

IMF's Article IV consultations – Mexico is a stable economy with important challenges ahead

- The Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with Mexico
- The IMF highlighted the resilience of the Mexican economy in the face of a complex external backdrop underpinned by strong policies and institutional policy frameworks
- The IMF welcomed the conclusion of the USMCA negotiations which opens the way for the three countries to sign an updated trade pact by the end of November
- The institution forecasts growth rates of 2.1% and 2.3% for 2018 and 2019, respectively, with important downward risks:
 - (1) Weaker-than-projected global growth;
 - (2) Renewed volatility in global financial markets;
 - (3) Global trade-related uncertainty; and
 - (4) On the domestic side, “...risks pertain to uncertainty about the prioritization of the incoming administration’s fiscal plans in light of constrained fiscal space...”, the implementation of structural reforms as well as oil production levels
- In addition, the IMF welcomed the measures adopted by the current administration on the fiscal front and in the Pemex business plan
- With respect to more structural issues, the Fund recommends implementing the structural reform agenda with emphasis on strengthening the rule of law, fighting corruption and reducing informality
- They also highlighted the central bank’s improvements to its communication strategies and said that the monetary authority should prepare to lower the reference rate if inflation continues to converge towards the target, as it is expected

The Executive Board of the International Monetary Fund (IMF) released the Article IV with 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 resilience exhibited by the Mexican economy in the face of a complex external environment, with the flexible exchange rate playing a key role in helping the economy adjust to external shocks. They also mentioned that fiscal consolidation efforts are still underway, while maintaining that monetary policy has remained firm and that financial supervision and regulation is solid. Finally, they see the completion of USMCA negotiations among Mexico, USA, and Canada, as positive. However, they considered that the outlook for the Mexican presents important challenges and stressed the need to continue with sound economic management, as well as persevere in the agenda of structural reforms to boost growth, improve the living standards of the population, as well as reduce poverty and inequality.

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Downward revisions to growth estimates in 2018-2019. The IMF now forecast growth of 2.1% for the Mexican economy in 2018 and around 2.3% in 2019. It is worth mentioning that these estimates represent a downward revision with respect to the *World Economic Outlook* document published at the beginning of October, document that the IMF normally uses to make changes to its estimates. The institution points out among the risks to the scenario: (1) Weaker-than-projected global growth; (2) renewed volatility in global financial markets; (3) global trade-related uncertainty; and (4) on the domestic side, “...risks pertain to uncertainty about the prioritization of the incoming administration’s fiscal plans in light of constrained fiscal space...”, the implementation of structural reforms as well as oil production levels.

FMI Forecasts

% of GDP, unless otherwise stated

	2016	2017	2018 ^f	2019 ^f
Real GDP (% , annual)	2.9	2.0	2.1	2.3
Gross domestic investment	23.7	23.1	23.1	23.1
Gross domestic savings	21.5	21.4	21.4	21.3
Inflation (% , end of period)	3.4	6.8	4.4	3.1
Current account	-2.2	-1.7	-1.7	-1.8
External Debt	38.5	38.1	38.5	38.6
Govt. Revenue	24.6	24.8	23.5	21.7
Govt. Expenditure	27.4	25.9	26.0	24.2
Augmented overall balance	-2.8	-1.1	-2.5	-2.5

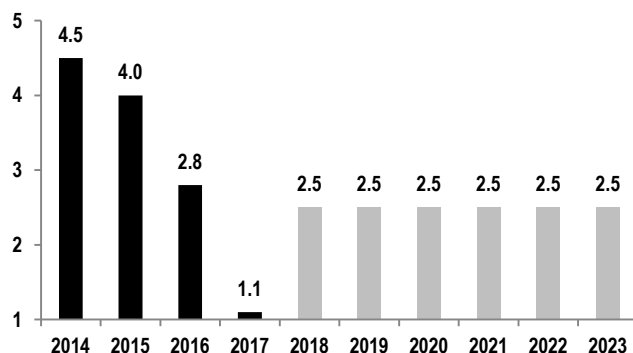
Note: Methodological differences mean that the figures in this table may differ from those published by Mexico’s authorities

Source: IMF

Once again, the IMF highlighted the importance of sound macroeconomic policies. They stressed that the plans to raise public and social investment must be accompanied by fiscal consolidation to maintain the soundness of public finances and a debt-to-GDP ratio, in order to maintain investor confidence. They also recommended to continue working on increasing non-oil revenues and improving the efficiency of public spending in order to further strengthen the credibility of fiscal policy in the long term. In this context, the IMF team considered that the government will meet its public sector borrowing requirements (PSBR) target of 2.5% of GDP. Moreover, it is expected that the debt-to-GDP levels will reach 53% at the end of this year from 54.3% in 2017, on the back of a primary surplus of 1.3% of GDP.

General Government Overall Balance*

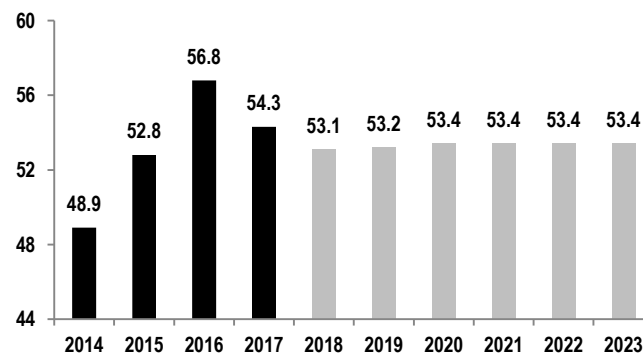
% of GDP



* Public Sector Borrowing Requirements. Positive means deficit
Source: IMF

General Government Gross Debt

% of GDP



Note: Methodological differences mean that the figures in this table may differ from those published by Mexico’s authorities. Source: IMF

The new administration receives a stable country, but with important challenges ahead. The administration that will take office on December 1 will receive a country with a stable economy reinforced by sound economic policies and structural reforms, which have allowed Mexico to navigate a complex external environment. Nonetheless, the new administration will face significant challenges: (1) The level of debt as a percentage of GDP must take a permanent downward trajectory, while (2) fiscal space is constrained by large tax compliance gaps, as well as inefficiencies of the public spending amidst large infrastructure needs and long-term demographic pressures. Additionally, structural reforms begin to show signs of success, although they have not managed to increase welfare levels according to expectations and even levels of corruption and violence have peaked.

The incoming administration platform promises to tackle some of these challenges. Nevertheless, the IMF considers that "*... some other policy proposals generate some uncertainty ...*". While the new government has committed to central bank independence, fiscal prudence and has endorsed the USMCA, it also proposes an ambitious program of infrastructure and social projects, without damaging the fiscal balance or raising taxes. Moreover, they consider that there is a high degree of uncertainty surrounding the future of the energy reform. In this context, 2019 fiscal budget, which must be presented next month will be key.

Recommendations to strengthen non-oil income in order to make fiscal space to accommodate spending plans. Although the new administration has contemplated some efficiencies in terms on the spending side of the budget that will be used to finance its plans, the IMF recommends increasing non-oil fiscal revenues by reducing distortions and increasing the tax base among others: (1) Applying generalized VAT, which could increase revenues by 1% of GDP; (2) eliminate the compensations in the VAT payments; (3) eliminate the current practice of fuel price smoothing by reducing the fuel excise would help to stabilize excise revenues and promote efficient fuel usage; (4) limit exemptions from personal income taxation; (5) reform on property taxes and capital income taxation; and (6) improve tax administration.

On the expenditure side, they recommend always have as a priority fiscal stability. The IMF points out the need to maintain the competitiveness of public servants in management positions in order to reduce corruption and ensure the quality of services. Regarding social programs, they agree that they could be consolidated and better targeted, but not without first having a rigorous evaluation of their effectiveness. Finally, they propose to gradually increase the contribution rate for the defined-contribution pension system, among other measures.

Further improve Pemex financial situation before contemplating investments. The debt levels of the company remain high in a context in which production is falling, which evidences the investment needs. The IMF team stressed the need to persevere in the implementation of the energy reform and the multi-year business plan of Pemex. Joint ventures with the private sector remain the best way to increase production, in both in mature and new fields.

A fiscal council could help strengthen de fiscal framework. Among the IMF proposals to strengthen the fiscal framework is the creation of a non-partisan fiscal council with a formal mandate to provide an evaluation of the policies proposed by the governments. They also consider that it would be necessary to strengthen the link between the desired level of public debt and the target levels of RFSP.

In terms of monetary policy, the IMF considers that Banxico should be prepared to cut interest rates. They considered that current monetary policy stance has helped inflation to converge to the target, although they warn that the scenario is still uncertain, so the central bank should remain vigilant in order to calibrate the position if necessary. In this context, they consider that, if inflation continues perform in line with expectations, they could even consider cut the reference rate. Additionally, the IMF welcomed the central bank's efforts made to improve its communication strategy.

IMF considered that a flexible exchange rate should continue to be the main buffer against external shocks. This type of exchange rate regime is essential to restore balance in response to shocks. The IMF considers that the current levels of international reserves are adequate -to which it must be added the Flexible Credit Line (FCL) with the IMF-, in order to attack the volatility that could arise should any of the risks mentioned above.

The IMF concludes that Mexico's sound economic policies, together with structural reforms, support the resilience that the economy has shown in a complex external environment. They point out that Mexico's external position remains solid and they welcome the negotiation of the trade agreement with Canada and the United States. Among the challenges presented by the economy are an adverse external environment, as well as the need to persevere on the agenda of structural reforms to boost growth, improve living standards and reduce poverty and inequality.

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