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Statement by Mr. Guerra and Ms. Arevalo Arroyo on Mexico
Executive Board Meeting
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We thank staff for their comprehensive analysis and frank policy dialogue with our Mexican authorities. We appreciate their hard work under difficult and challenging circumstances.

The world economy has been gravely affected by the COVID-19 pandemic, and Mexico is not the exception. Continuing their commitment to a very strong policy framework, the authorities have put in place a timely and comprehensive response to the pandemic. A focused, effective strategy was implemented to tackle the health emergency: first, increasing hospital capacity and boosting medical resources; and second, mitigating the economic impact on the most vulnerable households, workers, and firms. In addition, liquidity to the financial sector was provided to set the basis for a safe reopening of activity and support the recovery.

Contagion cases and deaths had dropped until recently, while utilization of hospital capacity has steadily decreased. A gradual reopening of sectors and regions is underway, prioritizing sectors with low risk of contagion and those linked to the North American value chain. Although still pointing to a severe contraction of the economy this year, growth projections by staff and private analysts have recently been revised upwards for this year and 2021. High-frequency data reaffirms that economic recovery is on track, with higher debit card usage, electricity demand, and gasoline sales. In August, manufacturing production reached 94 percent of February levels while exports reached 97 percent. The latest figures show that, of the 12 million workers that exited the labor market in April, 8.4 million have already returned in September.

Despite the slight signs of improvement, the authorities recognize that external risks and the uncertainty regarding the pandemic's path and duration remain high. As this could result in additional shutdowns affecting the economic recovery, it is critical to continue a cautious and resilient policy strategy. The prudent approach to date, will enable the authorities to react with additional support measures if there is a second wave of the pandemic or the recovery takes longer than expected.

The response to the pandemic

The COVID-19 pandemic affected Mexico with a lag. This allowed the country to increase healthcare infrastructure to address the emergency and to put in place preventive measures to protect the most vulnerable population:

1) **Timely and adequate increase in healthcare capacity**: Ensuring adequate hospital capacity in all states. Given a possible second COVID-19 wave, enlarged hospital infrastructure and human resources will remain in place.
2) **Protection to the most vulnerable, households and small firms:** Upfront payments of unconditional cash transfers programs to ensure that the most vulnerable have enough resources to face the contingency. Housing credits, personal loans to government workers at a low rate, credit deferral programs, and loans to formal workers and recently laid-off workers. Micro-loans to both formal and informal small firms.
3) **Maintaining infrastructure expenditure to support the economic recovery**: Additional resources redirected to social spending related to infrastructure, security, education, among other areas. Flagship infrastructure projects like the Maya Train and the Istmo Corridor, aimed at reducing regional disparities, continue.
4) **Comprehensive agenda of policy measures to secure access to credit and financial stability:** The authorities issued temporary exceptional accounting standards allowing credit providers to defer loans for 4 or 6 months, with almost 9 million restructured credits. The Central Bank set up a wide array of measures to secure liquidity in financial markets. Development banks have implemented guarantee programs for small and medium firms in the services sector, the most affected by the recession.
5) **The focus is now on ensuring broad access to vaccination:** Mexico, as a participant of the COVAX initiative and other international strategies, is committed to multilateral efforts to secure worldwide equitable access to a vaccine that is secure and proves effective in the fight against COVID-19. Alongside the multilateral response, Mexico has undertaken measures to ensure broad access to the vaccine for its population in a timely manner.

The fiscal measures are estimated to amount to 0.7 percent of GDP and below-the-line measures at about 1.1 percent of GDP, in addition to the Central Bank's support to financial markets of 3.5 percent of GDP. The authorities believe that staff's comparisons and evaluation regarding the adequacy of the response to the pandemic should be carefully communicated and would benefit from further analysis that sheds light on the effectiveness of the policy measures. In particular, these comparisons should consider the state of the health system in each country and the specific type of expenditure response needed at each point in time. Also, given the very distinct nature of the economic disruption during a pandemic, economic models may have limited use in assessing the optimal size of a broad fiscal impulse given the uncertainty in effectiveness of the fiscal multipliers. This is particularly important in emerging and developing economies, where policy space should be used prudently, focally and be evaluated with a medium-term perspective given the unprecedented global uncertainty regarding the path of the pandemic and the relatively small fiscal space available. Moreover, while Advanced Economies have been the benchmark in terms of fiscal support during the current episode, emerging and developing countries encounter a significantly different set of constraints, including higher interest rates, and their response cannot thus be evaluated in the same way. Finally, the authorities consider that pre-existing social programs (e.g. cash transfer programs, among others) – which will remain going forward – should also be included as part of the COVID-19 response, as they have been instrumental in addressing the pandemic effects on the most vulnerable population.

Fiscal Policy

The authorities are committed to a very strong fiscal policy framework. This includes limiting debt issuance, consistent with Mexico's legal framework and fiscal rules to not compromise future generations' resources and maintain the limited fiscal space to continue carrying out a strong social policy agenda to fight poverty effectively and durably. The main elements of the current fiscal strategy in the context of the pandemic are:

1) Balance short-term needs with medium-term growth and fiscal sustainability objectives.
2) Reallocate public spending strategically to the health sector.
3) Use of fiscal buffers and idle balances at the Treasury designed to alleviate economic distress during crises.
4) Continue to implement a comprehensive agenda to address tax avoidance and evasion.

Since the beginning of the current administration, the authorities have emphasized the importance of developing a more progressive, efficient and robust tax structure, which would help the country secure a more stable source of income and allow for a more adequate level of expenditure on infrastructure and social protection, among other key elements for medium-term growth. A tax reform focused on collection efficiency on different fronts can deliver up to 3.5 percent of GDP in additional revenue. For instance, permanent measures to fight tax avoidance and tax evasion implemented since end-2018 have been effective, with increased tax collection from big firms. Despite the economic downturn caused by COVID-19, tax revenues have remained strong, decreasing only 0.5 percent annually in the period from January-August 2020. The authorities do not concur with a strategy to announce a tax increase during the COVID-19 pandemic as they believe it would not have the political or social support and could be detrimental to the fiscal reform agenda. In contrast, the authorities agree that to ensure adequate fiscal resources in the medium-term to support the strong social agenda, a comprehensive fiscal reform should be put in place once the pandemic has abated. In this regard, they will continue the policy dialogue with the IMF and technical assistance on these matters in due time.

Lastly, the authorities expect a deficit in the public balance of 2.9 percent of GDP in 2020 (4.7 percent of GDP in the PSBR definition) and 2.9 percent of GDP in 2021 (including a primary balance equilibrium in 2021). The fiscal strategy will be adjusted as needed to respond with additional public support contingent on the pandemic's path. Regarding the additional fiscal impulse of 2.5 – 3.5 percent of GDP proposed by staff, the authorities have a different view of this course of action given the high uncertainty. A prudent and robust fiscal and monetary policy framework is best suited to address these challenging times.

Monetary Policy

Banco de Mexico has responded swiftly yet prudently to the COVID-19 shock. The pandemic has posed wide-ranging challenges for monetary policy which include a significant impact on economic activity, the shock to the financial sector and their effects on inflation. A prudent and gradual approach has provided the Central Bank with optionality in light of these factors.

Monetary policy has been eased significantly since mid-2019, with rate cuts representing 400 basis points. Since March, Banco de Mexico has reduced the reference rate by 275 basis points, bringing the policy rate down to 4.25 percent. Regarding inflation dynamics, annual headline inflation rose from 2.15 percent to 4.01 percent between April and September 2020 due to increases in both its core and non-core components. Headline

inflation expectations for the end of 2020 rose while those for the medium and long term remained at levels above the 3 percent target. This contrasts with the negative inflation gap prevailing in most G20 countries. In this regard, the authorities emphasize they have eased monetary policy significantly despite the evident tradeoffs given the evolution of inflation in the past several months.

Due to the severe weakening of financial conditions, Banco de Mexico acted to foster the necessary conditions for the financial markets to adjust in an orderly manner. Under these circumstances, the central bank announced several policy measures to improve FX's liquidity conditions, money, and fixed income markets. Once the liquidity conditions were ensured and regained some degree of stability, Banco de Mexico undertook a second objective by announcing more measures and facilities to improve the fixed-income markets trading conditions. Additionally, these actions helped the banking sector reduce their portfolios' risk and gave more certainty to local and foreign investors. Finally, the third action axis focused on announcing additional measures to directly improve credit flow through the liquidity provision to households and small and medium enterprises. Since March, market conditions have improved substantially and become more stable, which may be the principal reason behind the lower use of these facilities.

Mexico's capital markets are open and highly integrated into the global economy. Thus, monetary policy needs to be mindful of the different factors that influence capital flows and investors confidence, in addition to cyclical considerations. This becomes more relevant given that the peso is a fully convertible currency widely traded in global markets and the fact that non-resident investors play a key role in the local government debt market. Moreover, although global risk appetite has improved, EMs have shown a marked heterogeneity in terms of FX depreciation and risk premia associated with their macroeconomic strength and resilience. The authorities underscore the benefits of their cautious approach in providing essential support and predictability to markets, which has allowed for a more orderly adjustment relative to other EMs. The flexible exchange rate has served Mexico well and will continue to be a shock absorber to external developments. The authorities will continue to ensure that FX adjustments occur in an orderly manner, thus avoiding undesirable impacts on the price formation process. Adequate international reserves, the Flexible Credit Line, and the Federal Reserve's swap line represent instrumental buffers for external shocks.

While the authorities acknowledge that, in due time, a review of the monetary policy framework could provide useful insights, they underscore that careful consideration should be given to the distinct circumstances AEs and EMEs face and the rationale underlying such assessments. Recent reviews of major central banks have been driven by the specific challenges faced by AEs related to the effective lower bound and inflation expectations being persistently below their targets. These factors are not present in EMEs, including Mexico. It should be highlighted that the Inflation-Forecast Strategy has worked well for EMEs. Moreover, the use of unconventional monetary policies (UMP) in emerging economies deserves broad and detailed reflection. UMP cannot be prescribed as an over the counter medicine for all, but it rather has to be a patient-dependent measure.

Going forward, the Central Bank will take the necessary actions based on incoming information and considering the large impact on economic activity as well as the evolution of the financial shock and their effects on inflation, so that the policy rate is consistent with the orderly and sustained convergence of headline inflation to Banco de Mexico’s target within the time frame in which monetary policy operates.

Financial stability and financial inclusion

The Mexican financial sector has proved resilient to the economic shocks coming from the pandemic. Prior efforts, such as the implementation of the Basel III framework and the close monitoring of potential risks, have been instrumental in this regard. In addition to the temporary exceptional accounting standards to defer loans, the authorities have delayed enacting several regulatory measures until financial and economic conditions improve. In the short run, supervisory authorities and the central bank are working on a proposal to complete implementation of international standards on large exposures in line with the Basel III framework. While capital ratios and the credit portfolio's health have been resilient, the authorities recognize that risks are increasing. The Council for the Stability of the Financial System will continue to monitor any potential risks in the financial sector closely and conduct stress tests on banks and brokerage firms.

The authorities will continue their efforts to deepen financial inclusion as one of the pillars in their growth strategy, taking advantage of the recently approved Financial Inclusion Policy and the Financial Literacy Strategy. In urban centers, the approach is to focus on digital banking and fintech. A more traditional plan, using brick and mortar financial institutions, is being implemented in rural areas while simultaneously increasing connectivity in the most remote areas through the state electricity company. The new free-of-charge and secure online payment transfer system (CoDi) now has more than 5 million users since its launch one year ago.

Social policies, structural reforms, and investment to increase growth

Since the beginning of this administration, and before the pandemic hit, the government's main efforts have been directed to reprioritize public spending and promote inclusive growth with a strong focus on strengthening the social safety net and reducing inequality. Social policy has centered on unconditional cash transfer programs, with support to the elderly, people with disabilities, and scholarships for children and the youth. These programs have been crucial during the pandemic to alleviate the needs of the most vulnerable population and support consumption. Additionally, a wide range of social programs have been implemented in the past years, including paid internship programs for the young to build capacities, support to small agroforest producers, microcredit for small entrepreneurs, and aid for reconstruction programs in areas affected by natural disasters, among many others. The authorities are also implementing measures to increase gender participation in the labor market and started a program to increase girls' interest in STEM. Moreover, in line with its firm commitment to advance sustainable development and the 2030 Agenda, Mexico became the first country in the world to issue a sustainable sovereign bond linked to the Sustainable Development Goals (SDGs) in September 2020.

This year, access to a universal pension was introduced in the Mexican constitution, and reform to the pension system is currently under discussion in Congress. The aim is to improve workers' pensions by gradually increasing the contribution rate from 6.5 percent to 15 percent. Furthermore, the reform contemplates a reduction in the number of contributed weeks required to be eligible for a full pension – from 1,250 to 750 – to address high informality levels. In the long run, this reform will be reflected in net savings to public finances. Pension Fund Savings are expected to increase from 19 to 40 percent of GDP during 2020-2029, which will help support investment. The authorities are also evaluating complementary reforms to tackle informality holistically.

The government is closely working with the private sector to boost private investment in infrastructure through the *Economic Recovery Agreement*. On October 5, the first set of 39 infrastructure projects was announced.

These new projects, with at least 50 percent of private sector participation, represent an investment of 297.3 bn pesos and will create around 190 thousand jobs next year. Of these, five energy-related projects amount to an investment of around 100 bn pesos.

The ratification of the USMCA will further strengthen Mexico's trade ties with the US and Canada, giving long-term confidence to investors in times of trade uncertainty.

The authorities regard PEMEX as a strategic asset of the nation. In 2019, the company contributed approximately 720 bn pesos in revenues to the federal government (about 18 percent of total revenue), from hydrocarbons extraction licenses and fuels sales taxes, among other contributions. The company is profitable – its EBITDA was around 20 percent in the first half of 2020. The government is working on a permanent and sustainable way to reduce the company's historical tax burden (decreased already from 65 to 54 percent), as well as to bring down its high debt burden, which doubled between 2014 and 2018 lacking a boost in productive investment. The measures to date allowed the company to stabilize its production in 2019, after steadily decreasing between 2004 and 2018. In the first week of October 2020, PEMEX issued a five-year 1.5 bn USD bond more than 6 times oversubscribed.

Fight against corruption and AML/CFT reforms and transparency

The authorities agree with staff on the need to focus on implementing the anti-corruption and AML/CFT frameworks and ensuring timely adoption of pending legal reforms. They also recognize the importance of approving additional reforms to enhance law enforcement overall performance (e.g., broaden some competencies of the specialized anti-corruption prosecutor and increase the range of sanctions). For instance, corruption is now typified as a serious felony. These efforts have already been reflected on Mexico's improvement in assessing international and domestic corruption perception indexes. Last, but not least, the authorities reaffirm their full commitment to transparency and good governance practices.