MISSION CONCLUDING STATEMENT

Mexico: Staff Concluding Statement of the 2023 Article IV Mission

October 3, 2023

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The Mexican economy is in the midst of a broad-based expansion. Growth is expected to be 3.2 percent in 2023, led by robust private consumption and investment, with notable strength in service sectors, construction, and auto production. This has led to record-low unemployment rates and record-high manufacturing capacity utilization rates. The authorities have commendably kept public debt in check. Monetary policy is rightly focused on bringing down inflation.

Economic growth is expected to moderate to 2.1 percent in 2024. Although fiscal policy will loosen, amplifying its procyclicality, its growth impact will be limited by binding capacity constraints, a continuation of tight monetary policy, and slowing growth in the U.S. Maintaining the policy rate at current levels until around mid-2024 should allow inflation to return to Banxico's target by 2025. Risks to the growth outlook are broadly balanced. Stronger-than-expected growth in the U.S. or a larger-than-expected fiscal multiplier could boost growth in Mexico. However, an increase in global risk aversion, a higher path for interest rates in the advanced economies, or delays in implementing key infrastructure projects in Mexico would weigh on output. Risks to inflation are viewed to be modestly skewed to the upside.

Securing sustainable and inclusive growth in a complex global environment will require a broad set of reforms. The ongoing reshaping of global supply chains is an important opportunity for Mexico. Notably, Mexico's proximity to, and deep trade links with, the U.S. make it a key location for the "nearshoring" of production for the U.S. market. However, capitalizing on this potential and competing with other production locations will require addressing Mexico's long-standing structural challenges while continuing to pursue prudent macroeconomic policies. This will require higher and better-targeted public investment, better governance, increasing access to domestic sources of finance, increasing female labor force participation, and pivoting consumption toward cleaner sources of energy.

Fiscal policy

The expected outturn in 2023 would extend the authorities' track record in meeting their fiscal targets. The overall deficit is projected at 3.9 percent of GDP for the year, an increase of 0.5 percent of GDP in the structural primary balance. Weak revenue performance is being only partially offset by limits on capital spending. Despite the increase in the fiscal deficit, gross public sector debt is still expected to decline to 52.7 percent of GDP by end-2023 and is projected to be sustainable with high probability over the medium term.

The planned fiscal path for 2024 is unduly procyclical. Budgetary pressures from lower revenues are compounded by a targeted increase in current spending (i.e., wages, pensions, and social spending) and higher front-loaded spending to complete flagship investment projects. The expected increase in the deficit to 5.4 percent of GDP—a fiscal impulse of 2.4 percent of potential GDP—will boost demand at a time when the economy is operating above potential and inflation is not yet back to the central bank's target. This is likely to lead to a higher path for interest rates, a stronger currency, higher debt-to-GDP ratio, and a slower decline in inflation than would otherwise be the case. As such, a tighter fiscal stance would be more consistent with Banxico's efforts to bring inflation back to target.

The clear recording of support to Pemex in the 2024 budget—both tax expenditures and direct transfers—is a positive step forward . The reporting change increases transparency and will help facilitate a discussion of trade-offs between directing public resources to Pemex instead of other budgetary priorities. Continued budgetary support for Pemex should be conditioned on credible plans to improve Pemex's commercial viability risks.

The next administration will face stark choices to adhere to the targeted medium-term fiscal path. A large fiscal consolidation is forecast for 2025 which will exert a significant drag on growth, reversing the expected 2024 boost. Meeting these targets would require substantive fiscal measures of around 2½ percent of GDP, mostly incident on boosting non-oil revenue (which is significantly below Latin American and OECD peers). These could include (i) eliminating the zero-rating for VAT and rationalizing exemptions; (ii) broadening the personal income tax; and (iii) increasing property taxes.

A stronger medium-term fiscal framework would strengthen the credibility of fiscal policy and ensure greater consistency in the policy mix. Changes should incorporate: (i) a credible medium-term budget framework; (ii) building additional fiscal space for more countercyclical fiscal policy in the future; (iii) clearer escape clauses that are limited to specified exceptional circumstances; (iv) anchoring policy on a downward path for debt-GDP; and (v) improving fiscal forecasting capacity. Such a fiscal framework would institutionalize the government's long-standing commitment to fiscal responsibility.

Greater transparency in fiscal statistics would improve accountability. Financial transactions undertaken by and between public entities—including trust funds, state-affiliated enterprises, and development corporations—necessitate a more robust and transparent reporting of fiscal outturns that is aligned with international accounting practices. This is particularly important given the increased state presence in energy and other sectors that is envisioned by the administration. Improved statistics will allow for a better appreciation of trade-offs among competing demands on public resources as well as the potential fiscal risks and contingent liabilities that are being incurred.

Monetary policy

Banxico's proactive policy stance has been instrumental in countering inflationary pressures. Successive policy rate hikes and enhanced forward guidance have kept long-term inflation expectations anchored and led to a reversal of the 2021-2 upswing in inflation. However, inflation is not yet on a durably downward path. In particular, services inflation has proved persistent, possibly reflecting a delayed feed through of cost pressures. The expansionary budget for 2024—that includes a front-loaded increase in spending—represents a further near-term challenge to the inflationary outlook. As such, monetary policy should remain restrictive until inflation indicators are decisively heading toward the central bank's target. Based on the current macroeconomic outlook, this is likely to require delaying a reduction in the policy rate until mid-2024.

After a period of significant change in Mexico's monetary policy and practices, there is scope for Banxico to undertake an internal strategic review of its operations and communications. Banxico's legal mandate vis-à-vis inflation targeting has served Mexico well. Over the years, Banxico has improved its communication practices, including most recently by providing both inflation forecasts and qualitative forward guidance. In this context, it would be productive to assess the impact of these innovations, drawing lessons from experiences in other countries, and suggesting scope for future changes to decision-making processes, communication practices, forecasting and analysis. Such an assessment could include an evaluation of whether providing greater information on Banxico's forecasts—including the assumptions (such as the policy path) that the projections are based on—is warranted.

The authorities remain committed to rely on exchange rate flexibility to facilitate adjustment to external and domestic shocks. The IMF's Integrated Policy Framework does not identify material frictions that would warrant regular FX interventions in Mexico. Deep and liquid FX markets as well as limited FX mismatches in domestic balance sheets argue for limiting FX intervention to cases where there is a clear disruption in the proper functioning of the currency market. The policy rate should remain the primary instrument to anchor inflation expectations and maintain inflation at Banxico's 3-percent target.

Financial Policies

As underscored in the 2022 Financial System Stability Assessment (https://www.imf.org/-/media/Files/Publications/CR/2022/English/1MEXEA2022002.ashx) **, the financial system**

remains resilient to shocks. Capital ratios are strong and Banxico's stress tests show that capital levels would remain above regulatory minima even in the most severe downside scenarios. This systemic resilience was demonstrated earlier this year when strains arose in the financial systems of some advanced economies. Mexican financial institutions were well insulated from spillover effects, despite a brief sell-off in the equity prices of domestic banks. Notably, the system did not experience meaningful deposit outflows. While there have been strains recently in some non-bank financial institutions, the sector is unlikely to pose systemic risks given its relatively small size.

The authorities have made important progress in implementing recommendations from the FSAP. The authorities are reviewing their macroprudential toolbox. Banxico and the banking and securities regulator (CNBV), along with other Mexican financial authorities, are updating their capabilities to monitor and respond to cyber-attacks. Banxico has also introduced measures to expand its liquidity stress test framework. Some areas are yet to be addressed, including enhancing the autonomy of the financial regulators and strengthening the legal protections for supervisors.

Addressing outstanding gaps in the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework remains a priority. Creation of a beneficial ownership register would help ensure corporate transparency and mitigate the risks of misuse of legal entities for criminal purposes. CNBV and the tax authorities (SAT) should align their supervisory activities with the potential risks stemming from organized crime, drug trafficking, corruption, tax evasion, and the foreign proceeds of crime. The various AML/CFT agencies and anti-corruption bodies could enhance collaboration.

Structural Reforms

Making growth more inclusive and sustainable will require ambitious reforms. Per capita output growth in Mexico has lagged that of peers, despite Mexico's trade openness, moderate labor costs, productivity gains from foreign investment, and its integration into North American supply chains. Recent measures by U.S. companies to diversify supply chains has led to an increased sourcing of inputs from Mexico. However, securing the potential gains from existing networks and the proximity to the U.S. will require a reinvigorated set of supply side reforms. These should include encouraging female labor force participation, strengthening governance, improving public infrastructure, and promoting financial deepening.

Boosting female labor force participation and removing legal impediments to female economic empowerment would improve potential growth and raise living standards. The gap between male and female labor participation rate in Mexico is among the highest in the OECD, despite considerable progress in removing institutional impediments to women. Targeted fiscal policies and legal reforms could help close gender gaps including: (i) ensuring equal pay for equal work; (ii) improving maternity, paternity, and parental leave; (iii) investing more in maternal healthcare and childcare; (iv) curtailing unpaid family care work; (v) ensuring women have full recourse to the public pension; (vi) addressing inequities in education; and (vii) strengthening gender budgeting practices and the collection of gender-related data on socio-economic outturns.

Better governance would improve the business environment. Better coordination among national, state, and municipal levels would be important to effectively implement the existing anti-corruption framework and ensure its proper enforcement. Leveraging the AML framework—by enhancing due diligence in relation to Politically Exposed Persons, reporting suspicious transactions, and ensuring entity transparency—could help prevent, detect, and deter proceeds of corruption and tax evasion. The mission looks forward to Mexico's decision to participate in the IMF's voluntary assessment of transnational aspects of corruption, which recognizes the strength of the current AML framework and ongoing anti-bribery institutional and legal reforms, while recommending further measures to ensure adequate protection of reporting persons, clarify liability of legal persons, and promote effective enforcement.]

Improvements in infrastructure and reduced red tape would help attract private capital. Filling criticalinfrastructure gaps—in transport, water, and energy—would help meet the growing needs of firms investing in Mexico. Streamlining custom procedures, easing licensing and permitting procedures (e.g., in road transport and custom brokerage), and removing foreign direct investment restrictions (e.g., in the transport sector) would incentivize investment and encourage technology transfer.

A deepening of domestic financial intermediation could provide resources for private investment. Efforts in recent years have expanded access to credit, increased the availability of bank branches and financial products, improved financial sector transparency, increased digital connectivity, and encouraged financial innovation. These initiatives could be complemented by a reduction in the obstacles to collateral recovery (including through a strengthening of the functioning of the judicial system), investments in improving financial literacy, further transparency of financial products, and an expansion of internet access in remote areas.

Addressing climate change can provide more durable sources of energy but will require a comprehensive and well-sequenced strategy. As multinationals incorporate environmental standards in their location decisions, incentivizing a switch to solar and wind energy has the potential to encourage industrial investment while meeting the government's emission targets. New investments in the hydrocarbon sector should internalize the potential for changing global demand for hydrocarbons, particularly given that Mexico is a relatively high-cost producer. The authorities have introduced a carbon tax and outlined a strategy to combat deforestation, raise the share of electric vehicle sales to 50 percent of total car sales by 2030, create a market for green bonds, and establish an Emission Trading Scheme. It will be important that the increased focus on electrification is accompanied with a switch to low carbon and renewable sources of generation. Increasing the carbon tax—and/or the shadow price of carbon in the emission trading scheme—to around US$50 per ton would be broadly consistent with the authorities' emission goals.

The IMF staff team would like to thank the Mexican authorities and other counterparts for their support, hospitality, and constructive discussions.

Table 1. Mexico: Selected Economic, Financial, and Social Indicators

I. Social and Demographic Indicators

GDP per capita (U.S. dollars, 2022)	11,279.2	Poverty headcount ratio (% of population, 2022) 1/	36.3
Population (millions, 2022)	130.0	Income share of highest 20 perc. / lowest 20 perc. (2022)	8.4
Life expectancy at birth (years, 2022)	75.5	Adult literacy rate (2020)	95.2
Infant mortality rate (per thousand, 2021)	11.4	Gross primary education enrollment rate (2020) 2/	103.7

II. Economic Indicators

						Proj.	
	2019	2020	2021	2022	2023	2024	2025
(Annual percentage change, unless otherwise indicated)							
National accounts (in real terms)							
GDP	-0.3	-8.7	5.8	3.9	3.2	2.1	1.5
Consumption	0.8	-9.3	6.8	5.5	3.7	1.6	1.2
Private	1.2	-10.6	8.1	6.2	4.0	1.6	1.1
Public	-1.6	-0.7	-0.5	1.3	1.5	1.5	2.0
Investment	-4.2	-18.4	10.2	8.5	14.4	0.7	1.4
Fixed	-4.4	-17.3	9.3	8.6	14.6	0.6	1.4
Private	-2.9	-18.6	11.2	9.5	15.2	0.6	1.4
Public	-14.8	-6.6	-3.6	2.0	10.0	0.7	1.5
Inventories 3/	0.0	-0.3	0.2	0.0	0.0	0.0	0.0
Exports of goods and services	1.2	-7.0	7.2	9.0	-2.6	2.9	2.2
Imports of goods and services	-1.1	-12.0	15.0	8.9	6.5	1.0	1.4
GDP per capita	-1.2	-9.4	5.2	3.1	2.3	1.3	0.6
External sector							

External current account balance (in percent of GDP)	-0.4	2.0	-0.6	-1.2	-1.5	-1.4	-1.1
Exports of goods, f.o.b. 4/	2.2	-9.4	18.6	16.7	2.2	5.4	4.0
Imports of goods, f.o.b. 4/	-2.0	-15.9	32.0	19.6	2.9	6.4	3.4
Net capital inflows (in percent of GDP) 5/	-1.4	0.8	-0.9	-0.9	-2.1	-2.0	-1.6
Terms of trade (goods, improvement +)	2.3	0.8	-1.7	-2.1	8.8	-2.8	-0.2
Gross international reserves (in billions of U.S. dollars)	183.0	199.1	207.7	201.1	212.3	224.5	234.4
Exchange rates							
Real effective exchange rate (avg, appreciation +)	3.2	-7.7	5.9	5.3	...	...	...
Nominal exchange rate (MXN/USD) (eop, appreciation +)	4.3	-5.9	-3.2	5.7	...	...	...
Inflation, Employment and Population							
Consumer prices (end-of-period)	2.8	3.2	7.4	7.8	4.5	3.2	3.0
Core consumer prices (end-of-period)	3.6	3.8	5.9	8.3	5.0	3.1	3.0
Formal sector employment, IMSS-insured workers (average)	2.3	-2.5	1.9	4.3	...	...	...
National unemployment rate (annual average)	3.5	4.4	4.1	3.3	2.9	3.1	3.4
Unit labor costs: manufacturing (real terms, average)	3.6	10.4	4.3	11.3	...	...	...
Total population 6/	1.0	0.8	0.6	0.8	0.9	0.9	0.8
Working-age population 6/	1.3	1.1	1.0	1.1	1.2	1.1	1.0
Money and credit							
Financial system credit to non-financial private sector 7/	3.0	0.9	4.2	10.9	7.1	6.4	3.6
Broad money	4.7	13.4	9.5	7.3	8.0	7.3	4.5
Public sector finances (in percent of GDP) 8/							
General government revenue	23.0	23.5	23.0	24.2	23.8	23.7	23.7
General government expenditure	25.2	27.8	26.8	28.5	27.7	29.1	26.3
Overall fiscal balance 9/	-2.3	-4.3	-3.8	-4.3	-3.9	-5.4	-2.6
Structural primary balance 10/	1.0	0.5	0.4	0.9	1.4	-1.0	1.6
Fiscal impulse 11/	0.0	0.5	0.1	-0.5	-0.5	2.4	-2.6
Gross public sector debt	51.9	58.5	56.9	54.1	52.7	54.7	55.1

Memorandum items							
Nominal GDP (billions of pesos)	25,143	24,080	26,609	29,504	32,022	34,541	36,266
Output gap (in percent of potential GDP)	2.4	-2.7	-2.0	0.0	1.1	1.2	0.5

Sources: World Bank Development Indicators, CONEVAL, National Institute of Statistics and Geography, National Council of Population, Bank of Mexico, Secretariat of Finance and Public Credit, and Fund staff estimates.

1/ CONEVAL uses a multi-dimensional approach to measure poverty based on a "social deprivation index," which takes into account the level of income; education; access to health services; to social security; to food; and quality, size, and access to basic services in the dwelling.

2/ Percent of population enrolled in primary school regardless of age as a share of the population of official primary education age.

3/ Contribution to growth. Excludes statistical discrepancy.

4/ Excludes goods procured in ports by carriers.

5/ Excludes reserve assets

6/ Based on CONAPO population projections.

7/ Includes domestic credit by banks, nonbank intermediaries, and social housing funds.

8/ Data exclude state and local governments and include state-owned enterprises and public development banks.

9/ The 2020 PSBR is adjusted for some statistical discrepancies between above-the-line and below-the-line numbers.

10/ Adjusting revenues for the economic and oil-price cycles and excluding one-off items, in percent of potential GDP.

11/ Negative of the change in the structural primary fiscal balance.

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