# IMF's Article IV consultations – Policy ideas in the face of COVID-19

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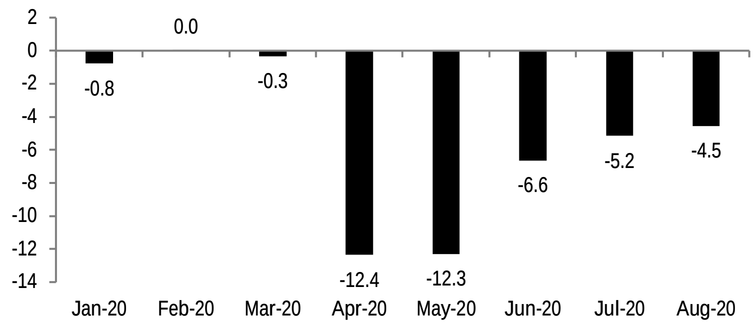
- **Yesterday, the IMF published the Concluding Statement of the 2020 Article IV Mission**
- **The institution increased its GDP estimate for this year and 2021 to -9.0% and 3.5%, respectively (previous: -10.5% and -3.3%). Moreover, they recognized the country's robust macroeconomic framework and proposed a series of policy measures to instrument in the short- and medium-term**
- **In the fiscal front, they recommended: (1) Higher spending to address the effects of the pandemic; (2) to make credible plans for a fiscal reform in the medium term; and (3) reorient spending to boost welfare, investment and growth**
- **The IMF considers the central bank could cut rates further to help the economy, while suggested that a review of the policy framework could be favorable**
- **They also stated that other reforms are necessary to boost productivity and bolster certainty levels**
- **We believe that a dialogue between multilateral organizations and Mexico's authorities is positive, particularly given the challenging global and domestic backdrop. Nevertheless, we see a limited room for these recommendations to be instrumented in the short term**

**The International Monetary Fund (IMF) publishes results of the 2020 Article IV Mission**. As a result of its annual assessment to member countries, the institution unveiled the staff's concluding statement about the country's situation and the policy recommendations that could improve its population's welfare. This is especially relevant considering the COVID-19 pandemic, with suggestions to fight the virus and its economic effects. In this backdrop, the IMF recognized again the country's robust macroeconomic framework, stating that it constitutes a good starting point to deploy a series of measures aimed to improve Mexico's position in the medium- and long-term.

**Upward revision to GDP estimates, still recognizing the strong impact from the pandemic.** Specifically, the IMF estimates a 9.0% y/y GDP contraction in 2020 comparing favorably to the -10.5% presented in its latest update of the *World Economic Outlook*, back in June. Moreover, the forecast for 2021 was adjusted to 3.5% (+0.2%-pts), with an average estimate of 2% for the years ahead. They reiterate that the shock from the pandemic has been very high, impacting employment –with about 4 million people still out of the labor force despite some recovery in recent months–, with the population in working poverty up more than 10%-pts, to 48%. In their view, a recovery of activity, employment and income to levels seen before the pandemic will take several years, with the long-standing challenge of low growth appearing to worsen. In this backdrop, they propose a set of measures that could be instrumented to help the most vulnerable sectors of the population, which have experienced a disproportionate burden of the shock.

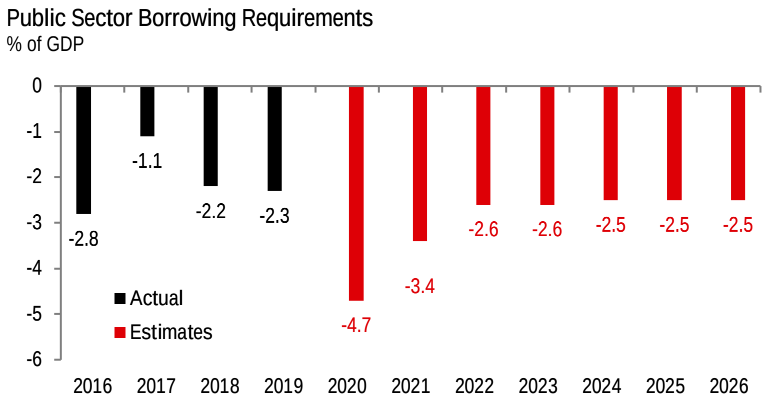
Accumulated change in the labor force*
Million people




*Nota: Changes in each month calculated relative to the level seen at the end of 2019. If the number for August is calculated relative to March, the decline in the labor force amounts to 4.2 million people.
Source: Banorte with data from INEGI

**The need for a stronger policy response.** Considering the country's macro framework, the IMF thinks that authorities' policy response has been limited and could be stronger, which would be beneficial to moderate the damage of current conditions, set the stage for a robust recovery, and limit a lasting damage to the economy. Specifically, measures are catalogued in three main fronts: (1) Fiscal and monetary support in the short-term; (2) credible medium-term reform plans; and (3) reforms to boost investment and growth. According to their estimates, this macroeconomic package could raise real GDP by 4%-pts and reduce the debt-to-GDP ratio.

**More fiscal spending in the short term…** Specifically, they mentioned that measures to support the health sector, households and companies represent only 0.7% of GDP, way below the average of 3% in G20 emerging countries. It should be remembered that some of the measures already deployed include front-loading social programs' payments (*e.g.* pensions for the elderly), credit facilities and higher spending in the health sector. Considering this, prudent growth, oil production and tax buoyancy, they estimate a deficit in *Public Sector Borrowing Requirements* of 5.8% of GDP this year and between 1.5% to 2% of GDP in 2021 and beyond. This contrasts with the expectations of the Ministry of Finance, with deficits of around 4.7% and 3.4% of GDP this year and next (see chart below). Considering this and their view that the government still has room for additional debt, they propose a focalized spending approach in three fronts: (1) Health spending: fully accommodating pandemic-related spending on health care, which should be the top priority; (2) Households: increase the coverage of social safety net programs to avoid a hefty increase in poverty levels, especially among informal sector workers; and (3) Businesses: additional financing facilities, including other mechanisms such as the deferral of tax and social security contributions, along other wage subsidies. Specifically, they calculate this could cost around 2.5%-3.5% of GDP, helping to bridge the gap in fiscal support relative to peers.



Source: MoF, 2021 Economic Policy Criteria

**…and a commitment to a credible tax reform in the medium term.** Moreover, they propose narrowing the fiscal gap through a tax reform, focused on four specific type of taxes:

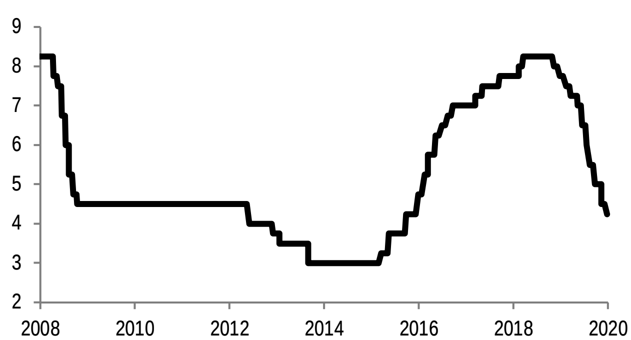
(1) *Income taxes*. To broaden the base, without ruling out an increase in tax rates and improve their progressivity, especially in the top income tax bracket
(2) *Property taxes.* To increase tax collection through higher rates to properties and vehicles, which would be efficient and progressive. Create a federal-level agency to update the cadaster and coordinate policies at the state and municipal level.
*(3) Value added taxes (VAT).* To reduce the number of goods exempted or with a zero rate, except for some key foodstuffs. This should be coupled with policies to mitigate distributional concerns and the impact to vulnerable groups. They applauded recent efforts to improve the tax administration in search for higher efficiency. On the other hand, they recommend to not continue with the reduction of this tax at the Northern Border, remembering that the VAT rate declined to 11% from 16% in 2019.
(4) *Excise tax to gasolines*. Eliminate subsidies that guarantee cumulative retail price growth below inflation, as it disproportionately helps the well off.

Regarding these suggestions, the Deputy Minister of Finance, Gabriel Yorio, said they reject increasing taxes, particularly in the current backdrop. He also stated that the government’s strategy is focused on tackling tax evasion and other schemes to minimize payments, improving overall collection levels.

**Adjustments in spending priorities in the medium term.** The institution suggests adjustments in the administration’s priorities, focusing in three points: (1) Social protection; (2) pensions; and (3) public investment. In the former, actions should be directed on the sustainability of social programs, suggesting the creation of a nation-wide unemployment benefits system and improve the scope of social security measures, eliminating overlaps and other inefficiencies. Regarding the second, they consider the recent reform proposal is a good step forward, although adding that it would be favorable to include provisions to try to lower informality and increase coverage efficiently. On the latter, they highlight the need to increase investment, not only physical but also on human capital, to improve productivity.

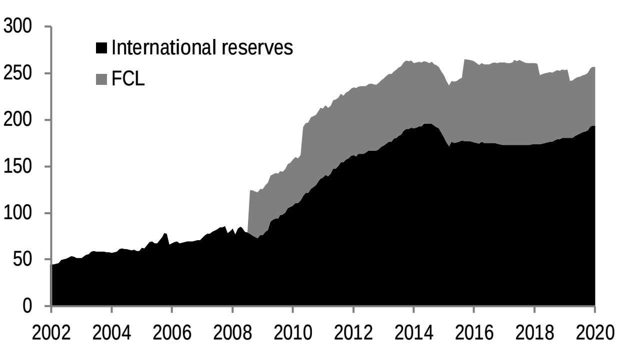
**Banxico can cut the reference rate further.** The IMF recognizes the central bank's response in the face of this complex environment, including the easing cycle started last year –with 400bps accumulated cuts, as shown in the chart below to the left– and facilities to improve market functioning, liquidity and the supply of credit. Although positive, they argue the reference rate can be cut further, as: (1) recent price pressures reflect transitory factors; and (2) inflation expectations remain anchored, with the one-year ahead, mid- and long-term estimates around 3.5%. They note the real policy rate is among the highest among EM peers and the stance is modestly accommodative, with Mexico able to withstand external stress due to comfortable international reserves (see chart below, right), access to the US Fed swap line and the IMF's Flexible Credit Line, among other factors. This could help in reducing debt servicing pressures, possibly boost investment and increase the attractiveness of the abovementioned credit facilities. They acknowledged a difficult tradeoff stemming from a lower rate, such as concerns over capital outflows and peso depreciation –broadly catalogued as financial stability risks by some Board members–. Nevertheless, they think downside risks of portfolio outflows have diminished because of a very strong policy support by advanced economies. Given the very uncertain outlook, other recommendations include considering limiting capital distributions (e.g. dividend payments), closing regulatory and supervisory gaps in the banking system, and strengthening authorities' powers to request preemptive actions, among others.

Reference rate
%




Source: Banxico

International reserves
US$ billion




Source: Banorte with data from Banxico and the IMF

**Mexico should also consider an independent review of the monetary policy framework.** The IMF said a review may be favorable as inflation and its expectations have remained "somewhat above target", even though inflation and its volatility has declined since the introduction of the inflation targeting regime, adopted officially in 2001 (with the 3% +/- 1% target since 2003). The opportunity has widened after the recent strategy review by the Fed (and potential changes by other major central banks, such as the ECB), in which they could explore, among others, the determinants of inflation, measures and the policy toolkit.

**Recommendations seeking to increase certainty and productivity in the long-term.** The institution mentioned that the approval of USMCA has helped to reduce uncertainty in trade, however "*...domestic reform reversals that weighed on investment before the pandemic have continued [...], potentially weakening the recovery...*". Considering this, they call for structural measures, with specific actions in five fronts: (1) Reduction of labor informality; (2) promote investment from the private sector in energy projects; (3) increase regulators' capabilities to improve competition; (4) foster greater financial inclusion; and (5) strengthen governance, focusing on anti-corruption and money-laundering.

**The dialogue between multilateral institutions and Mexican authorities is positive, although will little space to be instrumented in the short-term.** Overall, we consider that the IMF's suggestions are valuable. In addition, the fact that they had the blessing from the Federal Government for a second consecutive year gives greater weight to the possibility of some of these recommendations to be followed. Despite of the latter and as already mentioned, we believe the government will remain firm in their stance in some fronts. Therefore, we see little space for these recommendations to be instrumented in the short-term. Moreover, we believe it is positive that this type of dialogue with multilateral institutions continues, especially in a very challenging global and local backdrop.

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