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October 29, 2020

Statement by Mr. Rosen, Ms. Shortino, and Ms. Robitaille on Mexico
(Preliminary)
Executive Board Meeting
November 2, 2020

The COVID-19 pandemic has taken a heavy toll on Mexico in terms of both the human suffering from the virus and the steep decline in economic activity. Indeed, staff project that Mexican real GDP will decline 9 percent this year, one of the steepest declines in activity among emerging market economies. **At the same time, measures taken by the authorities in advance of and during the crisis represent a deterioration in the policy framework and pose risks for Mexico's sound fundamentals. Amid this backdrop, we agree with staff's view that it would be appropriate to provide more aggressive fiscal stimulus, particularly if the crisis persists, in combination with a strong commitment to increase tax revenues in the future. We also agree that now is the time to take advantage of potential gains from the recent U.S. Mexico-Canada Agreement (USMCA).** We thank staff for a well-written report and illuminating review of the Mexican economy, and we particularly welcome the candid views on the authorities' COVID response.

The crisis came at a time when economic growth was already weak, with GDP essentially stagnating last year and investment falling sharply. A key factor weighing on activity, as staff note, is the high degree of policy uncertainty. **Investment will be critical to Mexico's economic recovery, and we urge the authorities to take steps to foster a policy environment that is conducive to private investment. In that regard, we view with deep concern the measures taken by the authorities to reverse the 2013 energy reform.** *Can staff comment on the extent to which canceling private investment projects, specifically in the energy sector, may have dampened growth prospects? To what extent does uncertainty limit Mexico's ability to exploit its comparative advantage in global trade?*

<u>Energy</u>. Staff's analysis suggests that the outlook for the energy sector is increasingly worrisome, as Pemex will continue to be constrained from concentrating on areas in which it performs best because it is required to meet social and energy self-sufficiency goals. One consequence of these actions is that Pemex will remain a fiscal burden on the sovereign.

Pemex recently returned to global international debt markets but paid a very high interest rate on the debt issue (nearly 7 percent), well over the cost of borrowing by the sovereign. Its CDS premium has also been well over that of the sovereign over the past few years. *Is this not persistently high cost of borrowing the clearest sign that investors remain skeptical about the creditworthiness of Pemex and about whether the sovereign can indefinitely support Pemex?*

Fiscal policy and debt management. The jump in the number of Mexicans in poverty has erased years of hard-won improvements in economic wellbeing, and the labor market and broader scarring effects of the crisis could further trap Mexicans in poverty. Yet, the discretionary fiscal stimulus has amounted to less than 1 percent of GDP, among the lowest fiscal stimulus of the emerging market economies. We regret that Mexico has not done more to protect its small firms and its workers, and we fear that the resulting scarring effects of this lack of support will be particularly large. The aggressive steps taken by authorities to increase tax payments by large firms likely contributed to the elevated level of policy uncertainty and undermined business confidence. We support staff's argument that a discretionary fiscal stimulus of about 2.5 to 3.5 percent of GDP could raise GDP by as much as 5 percentage points over the medium term. Critically underpinning the staff's analysis is the assumption that the additional fiscal stimulus would lower the risk premium by 50 basis points. *We would like to better understand how staff arrived at 50 basis points and on how staff arrived at an upper bound of 3.5 percent of GDP as the appropriate discretionary fiscal policy response.*

Over the medium term, after the degree of economic slack fades to the point where it is appropriate for authorities to remove the discretionary fiscal stimulus measures, Mexico's long-standing weaknesses in public finances need to be addressed to keep the public debt to GDP ratio on a stable path. Tax revenue as a share of GDP is the lowest of the OECD countries, and Mexico has no national unemployment insurance. The scope for further cutting spending to fund additional social spending is extremely limited. Staff note that the disruptive expenditure cuts over the past year in fact could be undermining the quality of social services.

Monetary policy. Monetary management has greatly improved under the inflation targeting framework that was adopted in the early 2000s. Inflation has remained relatively low and, crucially, long-term inflation expectations appear to be well-anchored. Further monetary policy easing may be appropriate. Judging from the Bank of Mexico's monthly survey of professional forecasters, the supply-side disturbances that have increased food and other prices in recent months are having a transitory effect on headline inflation. These disturbances have not undermined investor views that inflation over the longer term will remain close to the 3 percent target.

Financial sector. Mexico's financial sector has shown resilience during the crisis, given the sound regulatory and supervisory practices it has in place. Nonetheless, we share staff's concerns about smaller banks and their exposure to troubled businesses that have been particularly hard-hit by COVID-19. We urge continued vigilance over these smaller banks and support a cautious approach with further capital distribution until we understand the full brunt of the crisis on the financial sector. *In that vein, we welcome staff's view on whether* *the worst-case adverse scenario used by the Bank of Mexico in its stress test, which is a scenario similar to that of the 1995 crisis, adequately captures the downside risk to bank capital*. More generally, we stress the importance in advancing AML/CFT and anti-corruption reforms to protect the credibility of the financial sector and domestic regulators.

Structural Reforms. We would like to see renewed attention to addressing problems that constrain Mexico's longer-term growth potential, including financial sector reforms that would improve access to credit and reforms that would address the high degree of informality. The 2013 reform, which had aimed to help narrow the large gap between Mexico and other OECD countries in terms of educational attainment, appears to have been reversed. We reiterate our disappointment about the steps taken to reverse the 2013 energy reform. Increased private participation in the energy sector would fuel long-term growth not only by increasing investment, but also by freeing scarce resources to move into areas in which Mexico has a comparative advantage, hence contributing to productivity growth.