MISSION CONCLUDING STATEMENT

Mexico: Staff Concluding Statement of the 2024 Article IV Mission

October 15, 2024

Key Messages

Activity is decelerating. Despite an expansionary fiscal stance, growth is slowing to around 1½ percent this year, partly due to binding capacity constraints and a tight monetary policy stance. Continuing monetary restraint and slowing activity are expected to lower inflation to Banxico's 3-percent target by 2025. The current account deficit is expected to widen slightly in 2024 as investment- and consumption-related imports outpace exports. Risks to growth are tilted to the downside while inflation risks remain on the upside. Weaker-than-expected growth in the U.S., an increase in global risk aversion, and unforeseen effects from recent institutional reforms could weigh on output. On the other hand, better-than-expected import demand from the U.S. or the ongoing reshaping of global value chains could boost activity and inward investment.

A medium-term fiscal strategy is needed to reduce deficits and debt, raise tax revenues, and create fiscal space for investments in human and physical capital. This would require putting in place a comprehensive tax reform early in the new administration, durably reducing the fiscal deficit while carefully prioritizing public spending, and reducing inequities in the pension system. Addressing the imbalances between the federal budget and Pemex, and enhancing corporate governance of the latter, are also important priorities.

The ongoing reshaping of global value chains offers the incoming administration an important opportunity to deepen the already-strong economic links with the U.S. Taking advantage of these prospects, however, requires a wide-ranging set of supply-side reforms to complement the well-established, very strong institutional framework for macroeconomic policies. Regulatory reforms, better-targeted public investment that further relieves infrastructure bottlenecks, broader access to financial services, and a more predictable supply of energy and water would all support private sector-led growth. Other priority measures include governance reforms that address corruption and tackle organized crime.

Recent judicial reforms create important uncertainties about the effectiveness of contract enforcement and the predictability of the rule of law. The replacement of judges at various levels of the judiciary in the coming year creates a new source of uncertainty that may impinge upon private investment decisions. It is critical that this reform be implemented in a clear and predictable way that ensures the independence and professionalism of the judiciary and strengthens the rule of law. Staff's current baseline does not incorporate potential headwinds from these uncertainties.

Fiscal Policy

The authorities are committed to achieving their 2024 fiscal target. The overall deficit for the year is currently projected to be 5.9 percent of GDP, a fiscal impulse of around 2 percent of GDP that is expected to bring gross public sector debt close to 58 percent of GDP by end-2024. Increased spending on large infrastructure projects, wages, pensions, and social spending are all adding to fiscal support for the economy. There is, however, a risk that additional support for Pemex and/or greater-than-expected spending on infrastructure projects could lead to a modest fiscal overrun by end-year.

Mexico needs to put in place a credible medium-term fiscal consolidation underpinned by well-identified policy measures. The incoming authorities' plan to initiate an important fiscal consolidation in 2025 that should lower the deficit to below 3 percent of GDP over the medium term, underscoring Mexico's commitment to fiscal prudence. This will require the identification and implementation of additional fiscal measures, preferably including an overarching tax reform. In particular, the 2025 budget should focus on reducing tax expenditures and reassessing both tax rates and thresholds, particularly for the personal income tax. Further expenditure rationalization, including tax exceptions, and improved tax administration would contribute to this needed adjustment and help bolster market confidence.

A review of policies regarding support for Pemex, and the energy sector more generally, would enhance the credibility of the government's fiscal plans. Federal government support for Pemex in the form of various tax reliefs, investments, and transfers have cost 1 percent of GDP in 2024. Further support should be conditioned on Pemex developing a viable business strategy and improving its corporate governance. This could include focusing Pemex activities on profitable fields, selling non-core assets, developing a new strategy for unprofitable refinery operations, and incentivizing public-private partnerships (including via equity participation). The strategy should also examine the implications for, and linkages with, the federal electricity company.

More is needed to address structural inequities in the pension system. Public pension spending has increased by 0.6 percent of GDP over the past three years and will continue to rise over the medium term. While the recent reform to raise the replacement rate aims to equalize treatment across workers, inequities remain between and within cohorts. A broader review is therefore needed of the benefit structure and the minimum contribution requirement.

Monetary Policy

The disinflation process is well advanced. Banxico's timely response to the post-pandemic upswing in inflation has kept medium-term inflation expectations anchored and facilitated a smooth process of disinflation. Nonetheless, services inflation has been slow to respond and increases in the price of gas and agricultural products–reflecting global developments and weather shocks, respectively–have added to headline inflation. This has justified Banxico's decision to remove monetary restraint gradually, contingent on clearer evidence that inflation is heading decisively back to the central bank's 3-percent target.

There is scope to boost the effectiveness of monetary policy by further enhancing Banxico's communication toolkit. Mexico's monetary policy framework proved itself to be robust and credible when it was tested during the post-pandemic period. Banxico now provides central inflation forecasts to the public and has developed its use of qualitative forward guidance, which has helped entrench forward-looking price-setting behavior among economic agents. Options to further strengthen the institutional framework could include providing greater information on the policy assumptions that underpin the authorities' inflation and activity projections, and further tailoring central bank communication to different audiences. Any additional disclosure should emphasize that the information being provided is not a policy commitment but is aimed at helping market participants and the public better understand the central bank's policy decisions and its interpretation of incoming data.

A flexible exchange rate is firmly ingrained into Mexico's policy framework. Mexico has a deep and liquid FX market, limited FX balance sheet mismatches, and a range of available natural and financial FX hedges. The peso continues to be supported by a strong external position. While the peso's dynamics are subject to both domestic and foreign factors, there is a strong commitment to exchange rate flexibility as an essential tool to facilitate a smooth adjustment of the economy in the face of external and domestic shocks.

Financial Policies

The financial system is resilient to a range of shocks. Strong capital ratios and results from Banxico's recent stress test exercise indicate that capital levels would remain above statutory requirements even in a very stringent downside scenario. Banks and corporate balance sheets continue to be well insulated from the impact of possible global shocks. Although several non-bank financial cooperatives have a highly concentrated deposit base, they are modest in size and have limited linkages to the banking sector.

Authorities have made progress in implementing the recommendations of the 2022 Financial System Stability Assessment . Together with other financial agencies, Banxico and CNBV, the banking and securities regulator, are continuing to modernize their systems to detect and address cyberattacks. Banxico has also implemented steps to broaden the scope of its framework for liquidity stress tests. In this regard, the authorities are continuing to operationalize a framework for market-wide cyber crisis simulation exercises. In addition, efforts are underway to enhance system capacity and resilience to ensure a more comprehensive and data-driven system of oversight. The outstanding agenda includes strengthening the independence of financial regulators and improving legal safeguards for supervisors. A review of macroprudential policies is underway, including examining the experience of other countries with the adoption of loan-to-value and debt service-to-income requirements.

Addressing 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. The banking and securities commission and the tax authority should align their supervisory activities in and tax evasion. There is scope for other AML/CFT agencies and anti-corruption bodies to enhance collaboration also. An updated national strategy should be developed to address ML/TF risks and investigate illicit financial flows that stem from financial crimes. Additionally, better understanding the financing of organized crime would help the authorities set appropriate AML/CFT policies and institutional priorities.

Supply-Side Reforms

Mexico is uniquely well placed to take advantage of opportunities arising from the ongoing reshaping of global value chains. Mexico has benefited from strong demand from the U.S. in the wake of the pandemic and is receiving robust FDI inflows which are leveraging Mexico's developed manufacturing system, availability of human capital, and favorable access to the U.S. market under the USMCA. Mexican industry is, as a result, increasingly integrated into global value chains connected to the U.S. generating significant domestic value added. Maintaining open trade policies will continue to underpin business investment and bolster Mexico's international competitiveness. Mexico has increased its imports of intermediate and final goods from China, though only by a fraction of the increase in Mexico's exports to the U.S. This rise in Chinese imports also reflects higher Mexican consumption of Chinese-made cars and smartphones as well as machinery imports that are being used to increase Mexico's capacity in a range of manufacturing sectors.

Taking full advantage of shifting global supply chains will require implementing a set of supply-side reforms. These involve streamlining regulations, addressing critical infrastructure gaps (including those in transportation, water, and energy), increasing worker skills, and raising female labor force participation. Greater regional market integration and addressing structural impediments to investing in regional markets would support more inclusive growth across the country.

Addressing crime, insecurity and corruption would spur investment and job creation. The increase in violence since 2007 has adversely impacted labor markets and raised the cost structure and uncertainty for firms operating in Mexico. Perceived judicial corruption, political interference, and pressures from organized crime undermine the business environment and compromise the predictability of the rule of law. Governance reforms should prioritize establishing a robust asset declaration system, adequate legal protections for whistleblowers, and improve the effectiveness of anti-corruption institutions. Strong safeguards are needed to protect judicial professionalism and independence to ensure commercial disputes are fairly adjudicated and contracts are enforceable.

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Further deepening of financial intermediation would make growth more inclusive. The recent development of fintech products and digital payments have expanded access to financial products. In addition, financial regulations that lower loan-loss provisioning for female borrowers have increased women's access to credit. These efforts could be complemented by expanding the adoption of digital payment systems and eliminating institutional barriers to entry for new products and entities that are deemed to be financially sound.

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

I. Social and Demographic Indicators			
GDP per capita (U.S. dollars, 2023)	13,643.3	Poverty headcount ratio (% of population, 2023) 1/	37.0
Population (millions, 2023)	131.1	Income share of highest 20 perc. / lowest 20 perc. (2022)	8.4
Life expectancy at birth (years, 2024)	75.5	Adult literacy rate (2020)	95.2
Infant mortality rate (per thousand, 2023)	13.6	Gross primary education enrollment rate (2022) 2/	102.0

II. Economic Indicators

						Proj.
	2020	2021	2022	2023	2024	2025
(Annual percentage change, unless otherwise indicated)						

National accounts (in real terms)						
GDP	-8.4	6.0	3.7	3.2	1.5	1.3
Consumption	-8.6	7.1	4.5	4.6	1.0	0.9
Private	-9.8	8.4	4.9	5.0	1.0	0.9
Public	-0.7	-0.5	1.7	2.1	1.2	1.1
Investment	-18.3	11.4	7.4	17.8	4.0	3.8
Fixed	-17.2	10.5	7.5	18.0	5.0	3.0
Private	-18.6	12.6	7.7	17.6	5.3	3.2
Public	-5.7	-3.5	5.8	20.9	3.8	1.2
Inventories 3/	-0.3	0.2	0.0	0.0	-0.2	0.2
Exports of goods and services	-7.0	7.1	8.9	-7.4	-0.6	3.3
Imports of goods and services	-12.0	15.7	7.6	5.0	1.1	2.3
GDP per capita	-9.1	5.4	2.9	2.3	0.6	0.5
External sector						
External current account balance (in percent of GDP)	2.4	-0.3	-1.2	-0.3	-0.7	-0.9
Exports of goods, f.o.b. 4/	-9.4	18.6	16.7	2.6	1.4	3.6
Imports of goods, f.o.b. 4/	-15.9	32.0	19.6	-1.0	3.0	4.6
Net capital inflows (in percent of GDP) 5/	0.8	-1.0	-0.9	-0.9	-1.9	-1.4
Terms of trade (goods, improvement +)	0.8	-1.0	-3.1	16.9	-1.7	-0.3

Gross international reserves (in billions of U.S. dollars)	199.1	207.7	201.1	214.4	235.0	244.8
Exchange rates						
Real effective exchange rate (avg, appreciation +) 6/	-7.7	5.9	5.3	16.4	...	...
Nominal exchange rate (MXN/USD) (eop, appreciation +)	-5.9	-3.2	5.7	12.8	...	...
Inflation, Employment and Population						
Consumer prices (end-of-period)	3.2	7.4	7.8	4.7	4.5	3.2
Core consumer prices (end-of-period)	3.8	5.9	8.3	5.1	4.0	3.1
Formal sector employment, IMSS-insured workers (average)	-2.5	1.9	4.3	3.6	...	...
National unemployment rate (annual average)	4.4	4.1	3.3	2.8	3.0	3.3
Unit labor costs: manufacturing (real terms, average)	10.4	4.4	11.8	1.9	...	...
Total population 7/	0.8	0.6	0.8	0.9	0.9	0.8
Working-age population 7/	1.1	1.0	1.1	1.2	1.1	1.0
Money and credit						
Financial system credit to non-financial private sector 8/	0.9	4.2	10.9	8.7	8.0	7.5
Broad money	13.4	9.5	7.3	11.0	7.8	7.3
Public sector finances (in percent of GDP) 9/						
General government revenue	23.5	22.9	24.3	24.4	24.2	23.8

General government expenditure	27.8	26.6	28.6	28.7	30.1	27.3
Overall fiscal balance 10/	-4.3	-3.7	-4.3	-4.3	-5.9	-3.5
Structural primary balance 11/	0.6	1.2	0.9	1.1	-1.1	0.9
Fiscal impulse 12/	0.5	-0.5	0.2	-0.2	2.2	-2.0
Gross public sector debt	58.5	56.7	54.1	53.0	57.6	57.9
Memorandum items						
Nominal GDP (billions of pesos)	24,087	26,690	29,473	31,772	34,313	36,766
Output gap (in percent of potential GDP)	-2.8	-2.0	0.0	1.2	0.6	-0.1

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 IMF staff calculations.