GRAY/20/3219

October 29, 2020

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

1. We thank the staff for their analytical report and Mr. Guerra and Ms. Arevalo Arroyo for their insightful Buff statement.

2. **We note with concern that the Mexican economy experienced a large contraction in the GDP growth (-)19 percent in Q2:2019, among the worst declines in the G20 countries as the labor markets were dislocated due to high stringency of lockdowns**. Though the stringency index still remains relatively high, it is encouraging to note from the high-frequency data that economic recovery is taking hold as the lockdown measures have been gradually eased. This is reflected in higher debit card usage, electricity demand, and gasoline sales, and manufacturing production and exports climbing up to reach close to the pre-Covid-19 period. Authorities' focus on health care and the implementation of social safety nets has helped minimize the adverse impact on society.

3. The staff report has strongly argued that Mexico needs a "Twist" in its response to Covid-19 and that the macroeconomic policy response so far has been very conservative. The fiscal measures estimated at 0.7 percent of GDP and below-the-line measures about 1.1 percent of GDP, seem to be much lower vis-à-vis EME peers. We would like to understand whether the current fiscal stimulus is adequate to protect the economy which is expected to contract by 9 percent in 2020. The staff pitches for enhancing near-term fiscal support by 2.5 to 3.5 percent of GDP. **In our view, given the moderate level of structural fiscal deficit for 2020 and 2021, and a general government primary surplus projected for 2021, authorities should consider revisiting the fiscal stance.** The fiscal policy stimulus may be seen in the context of the assessment of the staff that large numbers of workers have left the workforce or become underemployed or unemployed, mostly in the informal sector with no safety net. The problem is more severe because of the spike in absolute poverty. **We would also like the staff to examine the authorities' concern about the difficulty in assessing the optimal size of a broad fiscal impulse given the uncertainty in the effectiveness of the fiscal multipliers due to the pandemic.**

4. On tax reforms, though we fully concur with the staff's advice on undertaking tax reforms, we are sympathetic with the authorities' concerns that a strategy to announce a tax increase during the COVID-19 pandemic would not have the political or social support and could be detrimental to the fiscal reform agenda and may also undermine the recovery effort. **However, once the pandemic is behind us, a relatively low tax-GDP ratio compared to its peers, provides the country scope to augment tax revenues and simultaneously enhance productive public spending.** We agree with the staff assessment that revenue administration could be strengthened by adopting a comprehensive strategy to tackle VAT non-compliance in the light of the observation that fundamental reforms to reduce policy and compliance gaps could increase revenues by at least 2 percent of GDP. We also appreciate the reassurance acknowledged in the Buff statement that authorities are pushing forward permanent measures to fight tax avoidance and tax evasion.

5. High level of informality is a characteristic of the EMDEs. Similar to other EMEs, Mexico also has an informal workforce comprising 55-60 percent of the total workforce, with a lack of formal ties with social safety nets and limited access to the formal financial system. In light of these facts, as argued by the staff report, **the coverage of social safety nets can be increased by temporarily relaxing eligibility criteria of existing programs and extending the safety net to informal workers in hard-hit sectors.**

6. **Over the medium-term, another equally important challenge is the policy choice of maintaining a balance between stabilizing the debt-GDP ratio on a downward path and preserving the quality of public spending.** While we welcome the authorities' medium-term fiscal targets, which will keep the debt-GDP ratio contained, a more pointed concern raised by the staff is the disruptive expenditure cuts to narrow the fiscal gaps, which could undermine the quality of public services.

7. The staff has argued that the monetary policy rate remains above the trough reached in the previous easing cycle, despite growth being the weakest in decades and with a very sizable output gap that is projected to persist. Nevertheless, we appreciate the concern of the authorities that monetary policy also needs to be mindful of the different factors that influence capital flows and investors' confidence, in addition to cyclical considerations given Mexico's capital markets openness and high integration into the global economy. **We also believe that renewed volatility in global financial markets and rising risk of a sharp pullback of capital from EMEs as portfolio rebalancing takes place, remain the biggest tail risks for Mexico as well. This is more so due to higher financial account openness and a high share of non-resident holdings of government debt.**