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October 29, 2020

Statement by Mr. Merk and Mr. Buetzer on Mexico
(Preliminary)
Executive Board Meeting
November 2, 2020

We thank staff for the informative set of reports and Mr. Guerra and Ms. Arevalo Aroyo for their helpful Buff statement. Notwithstanding generally strong policy frameworks, Mexico entered the crisis against the backdrop of an already stagnating economy and policy uncertainty that led to lower investments. Since then, the Covid-19 pandemic has intensified short- and medium-term policy challenges, exacerbated by some loss of reform momentum before the crisis. As staff highlights, and starting already before the current crisis*,* the Mexican economy is experiencing setbacks in terms of growth, employment, and poverty that will likely take several years to recover from without a reinvigoration of structural reforms to boost investment and potential growth.

Against this background, we see some merit in staff's advice to implement a comprehensive package of macroeconomic policies and structural reforms:

In particular, we agree with staff that a well-designed tax reform would help increase medium-term government revenue, which currently lags behind regional peers. In doing so, special attention could be paid to broadening the tax base and adjusting the formula for the gasoline excise tax. That said, we welcome the plans of the authorities to increase the efficiency of the tax system and to address tax evasion and avoidance as outlined in the Buff statement.

Improving social protection for the poor to cushion the social costs of the current crisis and limit inefficiencies in the social system could also be an important building block for a broad-based recovery. We take positive note of the steps that the authorities are taking to this end as described in the Buff statement.

Moreover, as staff outlines, Mexico's large informal sector constitutes a structural impediment to growth and a straining factor for the pension system. Creating incentives for employers and workers alike to increase the share of formal working relations would thus be an important improvement.

Finally, increasing the profitability and debt sustainability of Pemex by refocussing the business model and selling non-core assets could be an important element of a wider push to improve the quality of public investment and to enhance productivity growth over the medium term.

Given the different phasing/time horizons of the envisaged reforms, could staff comment on the risks of incomplete implementation of the proposed comprehensive package, including in terms of foreign investor confidence?

Turning to macroeconomic policies, in light of the very uncertain economic environment (including volatility in financing conditions earlier this year), we would come to a less critical assessment than staff regarding the short-term monetary policy response by the authorities. Monetary conditions have already been eased considerably, as the policy rate was lowered by 400 bps since mid-2019 and the authorities provided additional liquidity support to the financial sector. Moreover, the flexible exchange rate has acted as an important shock absorber, although monetary policy should remain vigilant regarding attendant pressures from import prices. As the Buff statement notes, headline and core inflation have increased sharply over the last months and are at the upper bound of the 2-4 percent inflation range, although it is difficult to gauge whether and how quickly these pressures may abate due to weak demand.

In contrast, we do see room for a more active role in response to the crisis. In particular, given the extraordinary magnitude of the crisis, the use of existing fiscal space would appear appropriate to support the Mexican economy through targeted measures as also suggested by staff. At the same time, we broadly acknowledge the authorities' arguments in favour of a cautious approach as uncertainty remains high. In this context, we note that borrowing costs initially increased for Mexico early in the crisis, although spreads have since come down considerably. Elevated uncertainty is also reflected in the country's sovereign risk rating.

Going forward - and especially in the case of downside risks materializing over the coming months - we would encourage the authorities to identify options for targeted fiscal measures in direct response to Covid-19. Credible plans to anchor fiscal sustainability over the medium term through structural and tax reforms should accompany these measures. Generally speaking, given continued high uncertainty and the importance of providing predictability to markets, an overall balanced fiscal and monetary policy mix should be pursued.

We note staff's assessment that the external position in 2019 was broadly in line with the level implied by medium-term fundamentals and desirable policies. Moreover, we take positive note that gross reserves are set to improve against all external vulnerability indicators in 2020. This highlights the resilience of Mexico's external position and the key role of the flexible exchange rate as a shock absorber. As significant risks and uncertainties prevail, we welcome the authorities' intent to remain mindful of factors that influence capital flows and investors' confidence in the context of a widely traded currency and the country's close integration in the global economy.

Regarding the financial sector, we broadly share staff's assessment, including on the need to closely monitor risks in the banking sector. Specifically, the high level of private debt of households and smaller companies that is held by domestic smaller and medium-sized banks might become an issue of concern if the economy weakens further.

We take note of the issuance of a sustainable sovereign bond by Mexico linked to the UN Sustainable Development Goals. *In this context, we were wondering how this squares with the authorities' decision to reverse energy reforms, favouring public "brown" energy providers over private "green" ones according to staff (cf. para. 12, 17). Furthermore, given that the national oil company's ability to access external bond markets has been impaired so far in 2020, we wonder how staff assesses the funding strategy of Pemex going forward?*

We encourage the authorities to continue to strengthen governance, transparency and AML/CFT frameworks and look forward to a swift implementation of reforms and a timely adoption of pending legal reforms in this regard.