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October 30, 2020

Statement by Mr. El Qorchi and Mr. Sassanpour on Mexico
(Preliminary)
Executive Board Meeting 20/106
November 2, 2020

We welcome the resumption of Article IV consultations and thank staff for a well-written report. We also thank Mr. Guerra and Ms. Arevalo Arroyo for their candid Buff statement, offering a fresh prospective on developments and policies. We are in broad agreement with the thrust of the staff appraisal.

The human toll of the pandemic in Mexico is already among the heaviest worldwide. The economic and social fallout of the crisis has also been significant, partly because Mexico entered the crisis on a weak economic footing, unlike most regional peers. There are promising signs of recovery—in part propelled by rerouting of supply chains and US-related activities—but some of the economic scars of the pandemic—particularly those arising from labor market dislocations—are likely to be more permanent. The path of economic recovery is closely intertwined with the path of the pandemic that is highly uncertain and difficult to predict. *We wonder whether the path of the pandemic underlying the October 2020 WEO, also used in this report, is a reasonable common assumption across countries where there are wide divergences in terms of mitigation, containment and preparedness. Staff comments are welcome.*

The Mexican authorities are at an important policy juncture: the authorities' preference is to "keep the powder dry" and limit debt issuance in anticipation of likely resurgence of the pandemic, as evidenced by the recent surge in neighboring countries. Staff, however, recommends a preemptive easing of macroeconomic policy stance—especially fiscal policy—to ensure that the recovery gains traction and to mitigate scarring effects. We tend to favor the latter, but as long as the policy response is measured and adjusts in tandem with the evolution of the pandemic, while keeping medium-term fiscal and debt sustainability in sharp focus. In any event, containing the pandemic and addressing related health issues, saving lives, and protecting the vulnerable should continue to be of highest priority.

We support the staff's comprehensive policy proposal. The initial fiscal response to the pandemic was fairly modest with virtually no additional budgetary support for affected households. With the comfort of a large external buffer and fairly unimpaired market access, we are of the view that Mexico has sufficient fiscal space to deploy greater near-term fiscal support to vulnerable households and small businesses, and to address pandemic-related issues particularly in remote and more heavily affected areas. The 2021 budget allocations are probably not sufficient and Mexico can afford a modest increase in debt in the short term. Beyond the immediate crisis, fiscal prudence is highly advisable where a comprehensive and progressive tax reform could support a strong social agenda. *There are passing references in the report to poverty and income inequality. We were expecting a more thorough assessment of the incidence, the extent to which they may have worsened by the crisis, and their likelihood to become a permanent feature post-crisis. We would also be concerned about the impact of tax reforms on poverty. Staff comments are welcome.*

The free-floating *peso* has been the economy's main shock absorber and the policy should continue. Monetary policy going forward is a difficult balancing act. While staff analysis suggests there is still some room for monetary easing, particularly considering a persistently large negative output gap, we also recognize the authorities' concerns about uncertainties and high risks in the global financial markets that advise caution. On balance, however, and as long as current price pressures are transitory and inflation expectations are firmly grounded, we feel that Mexico's strong external position, bolstered by a large FCL, and its highly efficient exchange rate system minimize these risks. In any event, monetary policy should be kept under close review as the crisis evolves. The take up of central bank financing by SMEs and small borrowers has been disappointing. While the recent improvements in overall market liquidity and sentiments may have eased financing pressure for larger corporate borrowers, SMEs and small borrowers may need the support of development banks to access central bank facilities. We also encourage the authorities to implement the outstanding recommendations of the 2016 FSAP, and more broadly to remain vigilant about the risks to the financial system.

Low productivity and subdued potential growth rates are major impediments to a strong, sustained, and inclusive growth in Mexico. Shifting resources from low to high productivity activities, encouraging private investment, and addressing informality are key issues Relatedly, we welcome the recent private sector investments in infrastructure, including in energy-related projects, as indicated by Mr. Guerra and Ms. Arevalo Arroyo. *Would staff please comment on private sector investment incentives in the oil sector in an environment of low international prices and inefficiencies in the domestic market?* Tackling the high labor market informality merits particular attention given its linkages, *inter alia*, to social safety nets, the ongoing pension reform, and migration. We encourage staff to undertake a dedicated study on labor market informality for the next consultation report. *Are there any estimates of the loss of human capital due to the pandemic and its impact on potential* *growth?* Broadly, in our view, structural reforms are most effective when recovery is on a firm track as reforms typically have short term costs and use political capital.

We wish the authorities all the success during these difficult times.