find that a one-unit improvement in the perceived corruption index is associated with an increase of 0.59-0.86 percentage point in per capita GDP growth.

26. ***Reforms to address informality, security, corruption, and the rule of law are needed to increase productivity and ensure more inclusive growth. In this context, could staff elaborate on whether the "Pacto por México" remains valid?***

- The “Pacto por México” was an agreement signed in late 2012 to promote political cooperation on structural reforms between the main political parties. Many of the reforms agreed haven been or are being implemented. However, the new government has halted the implementation of the energy reform, while the education reform was canceled and replaced with revised legislation (including to abolish “punitive” teacher evaluations). At the same time, the authorities have moved forward in implementing the labor reforms.