

IMF's Article IV consultations – Mexico's main challenge is to foster sustainable growth conditions

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- The Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with Mexico
- The IMF highlighted the sharp deceleration of economic activity amid highly uncertain external backdrop and domestic risks
- The institution revised growth forecasts to 0.4% in 2019 and to 1.3% for 2020, with risks to the downside which include:
 - (1) A more moderate economic activity than expected globally;
 - (2) Volatility in international financial markets;
 - (3) Uncertainty in the relationship between Mexico and the United States; and
 - (4) On the domestic front, the IMF pointed out that “...*medium-term growth could be lower, and investors could reconsider Mexico's credit quality, should the administration weaken its commitment to fiscal prudence, strong institutions, and a favorable business environment...*”
- On the fiscal front, the IMF welcomed the administration's commitment to fiscal prudence, but stressed the need to have more ambitious goals that put the Debt-to-GDP ratio on a downward path
- It also recommended the creation of a non-partisan council to evaluate fiscal policies
- With respect to monetary policy, they see scope for further easing if inflation remains on check and inflation expectations anchored
- Meanwhile, the financial sector could benefit from strengthening the regulatory and supervisory framework

The Executive Board of the International Monetary Fund (IMF) released the Article IV for Mexico. The IMF evaluates each year the economic and financial situation of its member countries. After such evaluation, the IMF draws up a report that is presented to the Board and makes conclusions and recommendations for each nation. In this regard, the IMF highlighted the sharp deceleration of economic growth in an environment of elevated external and domestic risks. Nevertheless, they felt comfortable with the authorities' commitment to very strong policies and policy frameworks with the main challenge for the Mexican economy being to create conditions for strong, sustained, and inclusive growth, while maintaining macroeconomic stability.

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Downward revisions to growth in 2019-2020. The IMF now forecasts a growth of 0.4% for the Mexican economy in 2019 and of around 1.3% in 2020. It is worth mentioning that these estimates represent a downward revision with respect to the *World Economic Outlook* published in July (the October update will be released tomorrow). The institution indicated the following risks to the scenario: (1) A more moderate than expected economic activity globally; (2) volatility in international financial markets; (3) uncertainty in the relationship between Mexico and the United States; and (4) on the domestic front, the IMF pointed out that “...*medium-term growth could be lower, and investors could reconsider Mexico’s credit quality, should the administration weaken its commitment to fiscal prudence, strong institutions, and a favorable business environment...*”. In addition, they added that a downgrade in Pemex’s rating - below investment grade-, by yet another rating agency could generate higher financing costs and indirect effects for other companies. On the upside, strengthening in the rule of law and the implementation of structural reforms could be positive for growth.

On the fiscal front, the IMF welcomed the government’s commitment to fiscal prudence, but stressed the need to have more ambitious goals that put the debt ratios on a downward path. According to the document, maintaining the public sector borrowing requirements (PSBR) between 2.2% and 2.4% of GDP in the medium term, keeps debt-ratios stable at levels around 55% of GDP. While this level is sustainable, the Fund considered that more ambitious medium-term fiscal objectives would help rebuild buffers and insure against downside risks and demographic-related spending pressures.

Additional fiscal measures needed to meet fiscal objectives. In the opinion of the IMF's mission -as it is the case of many economic analysts-, fiscal objectives in the short term are based on optimistic assumptions for GDP growth, oil production and the flow of fiscal revenues while, at the same time, they show some concerns on the projected reduction on the spending side. The IMF estimates that the fulfillment of the announced fiscal objectives will require closing a fiscal gap of between 0.5% and 1.5% of GDP between 2020 and 2024, so specific measures are required in order to maintain the credibility of fiscal policy. Among others, the main priority should be to increase non-oil tax revenues, improving VAT collection, as well as increasing the tax base, as shown in the following table.

Summary of revisions to tax framework suggested by the IMF

Type of tax	Measures
VAT	<ul style="list-style-type: none"> ▪ 16% VAT of food items could improve collection by 1% of GDP ▪ Targeted benefits could offset the impact on the poor (an initially reduced rate could smooth the transition to the standard rate)
Income taxes	<ul style="list-style-type: none"> ▪ Rationalizing inefficient and regressive tax expenditures ▪ Widening the PIT top bracket could boost revenues and increase progressivity
Excise taxes	<ul style="list-style-type: none"> ▪ Eliminate excise rate subject to a zero floor to guarantee retail fuel prices as they benefit the rich
Local taxes	<ul style="list-style-type: none"> ▪ A reform of both the property and vehicle registration taxes would allow for a reduction in central government transfers to states and municipalities and thus encourage fiscal responsibility
Border tax regime	<ul style="list-style-type: none"> ▪ Eliminate special regime as it creates distortions and likely erodes the tax base
Tax administration	<ul style="list-style-type: none"> ▪ The mission welcomes recent steps to improve tax administration ▪ Adopt a comprehensive strategy to tackle VAT non- ▪ Integrating the income tax and social security administrations could reduce tax evasion over the medium-term

Source: FMI

On the spending side, they recommend improvements in efficiency. The IMF noted the need to increase public investment in large-scale projects, but only in a context in which a sustainable fiscal position is maintained, priorities are established, and financing options are managed. Regarding social spending, they recommend improvements in the efficiency of projects, reducing their number and improving their objectives, in order to reduce errors of inclusion and exclusion, overlapping beneficiaries and duplication of programs. Furthermore, they recommend stricter standards and more transparency in the use of temporary personnel, along with the consistent application of merit-based recruitment and the establishment of a centralized payroll system along with maintaining pay competitiveness to ensure staff quality and mitigate corruption incentives. Finally, they also made some recommendations regarding education spending and the pension system.

Pemex's business plan should be reconsidered with the objective of improving profitability while providing budgetary relief. According to the IMF's evaluation, the company's financial situation "...remains weak, its debt is high and oil production had been dropping until very recently...". They also consider that the plan "...limits cooperation with private firms in Pemex's upstream business to service contracts, envisages investing heavily in its loss-making downstream business, and lacks concrete ways to reduce operating costs...". In this context, they continue to view private sector participation as the most efficient way to replace reserves and increase production given fiscal pressures.

Creation of a fiscal council. Among the measures to strengthen the fiscal framework, the IMF mission reiterates its recommendations to: (1) Set a well-calibrated debt anchor; (2) establish a broader structural expenditure rule; (3) a well-defined adjustment path to return to target after a shock; (4) triggers for the use of escape clause should be significantly tightened; and (5) the creation of a non-partisan fiscal council, as well as adequate institutions with a formal mandate to provide an independent evaluation of fiscal policy. The IMF welcomes the intentions of the new administration to make changes in this regard and says it is ready to support these efforts.

Monetary policy has room for lower interest rates, while the flexible exchange rate has played an important role as a shock-absorber. With a negative output gap, the IMF sees scope for further monetary accommodation, provided inflation remains close to the target and expectations remain anchored. The Fund considered that improvements made to the communication strategy by Banxico have helped guide market expectations. Regarding the exchange rate, they continue to recognize that a flexible regime has played an important role in restoring balance in response to permanent shocks, while exchange intervention should be limited to the incidence of disorderly market conditions. The *Flexible Credit Line* (FCL) provides an additional buffer, in case the downside risks materialize.

The financial sector could benefit from strengthening the regulatory and supervisory framework. In particular, the IMF considers that, in accordance with the recommendations of the Financial System Stability Assessment (FSSA) of 2016, the financial system could be strengthened by: (1) increased operational independence, budget autonomy, and legal protection of the banking and securities supervisor; (2) integration of prudential supervision functions under one authority for all financial institutions; (3) enhancements to the definition of ‘common risk’ and ‘related party’; and (4) expansion of the resolution regime to cover financial holding companies and strengthening the authorities’ powers to require banks to make changes to improve their resolvability.

Financial inclusion: Priority to initiatives that promote competition and transparency. The IMF recognized efforts to boost competition and the inclusion of the financial sector. Looking ahead, they recommend a multi-pronged strategic approach to boost loans and strengthen competition and inclusion amid a weakening economic activity. Specifically, priority should be given to initiatives that boost competition and transparency in financial products, reduce the use of cash and improve financial infrastructure, especially in terms of support for SMEs. Finally, the next secondary regulations of *fintech* should promote competition in the sector and preserve financial stability.

Need to continue with the structural reform agenda to boost potential growth. This could be achieved through productivity improvements that lead to poverty and inequality reduction as well as to narrow regional income disparities. Among others, the need for progress is mentioned in: (1) The fight against corruption and money laundering; (2) reduction of labor informality; and (3) improve the security situation. They also mention the need to continue addressing gender gaps, strengthen competition and lighten regulations in markets. In terms of wage increases, they need to be very gradual to avoid short-term interruptions and adverse effects on formal employment.

In conclusion, the IMF feels relatively comfortable with the authorities' commitment to strong macroeconomic policies and framework. Nevertheless, they believe that the Mexican economy still faces the challenge of creating conditions of strong, sustained and inclusive growth. In summary, as we have already mentioned, the mission recommended: (1) Seek a combination of fiscal policies that is more favorable to growth and inclusion, placing debt ratios on a downward path, especially by increasing non-oil revenues and improving spending efficiency; (2) continue with the monetary policy easing if inflation remains close to the target and inflation expectations anchored; (3) boost financial inclusion and strengthen the resilience of the financial system; and (4) revitalize structural reforms, including measures to reduce corruption and insecurity.

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