INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/336

MEXICO

2019 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

November 2019

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 4, 2019 consideration of the staff report that concluded the Article IV consultation with Mexico.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 4, 2019, following discussions that ended on September 30, 2019, with the officials of Mexico on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 18, 2019.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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November 5, 2019

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2019 Article IV Consultation with Mexico

On November 4, 2019 the Executive Board of the International Monetary Fund concluded the Article IV Consultation[1] with Mexico.

The Mexican economy has continued to exhibit resilience in a complex environment, but growth has come to a standstill amid elevated policy uncertainty, tight monetary conditions, and budget under-execution. The authorities' commitment to fiscal prudence is strong, monetary policy has succeeded in bringing inflation to target, and financial sector supervision and regulation remain robust. The flexible exchange rate is playing a key role in helping the economy adjust to shocks.

Growth is expected to accelerate modestly in the near-term, reaching 0.4 percent in 2019, as macroeconomic policies become less contractionary. It is projected to recover to 1.3 percent in 2020 on the back of strengthening consumption and despite continued weakness in investment. Headline inflation is projected to remain around the central bank's target of 3 percent, while core inflation is expected to gradually decline from elevated levels amid still tight monetary policy.

Fiscal policy remains prudent. The authorities adhered to their 2.5 percent of GDP fiscal deficit target in 2018 but are projected to narrowly miss the same target in 2019 due to a weak revenue performance. The authorities' current medium-term targets would keep debt broadly stable at around 55 percent of GDP. However, in the absence of additional measures to raise revenues or reduce spending, a fiscal gap of 0.5–1.5 percent of GDP would emerge during 2020–24.

Monetary policy has started easing in the context of a widening negative output gap and declining inflation. The central bank reduced the policy rate in two 25 basis point steps in

[1] Under Article IV of its Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussions by the Executive Board.

August and September to 7.75 percent. Meanwhile, it did not intervene in the market, which allowed the peso to adjust freely to shocks.

Mexico’s external position remains broadly consistent with medium-term fundamentals and desirable policy settings. Staff projects the current account deficit to narrow this year and to widen modestly over the medium-term. Foreign exchange reserves are adequate according to a range of indicators, while the FCL continues to provide an effective complement in reducing risks. However, the strong presence of foreign investors leaves Mexico exposed to greater risks in terms of capital flow reversals and increased risk premia.

Executive Board Assessment[2]

Executive Directors commended the authorities for the continued maintenance of a strong policy framework, which contributed to the resilience of the Mexican economy in the face of elevated uncertainty. Noting these risks and the recent slowdown in growth, they highlighted the need for steadfast implementation of sound macroeconomic policies combined with an acceleration of structural policy reforms to foster strong, sustainable, and inclusive growth.

Directors welcomed the authorities’ resolve to maintain fiscal discipline. They stressed, however, that more ambitious fiscal targets were necessary to put the public debt ratio on a downward path. In this context, they underscored the need to increase non-oil tax revenues. They saw scope for, strengthening revenue administration, rationalizing tax expenditures, raising subnational taxes, and making the tax system more progressive, while also enhancing public expenditure efficiency. In this regard, Directors also saw merit in establishing a fiscal council to support the administration’s commitment to fiscal responsibility.

Directors urged the authorities to revise Pemex’s business plan to strengthen its financial position and reduce risks to the budget. Directors underscored the need for Pemex to make progress in selling non-core assets and provide credible plans to reduce operating costs to strengthen profitability. Increased cooperation with private firms could also bolster production and diversify risks.

While being mindful of risks, directors saw scope for easing of monetary policy, as long as inflation stays close to the target and inflation expectations remain anchored. They commended the Banco de México’s continued efforts in improving its communication strategy, which would help provide greater clarity and effectiveness to monetary policy. They noted that exchange rate flexibility should remain a key absorber of shocks, foreign exchange intervention should be limited to incidences of disorderly market conditions.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors noted that the financial sector remained sound and emphasized that resilience could be further enhanced by closing gaps in the regulatory and supervisory framework. They welcomed efforts to boost financial sector competition and inclusion and considered that a multi-pronged strategy to further boost competition and inclusion should be a policy priority going forward.

Directors underscored that reinvigorating the structural reform agenda is an imperative to foster strong, sustainable and inclusive growth. They emphasized the need to reduce corruption, labor informality, and enhance the rule of law by strengthening the AML/CFT framework and implementing the National Anti-Corruption System (NACS). Lowering participation barriers for women and removing constraints to trade in services could narrow the gender gap and boost activity. Directors considered that, in general, labor informality could be addressed by reducing entry costs strengthening enforcement and replacing hiring and firing restrictions with an unemployment insurance scheme.

Mexico: Selected Economic, Financial Indicators 1/

(2015–2019)

	2015	2016	2017	2018	2019 2/
	(Annual percentage changes, unless otherwise indicated)				
National accounts and prices					
Real GDP	3.3	2.9	2.1	2.1	0.4
GDP per capita in U.S. dollars 3/	9,674	8,816	9,373	9,786	10,064
Gross domestic investment (in percent of GDP)	23.3	23.8	23.0	22.7	21.6
Gross domestic savings (in percent of GDP)	20.6	21.5	21.2	20.9	20.4
Consumer price index (end of period)	2.1	3.4	6.8	4.8	3.1
External sector					
Exports, f.o.b.	-4.1	-1.7	9.5	10.1	2.2
Imports, f.o.b.	-1.2	-2.1	8.6	10.4	1.2
External current account balance (in percent of GDP)	-2.6	-2.2	-1.7	-1.8	-1.2
Gross international reserves (in billions of U.S. dollars)	177.6	178.0	175.4	176.4	178.0
Outstanding external debt (in percent of GDP)	35.6	38.3	37.7	36.6	37.4
Nonfinancial public sector (in percent of GDP)					
Government Revenue	23.5	24.6	24.7	23.5	22.8
Government Expenditure	27.5	27.4	25.7	25.7	25.6
Augmented overall balance	-4.0	-2.8	-1.1	-2.2	-2.8
Money and credit					
Financial system credit to the non-financial private sector	14.8	16.5	10.8	8.8	6.9
Broad money (M2a)	12.2	12.3	11.2	5.5	5.1

Source:
1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.
2/ Staff projections.
3/ IMF staff estimates.

INTERNATIONAL MONETARY FUND

MEXICO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

October 18, 2019

KEY ISSUES

Context: The authorities are committed to very strong policies and policy frameworks. However, policy uncertainty and new priorities have created challenges and have clouded the growth outlook. Large-scale investment projects and social transfers—and a commitment to not raise taxes until after 2021—are yet to be reconciled with the administration's fiscal targets and the objective of putting public debt on a downward path. Meanwhile, drastic budget cuts for some institutions have raised concern about their impact on human capital. A state-centered energy policy that limits the role of the private sector—putting the onus of stabilizing Pemex (the state-owned oil and gas company) squarely on the government—has imposed further pressure on the budget and has weakened prospects for oil production. Promises to tackle some of Mexico's salient structural challenges—including corruption, informality and crime—have yet to be followed by concrete policy action.

Outlook and Risks: Output growth is projected to fall to 0.4 percent in 2019 before recovering to 1.3 percent in 2020 and 2.4 percent over the medium term as uncertainty subsides. Headline inflation reached the central bank's target, but core inflation remains stubbornly high notwithstanding a very tight monetary policy stance. The main external risks pertain to trade-related uncertainty, weaker-than-projected global growth, and volatility in global financial markets. Domestic risks include a failure to introduce credible measures to meet the fiscal targets, a weakening of institutions, a further decline in oil revenues, and a Pemex downgrade to non-investment grade status by a second major rating agency.

Macroeconomic Policies: The administration's solid mandate presents an opportunity to address Mexico's longstanding structural challenges while maintaining very strong policies and policy frameworks. Staff highlighted the need to specify credible measures to reach the announced fiscal targets while adopting a more growth-friendly and inclusive policy mix. Increasing non-oil tax revenues, paired with improving the efficiency of spending, will be an imperative in this regard. Over the medium term, more ambitious fiscal targets will help build buffers and put debt on a downward path, while strengthening the fiscal framework would enhance the credibility of fiscal policy. Reconsidering Pemex's business plan, and a renewed commitment to private participation in the energy sector would help increase the prospects of a sustained rebound in oil production. The authorities should continue to ease monetary policy so long as inflation remains close to target and inflation expectations remain anchored. On the structural front, re-invigorating the reform agenda with an emphasis on strengthening the rule of law, fighting corruption, and reducing informality would help boost potential output and foster inclusiveness.

Advice from Previous Article IV Consultations: Consistent with past Fund advice, the government adhered to the 2.5 percent of GDP target for the Public Sector Borrowing Requirement in 2018, although it is projected to miss the same target for 2019. As recommended in the 2018 Article IV consultation, the authorities canceled the universal tax offset—which should constrain opportunities for tax fraud once the backlog of existing claims clears—and reduced management fees for pension funds to strengthen pension adequacy. Banxico began lowering the policy rate as inflation came down and expectations remained anchored. As for structural reforms, the authorities initiated a package of reforms to strengthen financial deepening and inclusion.

Approved By
Krishna Srinivasan (WHD) and Tam Bayoumi (SPR)

Discussions were held in Mexico City during September 19–30, 2019. The mission comprised Costas Christou (head), Julia Bersch and Christian Saborowski (WHD), Richard Berkhout (LEG), Balazs Csonto (SPR), Dimitris Drakopoulos (MCM), and Mehdi Raissi (FAD). Jorge Alvarez (WHD) contributed to the mission's work from headquarters. Krishna Srinivasan (WHD) joined the concluding meetings. Mr. Guerra and Ms. Arevalo Arroyo (OEDCE) also participated. The mission met with Bank of Mexico Governor Diaz de Leon, Secretary of Finance and Public Credit Herrera, Energy Secretary Nahle, other senior officials, representatives of the business community, other IFIs, and academics. Juan Pablo Cuesta and Irina Sirbu (WHD) contributed to the preparation of this report.

CONTENTS

FIGURES

TABLES

ANNEXES

A DOMESTIC POLITICAL SHIFT IN AN UNSETTLED EXTERNAL ENVIRONMENT

1. **The authorities are committed to very strong macroeconomic policies and policy frameworks.** President Lopez Obrador took office in December 2018. He has since repeatedly pledged his government's commitment to fiscal prudence and an independent central bank. Monetary policy has succeeded in returning inflation to target, and financial sector supervision and regulation remain robust. The flexible exchange rate is playing a key role in helping the economy adjust to external shocks, while Mexico's external position remains broadly consistent with medium-term fundamentals and desirable policy settings.

2. **But policy uncertainty has weakened the investment climate.** Uncertainty has arisen in the context of decisions on the part of the administration that appeared to weaken policy predictability. These included the cancelation of energy auctions, the renegotiation of pipeline contracts, and a controversial public consultation that led the administration to cancel the construction of a new airport in Mexico City that had already been partially built. Meanwhile, concerns have arisen about the sustainability of drastic budget cuts and their potential impact on human capital and the role of some regulatory agencies and autonomous institutions. The resignation of the former Finance Minister and his reported criticism of some of the administration's decisions reinforced uncertainty.

3. **New policy priorities have created fiscal challenges.** Large-scale investment projects and social transfers—and a commitment to not raise taxes until after 2021—have yet to be reconciled with the announced fiscal targets and the authorities' objective of stabilizing public debt. A state-centered energy policy constrains the role of the private sector and puts the onus of stabilizing Pemex squarely on the government. Meanwhile, the structural reform agenda has mostly stalled.

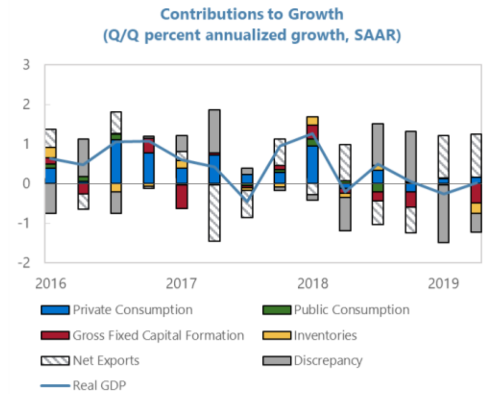
4. **An unsettled external environment further complicates policymaking.** Although Mexico has ratified the new trilateral trade agreement (USMCA), Canada and the U.S. have yet to do so. Moreover, tensions between Mexico and the U.S. heightened in May, when the U.S. threatened to impose tariffs of up to 25 percent on all goods imports from Mexico, which was avoided only after a commitment by Mexico to curb migration to the U.S. The tariffs have been shelved for now, but the threat remains.

RECENT DEVELOPMENTS

5. **The Mexican economy has slowed sharply.** Growth came to a stand-still in 2019:H1 amid weak domestic demand—owing to policy uncertainty, tight monetary conditions and budget under-execution—as well as slowing global manufacturing activity (Box 1).[1] Net exports supported

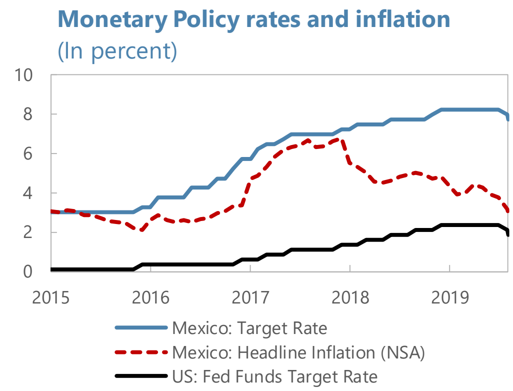
[1] The text chart is based on quarterly data which do not yet reflect modest revisions to annual national accounts data published on October 2.

economic activity, though largely due to a compression in imports. The long-awaited investment recovery has been held back by elevated uncertainty, while consumption, which had been the main engine of growth thus far, has started to show signs of weakness. The unemployment rate has edged up to 3.7 percent as real wage growth turned positive (Figure 2).



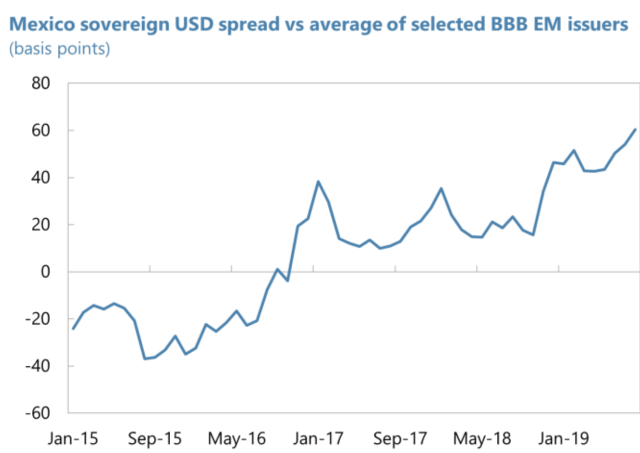
6. The current account improved as weak activity weighed on imports. In 2019:H1, import growth, notably of capital goods, declined significantly amid weak domestic demand, while exports held up relatively well, owing partly to trade diversion in the context of trade tensions between the U.S. and China (Box 3). The current account was also supported by strong remittances. Following a solid performance in 2019:Q1, portfolio and FDI inflows have slowed in the second quarter.

7. Headline inflation has continued to fall, prompting a monetary policy easing. A very tight monetary policy stance amid a sizeable and widening negative output gap has helped bring headline inflation to Banxico's 3 percent target. The decline from around 5 percent a year ago was driven by non-core inflation, particularly energy prices. However, core inflation remains stubbornly high at 3.8 percent—reinforced by strengthening real wage growth and, until recently, buoyant consumption—but weak activity and increasing slack should soften it going forward. Against this backdrop, and given U.S. policy easing, Banxico reduced the policy rate in two 25-basis-point steps in August and September to 7.75 percent. Meanwhile, it refrained from any FX intervention and allowed the peso to adjust freely to shocks.



Source: Banco de Mexico, INEGI, and Federal Reserve Board.

8. Asset prices have reflected the increased uncertainty. The peso was relatively resilient in 2019 and strengthened relative to regional peers, due in part to its high carry. However, sovereign spreads widened against similarly rated issuers as some market participants expected ratings downgrades for both Pemex (Box 2) and the sovereign, while equities dropped in the context of increased policy uncertainty and weakening economic growth. Fitch downgraded Mexico's BBB+ rating to BBB with a stable outlook in June and reduced Pemex's rating in



Sources: IMF staff estimates and Bloomberg.

two steps from BBB+ to non-investment grade (BB+). S&P and Moody's revised their outlook to negative in March and June, respectively.

9. The financial sector remains profitable and well capitalized. As of June, the sector's Tier-1 capital ratio stood at 14.2 percent and the return on equity at 20.9 percent, driven by near record high net interest margins, while the NPL ratio remained at a near record low of 2.1 percent. Over the past year, commercial bank credit growth to the non-financial corporate sector has slowed from over 11 percent y-o-y to 9 percent in August, while consumer credit growth has remained stable at 7.2 percent y-o-y.

10. The structural reform agenda has mostly stalled. The authorities passed labor reforms to strengthen worker rights and labor unions and establish an independent labor dispute resolution mechanism. In the financial sector, they have taken several legislative initiatives to strengthen financial deepening and inclusion. However, promises to tackle some of Mexico's salient structural challenges—namely, corruption, informality and crime—have yet to be followed by significant policy action. Prospects for increased private investment in the energy sector have weakened as the authorities halted oil and gas auctions and plans for further Pemex farm-outs.

OUTLOOK AND RISKS

11. Uncertainty will weigh on the near-term outlook. Staff's baseline scenario is predicated on the assumption that uncertainty will subside gradually in the context of an improving investment climate and the anticipated ratification of the USMCA by all signatories by next year. Furthermore, the scenario assumes that Banxico will continue easing monetary policy as domestic and external risks dissipate, and core inflation converges to the 3 percent headline inflation target, reaching a neutral policy stance by 2021.

12. Budget execution is expected to accelerate, and the fiscal stance to turn expansionary. A budget under-execution during the first half of the year prompted measures announced in July that would accelerate spending within budgetary limits and boost SME and consumer lending by development banks and other public institutions. While staff assumes expenditure to accelerate in line with these plans, revenues would continue to disappoint as growth remains weak. The Public Sector Borrowing Requirement (PSBR) would reach 2.8 percent of GDP in 2019—compared to the 2.5 percent target—which would imply a notable fiscal expansion (from a PSBR of 2.2 percent of GDP in 2018).[2] The composition of spending is expected to shift away from goods and services and transfers to states toward social spending and Pemex investment. *The authorities project a PSBR of 2.7 percent of GDP, with the deviation from the target explained by lower-than-budgeted revenues on account of slowing economic growth and lower-than-expected oil production.*

[2] Transfers of 0.5 percent of GDP from the revenue stabilization fund would compensate for the shortfall of budgetary revenues with respect to the approved level but represent a financing item from the perspective of the PSBR.

Mexico: Key Macroeconomic Indicators, 2016-2024
(Percent of GDP, unless otherwise indicated)

				Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Real GDP growth (percent)	2.9	2.1	2.1	0.4	1.3	1.9	2.1	2.3	2.4
Inflation (period average, percent)	2.8	6.0	4.9	3.7	3.1	3.0	3.0	3.0	3.0
General government overall balance (Net lending/borrowing)	-2.8	-1.1	-2.2	-2.8	-2.6	-2.2	-2.3	-2.3	-2.4
General government gross debt	56.8	54.0	53.7	54.0	54.8	54.9	55.0	55.1	55.1
Current account	-2.2	-1.7	-1.8	-1.2	-1.6	-1.7	-1.8	-1.9	-2.0
Net international reserves (in billions of U.S. dollars)	176.5	172.8	174.8	176.4	178.1	181.0	184.5	189.1	194.1

Sources: Bank of Mexico, Ministry of Finance and Public Credit, and Fund staff estimates.

13. **Monetary and financial conditions are also expected to ease but will remain tight.** With the ex-ante real rate just below 5 percent in staff's projection as of October—and thus still notably above staff's and Banxico's estimates of the neutral rate of 2.0–2.5 and 1.8–3.4 percent—policy remains very tight and is expected to loosen only gradually. Credit growth would edge down slightly, including due to continued policy uncertainty and weak growth prospects. Financial sector profitability could come under pressure given the slowing economy and the projected easing of financial conditions but should remain high. Policy uncertainty, trade risks and concerns about Pemex could also weigh on credit spreads, while still-high interest rates could impact repayment capacity.

14. **Economic activity is projected to benefit from less contractionary macroeconomic policies going forward and should recover as uncertainty subsides.** Growth is projected to reach 0.4 percent in 2019, with an acceleration in public spending supporting a modest growth pick-up during 2019:H2. It would reach 1.3 percent in 2020 as monetary conditions ease further, uncertainty gradually subsides, and private consumption recovers. Staff has revised medium-term growth down to 2.4 percent, in part reflecting several years of sub-par investment and the stalling of structural reforms, particularly in the energy sector. Headline inflation is expected to remain around Banxico's 3-percent target, while core inflation should reach the headline inflation target by mid-2020. *The authorities held a somewhat more upbeat view on the short-term outlook, projecting growth in 2020 to accelerate to around 2 percent, including driven by strengthening private consumption, increasing oil production and development bank lending. There was broad agreement on the medium-term outlook.*

15. **There was agreement that the external position remains broadly in line with medium-term fundamentals and desirable policy settings.** Following a temporary narrowing in 2019, staff projects the current account deficit to widen slightly over the medium term, and, at these levels, it is broadly in line with medium-term fundamentals and desirable policy settings (Annex II). At end-September, the peso was 2 percent stronger in real effective terms relative to its 2018 average. In staff's assessment, the peso is currently broadly in line with the level suggested by fundamentals. The net international investment position would improve modestly to below 46 percent of GDP over the medium term. Foreign exchange reserves are adequate, while the FCL provides an effective complement.

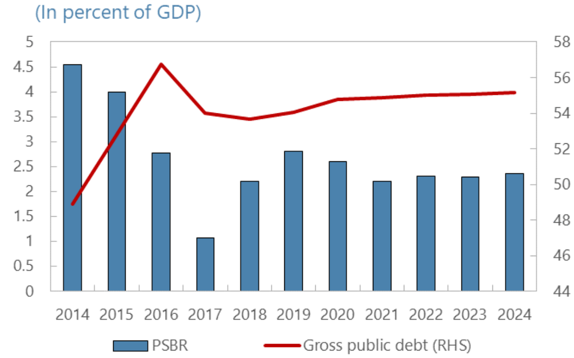
16. The balance of risks is tilted to the downside (Annex I). External risks that could weaken Mexico's growth outlook include a fall in global growth originating, for example, from a U.S. slowdown. At the same time, uncertainty about Mexico's trade relationship with the U.S. persists as the USMCA has yet to be ratified by Mexico's trade partners, while the U.S. tariff threat related to migration issues remains. Mexico is also exposed to the risk of financial market volatility, increased risk premia, and a sharp pull-back of capital from emerging markets. On the domestic front, 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. A Pemex downgrade to non-investment grade by a second major rating agency would lead to selling pressure, while lower oil revenues could make it harder to achieve the fiscal targets. On the other hand, concrete steps to enhance good governance and the rule of law, and advance productivity-enhancing structural reforms, constitute upside risks. *The authorities highlighted continued uncertainty about trade relations with the U.S. and volatility in global financial markets as key risks. They agreed with staff that uncertainty generated by rising global trade tensions remains a significant risk for the Mexican economy, although trade diversion effects may mitigate part of the adverse impact. Finally, they considered that a USMCA ratification would reduce uncertainty, boost FDI and strengthen the domestic investment climate.*

STRENGTHENING INCLUSIVE GROWTH WHILE ENSURING STRONG MACROECONOMIC POLICIES

A. Fiscal Policy: Raising Non-Oil Tax Revenues and Improving Spending Efficiency with a More Growth-Friendly and Inclusive Policy Mix

17. Staff welcomed the commitment to fiscal prudence but emphasized that medium-term targets need to be more ambitious to put public debt on a downward path. The authorities' deficit target of 2.6 percent of GDP for 2020 appropriately balances fiscal prudence with the need to avoid a contractionary policy stance in the context of a large negative output gap. While the overall macro policy mix will likely not be accommodative—as monetary policy is expected to ease only gradually from a very tight stance—preserving a prudent fiscal stance as an anchor of stability remains important. The authorities' medium-term fiscal projections target a PSBR of 2.2–2.4 percent of GDP, which would keep debt broadly stable at around 55 percent of GDP over the medium-term. While a broadly stable debt path would help preserve policy credibility, staff recommended more ambitious fiscal targets over the medium term—as the output gap closes—with deficits low enough to rebuild buffers against shocks and put debt on a declining path, while accommodating higher levels of

PSBR and Gross Public Debt Projections
(In percent of GDP)



Source: SHCP and Staff Calculations

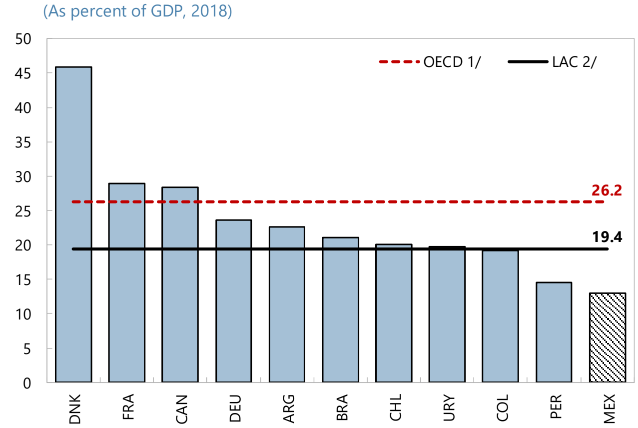
social, investment and aging-related spending. *The authorities noted that their projections—assuming higher nominal growth—do see the debt ratio decline over the medium-term.*

18. Staff urged the authorities to specify additional measures to underpin their fiscal targets. Staff projects a fiscal gap of about 0.5 percent of GDP in 2020, and up to 1.5 percent of GDP thereafter. Compared to the authorities' projections, gaps arise from less optimistic assumptions for nominal growth, oil production and revenue administration gains as well as doubts about the feasibility of sharp cuts to goods and services spending. Staff also voiced concern about the low level of non-Pemex capital spending, which would additionally be crowded out by large priority projects (e.g., the Maya train and the Trans-Isthmus railway). In an adverse scenario in which the fiscal gap persists, staff projects debt to increase to 63 percent of GDP by 2024 (Annex III). *The authorities were confident that they would not exceed their deficit targets. They highlighted that they would continue to prioritize a non-increasing net debt-to-GDP ratio in line with the existing fiscal framework, and that they stood ready to cut spending—including capital expenditure—or take revenue-enhancing measures in the event of shortfalls.*

19. Staff recommended reformulating Pemex's business plan, with a view to strengthening the company and reducing risks to the budget. The plan limits cooperation with private firms in Pemex's upstream business to service contracts, envisages investing heavily in its loss-making downstream business, does not lay a focus on selling non-core assets, and lacks credible measures to reduce operating costs. The mission recommended reconsidering these decisions as they place the onus of stabilizing Pemex squarely on the government (Box 2). *The authorities were confident that Pemex's business plan would deliver the projected increases in oil production, reserves and refining capacity, and do not see a reason to reconsider it at this stage.*[3]

20. The authorities agreed with staff that there was a need to boost tax revenues and increase the progressivity of the tax system. Mexico stands out compared to peers with only 13 percent of GDP in tax revenues. The authorities are envisaging a reform that would deliver at least 2 percent of GDP in additional tax revenues. It would center on rationalizing inefficient and regressive income tax expenditures, broadening the income tax and VAT bases, and widening the top personal income tax bracket. They would start preparatory work shortly and seek advice from the Fund. The reform would be effective in 2022. Staff recommended an earlier implementation date to help underpin the 2021 fiscal target.

Total Tax Revenue
(As percent of GDP, 2018)



Sources: IMF World Economic Outlook
1/ OECD unweighted average excluding Austria, Japan, Lithuania, United Kingdom, and United States.
2/ LAC unweighted average including Argentina, Brazil, Colombia, Peru, and Uruguay.

[3] There was agreement between staff and the authorities that the changes to Pemex's tax regime could strengthen the link between taxation and profitability (Selected Issues Paper 3).

a. VAT. Staff welcomed proposals to collect VAT from digital service providers that was previously forgone. Steps to broaden the narrow VAT base could usefully include taxing (non-export related) zero-rated goods at the standard 16 percent rate, which could boost revenues by around 1 percent of GDP, while targeted benefits would need to offset the impact on the poor.

Tax Expenditures (Percent GDP)

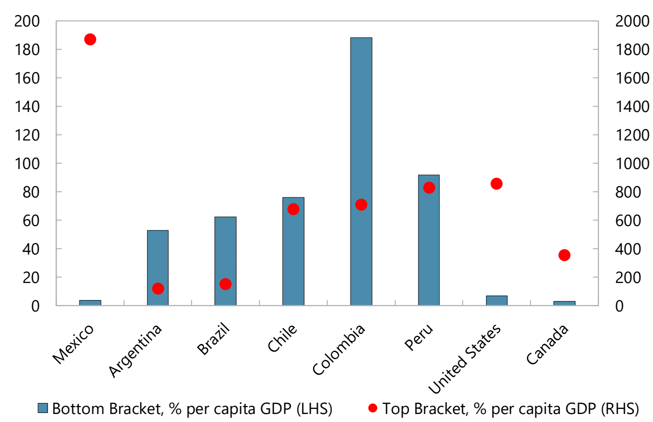
	2018	2019	2020
VAT	**1.4**	**1.4**	**1.4**
Zero Ratings	1.1	1.2	1.2
Exemptions	0.3	0.3	0.3
CIT	**0.5**	**0.5**	**0.5**
Deductions	0.1	0.1	0.1
Exemptions	0.1	0.0	0.0
Others	0.4	0.3	0.3
PIT	**1.0**	**1.0**	**0.9**
Deductions	0.1	0.1	0.1
Exemptions	0.7	0.7	0.7
Others	0.1	0.1	0.1

Source: SHCP

b. CIT and PIT. Tax expenditures for CIT and PIT accounted for 1.5 percent of GDP in 2018. The authorities consider that at least 0.7 percent of GDP of these are inefficient or regressive. There was agreement that these could be rationalized while the threshold for the top PIT bracket should be lowered.

c. Gasoline excise tax. The current formula guarantees cumulative retail fuel price growth below CPI inflation since November 30, 2018. Staff noted that this policy disproportionately benefits the rich and should be revoked, which could provide some 0.2 percent of GDP in additional revenues relative to the projection for 2019. *The authorities did not agree that the formula should be revoked and considered that it provides stability to energy prices and does not constitute a risk to public finances.*

Bottom and Top Personal Income Tax Brackets



d. Subnational taxes. Staff recommended raising additional revenues from property taxes which currently collect 1.5 percent of GDP less than the average Latin American country. A reform could be facilitated by creating an agency at the federal level to update the cadaster, as well as by policy coordination at the subnational level. Along with a redesigned vehicle registration tax, it would allow for a reduction in transfers to states and municipalities. *The authorities agreed that there was justification for subnational taxes, although they saw implementation challenges for property taxation.*

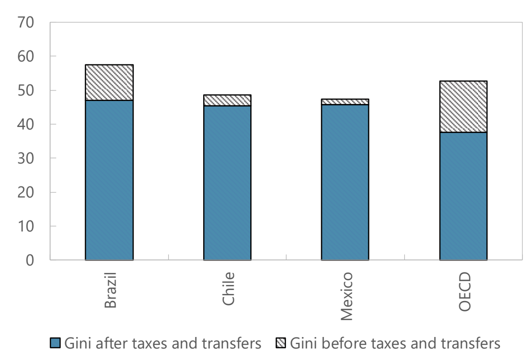
e. Border tax regime. Staff advised to cancel the VAT and CIT tax reductions at the border, which create distortions and erode the tax base (foregone revenues of about 0.2 percent of GDP). *The authorities highlighted that the border tax regime is a temporary special tax regime for 2019-20 and were of the view that it is instrumental in providing employment and economic opportunities in the border region.*

f. Revenue administration. Staff welcomed the abolition of the right to offset excess tax credits against other taxes—which should reduce fraud once the backlog of grandfathered claims clears—and other initiatives including strengthening sanctions against tax fraud.[4] Staff highlighted that Mexico already has an adequate toolkit to combat tax evasion and recommended adopting a comprehensive strategy to tackle non-compliance in line with IMF technical assistance, while moving towards a high-coverage audit process for VAT returns. *The authorities agreed that such measures could strengthen tax collections and will seek advice from the Fund on tax and customs administration.*

21. Enhancing expenditure efficiency can help shift spending toward a more growth-friendly and inclusive mix. While efficiency gains are needed, the proper functioning of public services should be a priority, while the redistributive role of fiscal policy needs to be strengthened. Moreover, public investment should be increased from current low levels. Staff analysis underscores this point by highlighting the crucial role for basic infrastructure investment in boosting firm productivity, including for the large number of Mexico's micro firms (Selected Issues Paper 1).[5]

a. Social protection spending. Efficiency gains could be achieved by improving targeting and rationalizing the numerous social protection programs—about 8,000 at the federal, state and municipal levels. Staff analysis (Selected Issues Paper 2) also notes the need to reduce errors of inclusion and exclusion, beneficiary overlaps, and program overlaps.

Gini Before and After Taxes



Source: OECD

b. Wage bill. 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 would contain the wage bill. However, maintaining pay competitiveness will be important to ensure staff quality and mitigate corruption incentives.

c. Education spending. Careful payroll audits to identify ghost workers and curb absenteeism, along with a rebalancing of spending towards investment in equipment and facilities, would help increase education spending efficiency. Improving the quality of early-childhood education, and access to education in low-coverage regions and for disadvantaged children, would strengthen education outcomes (Selected Issues Paper 2).

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[4] Other measures include incentivizing tax reporting of rental income by conditioning litigation on the provision of digital invoices, and requiring VAT withholding by firms that outsource parts of their work to other companies.

[5] Staff also recommended strengthening public investment management in line with the recent PIMA (Annex V).

d. **Pension system.** Staff welcomed the reduction in management fees for pension funds and recommended further improving pension adequacy by increasing the contribution rate for the defined-contribution system.[6] An increase in the effective retirement age and consolidating federal and local non-contributory pension pillars could also be considered.

e. **Health sector.** Investment should target rural and impoverished areas with deficient access to services. There is also room for reducing administrative and insurance costs. Improving the portability of insurance and building an information infrastructure compatible across sub-systems would improve continuity of care, health outcomes, and reduce beneficiary duplication.

f. **Public procurement.** Making further progress on centralizing procurement and adopting a digital platform could yield savings, while reducing the risks of corruption and bid rigging.

22. The authorities agreed that there was scope for efficiency gains. They emphasized the administration's spending efficiency improvements to date. They also underscored the importance of raising public investment, better targeting social benefits to those most in need, and reforming the pension system.

23. There was also agreement that the fiscal framework should be strengthened. The authorities plan to propose a revamp of the fiscal framework as part of the 2021 budget following a broad consultation with stakeholders. Staff and the authorities broadly agreed that: (i) the framework could benefit from a well-calibrated debt anchor, (ii) the structural spending rule should cover a broader expenditure envelope, (iii) the framework lacks a well-defined adjustment path to return to target after a shock, (iv) triggers for the use of escape clauses should be tightened, and (v) a non-partisan, adequately-sourced fiscal council should be created with a formal mandate to provide an independent evaluation of fiscal policy (Annex IV). Staff also recommended putting in place a modern medium-term budget framework and reiterated the recommendations of the 2018 Fiscal Transparency Evaluation.

B. Monetary and Exchange Rate Policies: Supporting the Economy While Ensuring Stability

24. Staff noted that there is scope to continue easing monetary policy. With policy still very tight despite a large negative output gap, staff advocated continuing to lower the policy rate so long as inflation remains close to the target and inflation expectations are anchored. *The authorities agreed that there could be scope for further easing but hold the view that caution in policy decisions is required since domestic and external risks remain elevated. They also highlighted that sticky core inflation above the target remained a concern.*

25. Staff commended Banxico for recent improvements in its communication. It encouraged the bank to keep communication concise, while limiting the focus on exchange rate

[6] The current contribution rate of 6.5 percent may at best yield a replacement rate of 26 percent for a full career average earner—the second lowest rate among OECD countries (OECD Economic Survey 2019).

movements and U.S. monetary policy decisions only to the extent that these have an important bearing on the inflation trajectory. Staff also noted that strong forward guidance can strengthen the efficiency of monetary policy transmission. *The authorities agreed that recent steps to strengthen communication had been an important improvement and noted that Mexico's complex risk environment limited their ability to engage in forward guidance.*

26. There was agreement that exchange rate flexibility should remain the key shock absorber. Staff and the authorities agreed that exchange rate flexibility is indispensable in restoring equilibrium in response to permanent shocks, and intervention should be limited to incidences of disorderly market conditions. In this context, staff highlighted the important role the flexible exchange rate has played by inducing a gradual strengthening of the non-oil balance to offset Mexico's shift from net oil exporter to net oil importer (Box 3). *The authorities agreed that the flexible exchange rate has served Mexico well. There was also agreement that foreign currency reserves were adequate at the current juncture, with the FCL providing an important buffer.*

C. Macro-Financial Policies: Ensuring Stability While Fostering Growth and Inclusion

27. The financial sector remains resilient to various shocks, but close monitoring remains crucial. The authorities' stress tests confirmed that, even under adverse scenarios (e.g., tariff hikes, rating downgrades) most banks—except for a few very small ones—will remain above the regulatory minimum capital ratios. Staff's stress tests of the largest corporates suggest that debt-at-risk would remain manageable even under severe exchange rate and earnings shocks (Annex VI). Nevertheless, the banking system remains subject to concentration risk given that most banks are exposed to a handful of large corporates. *The authorities noted that the financial sector's capital buffers would shield it from shocks and that they are closely monitoring concentration risks, especially in the case of Pemex and CFE.*

28. Financial sector resilience could be boosted by closing regulatory and supervisory gaps. In line with the 2016 FSAP recommendations, staff advocated: (i) increasing operational independence, budget autonomy, and legal protection of the banking and securities supervisor; (ii) integrating prudential supervision under one authority for all financial institutions: (iii) in the area of bank exposures, enhancing the definition of "common risk" and "related party"; and (iv) expanding the resolution regime to cover financial holding companies and strengthening the authorities' powers in banking resolution. *The authorities noted that the current governance structure has worked well and did not see the need to merge regulators. They noted that they are evaluating the revision of the supervisory regime for financial holding companies and are discussing a draft regulation that will implement Basel standards on large exposures.*

29. Staff emphasized that a multi-pronged strategy to boost financial deepening and inclusion should be a policy priority. The authorities have announced a diverse set of measures to boost deepening and inclusion.[7] There was agreement that financially vulnerable groups should be prioritized, particularly women and the rural population.

a. **Improving financial infrastructure.** Staff argued in favor of improving credit reporting systems to facilitate the development of value-added services and pushing ahead with earlier plans to improve the movable collateral registry and install specialized bankruptcy courts. *The authorities agreed that there is scope for improvements in credit reporting systems and that it will be beneficial for the retail payments market to have alternatives to the existing payment schemes, especially in the context of cash usage reduction efforts. They also noted upcoming fintech regulation for Open Banking that will promote information sharing among financial institutions and initiatives to improve the banking infrastructure in far flung areas through Banco del Bienestar.*

b. **Boosting competition and transparency in financial products.** Staff commended Banxico on initiatives to enhance client mobility in payroll loans and recommended such initiatives for additional products to boost competition. *The authorities agreed on the need for further actions to improve competition and cited complementary initiatives by CONDUSEF and Banco de Mexico that would improve transparency by assisting clients in comparing the cost of financial products.*

c. **Reducing the use of cash.** Promoting a wide use of the payment platform CoDi should boost the use of bank accounts and competition with other electronic payment methods, and lower fees. Staff noted that it would be advisable to migrate all government programs to electronic payments. *The authorities agreed that a reduced reliance on cash is a priority and were optimistic regarding the positive externalities from the adoption of CoDi.*

d. **Balancing competing priorities for Fintech.** Staff stressed that secondary regulation for Fintech should balance the priorities of promoting competition and improving financial inclusion while strengthening financial stability and consumer protection. *The authorities noted that these are the main principles in the Fintech law, which are the basis for developing secondary regulation. Moreover, they agreed on the need to monitor Fintech related risks.*

e. **Focusing development banks on underserved sectors.** Staff argued that lending to sectors that are served by commercial banks would commit scarce resources and would risk crowding out. Staff advised against setting quantitative targets and instead supported the targeting of financial inclusion metrics. In addition, the board composition and selection of CEOs of development banks should be aligned with international best practices. *The authorities noted that financial inclusion metrics are already taken into consideration and highlighted measures taken to consolidate development banks.*

[7] Measures focused on: (i) introducing a new retail payment platform (CoDi) using mobile devices; (ii) enabling young people to open savings accounts; (iii) modifying the Afores investment regime to incentivize voluntary savings; (iv) modifying the regulatory framework to enable Siefores to make repo transactions; (v) changing the tax schedule for IPOs and corporate bonds; and (vi) strengthening development banks to attend the needs of vulnerable groups and boost SME and consumer financing.

D. Macro-Structural Policies: Reinvigorating the Reform Agenda to Lift Growth and Make It More Inclusive

30. Staff stressed the need to foster strong, sustainable and inclusive growth by reinvigorating productivity-enhancing reforms. Despite important transformations of the Mexican economy, growth has continued to disappoint, and the medium-term outlook has weakened. Growth has also been insufficient to narrow the income gap with the U.S. and other advanced economies. Poverty and inequality have improved only modestly and have failed to do so in Mexico's South, which is increasingly trailing other regions along a broad set of socioeconomic indicators (Box 5). Reinvigorating productivity-enhancing reforms would be central in this context.

31. The administration's strong mandate would allow prioritizing politically difficult reforms. Staff's analytical work underpinning the 2017 and 2018 Article IV consultations showed that corruption, labor informality and crime are key drivers of Mexico's disappointing productivity growth. *Staff and the authorities agreed that priority should be given to addressing these key challenges.*

a. Combating corruption and money laundering. With most of the elements of the National Anticorruption System (NACS) now in place and the 2018 Fund-led AML/CFT assessment at hand (Box 6), the authorities should focus on effective implementation, prevention and enforcement. To this end, the authorities should support interagency cooperation[8] and strengthen accountability through mutual performance agreements and public sharing of performance results. The authorities should also ensure that sufficient funding is available to train, retain and protect the staff in the relevant agencies. Meanwhile, pending legislation to address recommendations from the recent AML/CFT assessment should be enacted in a timely manner. In addition, the authorities should introduce comprehensive criminal liability for legal persons, and reconsider statutes of limitations. To ensure an effective follow-up to Financial Intelligence Unit (UIF) disseminations, the federal prosecutor (FGR) should implement measures to rectify identified fundamental shortcomings in its functioning and consideration should be given to set up or appoint specialized courts or judges to handle complex financial crime cases. Finally, an inter-agency task force should design and implement a legal framework that ensures that accurate, verified and up-to-date basic and beneficial ownership information is available with company registers, Mexican banks and notaries as well as the companies. *The authorities agreed with the need to focus on implementation and for pending AML legislation to be enacted. They also noted steps already taken to improve the availability of beneficial ownership information and other relevant customer due diligence measures taken by supervisory authorities—including for politically-exposed-persons—for all financial institutions.*

[8] This relates to, among others, authorities represented in NACS such as the Attorney General's Office and the Secretariat of the Civil Service, and other anti-corruption and AML/CFT bodies such as the Financial Intelligence Unit, National Banking and Securities Commission, National Electoral Institute, and the judiciary.

b. **Reducing Mexico's labor informality.** The share of informal workers has declined but remains high at 56 percent. Efforts to reduce hiring and firing restrictions need to be reinvigorated and could be replaced with an unemployment insurance scheme, which should be financed at least in part by non-labor taxes. Staff analysis also highlights the importance of reducing entry costs for formal firms, e.g., by reducing the procedural costs and time burdens of starting and formalizing a business.[9] Recent labor reforms need to be implemented effectively to establish a more efficient labor dispute resolution mechanism, improve enforcement of worker right protections, and strengthen the even-handed application of labor union regulations.

c. **Improving the security situation.** The President's approach is based on long-term prevention—aimed at halting criminal recruitment of youth through education and training—and the creation of a National Guard. To prevent oil theft, the government guarded and shut-off pipelines in early-2019. Staff highlighted that enhancing the efficiency and quality of law enforcement and judicial institutions[10] is critical to strengthening the rule of law.

32. There is also a need to continue addressing gender gaps. Gender parity in education contrasts with low female labor force participation and pay gaps (Box 7). Lowering participation barriers for mothers remains a priority as gender gaps increase during child-bearing years, and women with more children participate less. Child care and maternity/paternity benefits remain well below OECD peers and should be expanded. Staff raised concern over the cancelation of subsidies for child care facilities and their replacement with direct transfers to families. Promoting the financial inclusion of women should be a pillar of the government's upcoming financial inclusion initiatives.

33. Productivity growth would also benefit from strengthening competition and easing product market regulations. Staff analysis suggests that lack of competition reduces firm investment (2018 SIP) and weakens productivity growth (2017 SIP). Staff advocated removing barriers to trade in services, especially in the transportation and logistics sector. It also recommended restarting energy auctions and risk-sharing arrangements between Pemex and private firms. Finally, staff encouraged the authorities to promote efforts to strengthen the multilateral trading system, including through supporting the modernization of WTO rules, overcoming the WTO Appellate Body blockage, and advancing WTO plurilateral and multilateral initiatives.

34. Further adjustments in the minimum wage should be gradual to avoid short-term disruptions and adverse formal employment effects. The minimum wage fell sharply in real terms during the early 1990s. It was raised by 16 percent this year (41 percent over the past three years) across the country and was doubled in the U.S. border region. While acknowledging that increases in the minimum wage could help reduce inequality and bring minimum-to-median wage indicators closer to regional and OECD averages, staff recommended a gradual adjustment, in line

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[9] See "Informality and Aggregate Productivity: The Case of Mexico", 2019, IMF Working Paper.

[10] Strengthening the rule of law also covers administrative and civil courts that allow for the protection of property and contractual rights.

with the evolution of labor productivity, to avoid short- and medium-term disruptions to formal employment growth (Box 8).

STAFF APPRAISAL

35. Very strong policies and policy frameworks have contributed to Mexico's resilience. The authorities' commitment to fiscal prudence is strong, monetary policy remains prudent and has succeeded in bringing inflation to target, and financial sector supervision and regulation are robust. The flexible exchange rate is playing a key role in helping the economy adjust to external shocks, while Mexico's external position remains broadly consistent with medium-term fundamentals and desirable policy settings. These policies have been instrumental in allowing Mexico to successfully navigate a complex external environment and should continue to do so going forward.

36. But growth has declined sharply, and fiscal pressures are mounting. Pressures have emerged in the context of new spending priorities and a commitment to not raise taxes until after 2021. Drastic budget cuts for some institutions have raised concern about their potential impact on human capital, while productivity-enhancing reforms have largely stalled. Growth is projected to reach 0.4 percent in 2019 and 1.3 percent in 2020 on the back of a modest recovery in domestic demand as uncertainty subsides and monetary conditions ease further.

37. The authorities' announced fiscal targets remain prudent but would need to be more ambitious to put the public debt ratio on a downward path. The current PSBR targets of 2.2–2.4 percent of GDP over the medium term would keep debt broadly stable at around 55 percent of GDP. While this level is sustainable, more ambitious medium-term fiscal targets would help rebuild buffers and insure against downside risks and demographics-related spending pressures.

38. Additional measures are needed to meet the announced fiscal targets. The recent cancelation of the universal tax offset as well as proposed measures to strengthen tax collection, such as on digital services, are welcome. Nevertheless, budget projections are based on optimistic assumptions for nominal GDP growth, oil production, tax revenue buoyancy, and the projected compression of spending on goods and services. In the absence of additional measures, a fiscal gap of 0.5–1.5 percent of GDP would emerge during 2020–24. Closing this gap with credible measures starting in 2020 is imperative to safeguard the credibility of fiscal policy.

39. Non-oil tax revenues should be boosted, while making the tax system more progressive to reduce income inequality. Mexico's revenue performance significantly lags that of regional and international peers. Rationalizing regressive tax expenditures, broadening the tax base, lowering the threshold for the top PIT bracket, abolishing border incentives and fuel price support, as well as raising subnational property and vehicle registration taxes could help boost revenues. Enhancing public expenditure efficiency could facilitate shifting spending toward a more growth-friendly and inclusive mix. Finally, revenue administration could be strengthened by adopting a comprehensive strategy to tackle VAT non-compliance, while moving towards a high-coverage audit process for VAT returns.

40. Pemex's business plan should be reformulated with a view to strengthening the company and reducing risks to the budget. To support a significant increase in production and reserves, more cooperation with private firms and a stronger focus on the company's upstream business would be important. Moreover, to strengthen profitability and limit risks to the budget, Pemex should make progress in selling non-core assets and provide convincing plans to reduce operating costs.

41. Strengthening the fiscal framework would support the administration's commitment to fiscal responsibility. The framework would benefit from a permanent debt ceiling and a structural spending rule, paired with effective correction mechanisms and a non-partisan, adequately-sourced fiscal council. A modern medium-term budget framework would be an effective complement.

42. There is scope for further monetary easing. Given the very tight policy stance in the context of a large negative output gap, Banxico should continue to lower the policy rate so long as inflation stays close to the target and inflation expectations remain anchored. Central bank communication should be kept concise, while exchange rate flexibility should remain the key shock absorber. Foreign exchange intervention should be limited to incidences of disorderly market conditions, while the FCL provides an additional buffer.

43. Financial sector resilience remains strong and could be enhanced by closing gaps in the regulatory and supervisory framework. Increasing the operational independence, budget autonomy and legal protection of the banking and securities supervisor, and extending its authority to financial holding companies, would close some of the gaps identified in the 2016 FSAP. Prudential supervision functions could then be integrated under one authority for all financial institutions. The definitions of "common risk" and "related party" should be enhanced, and the resolution and crisis management framework should be strengthened.

44. Efforts to boost financial sector competition and inclusion should continue. The authorities' resolve to improve financial inclusion through a diverse set of measures announced earlier in the year are welcome. Going forward, a multi-pronged strategic approach to boost lending and strengthen competition and inclusion should be a policy priority.

45. Reinvigorating the structural reform agenda is an imperative to foster strong, sustainable and inclusive growth. Structural reforms are central to raising growth, reducing poverty and inequality, and narrowing both regional income disparities and the income gap with other advanced economies. Restarting energy auctions and risk-sharing arrangements between Pemex and private firms would bring much needed private investment. Lowering participation barriers for women and removing constraints to trade in services, especially in the transportation and logistics sector, would narrow gender gaps and boost activity. High levels of informality could be addressed by reducing entry costs for formal firms, strengthening enforcement, and replacing hiring and firing restrictions with an unemployment insurance scheme. Further adjustments in the minimum wage should be gradual.

46. Concrete policy action is needed to fight corruption and strengthen the rule of law. The effective implementation of the National Anti-Corruption System would be an important step forward. Enhancing the effectiveness and quality of law enforcement and the prosecution, and addressing the shortcomings identified in the AML/CFT assessment should also be priorities.

47. It is proposed that the next Article IV Consultation with Mexico take place on the standard 12-month cycle.

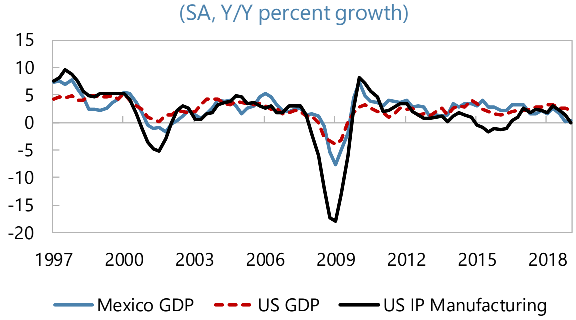
Box 1. Synchronization of Mexican Economic Activity with the U.S.

Growth in Mexico continues to be closely linked to the U.S. economy. The slowdown in U.S. manufacturing activity likely contributed significantly to the weak growth outturns in Mexico in 2019:H1.

Mexico's economy is closely linked to the U.S. economy. The U.S. is Mexico's main trading partner, accounting for 80 percent of Mexico's exports and 46 percent of its imports. In 2018, the U.S. was the origin of 38 percent of FDI in Mexico and the source of 94 percent of remittances. Mexico and the U.S. are also deeply integrated through supply chains, especially in the automotive sector. More than two-thirds of Mexico's exports are manufacturing products sold to the U.S., about a third of which are automotive exports.

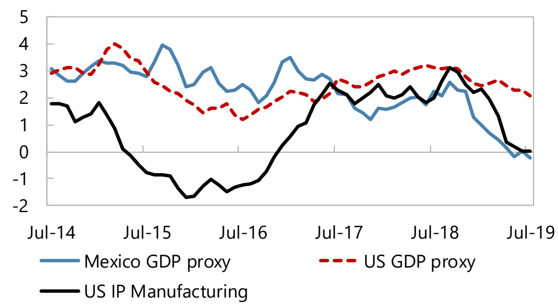
Until recently, Mexico's GDP growth closely tracked U.S. GDP growth and manufacturing activity. Since 1996, the correlation coefficient in GDP growth between the two countries was close to 0.8; however, overall economic activity seems to have decoupled during the last few years. While U. S. growth accelerated, growth in Mexico started to slow down in 2017 and declined further as U.S. manufacturing activities decelerated sharply.[1]

Economic activity in Mexico and the U.S.
(SA, Y/Y percent growth)



Sources: National Authorities, Haver Analytics: and IMF Staff estimates.

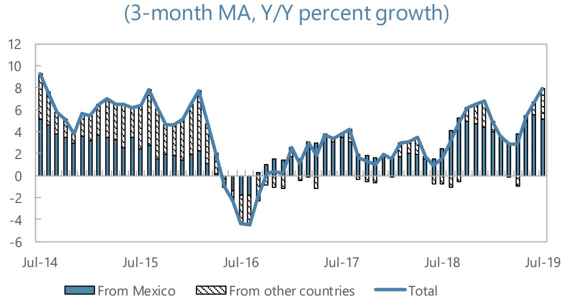
Economic activity in Mexico and the U.S.
(SA, 3-month MA, Y/Y percent growth)



Sources: National Authorities, Haver Analytics: and IMF Staff estimates.

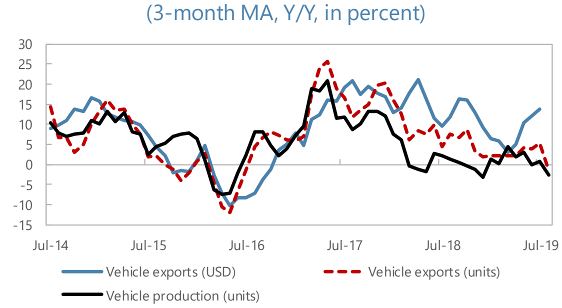
The slowdown in U.S. manufacturing growth likely contributed to the weakening of Mexican growth in 2019:H1. Since late-2018, U.S. manufacturing activity has been slowing down and leading indicators (such as the PMI) indicate a further deceleration. Given Mexico's deep integration with U.S. manufacturing activity, this is likely to have had a negative impact on Mexican growth, even though Mexican manufacturing activity has held up relatively well. While the global automobile industry contracted, Mexico maintained a robust trade surplus in the automotive sector and increased its market share in U.S. automotive imports, supported by a continued shift in Mexico's production and exports toward higher unit-value vehicles.

U.S.: Imports of motor vehicles and parts
(3-month MA, Y/Y percent growth)



Sources: National Authorities, Haver Analytics: and IMF Staff estimates.

Mexico: Vehicle production and exports
(3-month MA, Y/Y, in percent)



Sources: National Authorities, Haver Analytics: and IMF Staff estimates.

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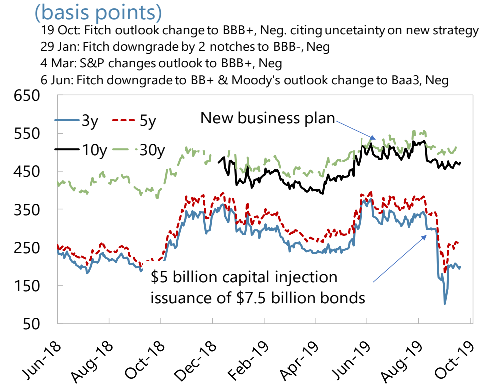
[1] Regression analysis using monthly proxies suggests that post-2016 U.S. manufacturing has become a bigger factor in driving GDP in Mexico. Relatedly, the large slump in U.S. manufacturing in 2015-16 is mostly explained by the impact the oil price decline had on shale gas activity and did not affect growth in Mexico.

Box 2. Pemex's Business Plan and Market Reaction

Pemex's business plan relies on optimistic production and reserve projections, limits cooperation with private firms and envisages investing heavily in its loss-making refining business. Recent capital injections have improved short-term liquidity needs, but the medium-term financial outlook remains weak thus potentially putting further pressure on the government.

Pemex's business plan, which was published in July, failed to reduce market uncertainty. Its main elements included: additional support through tax reductions and fiscal transfers, increased capital expenditures, production and refining targets, private participation limited to service contracts, and zero reliance on new net debt. As the plan did not offer any surprises, credit spreads were little changed, and rating agencies retained their negative rating outlook.

Pemex dollar bond spreads
(basis points)

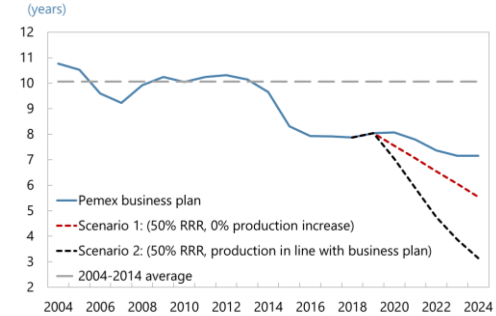


Additional support in September improved near-term liquidity needs but long-term spreads remain elevated. In September, the authorities announced additional support of $5 billion for debt buybacks, and Pemex issued $7.5 billion bonds, to cover maturing debt. This operation surprised markets and led to a decline in near-term (up to 5y) spreads. However, spreads at the long end of the curve remain elevated, pricing in further downgrades to below investment grade (IG). A downgrade by Moody's to below IG rating could lead to some additional selling pressure of $6–10 billion given that Pemex bonds will become ineligible for some global investment grade bond indices.

The current investment plan focuses on increasing production from current low levels. Current plans focus on areas where the company had better success rates in the past. This strategy will likely lead to some short-term production gains, but the 60 percent increase in production by 2024—to 2.7mbpd—currently projected by Pemex appears optimistic.

Focusing the limited resources on increasing production risks crowding out the rebuilding of reserves. The plan assumes that Pemex will be able to add reserves of around 140 percent of its annual production every year. Commercial discoveries are set to increase from 4 fields per year in the preceding 5 years to 34 per year in the next 5 years. In terms of discoveries, rating agencies are more conservative and assume a 50 percent replacement rate ratio (RRR) which is in line with the average of the last 15 years. In a conservative scenario where production stabilizes at 2019 levels but RRR stays at 50 percent, reserve life would decline to around 5 years in 2024 almost half of its 2014 level. In a scenario where production targets were to be met but RRR was 50 percent, reserve life would decline to only 3 years.

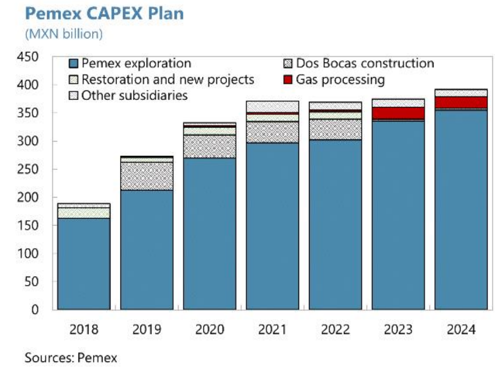
Reserves to Production Ratio
(years)



Sources: Pemex and IMF staff estimates

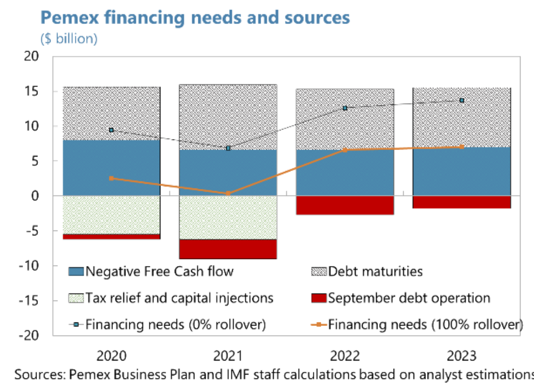
Box 2. Pemex's Business Plan and Market Reaction (concluded)

The investment in the Dos Bocas refinery will likely crowd out upstream investment even more. Most analysts expect the project to cost around $12–15 billion—compared to the authorities' $8 billion estimate—and completion to last longer than the current target of mid-2022. The project is earmarked at around 13 percent of the 2019–22 capex plan. Given Pemex's tight financing envelope, slippages could crowd out some of the much-needed investment in the upstream business which provides the bulk of the company's EBITDA and tax payments.



The business plan offers limited details on how to rationalize costs and assumes large gains in operating profitability. Although some efficiencies are assumed through changes in the procurement strategy and reduction in fuel theft, the plan assumes very large improvements in EBITDA margins from 33 percent in 2018 to over 60 percent. While PEMEX generated similar margins at the start of this decade, this happened in an environment when its reserves portfolio was significantly higher and oil prices were closer to $100 per barrel. Additionally, outstanding pension liabilities continue to be sizeable.

Pemex's financial situation is projected to remain weak in the coming years, potentially putting further pressure on government finances. Assuming a stabilization of production, and full execution of the investment plan, free cash flow (FCF) will likely remain negative for the foreseeable future. Additionally, potential difficulties to refinance maturing debt at favorable rates over the medium term could weigh on government finances.

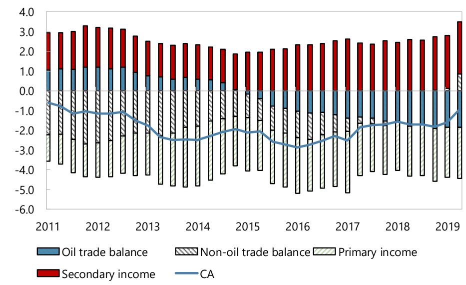


Box 3. Adjustment in External Accounts

Mexico's external accounts underwent significant shifts in composition in recent years. Since 2013, the oil trade balance shifted from a surplus of 0.7 percent of GDP to a deficit of around 2 percent, rendering Mexico a net oil importer. At the same time, however, the flexible exchange rate supported a significant strengthening in the non-oil trade balance that cushioned the impact on the current account.

Mexico was hit by a series of severe shocks in recent years that necessitated an improvement in the current account. Following a 40 percent fall in oil prices in 2014 and a gradual decline in Mexico's oil production, Mexico's oil trade balance swung from a surplus of 0.7 percent of GDP in 2013 to a deficit of around 2 percent in 2018. This dramatic shift occurred in the context of uncertain external financing prospects amid monetary policy normalization in advanced economies, tightening global financial conditions, and rising protectionism.[1] An adjustment in the non-oil current account balance was thus crucial.

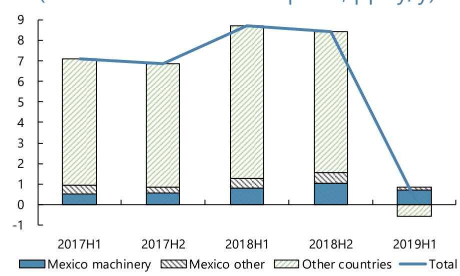
Current Account Balance
(percent of GDP, 4q rolling)



Source: Banxico, Staff calculations

The strengthening of manufacturing exports took place on the back of substantial real exchange rate depreciation. Between 2013 and 2018, the non-oil trade balance improved by almost 2 percentage points of GDP as manufacturing exports increased by 8 percent of GDP. The adjustment was facilitated by significant real exchange rate depreciation since 2014, mostly on the back of peso depreciation vis-à-vis the U.S. dollar. At the same time, broadly stable FDI flows and positive, albeit more volatile, net portfolio flows helped avoid a disorderly macroeconomic adjustment. Meanwhile, foreign exchange reserves remained broadly constant as the central bank allowed the peso to adjust freely to shocks. More recently, Mexico likely also benefited from trade diversion in the short term, as indicated by the 11.8 percent growth rate of U.S. imports from Mexico in 2018:H2, following the introduction of U.S. tariffs on Chinese imports in June. Although export growth slowed down in the 2019:H1, in line with decelerating manufacturing activity in the U.S., it remained the main driver of U.S. imports. Moreover, while the U.S. has remained Mexico's main export market throughout this period (about 80 percent of non-oil exports), the composition of import source countries has also shifted as the share of non-oil imports from the U.S. fell, while Chinese imports increased.

Trade Diversion
(Contribution to U.S. imports, ppt y/y)



Source: U.S. Department of Commerce, Staff calculations

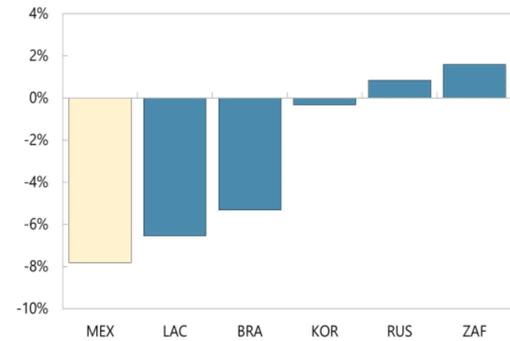
______
[1] Banco de Mexico, 2019, Quarterly Report October-December 2018.

Box 4. Financial Inclusion

Financial inclusion has strengthened but progress has been slow due in part to limited financial infrastructure and education, lack of competition in the banking sector and widespread informal activity.

Financial inclusion has shown limited progress while geographic and gender disparities remain. According to the 2018 ENIF survey, the proportion of adults with more than one financial product has remained largely unchanged at 45 percent since 2015; due mainly to high costs and informal employment. Despite progress facilitated by government programs, the gender gap in account ownership is at -8 percentage points (see: 2017 Findex survey). Moreover, large gender gaps remain in other areas such as holdings of retirement accounts and asset ownership (both at -18 percentage points). There are also geographic disparities, with the South lagging the rest of the country according to most measures of financial inclusion.

Gender gap in account ownership
(percentage points)

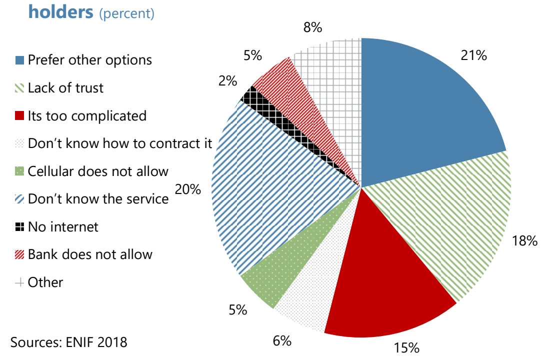


Sources: FINDEX

Cash remains the predominant means of payment. According to ENIF, more than 90 percent of rent, utility, and house service payments are made in cash. According to Findex, 38 percent of private sector wages are still paid in cash. By contrast, in the G-7 economies, private sector wages are paid almost exclusively into bank accounts. In 2017, the government provided close to one third of transfers and payments in cash, which is unchanged from 2014.

There are large geographic gaps in financial infrastructure, while the lack of financial education hampers growth in electronic payments. According to ENIF, regional disparities are large with 22 and 10 percentage points difference in the use of ATMs and branches, respectively, between the South and the Northwest. In terms of mobile services, according to Findex, 6 percent of Mexican adults (aged 15+) are mobile money users, which is close to the average of the LAC region. The main reasons for not using mobile money for holders of savings accounts is lack of trust or knowledge of the service as well as the complexity of use.

Reasons for not using mobile banking among account holders (percent)



Sources: ENIF 2018

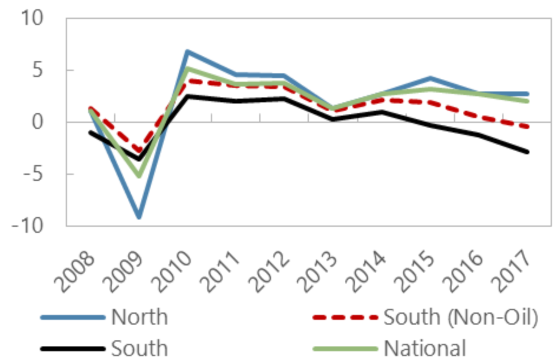
Low banking sector competition hampers financial inclusion. In recent years, mainly due to lack of competition, intermediation margins have increased, and overhead and administrative costs have not declined. Banks mostly serve known clients with credit based on strong balance sheets and penalize Micro and SMEs (MSMEs) with significant margins. According to INEGI, while MSMEs account for 95 percent of companies and provide over 70 percent of employment, only 11 percent have access to bank finance. Within those who have access, a large share is due to development banks. Over 60 percent of MSMEs reject bank loans due to high costs while education also has a role to play, as close to 50 percent of SMEs state not to be aware of any government programs.

Box 5. Regional Economic Disparities

Regional economic disparities are significant in Mexico, with the Center and North outperforming the South according to a wide range of socioeconomic indicators. Moreover, the gap has been widening in recent years amid solid growth in the North and an economic contraction in the South.[1]

Mexico's Center-North has grown at sizable rates in recent years while the South has been in recession. For the past 10 years, Mexico has struggled to achieve growth rates of more than 2 percent on average. However, the national growth rate conceals very different economic realities across regions. The economy of the North has been thriving at an annual average growth rate of 3.3 percent since 2015, while the South has been in recession.

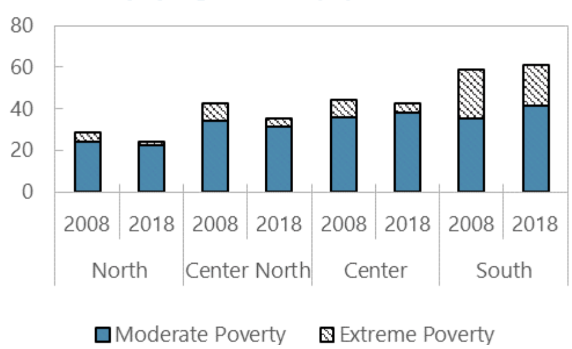
Real GDP Growth (y/y)



Source: INEGI; and IMF staff

Poverty rates are highest in the South and have failed to decline over the past decade. In 2018, just 24 percent of the population of the North was classified as poor compared with 61 percent of the South. While the North, Center-North, and Center have seen poverty rates declining over the last decade, poverty in the South has increased by 2.2 percentage points. Extreme poverty is also very high in the South with 19 percent of the population living under extreme poverty conditions, compared to 2 percent in the North.

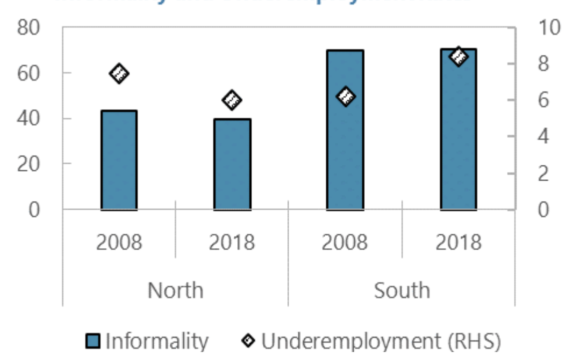
Poverty by regions (% of population)



Source: CONEVAL; and IMF staff calculations.

Labor market informality and underemployment are also highest in the South and show no sign of declining. Both informality and underemployment are much lower in the North than in the South. Moreover, in both cases the gap has widened further over the past decade.

Informality and Underemployment Rates



Source: INEGI: and IMF staff

[1] The regional groupings used in the box are consistent with INEGI's regional classification used in the Quarterly Indicator of State Economic Activity (ITAEE).

Box 6. Corruption and AML/CFT Reforms

Over the past several years, Mexico has embarked on an anti-corruption reform. Mexico was assessed against the Financial Action Task Force (FATF) anti-money laundering / combating the financing of terrorism (AML/CFT) standards in 2018. The current administration was elected on an anti-corruption platform.

The National Anti-Corruption System (NACS) is a constitutionally mandated anti-corruption reform. The NACS contains several measures, of which the most important are: i) appointment of an operationally independent anti-corruption prosecutor; ii) appointments of 18 judges to fill the new anti-corruption chamber at administrative courts; iii) implementation of new transparency requirements for public officials; iv) drafting of a national anti-corruption policy; and v) creation of the National Digital Platform, to provide access to important data, such as procurement information. Except for the appointment of the judges, most other elements of the NACS are formally in place. However, the reform has yet to yield visible results and for the most part, enforcement, effective coordination and inter-agency peer pressure are still lacking.

A majority of the recommendations from a 2018 Fund staff-led AML/CFT assessment against the FATF standards have yet to be implemented. The FATF noted a range of shortcomings, notably related to the effectiveness of law enforcement and prosecution. Other major shortcomings were a lack of effectiveness of preventive measures in the financial sector, financial supervision and transparency of legal persons. Following the adoption of the assessment in November 2017, Mexico was placed in enhanced follow-up and given three years to enact legislation to address "most, if not all" legal shortcomings. Although the authorities have reported some progress so far, none of these measures were sufficient to warrant the necessary re-ratings. After this three-year period ends, FATF may consider additional enhanced follow-up measures (which include high level visits and public warnings). The authorities have prepared corresponding legislation which is, however, pending in Congress.

The Financial Intelligence Unit (UIF) has increased the number of money laundering cases disseminated to the federal prosecutor (FGR). As noted by the new Attorney-General and the AML/CFT assessment, the FGR is facing fundamental shortcomings. These also prevent FGR from effectively following up on UIFs disseminations and from achieving levels of investigations, prosecutions, confiscations and convictions that would correspond to Mexico's corruption and money laundering risks. A lack of expertise and the effects of corruption have a negative impact on the judiciary's ability to effectively handle complex financial cases.

Box 7. Gender Gaps

While gender parity has been achieved in educational attainment, significant gaps remain in labor force participation and pay. At the political level, near gender parity has been achieved, while at the corporate level female representation lags. Violence against women remains the highest in the OECD.

Gender parity in enrolment and educational attainment has been achieved at all levels of education. However, Mexico's graduation rates from upper secondary education remain 30 percentage points below the OECD average, notwithstanding improvements in the last decade. The share of female students graduating from the fields of engineering, manufacturing and construction, at 11 percent in Mexico, is well above the 6-percent OECD average. However, women have a lower employment rate and earn less than men.

Female labor force participation has increased but remains significantly below male participation. While female labor force participation has increased from 41 percent in 2005 to 44 percent in 2018, it remains 33 percentage points below the labor force participation of men. It also remains significantly below the OECD average for women (64 percent) and most other Latin American countries. Most Mexican women work in the informal economy and remain heavily underrepresented in the formal private sector. Among 18–24 year-olds, women are more at risk than men of being neither in employment nor in education or training—36 percent of women compared with 8 percent of men (in 2017). Child care and maternity/paternity benefits remain well below OECD peers.

Mexico's gender wage gap declined but compares unfavorably with other Latin American countries. Since 2005, Mexico's gender wage gap declined by one third to 11 percent by 2017, which is somewhat lower than the OECD average, though higher than in other Latin American countries. However, tertiary-educated women earn only two-thirds of the average earnings of tertiary-educated men.

In terms of financial inclusion, although some gender disparities have been reduced, large gaps remain. Progress has been achieved in closing gender gaps as the government opened accounts for over six million people to receive social or cash transfers out of which 80 percent belong to women. However, gender gaps in terms of account holders are still large at -8 percentage points (Findex, 2017). Additionally, large gaps remain in other areas such as retirement accounts and asset ownership (both at -18 percentage points)—the latter could be a major constraint for women in terms of accessing credit.

At the political level, near gender parity has been achieved, while at the corporate level female representation lags. In 2018, Mexico's Congress achieved near gender parity for the first time in history, in part due to quotas in the electoral process. The cabinet has also equal numbers of women and men. In June, the constitution was amended to guarantee women's equal participation in politics and government. However, female representation at the corporate level remains very low: women held only 5 percent of board seats of publicly listed companies in 2016, compared to 20 percent across the OECD.

Violence against women remains the highest in the OECD. Nearly every second Mexican woman has experienced domestic violence at some time in her life, the highest across OECD countries. The number of femicides—the killing of females because of their gender—continues to increase, reaching 861 in 2018.

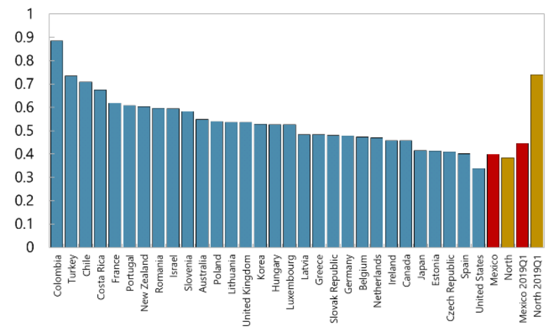
Box 8. Minimum Wage Policy

Mexico's minimum wage was increased substantially this year, especially in the northern border region, with potentially significant adverse effects on formal employment.

In January 2019, the national minimum wage was raised by 16 percent, and the minimum wage was doubled in 43 municipalities in the border region. The national minimum wage increase is the first step in the administration's objective to significantly raise the minimum wage by 2024. The immediate doubling in 43 municipalities of the newly created Northern Border Free Zone forms part of a wider package of incentives that include lower VAT and CIT rates.

The new minimum wage policy constitutes a significant change by historical and international standards. Mexico's real minimum wage has remained low since the 1990s at levels that are well below regional and OECD peers. Thus, the 2019 increase constitutes the biggest policy shift in over two decades. While the minimum-to-median wage ratio remains below the OECD average at the national level, the ratio in the northern region has already risen well above the average. Moreover, the share of workers earning up to or less than a minimum wage in the northern region has doubled from 8 to 17 percent.

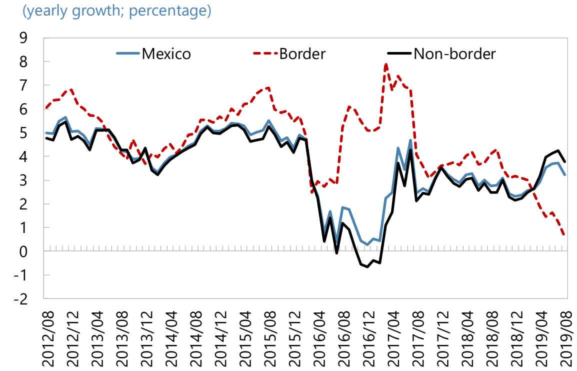
Minimum to median wage ratio in 2017



Sources: OECD, ENOE, and staff calculations.

The effects of this rapid increase are hard to estimate, but past evidence points to adverse effects on formal employment. Minimum wages make formal employment relatively more expensive, influencing contractual decisions. Past minimum wage increases, which were significantly more moderate, were associated with lower formalization rates and decreases in overall inequality.[1] Negative effects are likely to be concentrated in selected northern industries relying on formal contracts with limited scope for contractual adjustments.[2] In 2019:H1, the policy has already produced an increase in wages of formal employees accompanied by slower formal employment growth in the border states. The effects on total employment, however, could be less prominent as there is the possibility of switching from formal to informal contracts in many industries located at municipalities at the north border.

Formal employment growth
(yearly growth; percentage)



Sources: INEGI; and staff calculations

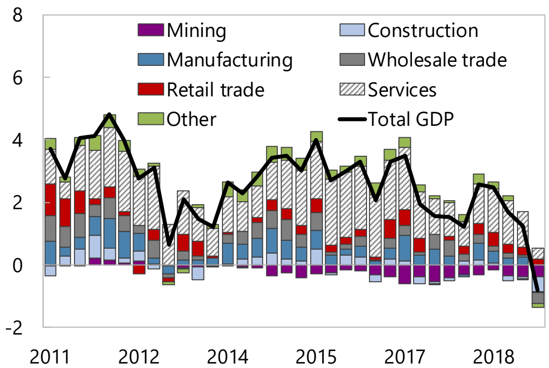
[1] See "Formality and Equity: Labor Market Challenges in Mexico", SIP, 2018.

[2] Staff analysis suggests that labor market duality—between informal and formal firms as well as salaried and non-salaried forms of contractual employment—introduces flexibility in hiring decisions and limits adverse aggregate productivity effects. See "Informality and Aggregate Productivity: The Case of Mexico", 2019, IMF Working Paper.

Figure 1. Mexico: Real Sector

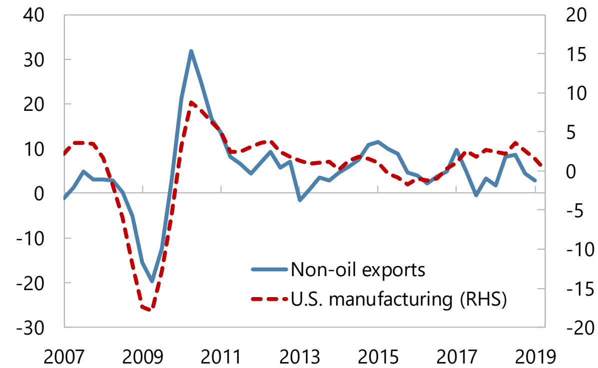
Growth has been decelerating amid weakening services and manufacturing as well as falling oil production.

Supply Contributions to Growth
(In percent, NSA)



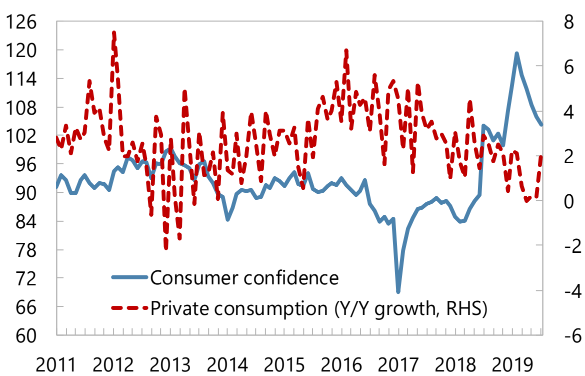
Non-oil exports rebounded in 2018 but are starting to slow down again as U.S. manufacturing weakens.

Real Export Growth
(Y/Y growth, NSA)



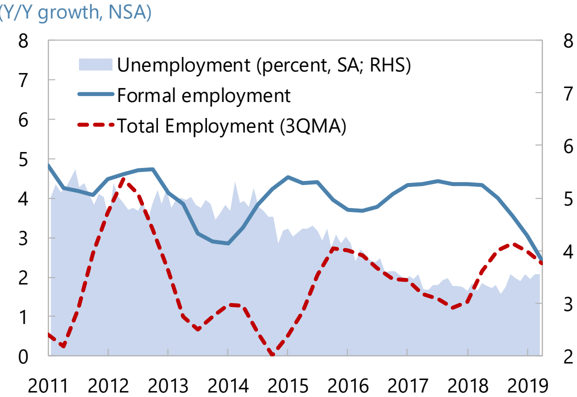
Private consumption is slowing as sentiment declined from recent highs,...

Consumption
(Index, Jan. 2003 = 100, NSA)



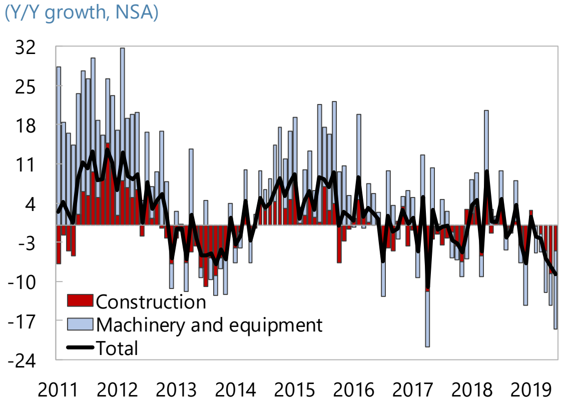
... while job creation is decelerating, particularly in the formal sector.

Employment
(Y/Y growth, NSA)



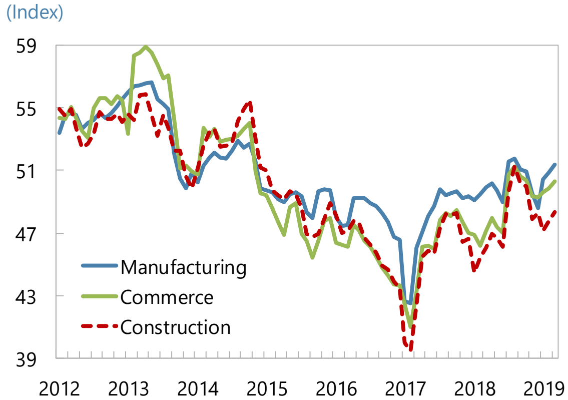
Gross fixed capital formation has weakened further...

Gross Fixed Capital Formation
(Y/Y growth, NSA)



... while business confidence is showing signs of improvement after recent declines.

Business Confidence by Sector
(Index)

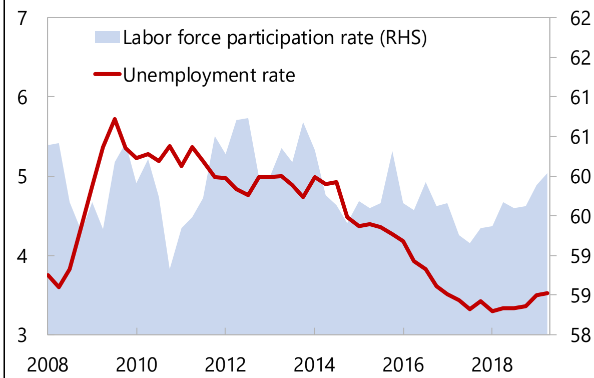


Sources: National Authorities, Haver Analytics; and, IMF Staff estimates.

Figure 2. Mexico: Labor Market Indicators

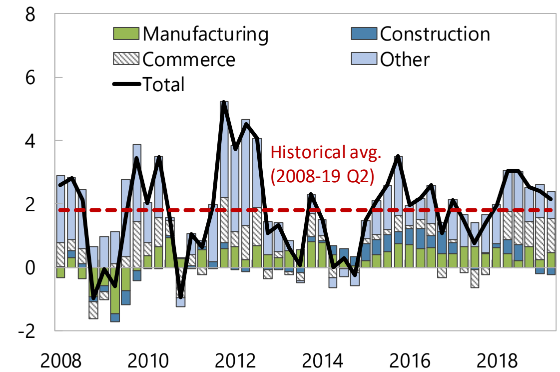
The unemployment rate has started to increase.

Unemployment Rate
(In percent, SA)



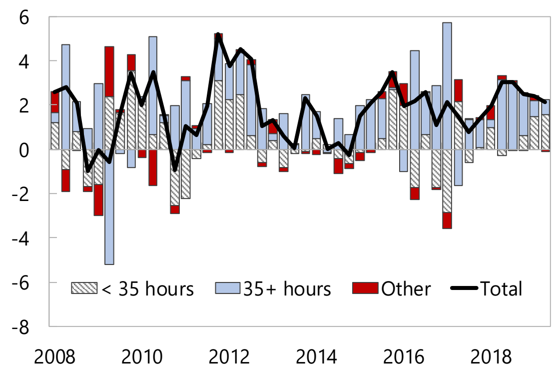
Job creation is slowing down towards the historical average...

Contributions to Employment Growth
(Y/Y percent growth)



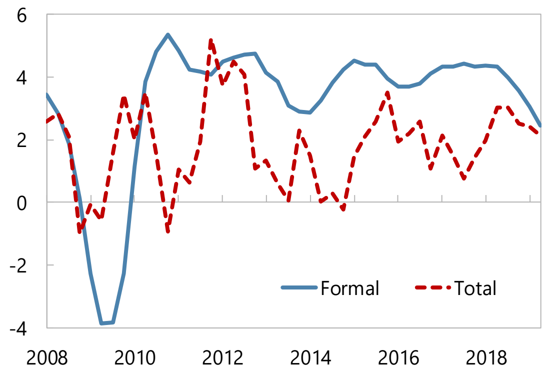
... with a deceleration in the creation of full-time jobs ...

Contributions to Employment Growth
(Y/Y percent growth)



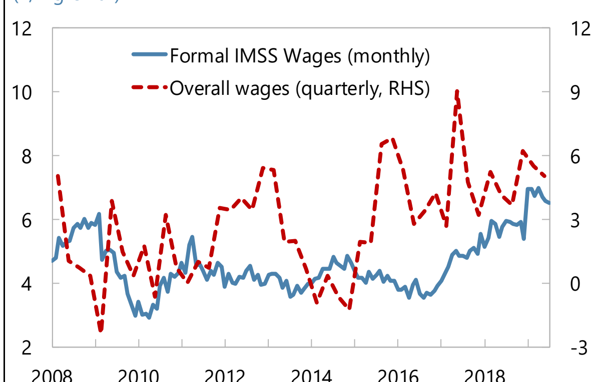
... and of formal employment.

Total and Formal Employment
(Y/Y percent growth)



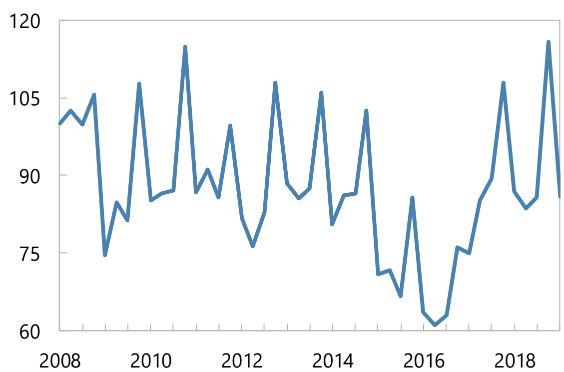
At the same time, nominal wage growth has picked up ...

Average Nominal Wages
(Y/Y growth)



... and the ULC based REER recovered from low levels.

Unit Labor Cost Real Effective Exchange Rate
(Index, Mar. 2008=100)

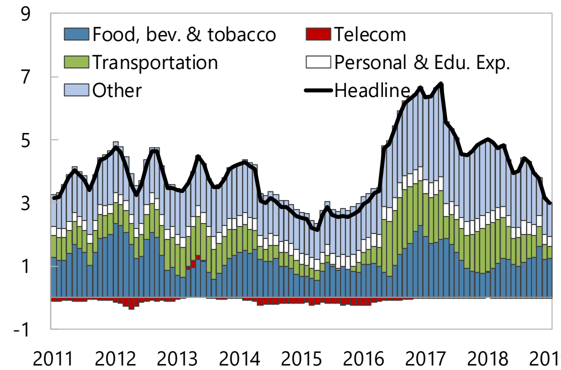


Sources: National Authorities, Haver Analytics; and, IMF Staff estimates.

Figure 3. Mexico: Prices and Inflation

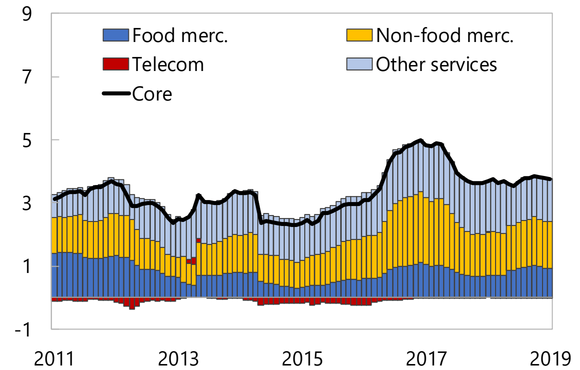
Headline inflation has been coming down and is now close to the target.

Contributions to Headline Inflation
(Y/Y, in percent)



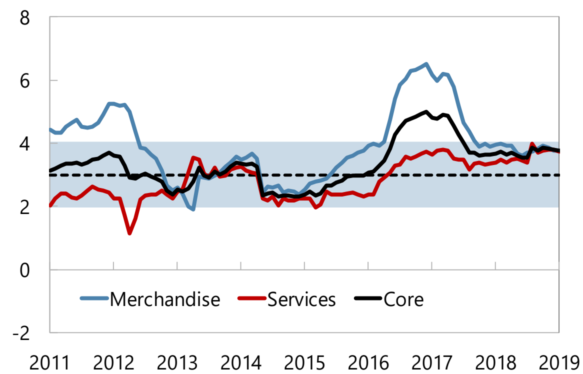
Core inflation remain sticky above the target...

Contributions to Core Inflation
(Y/Y, in percent)



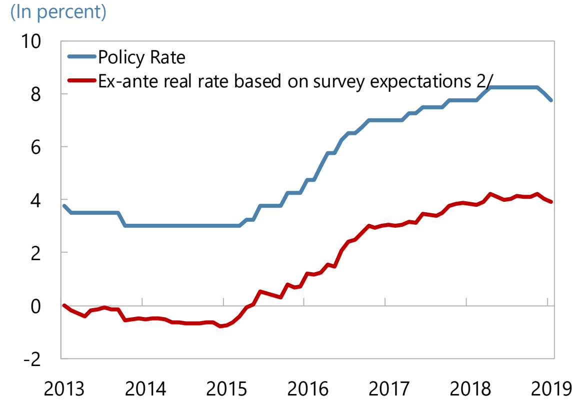
... with both services and merchandise inflation close to the upper band.

Inflation
(Y/Y percent growth)



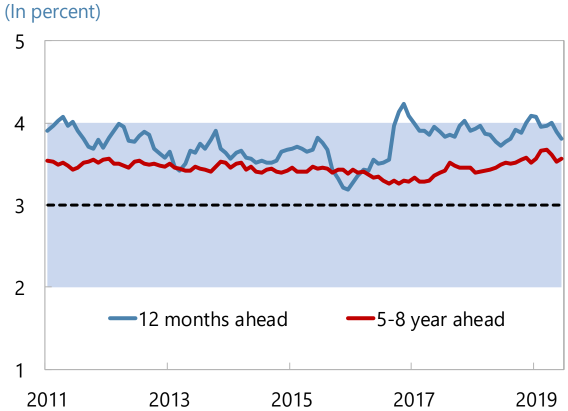
Tight monetary policy has helped contain second-round effects from externded episodes of exchange rate depreciation...

Policy Rates
(In percent)



...keeping medium-term inflation expectations anchored within the target band.

Survey-based Inflation Expectations
(In percent)



Real wage growth has rebounded despite still high inflation.

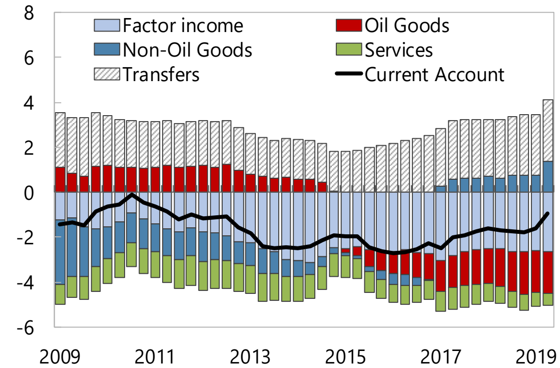
Real Wages and Labor Productivity
(Y/Y percent growth)

Sources: National Authorities, Haver Analytics; and, IMF Staff estimates.
1/ Based on hours worked.
2/ Calculation using the average inflation expectation for the next 12 months (NSA, %). Source: Banco de Mexico. Survey on the Expectations of Private Sector Economists.

Figure 4. Mexico: External Sector

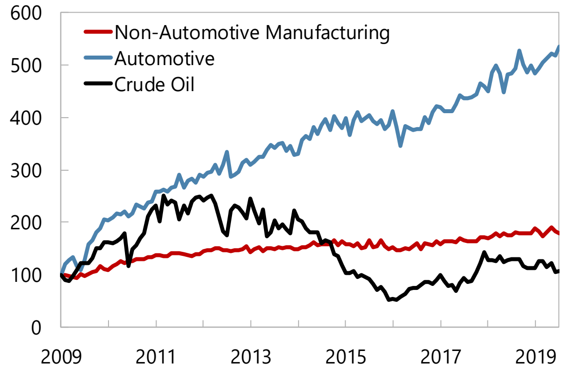
The current account deficit has declined …

Current Account Balance
(Cumulative last 4 quarters, in percent of GDP)



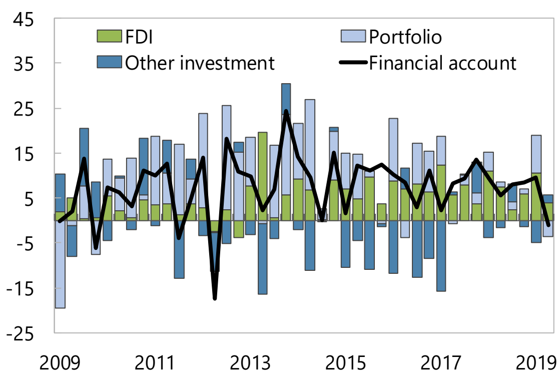
…helped by the depreciation of the peso and a boom in automotive exports.

Value of Exports
(Index, Jan. 2009 = 100, SA)



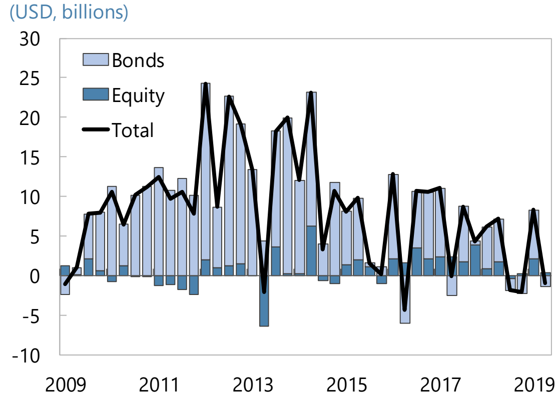
Outflows have remained contained despite a period of elevated uncertainty.

Net Capital Flows
(USD, billions)



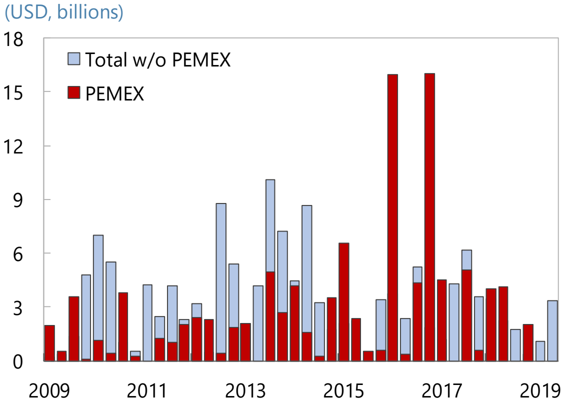
With increased volatility in equity and debt portfolio flows.

Gross Portfolio Inflows
(USD, billions)



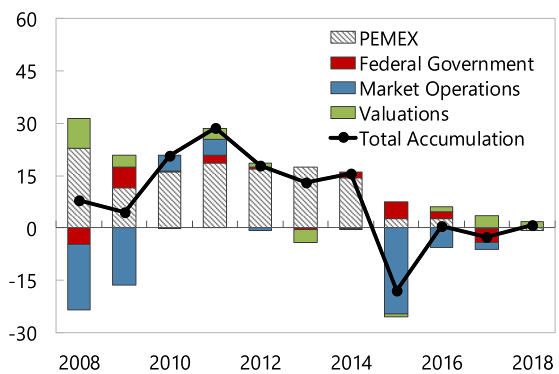
Corporate bond issuance has moderated.

Corporate Bond Issuance: Foreign Placements
(USD, billions)



Reserves have remained stable with no discretionary intervention in sind end-2017.

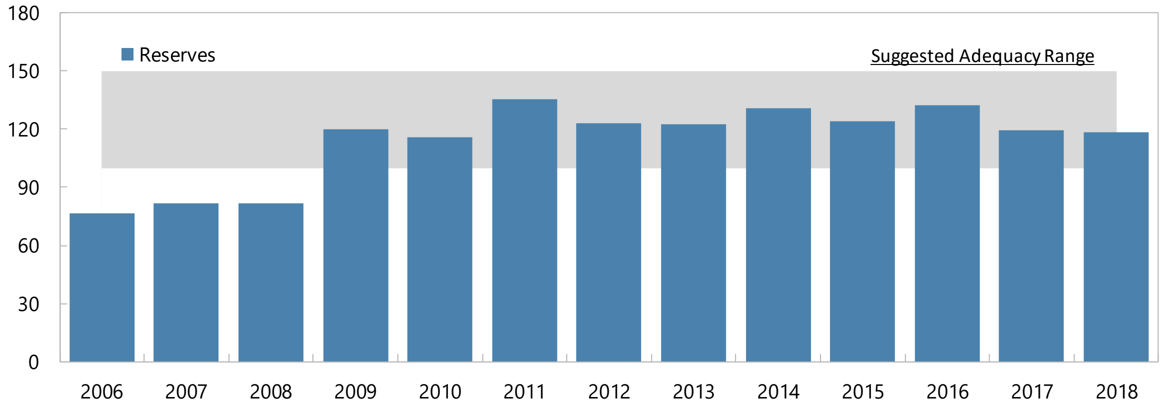
Sources of Reserve Accumulation
(USD, billions)



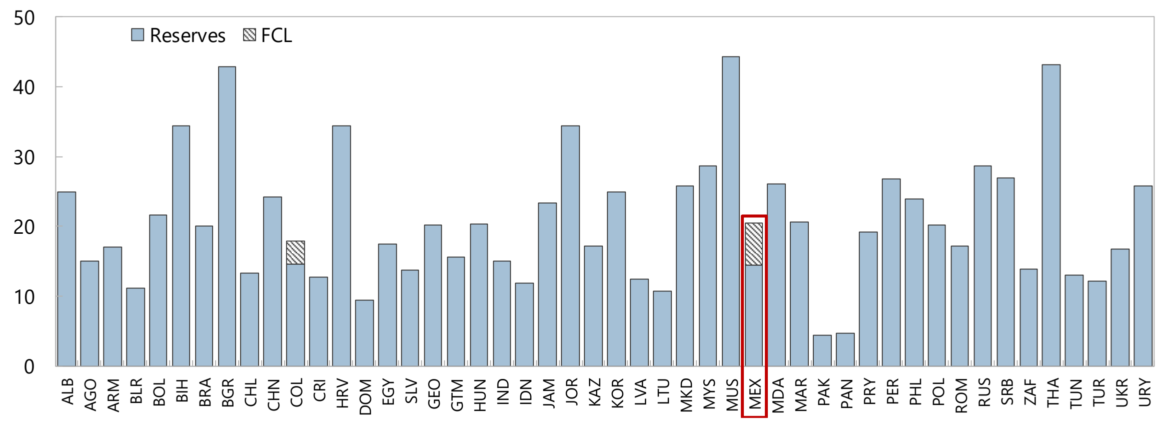
Sources: National Authorities, Haver Analytics; and, IMF Staff estimates.

Figure 5. Mexico: Reserve Coverage in an International Perspective, 2018 1/

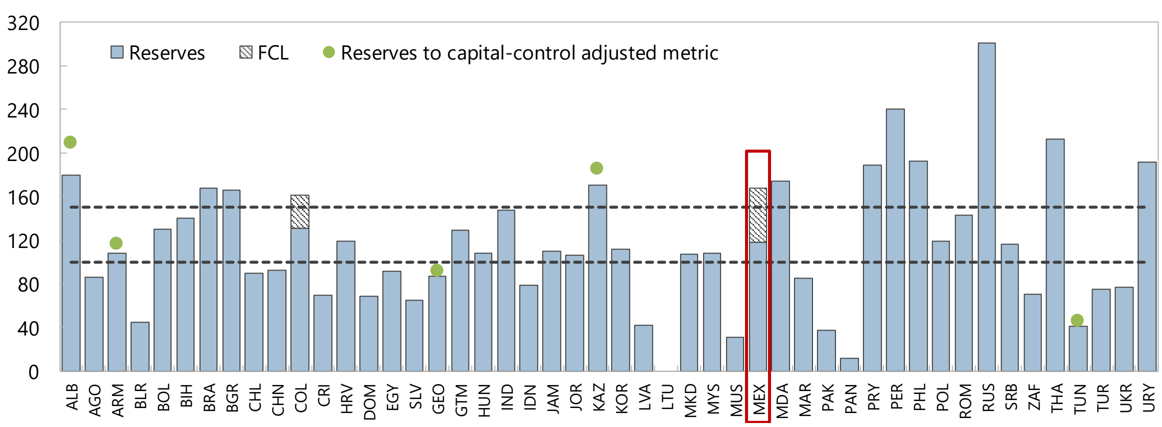
Reserves
(In percent of ARA Metric 1/)



Reserves
(In percent of GDP)



Reserves to ARA Metric 1/
(Adequacy range: 100-150%)

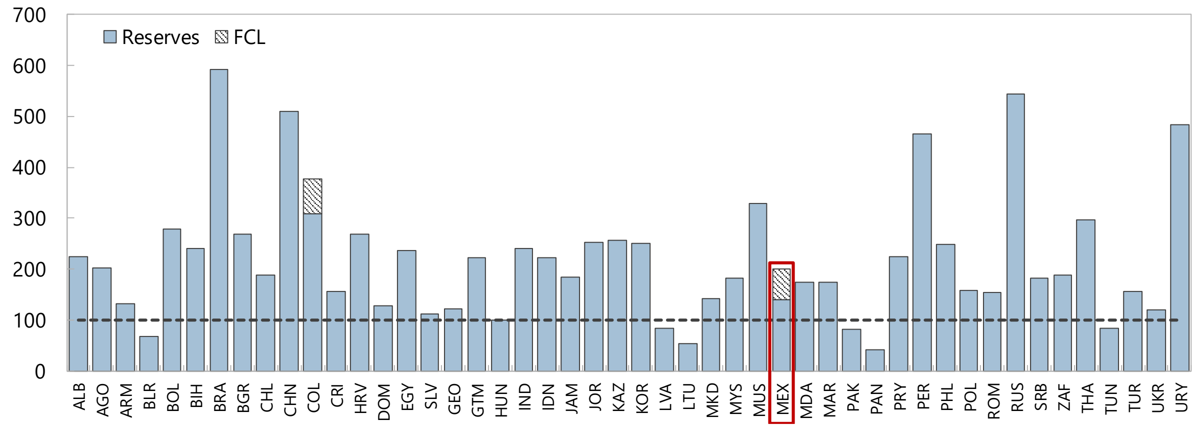


Sources: World Economic Outlook, Balance of Payments Statistics Database; and, IMF staff estimates

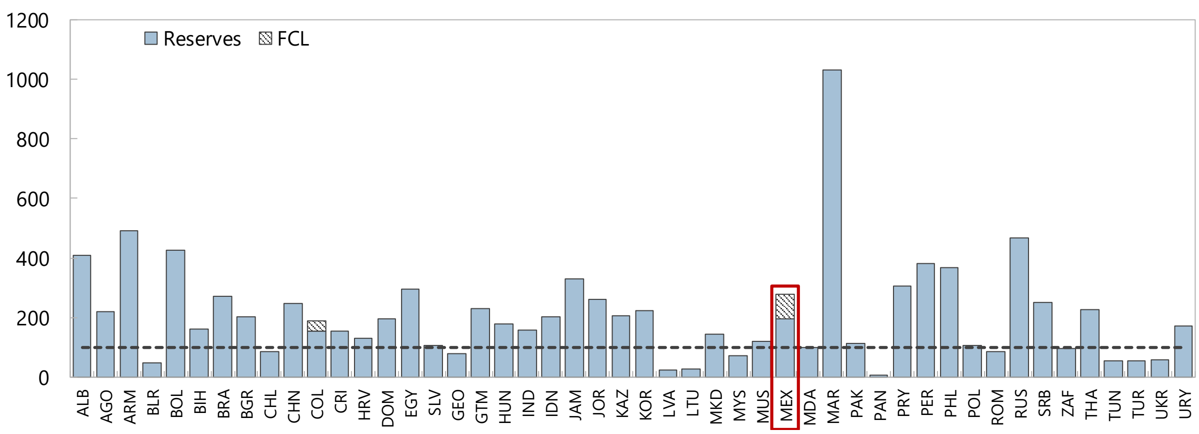
1/ The assessing reserve adequacy (ARA) metric for emerging markets comprises four components reflecting potential balance of payment drains: (i) export income, (ii) broad money, (iii) short-term debt, and (iv) other liabilities. The weight for each component is based on the 10th percentile of observed outflows from emerging markets during exchange market pressure episodes, distinguishing between fixed and flexible exchange rate regimes.

Figure 5. Mexico: Reserve Coverage in an International Perspective, 2018 (Concluded)

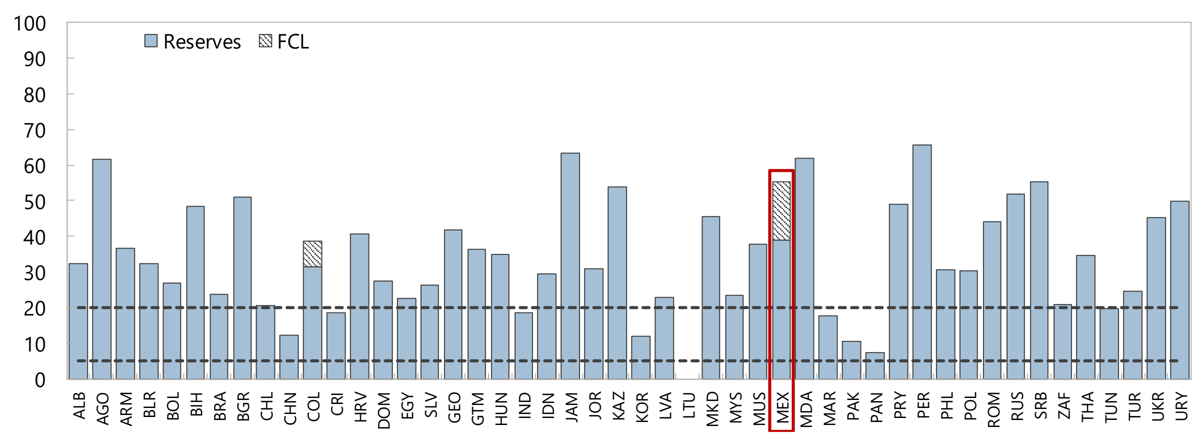
Reserves to 3M Imports
(Adequacy range: > 100%)



Reserves to Short-Term Debt
(Adequacy range: >100%)



Reserves to Broad Money
(Adequacy range: 5-20%)

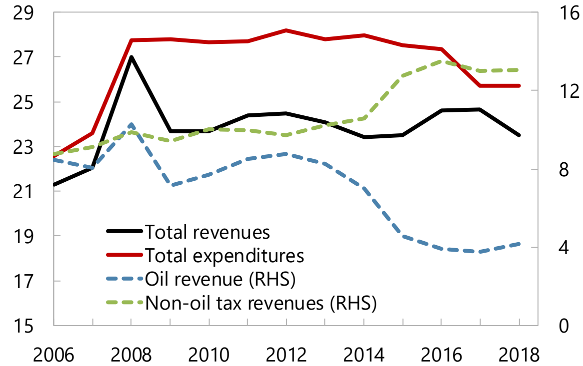


Sources: World Economic Outlook, Balance of Payments Statistics Database; and, IMF staff estimates.

Figure 6. Mexico: Fiscal Sector

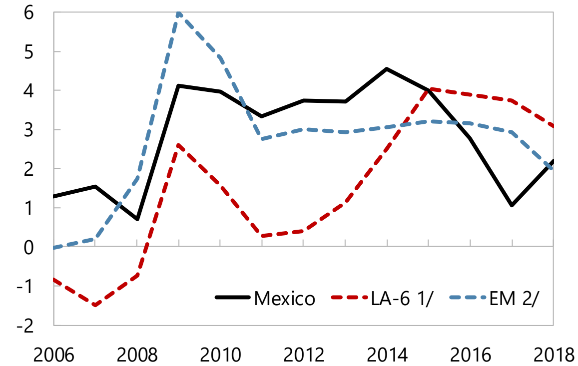
The 2013 tax reform and lower oil production have reduced fiscal dependence on oil…

Public Sector Revenues and expenditures
(In percent of GDP)



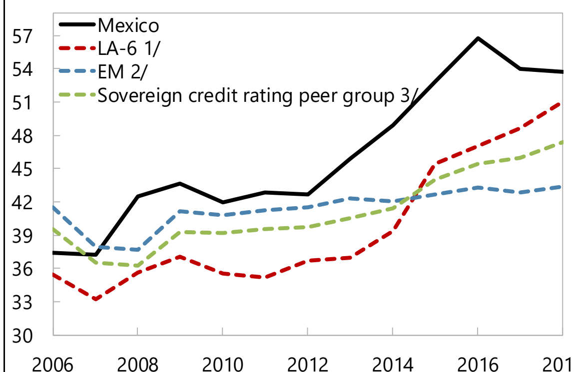
…and narrowed the public sector deficit, together with declining expenditure.

Overall Public Sector Deficit
(In percent of GDP)



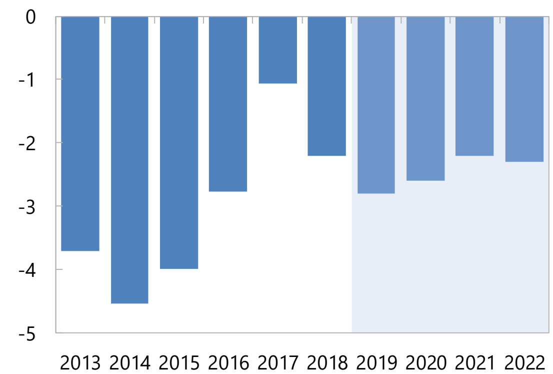
However, public debt has only declined modestly from previous peaks in recent years.

Gross Public Sector Debt
(In percent of GDP)



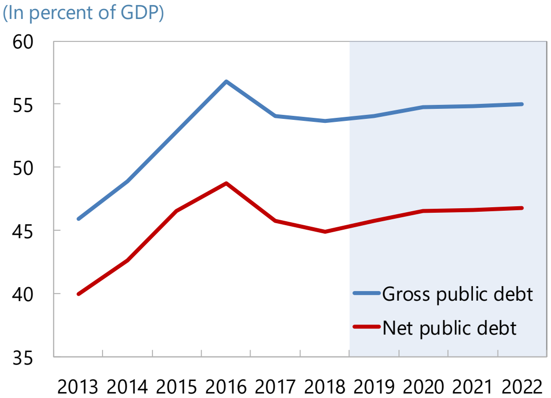
Stabilizing the PSBR at 2.1-2.2 percent of GDP over the medium-term…

Fiscal Balance
(In percent of GDP)



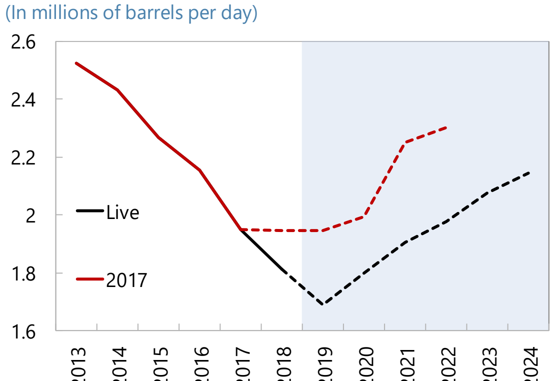
…would stabilize the debt-to-GDP ratio at around the current level of 54 percent.

Public Sector Debt Path
(In percent of GDP)



Further declines in oil production, however, remain an important fiscal risk.

Oil Production Forecast Vintages
(In millions of barrels per day)

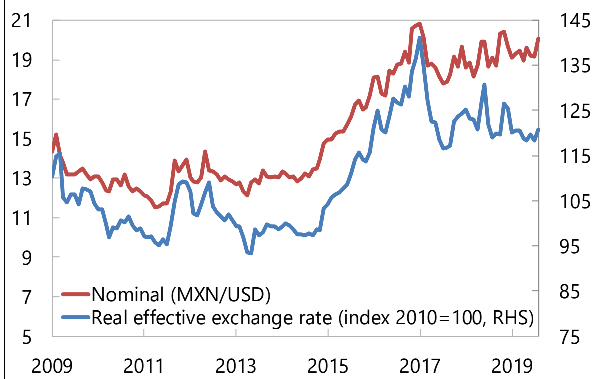


Sources: National authorities, World Economic Outlook, Fitch Ratings; and, Fund staff estimates.
1/ LA-6 excluding Mexico is comprised of Brazil, Chile, Colombia, Peru, and Uruguay.
2/ EM comparator group is comprised of India, Indonesia, Poland, Russia, Thailand, and Turkey.
3/ Fitch sovereign credit rating peer group includes Brazil, Chile, Colombia, India, Poland, Russia, South Africa, Thailand, and Turkey.

Figure 7. Mexico: Financial Sector

In 2018, the Peso was relatively stable despite EM weakness but trade and policy uncertainty have increased volatility recently

Exchange Rate
(As of August, 2019)

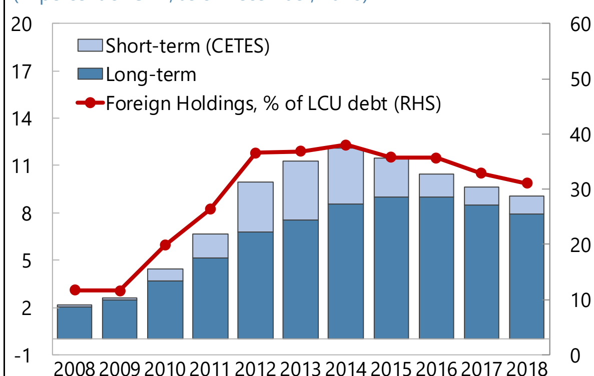


Government bond yields in local currency have been coming down most recently as markets have priced in more easing…

Local Government Bonds Yields
(In percent; as of September, 2019)

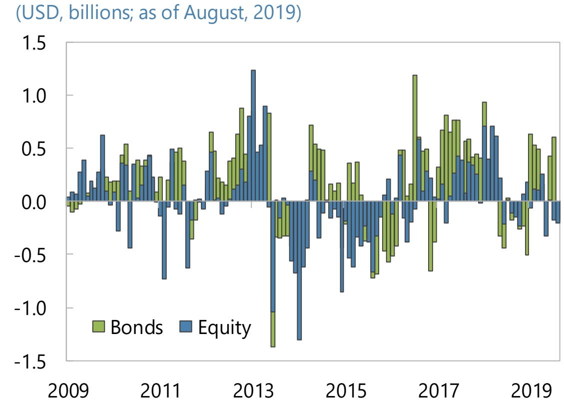
The share of foreign holdings in local-currency sovereign debt has continued to decline

Sovereign Debt Holdings in Local Currency
(In percent of GDP; as of December, 2018)



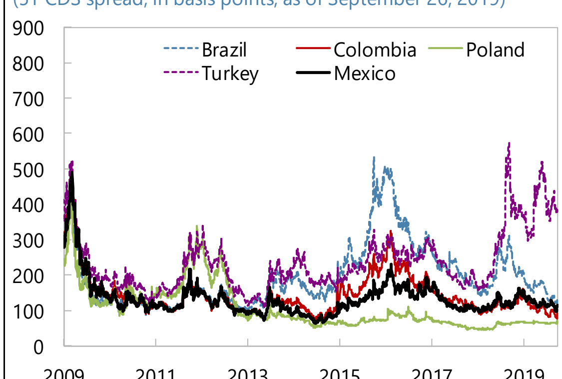
ETF and mutual fund flows have weakened in recent months amid regional and domestic uncertainty but outflows remained contained.

ETFs and Mutual Fund Flows
(USD, billions; as of August, 2019)



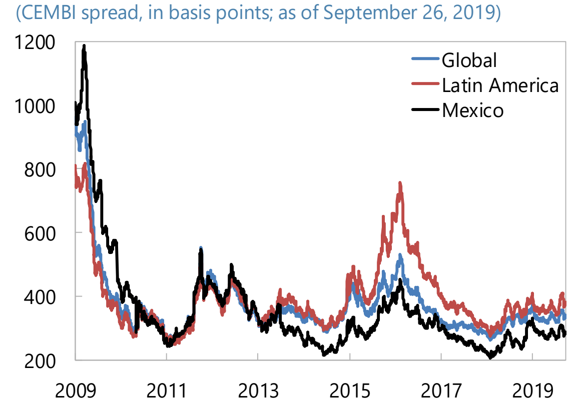
Credit spreads on sovereign dollar-denominated debt….

Sovereign Risk Spreads
(5Y CDS spread, in basis points; as of September 26, 2019)



…and on corporate debt ex-PEMEX have remained stable.

Corporate Risk Spread
(CEMBI spread, in basis points; as of September 26, 2019)

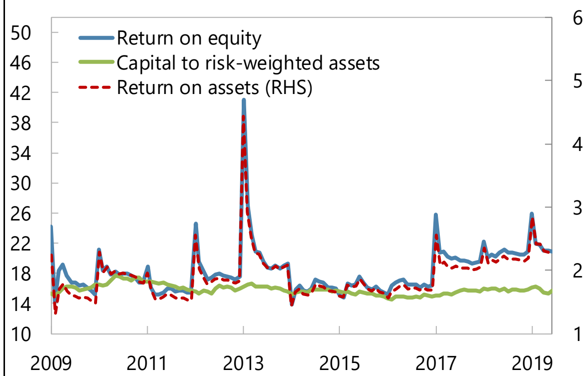


Sources: Bloomberg, Haver Analytics; and, National authorities.

Figure 8. Mexico: Banking System

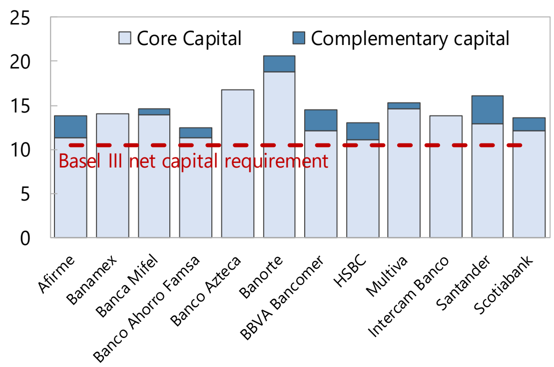
The banking sector remains profitable…

Commercial and Development Banking Sector
(In percent; as of July, 2019)



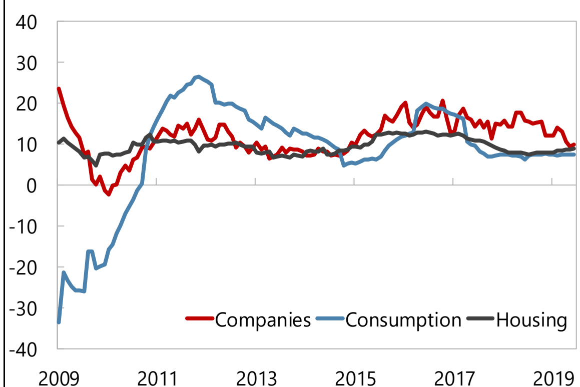
… and well capitalized.

Capital to Risk-Weighted Assets
(In percent; as of July, 2019)



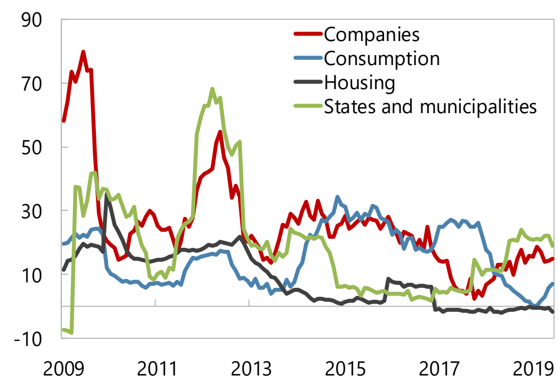
Growth of credit to companies has declined

Commercial Bank Credit Growth by Sector
(Y/Y monthly growth, nominal; as of July, 2019)



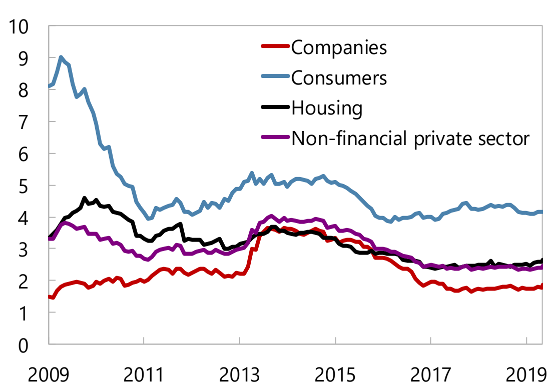
…while development bank credit growth to companies has increased.

Development Bank Credit Growth by Sector
(Y/Y monthly growth, nominal; as of July, 2019)



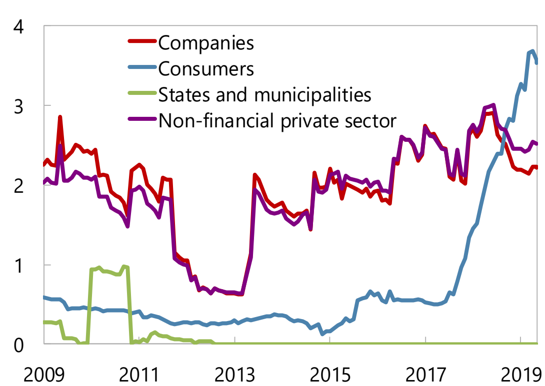
Non-performing loans at commercial banks …

Total Commercial Bank NPLs
(In percent of oustanding loans; as of July, 2019)



…and development banks remain low.

Total Development Bank NPLs
(In percent of oustanding loans; as of July, 2019)

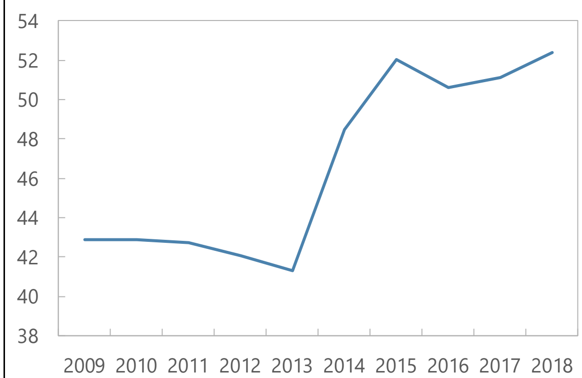


Sources: Bloomberg, Haver Analytics, National authorities; and, IMF staff estimates.

Figure 9. Mexico: Nonfinancial Corporate Sector

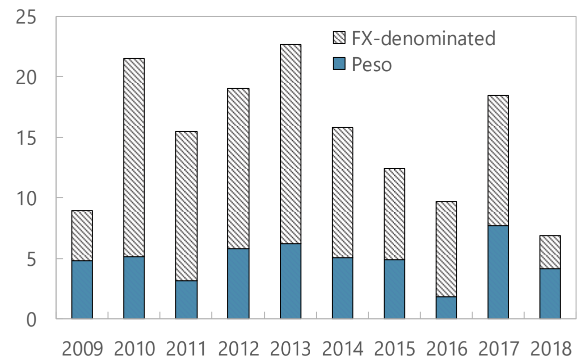
Nonfinancial corporate leverage edged up....

Total Debt to Total Equity
(In percent, median)



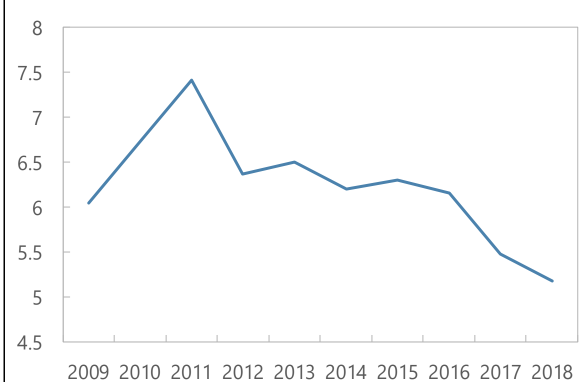
...while bond issuance declined.

Nonfinancial Corporate Bond Issuance 1/
(In US$ billion)



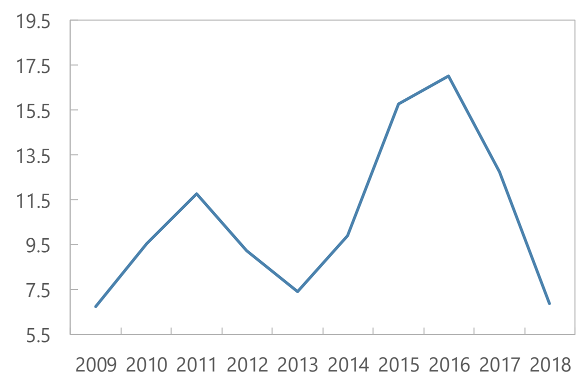
Debt servicing capacity remains strong even though it has weakened in recent years...

Interest Coverage Ratio
(Earnings in multiples of Interest Expense, median)



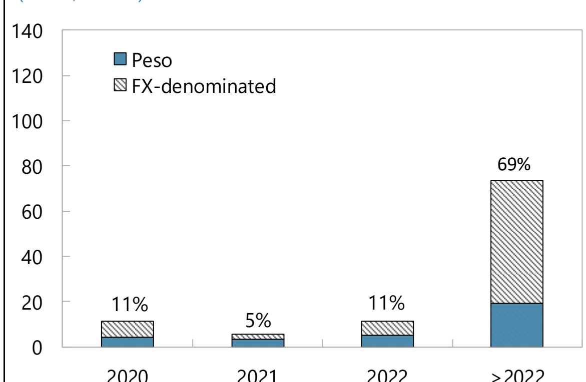
...while profitability has declined.

EBITDA Growth
(year-on-year percent change, median)



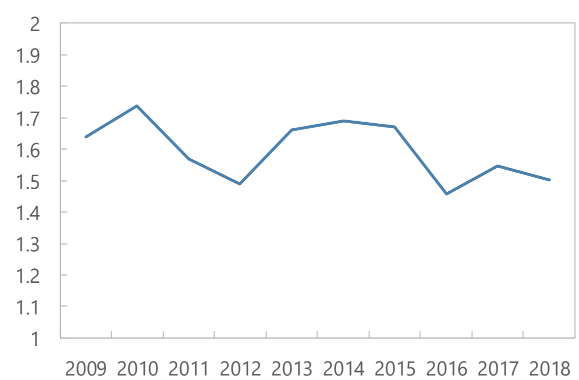
The maturity structure of borrowing has largely been termed out...

Nonfinancial Corporate Bond Maturity Profile
(In US$ billion)



...and corporate liquidity remains good.

Current ratio: Current Assets to Current Liabilities
(Multiples, median)

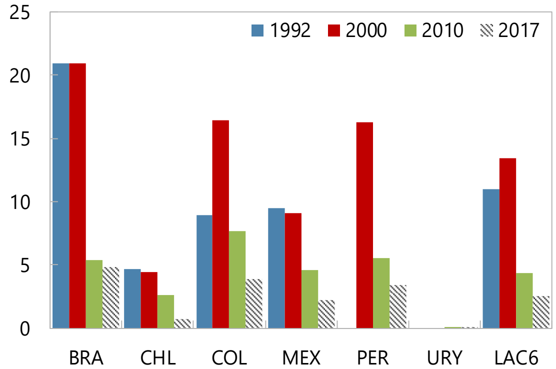


Sources: Bloomberg, Haver Analytics, National authorities; and, IMF staff estimates.
1/ Totals exclude PEMEX, CFE and its affiliates.

Figure 10. Mexico: Social Indicators

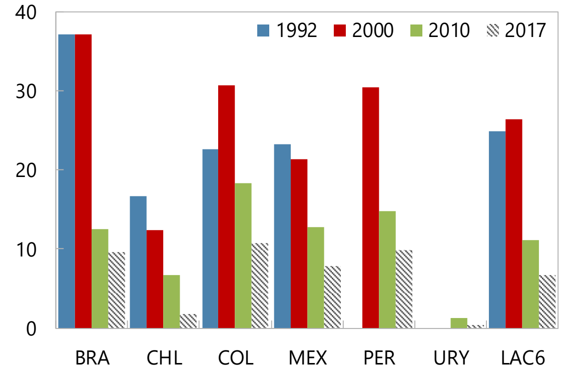
Extreme poverty has declined over the past 25 years.

Poverty Headcount Ratio at $1.90
(2011 PPP, % of population)



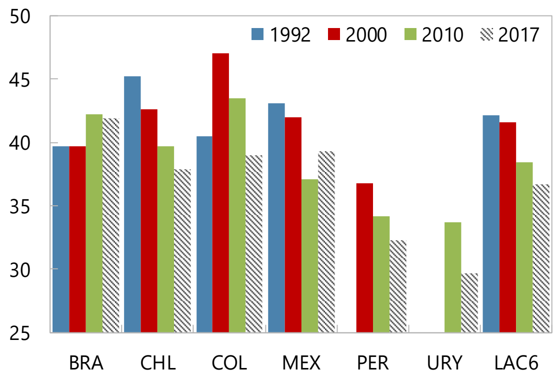
Still, poverty in Mexico remains higher than the LAC6 average.

Poverty Headcount Ratio at $3.20
(2011 PPP, % of population)



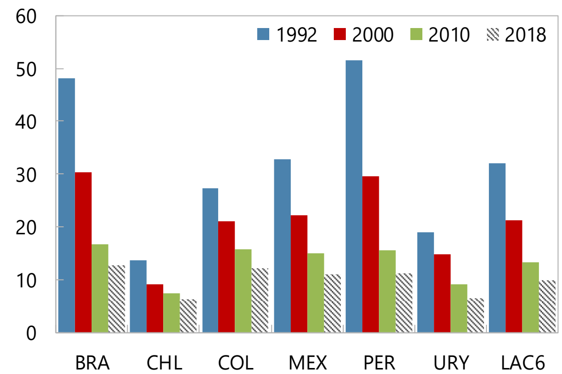
Income inequality is slightly below the regional average.

Income Share Held by Highest 10%



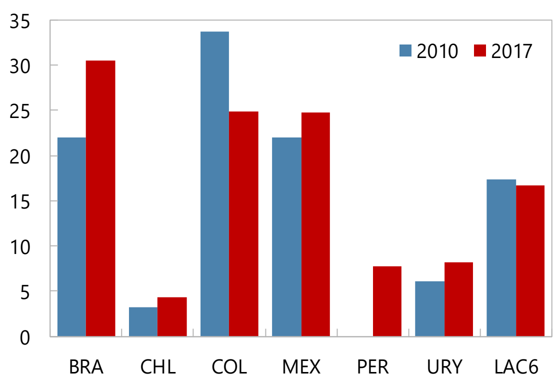
High poverty and inequality go along with higher than average infant mortality rates.

Infant Mortality Rate
(per 1,000 live births)



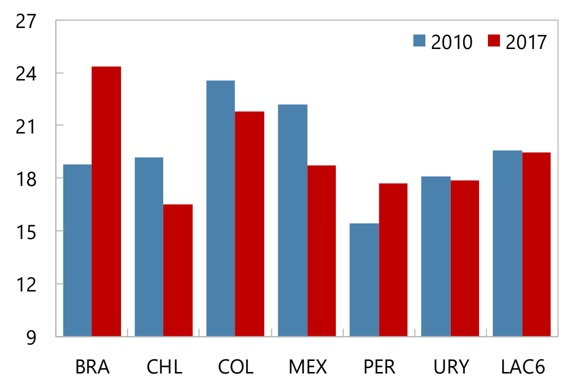
The homicide rate remains high.

Intentional Homicides
(Per 100,000 people)



A large share of youth is excluded from education or employment.

Share of Youth not in Eductaion, Employment or Training
(Total, % of youth population)



Sources: World Development Indicators.

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

I. Social and Demographic Indicators

GDP per capita (U.S. dollars, 2018)	9,786.1	Poverty headcount ratio (% of population, 2018) 1/	41.9
Population (millions, 2018)	124.7	Income share of highest 20 perc. / lowest 20 perc. (2018)	9.7
Life expectancy at birth (years, 2017)	74.9	Adult literacy rate (2018)	95.4
Infant mortality rate (per thousand, 2018)	11.0	Gross primary education enrollment rate (2017) 2/	105.8

II. Economic Indicators

					Proj.	
	2015	2016	2017	2018	2019	2020
	(Annual percentage change, unless otherwise indicated)					
National accounts (in real terms)						
GDP	3.3	2.9	2.1	2.1	0.4	1.3
Consumption	2.6	3.6	2.8	2.4	0.7	1.7
Private	2.7	3.7	3.2	2.3	0.8	1.8
Public	1.9	2.6	0.7	3.0	0.3	1.1
Investment	4.3	1.4	-1.6	0.3	-3.9	-0.5
Fixed	5.0	1.0	-1.6	0.9	-4.5	0.1
Private	8.9	1.4	0.4	1.2	-3.8	0.2
Public	-10.7	-0.8	-11.9	-0.9	-9.2	-1.0
Inventories 3/	-0.1	0.1	0.0	-0.1	0.1	-0.1
Exports of goods and services	8.4	3.6	4.2	5.9	3.1	2.2
Imports of goods and services	5.9	2.8	6.4	5.9	0.5	2.1
GDP per capita	2.2	1.8	1.1	1.1	-0.5	0.4
External sector						
External current account balance (in percent of GDP)	-2.6	-2.2	-1.7	-1.8	-1.2	-1.6
Exports of goods, f.o.b. 4/	-4.1	-1.7	9.5	10.1	2.2	2.0
Export volume	7.6	2.5	3.8	6.3	3.1	2.1
Imports of goods, f.o.b. 4/	-1.2	-2.1	8.6	10.4	1.2	3.4
Import volume	6.2	2.9	6.2	6.3	0.8	2.1
Net capital inflows (in percent of GDP)	-1.9	-3.0	-2.5	-2.6	-1.4	-1.7
Terms of trade (improvement +)	-4.2	0.7	3.1	-0.3	-1.3	-1.4
Gross international reserves (in billions of U.S. dollars)	177.6	178.0	175.4	176.4	178.0	179.7
Exchange rates						
Real effective exchange rate (CPI based, IFS)						
(average, appreciation +)	-10.4	-12.9	2.3	0.1	...	...
Nominal exchange rate (MXN/USD)						
(end of period, appreciation +)	-16.9	-20.5	4.6	0.5	...	...
Employment and inflation						
Consumer prices (end-of-period)	2.1	3.4	6.8	4.8	3.1	3.0
Core consumer prices (end-of-period)	2.4	3.4	4.9	3.7	3.6	3.0
Formal sector employment, IMSS-insured workers (average)	4.3	3.8	4.4	4.1	4.5	...
National unemployment rate (annual average)	4.3	3.9	3.4	3.3	3.4	3.4
Unit labor costs: manufacturing (real terms, average)	2.9	5.5	2.3	3.4	...	...
Money and credit						
Financial system credit to non-financial private sector 5/	14.8	16.5	10.8	8.8	6.9	7.2
Broad money	12.2	12.3	11.2	5.5	5.1	5.4
Public sector finances (in percent of GDP) 6/						
General government revenue	23.5	24.6	24.7	23.5	22.8	22.3
General government expenditure	27.5	27.4	25.7	25.7	25.6	24.9
Overall fiscal balance	-4.0	-2.8	-1.1	-2.2	-2.8	-2.6
Gross public sector debt	52.8	56.8	54.0	53.7	54.0	54.8
Memorandum items						
Nominal GDP (billions of pesos)	18,551.5	20,118.1	21,911.9	23,491.5	24,479.9	25,577.7
Output gap	0.2	0.5	0.0	0.0	-1.1	-1.1

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 measuring 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/ Includes domestic credit by banks, nonbank intermediaries, and social housing funds.
6/ Data exclude state and local governments and include state-owned enterprises and public development banks.

Table 2. Mexico: Statement of Operations of the Public Sector, Authorities' Presentation 1/
(In percent of GDP)

	2016	2017	2018	Proj. 2019	2020	2021	2022	2023	2024
Budgetary revenue, by type	**24.1**	**22.6**	**21.8**	**21.7**	**21.2**	**21.3**	**21.4**	**21.5**	**21.7**
Oil revenue	3.9	3.8	4.2	3.8	3.8	3.9	3.9	3.9	4.0
Non-oil tax revenue	13.5	13.0	13.0	13.2	13.4	13.4	13.5	13.5	13.6
Non-oil non-tax revenue 2/	6.7	5.8	4.6	4.7	4.0	4.0	4.0	4.0	4.1
Budgetary revenue, by entity	**24.1**	**22.6**	**21.8**	**21.7**	**21.2**	**21.3**	**21.4**	**21.5**	**21.7**
Federal government revenue	17.8	17.5	16.5	16.4	15.6	15.6	15.7	15.7	15.9
Tax revenue, *of which:*	13.5	13.0	13.0	13.2	13.4	13.4	13.5	13.5	13.6
Excises (including fuel)	2.0	1.7	1.5	1.9	1.9	1.9	1.9	2.0	2.0
Nontax revenue	4.3	4.5	3.4	3.2	2.2	2.2	2.2	2.2	2.3
Public enterprises	6.3	5.1	5.3	5.3	5.6	5.7	5.8	5.8	5.8
PEMEX	2.4	1.8	1.9	1.9	2.2	2.3	2.4	2.4	2.4
Other	3.9	3.3	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Budgetary expenditure	**26.6**	**23.7**	**23.8**	**23.7**	**23.3**	**23.0**	**23.2**	**23.3**	**23.6**
Primary	24.2	21.2	21.2	20.8	20.9	21.1	21.7	21.9	22.3
Programmable	20.7	17.6	17.3	17.1	17.2	17.4	17.9	18.2	18.5
Current	14.8	14.0	14.2	14.2	14.4	14.5	14.7	14.9	15.1
Wages	5.5	5.2	5.2	5.1	5.2	5.2	5.2	5.2	5.2
Pensions 3/	3.2	3.2	3.4	3.6	3.8	4.0	4.2	4.4	4.6
Subsidies and transfers	3.4	2.9	2.7	2.8	2.8	2.8	2.8	2.8	2.8
Other	2.7	2.7	2.9	2.7	2.7	2.5	2.5	2.5	2.5
Capital	5.9	3.6	3.1	2.8	2.8	2.9	3.3	3.3	3.3
Physical capital	3.6	2.6	2.6	2.6	2.6	2.9	3.2	3.2	3.3
Financial capital 4/	2.3	1.0	0.4	0.2	0.2	0.1	0.1	0.1	0.1
Nonprogrammable	3.6	3.6	3.9	3.7	3.7	3.7	3.7	3.7	3.8
Of which: revenue sharing	3.4	3.5	3.6	3.7	3.6	3.6	3.6	3.6	3.6
Interest payments	**2.4**	**2.4**	**2.6**	**2.9**	**2.9**	**2.9**	**2.9**	**2.9**	**2.9**
Unspecified measures	**0.0**	**0.0**	**0.0**	**0.0**	**-0.5**	**-0.9**	**-1.4**	**-1.5**	**-1.5**
Traditional balance	**-2.5**	**-1.1**	**-2.1**	**-2.0**	**-2.1**	**-1.7**	**-1.8**	**-1.8**	**-1.9**
Adjustments to the traditional balance	**-0.3**	**0.0**	**-0.1**	**-0.8**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Public Sector Borrowing Requirements	**2.8**	**1.1**	**2.2**	**2.8**	**2.6**	**2.2**	**2.3**	**2.3**	**2.4**
Memorandum items									
Structural current spending 5/	11.1	10.1	9.9						
Structural current spending real growth (y/y, in percent)	-5.0	-6.6	-0.2						

Sources: Ministry of Finance and Public Credit; and IMF staff estimates.

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

2/ Includes revenues from the oil-price hedge for 0.6 percent of GDP in 2015 and 0.3 percent of GDP in 2016; and Bank of Mexico's operating surplus transferred to the federal government for 0.2 percent of GDP in 2015, 1.2 percent of GDP in 2016, and 1.5 percent of GDP in 2017.

3/ Includes social assistance benefits.

4/ Due to lack of disaggregated data this item includes both financing and capital transfers.

5/ The 2014 amendment to the FRL introduced a cap on the real growth rate of structural current spending set at 2.0 percent for 2015 and 2016, and equal to potential growth thereafter. Structural current spending is defined as total budgetary expenditure, excluding: (i) interest payments; (ii) non-programable spending; (iii) cost of fuels for electricity generation; (iv) public sector pensions; (v) direct physical and financial investment of the federal government; and (vi) expenditure by state productive enterprises and their subsidiaries.

Table 3. Mexico: Statement of Operations of the Public Sector, GFSM 2014 Presentation 1/

(In percent of GDP)

				Proj.					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue	**24.6**	**24.7**	**23.5**	**22.8**	**22.3**	**22.4**	**22.5**	**22.5**	**22.7**
Taxes	**13.5**	**13.0**	**13.0**	**13.2**	**13.4**	**13.4**	**13.5**	**13.5**	**13.6**
Taxes on income, profits and capital gains	7.1	7.1	7.1	7.0	7.0	7.0	7.1	7.1	7.1
Taxes on goods and services	6.0	5.4	5.4	5.8	5.8	5.9	5.9	6.0	6.0
Value added tax	3.9	3.7	3.9	3.9	3.9	3.9	4.0	4.0	4.0
Excises	2.0	1.7	1.5	1.9	1.9	1.9	1.9	2.0	2.0
Taxes on international trade and transactions	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other taxes	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**
Other revenue	**9.0**	**9.6**	**8.3**	**7.4**	**6.8**	**6.8**	**6.8**	**6.8**	**6.9**
Property income 2/	4.1	4.6	3.5	3.1	2.3	2.2	2.2	2.2	2.3
Other	4.8	5.0	4.9	4.3	4.5	4.6	4.6	4.6	4.6
Total expenditure	**27.4**	**25.7**	**25.7**	**25.6**	**24.9**	**24.6**	**24.8**	**24.8**	**25.0**
Expense	**24.7**	**24.1**	**24.1**	**23.8**	**23.6**	**23.4**	**23.7**	**23.8**	**24.1**
Compensation of employees	3.5	3.4	3.4	3.3	3.4	3.4	3.4	3.4	3.4
Purchases of goods and services	3.8	3.3	3.6	3.3	3.3	3.1	3.1	3.1	3.1
Interest 3/	3.3	4.0	4.1	4.0	3.8	3.7	3.7	3.7	3.7
Subsidies and transfers	2.0	1.7	1.8	1.6	1.6	1.7	1.6	1.7	1.6
o/w fuel subsidy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants 4/	8.6	8.3	8.2	8.3	8.3	8.2	8.2	8.2	8.3
Social benefits	3.2	3.2	3.4	3.6	3.8	4.0	4.2	4.4	4.6
Other expense	0.2	0.1	-0.4	-0.3	-0.5	-0.7	-0.4	-0.6	-0.6
Net acquisition of nonfinancial assets 5/	**2.7**	**1.6**	**1.6**	**1.7**	**1.8**	**2.1**	**2.4**	**2.5**	**2.4**
Unspecified measures	**0.0**	**0.0**	**0.0**	**0.0**	**-0.5**	**-0.9**	**-1.4**	**-1.5**	**-1.5**
Gross Operating Balance	**-0.1**	**0.6**	**-0.6**	**-1.0**	**-1.3**	**-1.0**	**-1.3**	**-1.3**	**-1.5**
Overall Fiscal Balance (Net lending/borrowing)	**-2.8**	**-1.1**	**-2.2**	**-2.8**	**-2.6**	**-2.2**	**-2.3**	**-2.3**	**-2.4**
Primary net lending/borrowing	**0.4**	**2.6**	**1.6**	**0.8**	**0.9**	**1.2**	**1.1**	**1.1**	**1.0**
Memorandum items									
Primary expenditure	24.0	21.7	21.6	21.7	21.1	20.8	21.1	21.1	21.4
Current expenditure	24.7	24.1	24.1	23.9	23.1	22.5	22.3	22.3	22.6
Structural fiscal balance	-3.9	-2.3	-2.3	-2.8	-2.5	-2.1	-2.2	-2.3	-2.4
Structural primary balance 6/	-0.8	1.4	1.5	0.9	1.0	1.4	1.2	1.1	1.0
Fiscal impulse 7/	-0.8	-2.2	-0.1	0.6	-0.1	-0.4	0.2	0.1	0.1
Gross public sector debt 8/	56.8	54.0	53.7	54.0	54.8	54.9	55.0	55.1	55.1
In domestic currency (percentage of total debt)	66.3	66.7	67.5	67.0	66.6	66.4	65.6	65.3	64.4
In foreign currency (percentage of total debt)	33.7	33.3	32.5	33.0	33.4	33.6	34.4	34.7	35.6
Net public sector debt 9/	48.7	45.8	44.9	45.8	46.5	46.6	46.7	46.8	46.9

Sources: Ministry of Finance and Public Credit; and Fund staff estimates and projections.

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

2/ Includes revenues from the oil-price hedge for 0.6 percent of GDP in 2015 and 0.3 percent of GDP in 2016, treated as revenues from an insurance claim. It includes also Bank of Mexico's operating surplus transferred to the federal government for 0.2 percent of GDP in 2015, 1.2 percent of GDP in 2016, and 1.5 percent of GDP in 2017.

3/ Interest payments differ from official data due to adjustments to account for changes in valuation and interest rates.

4/ Includes transfers to state and local governments under revenue-sharing agreements with the federal government.

5/ This category differs from official data on physical capital spending due to adjustments to account for Pidiregas amortizations included in budget figures and the reclassification of earmarked transfers to sub-national governments.

6/ Adjusting revenues for the economic and oil-price cycles and excluding one-off items (e.g. oil hedge income and Bank of Mexico transfers).

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

8/ Corresponds to the gross stock of public sector borrowing requirements, calculated as the net stock of public sector borrowing requirements as published by the authorities plus public sector financial assets.

9/ Corresponds to the net stock of public sector borrowing requirements (i.e., net of public sector financial assets) as published by the authorities.

Table 4A. Mexico: Summary Balance of Payments
(In billions of U.S. dollars)

				Proj.					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Current account	**-24.2**	**-20.1**	**-22.0**	**-15.5**	**-20.6**	**-23.1**	**-25.9**	**-28.4**	**-31.4**
Merchandise goods trade balance	-13.1	-11.0	-13.6	-9.3	-16.1	-18.4	-20.8	-22.1	-22.1
Exports, f.o.b. 2/	373.9	409.4	450.7	460.5	469.8	491.0	520.0	554.9	594.7
o/w Manufactures	335.9	364.3	397.3	412.3	427.0	450.0	472.8	503.8	544.1
o/w Petroleum and derivatives 1/	18.8	23.7	30.6	26.6	26.2	26.8	27.6	29.3	30.7
Imports, f.o.b. 2/	387.1	420.4	464.3	469.8	485.9	509.4	540.8	577.0	616.7
o/w Petroleum and derivatives 1/	31.6	42.0	53.8	46.0	43.0	42.1	42.6	43.8	45.3
Services, net	-9.0	-9.9	-8.9	-7.0	-7.1	-7.6	-8.1	-8.7	-9.3
Primary income, net	-29.3	-29.4	-32.2	-32.9	-32.4	-33.9	-35.7	-38.0	-42.2
Secondary income (mostly remittances), net	27.1	30.1	32.9	33.7	35.0	36.8	38.7	40.4	42.2
Capital Account, net	**0.0**	**0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Financial Account (Net lending (+)/Net borrowing (-))	**-32.7**	**-33.5**	**-31.4**	**-15.6**	**-20.7**	**-23.1**	**-25.9**	**-28.5**	**-31.4**
Foreign direct investment, net	-30.4	-29.6	-26.7	-26.6	-29.1	-31.6	-33.5	-35.1	-36.9
Net acquisition of financial assets	6.0	3.4	10.8	11.2	10.7	11.1	11.5	11.9	12.3
Net incurrence of liabilities	36.4	32.9	37.5	37.9	39.8	42.7	44.9	47.0	49.2
Portfolio investment, net	-28.1	-10.2	-8.3	-12.0	-16.4	-6.8	-14.3	-14.2	-14.2
Net acquisition of financial assets	1.5	13.8	1.2	3.0	4.0	4.0	2.5	2.0	2.0
Net incurrence of liabilities	29.7	24.0	9.5	15.0	20.4	10.8	16.8	16.2	16.2
Public Sector	21.4	5.8	10.7	9.7	15.6	6.0	12.0	11.4	11.4
o/w Local currency domestic-issued bonds	-1.5	-0.3	0.1	4.7	10.1	-0.5	6.0	5.5	5.5
Private sector	8.3	18.3	-1.2	5.3	4.8	4.8	4.8	4.8	4.8
Securities issued abroad	-1.2	7.9	-3.6	2.8	2.8	2.8	2.8	2.8	2.8
Equity	9.5	10.3	2.4	2.5	2.0	2.0	2.0	2.0	2.0
Pidiregas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives, net	-2.2	3.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Other investments, net	28.3	8.0	2.6	21.5	23.2	12.4	18.4	16.4	14.7
Net acquisition of financial assets	24.8	5.5	9.3	23.5	25.2	14.4	20.4	18.4	16.7
Net incurrence of liabilities	-3.5	-2.4	6.7	2.0	2.0	2.0	2.0	2.0	2.0
Change in Reserves Assets	-0.1	-4.8	0.5	1.6	1.6	3.0	3.5	4.5	5.0
Total change in gross reserves assets	0.4	-2.6	0.9	1.6	1.6	3.0	3.5	4.5	5.0
Valuation change	0.6	2.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	**-8.5**	**-13.6**	**-9.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
International Investment Position, net	**-532.1**	**-558.6**	**-568.2**	**-583.8**	**-604.5**	**-627.6**	**-653.5**	**-682.0**	**-713.4**
Memorandum items									
Hydrocarbons exports volume growth (in percent)	2.0	1.2	1.8	-5.6	4.1	7.6	4.4	6.0	3.7
Non-hydrocarbons exports volume growth (in percent)	2.6	3.9	6.4	3.3	2.1	3.5	4.2	4.5	4.6
Hydrocarbons imports volume growth (in percent)	16.5	14.9	4.8	-8.9	0.2	2.2	2.1	2.3	2.1
Non-hydrocarbons imports volume growth (in percent)	2.6	5.9	6.4	1.1	2.2	3.7	4.3	4.6	4.6
Crude oil export volume (in millions of bbl/day)	1.2	1.2	1.2	1.1	1.2	1.2	1.3	1.4	1.4
Gross international reserves (in billions of U.S. dollars)	178.0	175.4	176.4	178.0	179.7	182.6	186.1	190.6	195.7
Gross domestic product (in billions of U.S. dollars)	1,077.9	1,157.7	1,220.7	1,267.3	1,306.2	1,363.8	1,424.7	1,490.1	1,560.2

Sources: Bank of Mexico, National Institute of Statistics and Geography, and Fund staff estimates.
1/ Crude oil, derivatives, petrochemicals, and natural gas.
2/ Excludes goods procured in ports by carriers.

Table 4B. Mexico: Summary Balance of Payments
(In percent of GDP)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Proj.					
Current account	**-2.2**	**-1.7**	**-1.8**	**-1.2**	**-1.6**	**-1.7**	**-1.8**	**-1.9**	**-2.0**
Merchandise goods trade balance	-1.2	-0.9	-1.1	-0.7	-1.2	-1.3	-1.5	-1.5	-1.4
Exports, f.o.b. 2/	34.7	35.4	36.9	36.3	36.0	36.0	36.5	37.2	38.1
o/w Manufactures	31.2	31.5	32.6	32.5	32.7	33.0	33.2	33.8	34.9
o/w Petroleum and derivatives 1/	1.7	2.0	2.5	2.1	2.0	2.0	1.9	2.0	2.0
Imports, f.o.b. 2/	35.9	36.3	38.0	37.1	37.2	37.3	38.0	38.7	39.5
o/w Petroleum and derivatives 1/	2.9	3.6	4.4	3.6	3.3	3.1	3.0	2.9	2.9
Services, net	-0.8	-0.9	-0.7	-0.5	-0.5	-0.6	-0.6	-0.6	-0.6
Primary income, net	-2.7	-2.5	-2.6	-2.6	-2.5	-2.5	-2.5	-2.6	-2.7
Secondary income (mostly remittances), net	2.5	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Capital Account, net	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Financial Account (Net lending (+)/Net borrowing (-))	**-3.0**	**-2.9**	**-2.6**	**-1.2**	**-1.6**	**-1.7**	**-1.8**	**-1.9**	**-2.0**
Foreign direct investment, net	-2.8	-2.6	-2.2	-2.1	-2.2	-2.3	-2.3	-2.4	-2.4
Net acquisition of financial assets	0.6	0.3	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Net incurrence of liabilities	3.4	2.8	3.1	3.0	3.0	3.1	3.2	3.2	3.2
Portfolio investment, net	-2.6	-0.9	-0.7	-0.9	-1.3	-0.5	-1.0	-1.0	-0.9
Net acquisition of financial assets	0.1	1.2	0.1	0.2	0.3	0.3	0.2	0.1	0.1
Net incurrence of liabilities	2.8	2.1	0.8	1.2	1.6	0.8	1.2	1.1	1.0
Public Sector	2.0	0.5	0.9	0.8	1.2	0.4	0.8	0.8	0.7
o/w Local currency domestic-issued bonds	-0.1	0.0	0.0	0.4	0.8	0.0	0.4	0.4	0.4
Private sector	0.8	1.6	-0.1	0.4	0.4	0.4	0.3	0.3	0.3
Securities issued abroad	-0.1	0.7	-0.3	0.2	0.2	0.2	0.2	0.2	0.2
Equity	0.9	0.9	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Pidiregas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives, net	-0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investments, net	2.6	0.7	0.2	1.7	1.8	0.9	1.3	1.1	0.9
Net acquisition of financial assets	2.3	0.5	0.8	1.9	1.9	1.1	1.4	1.2	1.1
Net incurrence of liabilities	-0.3	-0.2	0.5	0.2	0.2	0.1	0.1	0.1	0.1
Change in Reserves Assets	0.0	-0.4	0.0	0.1	0.1	0.2	0.2	0.3	0.3
Total change in gross reserves assets	0.0	-0.2	0.1	0.1	0.1	0.2	0.2	0.3	0.3
Valuation change	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	**-0.8**	**-1.2**	**-0.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
International Investment Position, net	**-49.4**	**-48.2**	**-46.5**	**-46.1**	**-46.3**	**-46.0**	**-45.9**	**-45.8**	**-45.7**

Sources: Bank of Mexico, National Institute of Statistics and Geography, and Fund staff estimates.
1/ Crude oil, derivatives, petrochemicals, and natural gas.
2/ Excludes goods procured in ports by carriers.

Table 5. Mexico: Financial Soundness Indicators
(In percent)

	2016	2017	2018	2019	Latest data available 1/
Capital Adequacy					
Regulatory capital to risk-weighted assets	14.9	15.6	15.9	15.7	June
Regulatory Tier 1 capital to risk-weighted assets	13.2	14.2	14.2	14.2	June
Capital to assets	9.9	10.4	10.7	10.7	June
Gross asset position in financial derivatives to capital	91.8	71.1	63.3	52.3	June
Gross liability position in financial derivatives to capital	96.5	76.0	63.9	53.3	June
Asset Quality					
Nonperforming loans to total gross loans	2.1	2.1	2.1	2.1	June
Provisions to Nonperforming loans	157.1	154.8	152.4	149.2	June
Earnings and Profitability					
Return on assets	1.7	2.0	2.2	2.3	June
Return on equity	16.3	19.6	20.9	20.9	June
Liquidity					
Liquid assets to short-term liabilities	42.4	42.2	42.3	40.2	June
Liquid assets to total assets	31.4	32.0	31.6	30.5	June
Customer deposits to total (noninterbank) loans	88.9	91.4	89.3	88.7	June
Trading income to total income	4.4	5.0	4.5	5.3	June

Sources: Financial Soundness Indicators.
1/ End of period.

Table 6. Mexico: Financial Indicators and Measures of External Vulnerabilities

	2016	2017	2018	2019	Latest data available
Financial market indicators					
Exchange rate (per U.S. dollar, period average)	18.7	18.9	19.2	19.3	Sep-19
(year-to-date percent change, + appreciation)	-17.8	-1.4	-1.7	-1.1	Sep-19
28-day treasury auction rate (percent; period average)	4.1	6.7	7.6	8.0	Sep-19
EMBIG Mexico spread (basis points; period average)	303.5	256.0	272.8	320.9	Sep-19
Sovereign 10-year local currency bond yield (period average)	6.2	7.2	7.9	7.8	Sep-19
Stock exchange index (period average, year on year percent change)	3.8	7.5	-3.8	-11.1	Sep-19
Financial system					
Bank of Mexico net international reserves (US$ billion)	176.5	172.8	174.8	176.4	Proj.
Financial system credit on non-financial private sector (year on year percent change) 1/	16.5	10.8	8.8	6.9	Proj.
Nonperforming loans to total gross loans (deposit takers)	2.1	2.1	2.1	2.1	Jun-19
External vulnerability indicators					
Gross financing needs (billions of US$) 2/	123.9	95.4	96.6	98.8	Proj.
Gross international reserves (end-year, billions of US$) 3/	178.0	175.4	176.4	189.4	Aug-19
Change (billions of US$)	0.4	-2.6	0.9	7.3	Aug-19
Months of imports of goods and services	5.1	4.6	4.2	4.2	Proj.
Months of imports plus interest payments	4.8	4.4	4.0	4.0	Proj.
Percent of broad money	48.6	41.1	39.0	37.1	Proj.
Percent of portfolio liabilities	39.9	35.2	36.5	35.7	Proj.
Percent of short-term debt (by residual maturity)	236.0	246.6	227.3	229.6	Proj.
Percent of ARA Metric 4/	134.8	121.9	119.9	117.4	Proj.
Percent of GDP	16.5	15.2	14.4	14.9	Jun-19
Gross total external debt (in percent of GDP)	38.3	37.7	36.6	37.4	Proj.
Of which: In local currency	9.5	9.3	8.9	8.9	Proj.
Of which: Public debt	25.9	25.6	25.1	24.9	Proj.
Of which: Private debt	12.4	12.1	11.5	12.5	Proj.
Financial sector	1.4	1.2	1.7		
Nonfinancial sector	11.0	10.9	9.8		
Gross total external debt (billions of US$)	412.6	436.6	446.7	474.2	Proj.
Of which: In local currency	102.1	107.2	108.5	113.2	Proj.
Of which: Public debt	278.7	296.6	306.0	315.8	Proj.
Of which: Private debt	133.9	140.0	140.7	158.4	Proj.
Financial sector	15.5	14.0	20.6		
Nonfinancial sector	118.5	126.0	120.1		
External debt service (in percent of GDP)	10.8	8.4	7.7	8.0	Proj.

Sources: Bank of Mexico, National Banking and Securities Commission, National Institute of Statistics and Geography, Ministry of Finance and Public Credit, and Fund staff estimates.

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

2/ Corresponds to the sum of the current account deficit, amortization payments, and the change in gross international reserves.

3/ Excludes balances under bilateral payments accounts. For 2009, includes the allocation of SDR 2.337 billion in the general allocation implemented on August 28, 2009, and another SDR 0.224 billion in the special allocation on September 9.

4/ The ARA metric was developed by the Strategy and Policy Review Department at the IMF to assess reserve adequacy. Weights to individual components were revised in December 2014 for the whole time series.

Table 7. Mexico: Baseline Medium-Term Projections

	2016	2017	2018	Proj. 2019	2020	2021	2022	2023	2024
National accounts (in real terms, contributions to growth) 1/									
GDP	2.9	2.1	2.1	0.4	1.3	1.9	2.1	2.3	2.4
Consumption	2.8	2.2	1.9	0.6	1.3	1.6	1.8	1.9	2.0
Private	2.5	2.1	1.5	0.5	1.2	1.4	1.6	1.7	1.8
Public	0.3	0.1	0.4	0.0	0.1	0.2	0.2	0.2	0.2
Investment	0.3	-0.4	0.1	-0.8	-0.1	0.3	0.3	0.4	0.4
Fixed	0.2	-0.3	0.2	-0.9	0.0	0.3	0.3	0.4	0.4
Private	0.3	0.1	0.2	-0.7	0.0	0.2	0.2	0.3	0.3
Public	0.0	-0.4	0.0	-0.3	0.0	0.1	0.1	0.1	0.1
Inventories	0.1	0.0	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0
Exports of goods and services	1.2	1.4	2.1	1.1	0.8	1.4	1.6	1.8	1.8
Oil exports	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Non-oil exports	1.2	1.4	2.1	1.2	0.8	1.3	1.6	1.7	1.8
Imports of goods and services	1.0	2.2	2.1	0.2	0.8	1.4	1.6	1.8	1.8
Oil imports	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Non-oil imports	0.9	2.1	2.1	0.3	0.8	1.3	1.6	1.7	1.8
Net exports	0.2	-0.8	0.0	0.9	0.0	0.0	0.0	0.0	0.0
Consumer prices									
End of period	3.4	6.8	4.8	3.1	3.0	3.0	3.0	3.0	3.0
Average	2.8	6.0	4.9	3.7	3.1	3.0	3.0	3.0	3.0
External sector									
Current account balance (in percent of GDP)	-2.2	-1.7	-1.8	-1.2	-1.6	-1.7	-1.8	-1.9	-2.0
Non-hydrocarbon current account balance (in percent of GDP)	-1.1	-0.2	0.1	0.3	-0.3	-0.6	-0.8	-0.9	-1.1
Exports of goods, f.o.b.	-1.7	9.5	10.1	2.2	2.0	4.5	5.9	6.7	7.2
Imports of goods, f.o.b.	-2.1	8.6	10.4	1.2	3.4	4.8	6.2	6.7	6.9
Terms of trade (improvement +)	0.7	3.1	-0.3	-1.3	-1.4	-0.3	-0.2	0.0	0.2
Crude oil export price, Mexican mix (US$/bbl)	35.8	46.4	61.7	57.9	54.5	52.0	51.3	51.4	52.0
Non-financial public sector									
Overall balance	-2.8	-1.1	-2.2	-2.8	-2.6	-2.2	-2.3	-2.3	-2.4
Primary balance	0.4	2.6	1.6	0.8	0.9	1.2	1.1	1.1	1.0
Saving and investment 2/									
Gross domestic investment	23.8	23.0	22.7	21.6	21.1	20.6	20.2	19.8	19.4
Fixed investment	22.9	22.1	22.1	20.9	20.4	19.9	19.5	19.1	18.8
Public	3.5	3.1	3.1	2.9	2.8	2.8	2.7	2.7	2.6
Private	19.4	19.1	19.0	18.0	17.6	17.2	16.8	16.5	16.2
Gross domestic saving	21.5	21.2	20.9	20.4	19.5	18.9	18.4	17.9	17.4
Public	0.8	2.0	0.9	0.1	0.2	0.6	0.4	0.4	0.3
Private	20.7	19.2	20.1	20.4	19.3	18.4	18.0	17.5	17.1
Memorandum items									
Financial system credit to non-financial private sector	16.5	10.8	8.8	6.9	7.2	8.6	8.8	8.9	9.1
Output gap (in percent of potential GDP)	0.5	0.0	0.0	-1.1	-1.1	-0.9	-0.6	-0.2	0.0
Total population	1.0	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.8
Working-age population 3/	1.6	1.6	1.5	1.5	1.4	1.3	1.3	1.2	1.1

Sources: Bank of Mexico, National Institute of Statistics and Geography, Ministry of Finance and Public Credit, Bloomberg, and IMF staff projections.

1/ Contribution to growth. Excludes statistical discrepancy.

2/ Reported numbers may differ from authorities' due to rounding.

3/ Based on United Nations population projections.

Table 8. Mexico: Monetary Indicators 1/
(In billions of Pesos)

	2015	2016	2017	2018	Proj. 2019
Banco de México					
Net foreign assets	3,019	3,619	3,392	3,408	3,410
Net international reserves	3,074	3,682	3,457	3,471	3,473
Gross international reserves	3,075	3,683	3,458	3,472	3,474
Reserve liabilities	1	1	1	1	1
Other net foreign assets	-55	-63	-65	-63	-63
Net domestic assets	-1,777	-2,198	-1,846	-1,794	-1,650
Net domestic credit	-1,293	-1,413	-1,627	-1,622	-1,627
Net credit to non-financial public sector	-1,543	-1,221	-1,516	-1,525	-1,589
Credit to non-financial private sector	0	0	0	0	0
Net credit to financial corporations	250	-192	-112	-97	-38
Net claims on other depository corporations	250	-192	-112	-97	-38
Net claims on other financial corporations	0	0	0	0	0
Capital account	419	715	153	113	-41
Other items net	-66	-70	-65	-59	-65
Monetary base	1,242	1,420	1,546	1,674	1,760
Other Depository Corporations					
Net foreign assets	6	23	92	-31	-33
Foreign assets	700	650	771	860	904
Foreign liabilities	694	627	679	892	937
Net domestic assets	6,304	7,079	7,805	8,238	9,150
Net credit to the public sector	2,835	2,854	3,071	3,190	3,501
Claims on non-financial public sector	3,217	3,272	3,526	3,688	3,990
in pesos	3,115	3,120	3,374	3,528	3,822
in FX	103	152	152	160	168
Liabilities to the nonfinancial public sector	382	418	455	498	489
Credit to the private sector	4,432	5,215	5,896	6,304	6,741
Local Currency	3,843	4,499	5,173	5,538	5,930
Foreign Currency	589	716	723	766	812
Net credit to the financial system	475	878	967	937	814
Other	-1,438	-1,868	-2,128	-2,194	-1,907
Liabilities to the private sector	6,310	7,102	7,898	8,206	8,260
Liquid liabilities	5,675	6,345	7,079	7,406	7,606
Local currency	5,294	5,780	6,384	6,788	654
Foreign currency	381	565	694	617	857
Non liquid liabilities	635	757	819	801	819
Local currency	604	730	786	765	38
Foreign currency	31	26	33	36	0
Total Banking System					
Net foreign assets	3,025	3,642	3,484	3,377	3,377
Net domestic assets	4,527	4,880	5,959	6,444	7,499
Liquid liabilities	6,917	7,766	8,625	9,080	10,020
Non-liquid liabilities	635	757	819	801	857
Memorandum items					
Monetary base (percent change)	16.8	14.4	8.8	8.3	5.1
Currency in circulation (percent change)	17.2	16.0	8.8	8.9	5.1
Broad money (percent change)	12.2	12.3	11.2	5.5	5.1
Bank credit to the non-financial private sector (growth rate)	15.6	17.7	13.0	6.9	6.9
Bank credit to the non-financial private sector (as percent of GDP)	23.9	25.9	26.9	26.8	27.5

Source: Bank of Mexico, National Institute of Statistics and Geography and Fund staff estimates.
1/ Data of the monetary sector are prepared based on the IMF's methodological criteria and do not necessarily coincide with the definitions published by Bank of Mexico.

Annex I. Risk Assessment Matrix

Potential Deviations from Baseline

Source of Risk	Up/ Downside	Relative Likelihood[1,2]	Impact[1,2]	Time Horizon	Policy Response
Sharp rise in risk premia. An abrupt deterioration in market sentiment (e.g., prompted by policy surprises, renewed stresses in emerging markets, or a disorderly Brexit) could trigger risk-off events such as recognition of underpriced risk. Higher risk premia cause higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; disruptive corrections to stretched asset valuations; and capital account pressures—all depressing growth.	↓	H	H	ST	Exchange rate flexibility and provision of liquidity to mitigate disorderly market conditions.
Rising protectionism and retreat from multilateralism. In the near term, escalating and unpredictable trade actions and a WTO dispute settlement system under threat imperil the global trade system and international cooperation. Additional barriers, including investment and trade restrictions in technology sectors, and the threat of new actions reduce growth both directly, and through adverse confidence effects and financial market volatility. In the medium term, geopolitical competition, protracted tensions, and fraying consensus about the benefits of globalization lead to economic fragmentation and undermine the global rules-based order, with adverse effects on investment, growth, and stability.	↓	H	H	ST, MT	Exchange rate flexibility would be critical to restore equilibrium. Temporary FX interventions and liquidity provision could help smooth extreme volatility. Steadfast implementation of structural reforms to boost growth potential. The authorities should continue to promote efforts to strengthen the multilateral trading system.

Source of Risk	Up/ Downside	Relative Likelihood[1,2]	Impact[1,2]	Time Horizon	Policy Response
Weaker-than-expected growth in the U.S.	↓	M	H	ST, MT	Steadfast implementation of structural reforms to boost growth potential.
Pemex downgrade to junk by second major agency.	↓	H	L	ST	Exchange rate flexibility and fiscal adjustment; consider changes to Pemex' business plan.
Lower oil revenues due to a further drop in Pemex production or declines in prices. A fall in proceeds would make it harder to meet fiscal targets.	↓	M	H	ST, MT	Exchange rate flexibility and fiscal adjustment.
Failure to achieve the current fiscal targets, leading to further steady increase in public debt and an increase in country risk premia.	↓	M	H	ST, MT	Maintain the consolidation effort. Use positive revenue surprises to reduce the deficit faster.
A meaningful erosion in institutional quality or a more prolonged period of elevated policy uncertainty would deteriorate the investment climate and weaken investment.	↓	M	H	ST, MT	Strengthen policy predictability and institutions.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.
2/ Low (L), Medium (M), High (H).

Annex II. External Sector Assessment

Update as of September 30, 2019

Overall Assessment: *In 2018, the external sector position was broadly in line with the level implied by medium-term fundamentals and desirable policies*. The CA deficit widened slightly, amid uncertainty about future trade relations with the United States and the Mexican elections, as well as significant exchange rate volatility. Developments so far in 2019 indicate a broadly unchanged overall assessment.

Potential Policy Responses: Despite the current absence of external imbalances, further structural reforms to improve competitiveness and the investment climate will be essential for boosting growth and exports while also maintaining external sustainability in the medium and long term. To this effect, the commitment to prudent fiscal targets over the medium term will help to safeguard fiscal and external sustainability, although efforts to boost non-oil tax revenue are necessary to underpin fiscal targets and provide space for much-needed public investment. The floating exchange rate should continue to serve as the main shock absorber, with FX interventions used to prevent disorderly market conditions. The IMF Flexible Credit Line provides an added buffer against global tail risks.

<table>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="6">Background. Mexico’s NIIP was –46.5 percent of GDP in 2018 (gross foreign assets and liabilities were 46.8 percent and 93.4 percent of GDP, respectively). Over the past five years, the NIIP has remained relatively stable in the range of –46 to –51 percent of GDP—with negative balance of payments flows largely compensated for by exchange rate and other valuation effects—and is projected to remain broadly stable through 2024. In 2018, foreign assets mainly consisted of direct investment (17 percent of GDP) and reserves (14 percent of GDP), whereas foreign liabilities were mostly FDI (45 percent of GDP) and portfolio investment (40 percent of GDP). Gross public sector external debt stood at 25 percent of GDP, of which about one-third was holdings of local currency government bonds and the remainder was mostly denominated in US dollars.

Assessment. Whereas the NIIP is sustainable, and the local currency denomination of a large share of foreign public liabilities reduces foreign exchange risks, the large gross foreign portfolio liabilities holdings could be a source of vulnerability in case of global financial volatility. Exchange rate vulnerabilities are also moderate as most Mexican firms with FX debt have natural hedges and actively manage their FX exposures.</td></tr>
<tr><td>2018 (% GDP)</td><td>NIIP: –46.5</td><td>Gross Assets: 46.8</td><td>Res. Assets: 14.4</td><td>Gross Liab.: 93.4</td><td colspan="2">Debt Liab.: 36.6</td></tr>
<tr><td>Current Account</td><td colspan="6">Background. In 2018, the CA deficit widened slightly to 1.8 percent of GDP (1.6 percent cyclically adjusted), from 1.7 percent in 2017, after having gradually narrowed from 2.6 percent of GDP in 2015 driven by an improved non-oil trade balance. Over the medium term, the CA deficit is projected to widen slightly, as a stronger oil balance is offset by some deterioration in the non-hydrocarbon current account.

Assessment. The EBA model estimates a cyclically adjusted CA norm of –2.6 percent of GDP in 2018. This implies a CA gap of 1.0 percent of GDP in 2018, with an estimated policy gap of 0.7 percent of GDP. Staff estimates a similar CA gap within the range of 0.0 and 2.0 percent of GDP.</td></tr>
<tr><td>2018 (% GDP)</td><td>Actual CA: –1.8</td><td>Cycl. Adj. CA: –1.6</td><td>EBA CA Norm: –2.6</td><td>EBA CA Gap: 1.0</td><td>Staff Adj.: 0.0</td><td>Staff CA Gap: 1.0</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="6">Background. The free-floating exchange rate continued to fulfill its role as a key shock absorber in 2018. It fluctuated notably during the year, reflecting periods of heightened uncertainty related to an unsettled global environment, NAFTA-related uncertainty, and the Mexican elections. The average REER in 2018 was broadly unchanged relative to the 2017 average. While subject to significant volatility, by September 2019 the REER was about 2 percent stronger than its 2018 average.

Assessment. The EBA REER Level model estimates an undervaluation of 9.5 percent in 2018, whereas the REER Index model yields a higher undervaluation (21.0 percent). Staff put less weight on the REER index approach as it has implied a large and persistent undervaluation of the peso for most of the sample period. The external sustainability approach suggests a 3.3 percent undervaluation. Considering all estimates and the uncertainties around them, staff’s assessment is based on the EBA CA model gap (applying a semi-elasticity of 0.16) and estimates Mexico’s REER gap to be in the range of –14 to 2 percent.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="6">Background. During 2010–14, a large share of capital inflows went into purchases of locally issued government paper and other portfolio investments. In 2015–18, gross portfolio inflows slowed markedly. In 2018, net inflows into the private sector turned negative, including due to high uncertainty from domestic and global developments. EPFR bond and equity flows turned negative in the second half of 2018, though they remained positive for the year overall. Going forward, the oil auctions completed since the start of the energy reforms are expected to support higher FDI, whereas portfolio inflows are unlikely to return to the previous high growth rates.

Assessment. The long average maturity of sovereign debt and the high share of local currency financing reduce the exposure of government finances to depreciation risks. The banking sector is well capitalized and liquid and assessed to be resilient to large shocks. Nonfinancial corporate debt levels are low and foreign exchange risks generally covered by natural and financial hedges. Nonetheless, the strong presence of foreign investors leaves Mexico exposed to capital</td></tr>
</table>

	flow reversals and risk premium increases. The authorities have refrained from capital flow management measures. Capital flow risks are also mitigated by prudent macroeconomic policies.
FX Intervention and Reserves Level	**Background.** The central bank remains committed to a free-floating exchange rate, which has been the key shock absorber, whereas discretionary intervention is used solely to prevent disorderly market conditions. In the past, the central bank built up reserves primarily through purchases of the net foreign currency proceeds of the state oil company, which have declined substantially, and occasionally through auctions. In 2018, no new NDF sales or other discretionary interventions took place. At end-2018, FX reserves increased to US$176.4 billion (14.4 percent of GDP) from US$175.4 at end-2017. **Assessment.** At 120 percent of the Assessing Reserve Adequacy metric at end-2018 and 230 percent of short-term debt (at remaining maturity), the current level of foreign reserves remains adequate. Staff recommends that the authorities continue to maintain reserves at an adequate level over the medium term. The Flexible Credit Line arrangement has been an effective complement to international reserves, providing protection against global tail risks.

Annex III. Debt Sustainability Analysis

Mexico's public debt is expected to be sustainable in the medium term. Under the baseline scenario, which assumes that the authorities reach their current fiscal targets, public debt would remain stable at around 55 percent of GDP over the medium term. Gross financing needs of around 10–11 percent of GDP are sizable. Debt could reach around 63 percent of GDP in staff's projections in a scenario in which the authorities fail to put forward measures to close the gaps under the current targets. A potential need of further financial support for Pemex constitutes a risk. The long average maturity and favorable currency composition of the debt mitigate short-term financing risks coming from a high foreign ownership. In the event of adverse shocks, debt would rise but remain below the threshold of 70 percent of GDP.

Baseline and Realism of Projections

- **Debt levels**. Gross debt levels are projected to remain broadly stable at around 55 percent of GDP over the medium term, while gross financing needs are projected to average around 10.2 percent of GDP.

- **Fiscal adjustment**. The public sector borrowing requirement (PSBR) is projected to reach 2.8 percent of GDP in 2019. It is projected to fall to 2.6 percent in 2020 and 2.2–2.4 percent over the medium term, in line with the authorities' targets. The structural primary balance (adjusted for the business cycle, certain one-offs and oil prices) is projected to increase from 0.7 percent of GDP in 2019 to 1.4 percent of GDP in 2021, before gradually declining to 1 percent of GDP by 2024. The fiscal targets should be underpinned by measures to increase revenues of around 1.5 percent of GDP.

- **Growth assumptions**. Past projections of GDP growth exhibit modest errors, but the median forecast error is in line with other emerging markets. There appears to be no evidence of a systematic projection bias in the baseline assumption for growth that could undermine the DSA assessment. Medium-term growth is expected to pick up gradually as uncertainty subsides, stabilizing at 2.4 percent of GDP in the second half of the projection horizon.

- **Sovereign yields**. Mexico's sovereign yields increased in the first half of the year but have since stabilized, with the 10-year local-currency bond yield remaining stable around 7.7 percent in August. The EMBIG spread has remained on average at 331 basis points for the last three months. Considering the possibility of further monetary easing by the Bank of Mexico from 2019, the effective nominal interest rate on Mexico's sovereign debt is projected to decline from 7.7 percent in 2019 to 7.4 percent in 2020 and 7.0 percent in the medium term.

Debt Profile

- **Rollover and exchange rate risks**. The long maturity structure of the debt reduces rollover risks, including for the large share of public debt held by non-residents. The real interest rate and real exchange rate shocks have a moderate impact on the debt stock, given the gradual interest rate pass-through to the budget and the large share of debt denominated in local currency (around 65 percent).

Stochastic Simulations

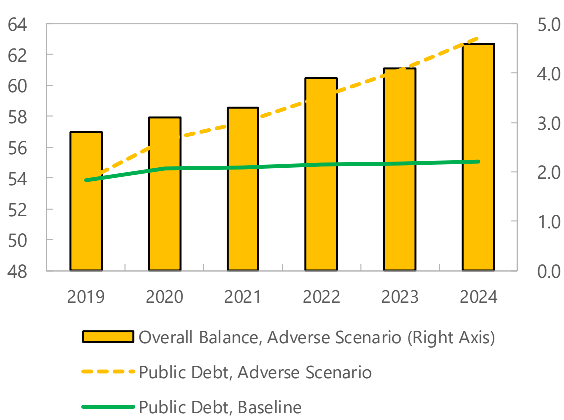
- **Fan charts**. The fan charts illustrate the possible evolution of the debt ratio over the medium term and are based on both the symmetric and asymmetric distributions of risk. Under the symmetric distribution of risk, there is a probability of around 70 percent that debt will remain below 60 percent of GDP over the medium term. If restrictions are imposed on the primary balance (i.e., the asymmetric scenario, where it is assumed that there are no positive shocks to the primary balance), there is around a 55 percent chance that the debt path will remain below 60 percent of GDP over the projection horizon.

Stress Tests

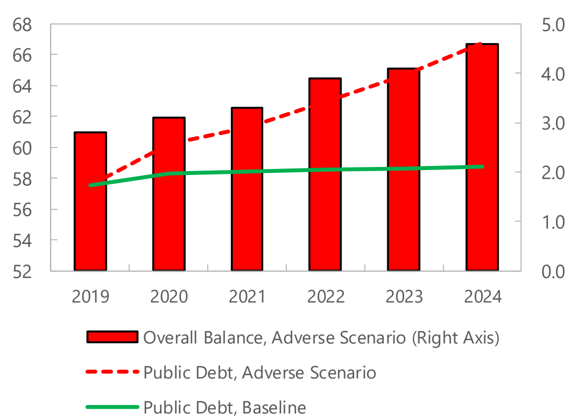
- **Individual shocks**. The debt ratio would remain below 60 percent of GDP under all but one scenario: a one-standard-deviation growth shock in 2019 and 2020 would increase the debt ratio to 62 percent of GDP by 2024. If the authorities fail to identify high-quality measures to close the fiscal gaps of around 1½ percent of GDP by 2024, debt will rise to 63 percent of GDP (see the left-hand-side text chart below). If the marketed treasury securities held by Banxico for liquidity management purposes are added to debt statistics, the debt ratio would remain below 60 percent of GDP under the baseline without additional fiscal risks (see below). However, if the authorities fail to close the fiscal gaps, the inclusion of marketed treasury securities by Banxico would increase the debt ratio to 67 percent of GDP (see the right-hand-side text chart below).

- **Combined shock**. A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). Under this scenario, debt would increase to 68 percent of GDP. Gross financing needs would reach 13 percent of GDP in 2024.

Overall Balance and Debt without Marketed Securities: Baseline and Adverse Scenario
(In percent of GDP)



Overall Balance and Debt with Marketed Securities: Baseline and Adverse Scenario
(In percent of GDP)



Debt Coverage

- **Treasury securities held by the central bank for liquidity management purposes are not included in general government debt.** Banxico has been using T-bonds issued directly by the Treasury for liquidity management. At end 2018, a stock of about 3.7 percent of the GDP in T-bonds had been marketed (some 18 percent of GDP had not been marketed). The proceeds from the securities are held in a special Government Monetary Regulation Deposit (MRD) that is ringfenced according to Art. 7 and 9 of Banco de México's Law. The government cannot access the MRD before the bonds mature. As such, the government earns no financing benefit from the securities; it also incurs no direct cost given that Banxico remunerates the MRD with the exact payment terms as is case for the securities. In the authorities' official debt statistics, these securities are not considered as general government (GG) debt, while in the Cuenta Pública they are reported under a specific liability line item (but not under the debt heading).[1] Mexico received technical assistance in 2017 from the IMF's Statistics Department to bring the fiscal and debt statistics to international standards.

Net Public Debt

- **In their communication on public debt, the authorities focus on the concept of Historical Balance of the Public Sector Borrowing Requirements (HBPSBR),** which is analogous to a net debt concept. Consistent with the present public debt stability analysis, staff estimates that net public debt (defined as gross debt minus public assets) would reach around 47 percent of GDP over the medium term.

External Debt Sustainability

- **Following a slight decline in 2018, Mexico's external debt is projected to increase moderately over the medium term.** Mexico's gross external debt declined slightly from 37.7 percent of GDP in 2017 to 36.6 percent of GDP in 2018, reflecting mostly price and exchange rate changes (-1.3 percentage points). Under the baseline scenario, external debt is projected to increase slightly to around 40 percent of GDP.

- **Risks are mitigated by several factors.** Around two thirds of Mexico's external debt (25 percent of GDP) is owed by the public sector, predominantly by the federal government (16 percent of GDP). Rollover risks for federal government debt are mitigated by a very favorable maturity structure (debt is predominantly at maturities exceeding one year) and currency composition (with around 1/3 of debt denominated in peso) as well as continuous prudent debt management by the government. Private sector external debt, concentrated in the non-financial corporate sector, is mostly medium and long term while foreign exchange risks are well-covered by natural and financial hedges. Moreover, the banking sector is well-capitalized and liquid and assessed to be resilient to large shocks. Notwithstanding the favorable currency composition of external debt, a depreciation of the exchange rate remains the most significant risk to external debt sustainability: a 30 percent depreciation is estimated to lead to an increase in the external debt to up to 55 percent of GDP.

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[1] As the coverage of debt statistics in Mexico is limited to two of the required six debt instruments, namely debt securities and loans.

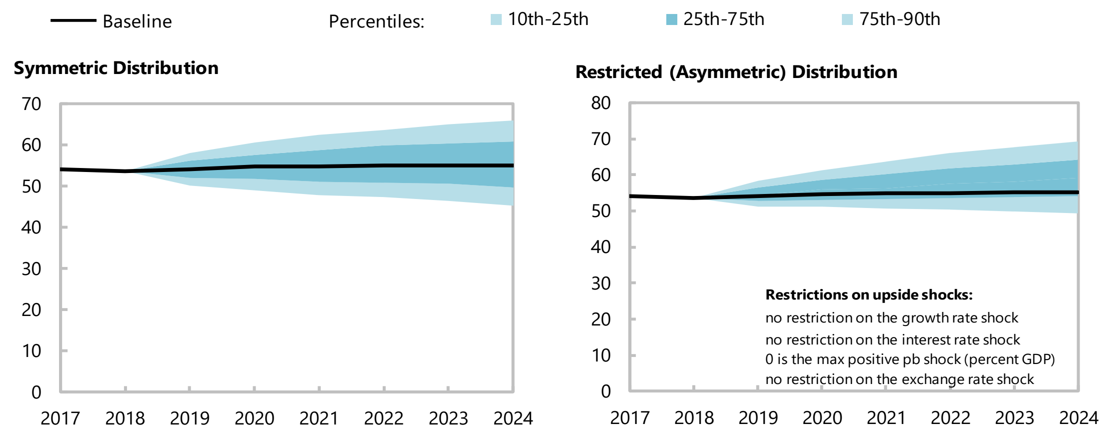
Figure 1. Mexico Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

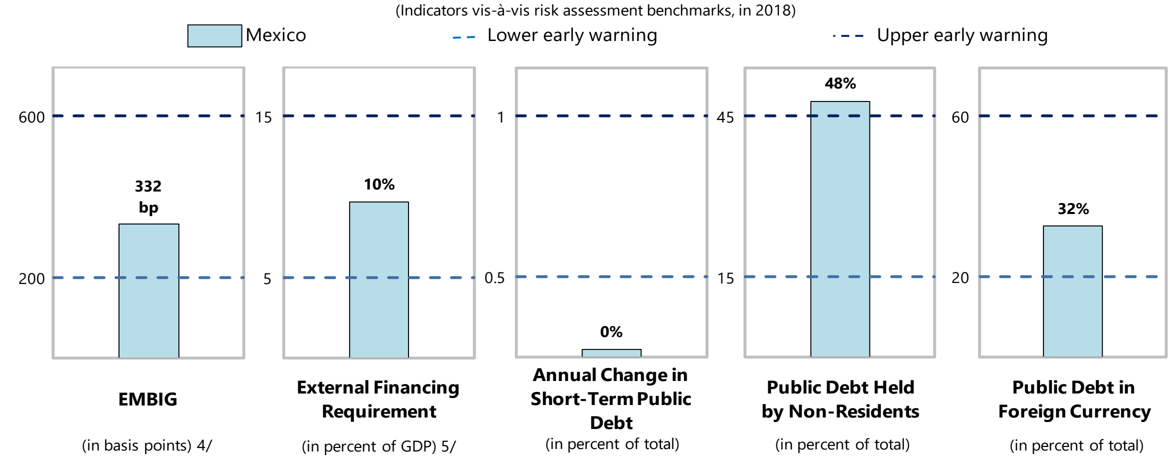
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

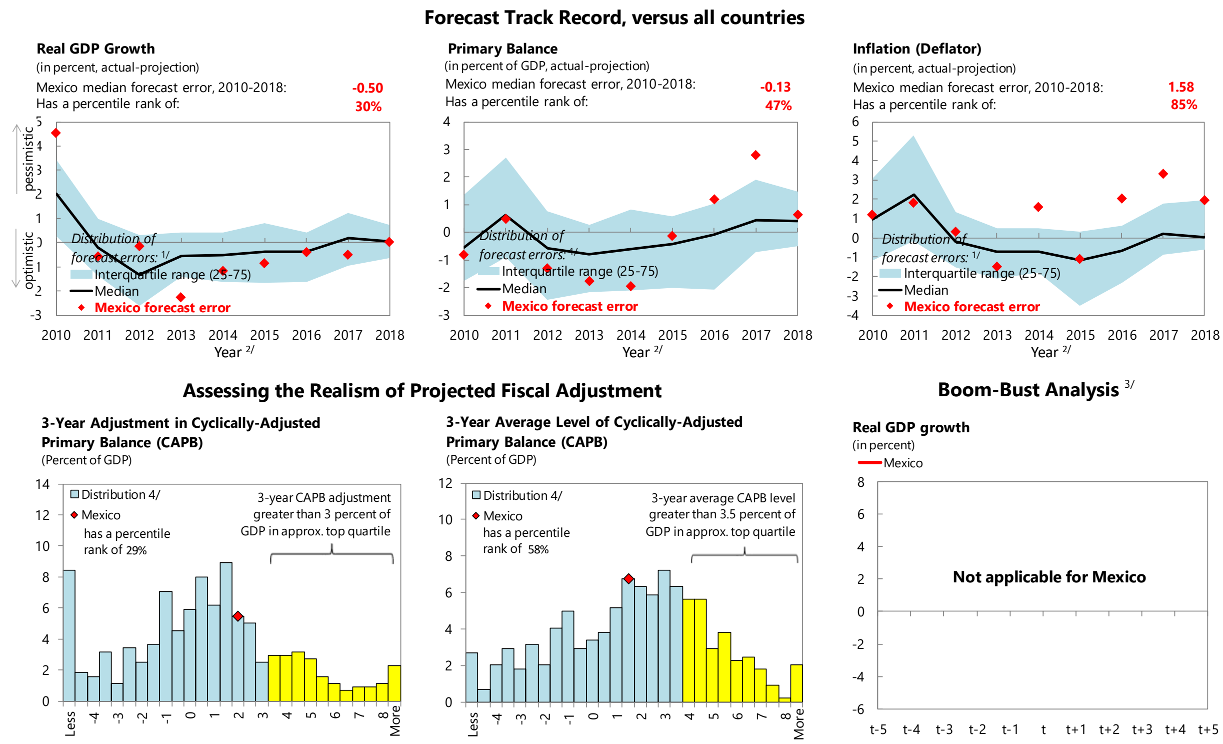
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 28-Jun-19 through 26-Sep-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Mexico Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Mexico, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Mexico Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

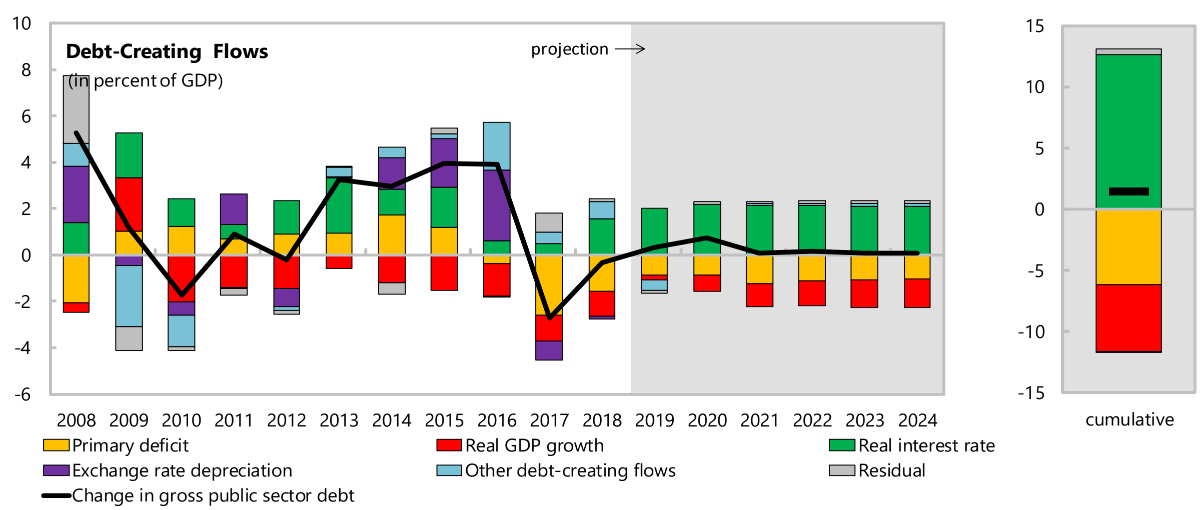
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	46.4	54.0	53.7	54.0	54.8	54.9	55.0	55.1	55.1
Public gross financing needs	11.6	7.5	7.8	10.6	9.9	9.9	10.3	10.5	10.1
Real GDP growth (in percent)	2.1	2.1	2.1	0.4	1.3	1.9	2.1	2.3	2.4
Inflation (GDP deflator, in percent)	4.3	6.7	5.0	3.8	3.1	3.0	3.0	3.0	3.0
Nominal GDP growth (in percent)	6.5	8.9	7.2	4.2	4.5	5.0	5.1	5.3	5.4
Effective interest rate (in percent) [4/]	7.7	7.8	8.2	7.7	7.4	7.2	7.1	7.0	7.0

As of September 26, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		320
5Y CDS (bp)		117
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	BBB+	A-
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.2	-2.7	-0.3	0.3	0.7	0.1	0.1	0.1	0.1	1.5	
Identified debt-creating flows	2.1	-3.6	-0.4	0.5	0.6	0.0	0.0	-0.1	-0.1	1.0	
Primary deficit	0.6	-2.6	-1.6	-0.8	-0.9	-1.2	-1.1	-1.1	-1.0	-6.2	1.0
Primary (noninterest) revenue and gra	24.0	24.3	23.2	22.5	22.0	22.1	22.2	22.2	22.4	133.3	
Primary (noninterest) expenditure	24.6	21.7	21.6	21.7	21.1	20.8	21.1	21.1	21.4	127.1	
Automatic debt dynamics [5/]	1.5	-1.4	0.4	1.8	1.5	1.1	1.0	0.9	0.8	7.2	
Interest rate/growth differential [6/]	0.5	-0.6	0.5	1.8	1.5	1.1	1.0	0.9	0.8	7.2	
Of which: real interest rate	1.4	0.5	1.6	2.0	2.2	2.1	2.1	2.1	2.1	12.6	
Of which: real GDP growth	-0.9	-1.1	-1.1	-0.2	-0.7	-1.0	-1.1	-1.2	-1.3	-5.4	
Exchange rate depreciation [7/]	0.9	-0.8	-0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.5	0.8	-0.5	0.0	0.1	0.1	0.1	0.1	0.0	
Interest revenues	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-1.8	
Change in assets	0.3	0.8	1.1	-0.2	0.4	0.4	0.4	0.4	0.4	1.8	
Residual [8/]	0.1	0.8	0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.5	



Source: IMF staff.

1/ Public sector is defined as the central government, state-owned enterprises, public sector development banks, and social security funds. Excludes local governments.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

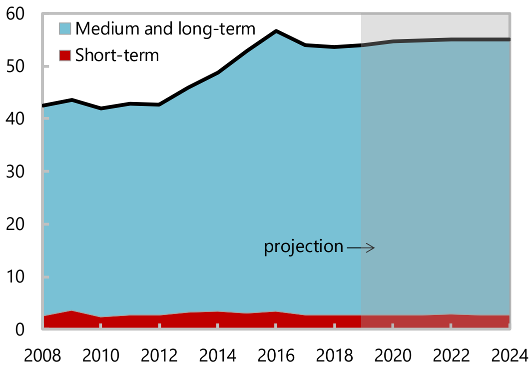
8/ Includes interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

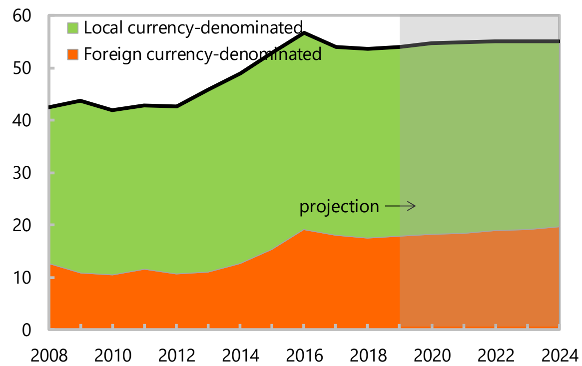
Figure 4. Mexico Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



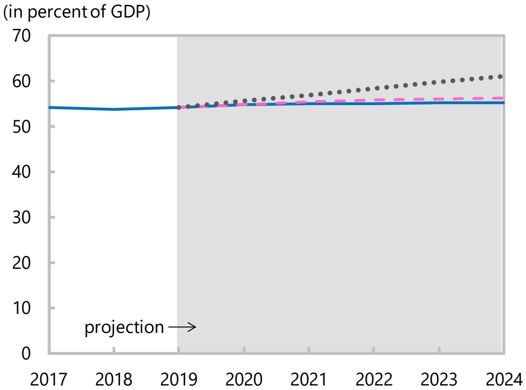
By Currency
(in percent of GDP)



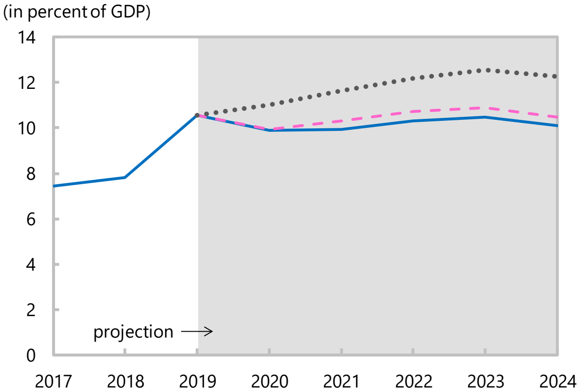
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

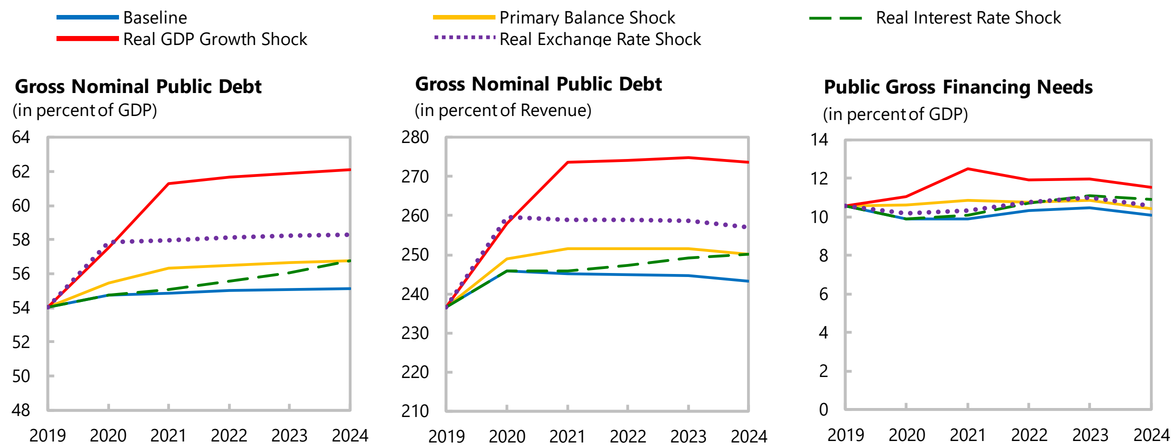
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.4	1.3	1.9	2.1	2.3	2.4
Inflation	3.8	3.1	3.0	3.0	3.0	3.0
Primary Balance	0.8	0.9	1.2	1.1	1.1	1.0
Effective interest rate	7.7	7.4	7.2	7.1	7.0	7.0
Constant Primary Balance Scenario						
Real GDP growth	0.4	1.3	1.9	2.1	2.3	2.4
Inflation	3.8	3.1	3.0	3.0	3.0	3.0
Primary Balance	0.8	0.8	0.8	0.8	0.8	0.8
Effective interest rate	7.7	7.4	7.2	7.1	7.0	7.0

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.4	2.2	2.2	2.2	2.2	2.2
Inflation	3.8	3.1	3.0	3.0	3.0	3.0
Primary Balance	0.8	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	7.7	7.4	7.0	6.8	6.6	6.5

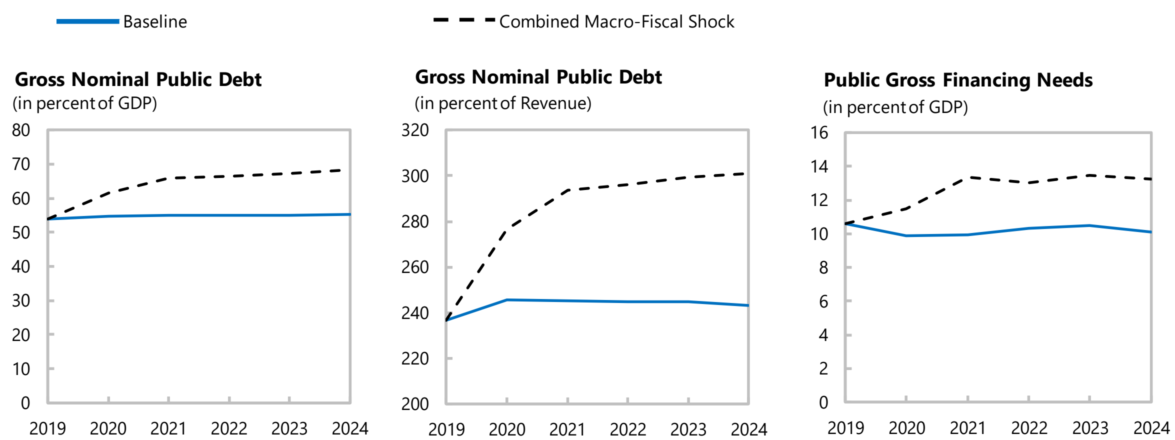
Source: IMF staff.

Figure 5. Mexico Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

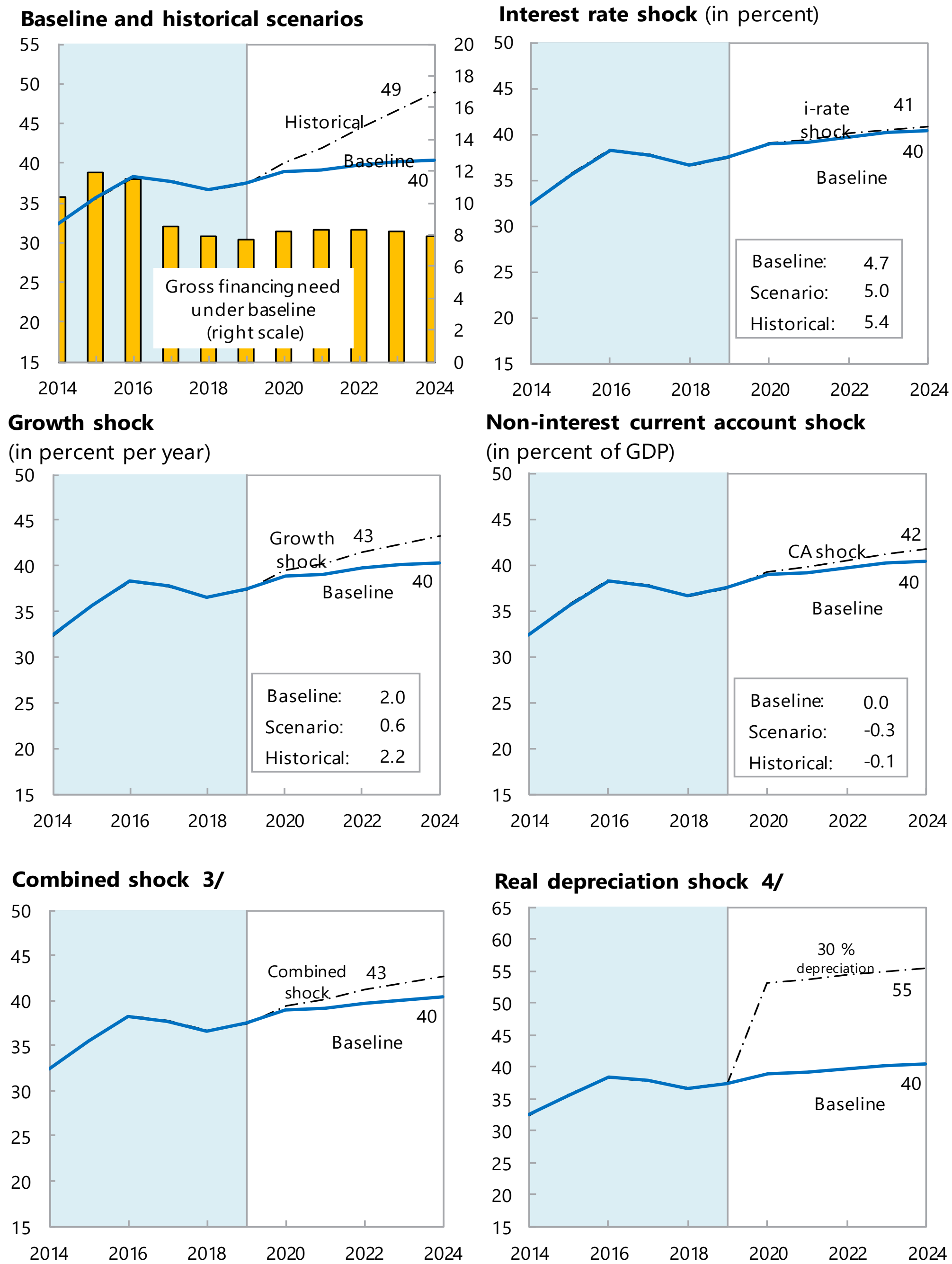
(in percent)

Primary Balance Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	0.4	1.3	1.9	2.1	2.3	2.4
Inflation	3.8	3.1	3.0	3.0	3.0	3.0
Primary balance	0.8	0.2	0.5	1.1	1.1	1.0
Effective interest rate	7.7	7.4	7.2	7.2	7.1	7.1
Real Interest Rate Shock						
Real GDP growth	0.4	1.3	1.9	2.1	2.3	2.4
Inflation	3.8	3.1	3.0	3.0	3.0	3.0
Primary balance	0.8	0.9	1.2	1.1	1.1	1.0
Effective interest rate	7.7	7.4	7.6	7.7	7.9	8.1
Combined Shock						
Real GDP growth	0.4	-1.5	-0.9	2.1	2.3	2.4
Inflation	3.8	2.4	2.3	3.0	3.0	3.0
Primary balance	0.8	0.1	-0.3	1.1	1.1	1.0
Effective interest rate	7.7	7.7	7.4	7.7	7.9	8.1

Real GDP Growth Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	0.4	-1.5	-0.9	2.1	2.3	2.4
Inflation	3.8	2.4	2.3	3.0	3.0	3.0
Primary balance	0.8	0.1	-0.3	1.1	1.1	1.0
Effective interest rate	7.7	7.4	7.2	7.2	7.1	7.1
Real Exchange Rate Shock						
Real GDP growth	0.4	1.3	1.9	2.1	2.3	2.4
Inflation	3.8	4.7	3.0	3.0	3.0	3.0
Primary balance	0.8	0.9	1.2	1.1	1.1	1.0
Effective interest rate	7.7	7.7	7.1	7.0	7.0	7.0

Source: IMF staff.

Figure 6. Mexico External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2020.

Table 1. Mexico: External Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	32.4	35.6	38.3	37.7	36.6			**37.4**	**38.9**	**39.1**	**39.7**	**40.1**	**40.4**	**-2.4**
2 Change in external debt	1.4	3.2	2.7	-0.6	-1.1			0.8	1.5	0.2	0.6	0.4	0.3	
3 Identified external debt-creating flows (4+8+9)	-1.7	2.0	0.6	-4.0	-2.5			-1.1	-1.1	-1.2	-1.2	-1.2	-1.2	
4 Current account deficit, excluding interest payments	0.3	0.9	0.4	-0.1	-0.1			-0.6	-0.2	-0.1	0.1	0.2	0.3	
5 Deficit in balance of goods and services	-64.9	-71.1	-76.0	-77.4	-80.5			-78.7	-78.5	-78.8	-80.0	-81.7	-83.5	
6 Exports	31.9	34.5	37.0	37.8	39.3			38.7	38.4	38.4	39.0	39.8	40.7	
7 Imports	-33.1	-36.6	-39.0	-39.6	-41.2			-40.0	-40.1	-40.3	-41.0	-41.9	-42.7	
8 Net non-debt creating capital inflows (negative)	-2.2	-2.5	-2.9	-2.9	-2.2			-2.2	-2.2	-2.2	-2.2	-2.2	-2.2	
9 Automatic debt dynamics 1/	0.2	3.6	3.1	-0.9	-0.2			1.7	1.3	1.1	1.0	0.9	0.8	
10 Contribution from nominal interest rate	1.6	1.7	1.9	1.9	1.9			1.9	1.8	1.8	1.8	1.7	1.7	
11 Contribution from real GDP growth	-0.8	-1.2	-1.1	-0.8	-0.8			-0.1	-0.5	-0.7	-0.8	-0.9	-0.9	
12 Contribution from price and exchange rate changes 2/	-0.5	3.1	2.4	-2.0	-1.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	3.0	1.1	2.1	3.4	1.4			1.9	2.5	1.4	1.8	1.6	1.4	
External debt-to-exports ratio (in percent)	101.7	103.1	103.5	99.8	93.1			96.7	101.4	101.8	101.9	100.8	99.2	
Gross external financing needs (in billions of US dollars) 4/	136.7	139.9	123.5	98.0	95.7			97.2	107.1	112.5	117.8	122.0	122.6	
in percent of GDP	10.4	12.0	11.5	8.5	7.8	10-Year	10-Year	7.7	8.2	8.3	8.3	8.2	7.9	
Scenario with key variables at their historical averages 5/								**37.4**	**40.0**	**41.9**	**44.3**	**46.6**	**49.0**	**-0.4**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.8	3.3	2.9	2.1	2.1	2.2	2.8	0.4	1.3	1.9	2.1	2.3	2.4	
GDP deflator in US dollars (change in percent)	0.3	-13.8	-10.5	5.2	3.2	-0.8	9.2	3.4	1.7	2.5	2.3	2.3	2.3	
Nominal external interest rate (in percent)	5.2	4.7	4.8	5.2	5.2	5.4	0.5	5.3	5.0	4.8	4.7	4.6	4.5	
Growth of exports (US dollar terms, in percent)	5.0	-3.6	-1.3	9.8	9.7	5.2	12.9	2.2	2.2	4.6	6.0	6.7	7.2	
Growth of imports (US dollar terms, in percent)	5.1	-1.5	-1.8	9.0	9.7	4.9	12.8	0.8	3.5	4.9	6.2	6.7	6.9	
Current account balance, excluding interest payments	-0.3	-0.9	-0.4	0.1	0.1	-0.1	0.5	0.6	0.2	0.1	-0.1	-0.2	-0.3	
Net non-debt creating capital inflows	2.2	2.5	2.9	2.9	2.2	2.3	0.6	2.2	2.2	2.2	2.2	2.2	2.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period, excluding reserve accumulation.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex IV. Strengthening the Fiscal Framework

This Annex summarizes the main features of Mexico's fiscal framework, discusses its weaknesses, and provides some recommendations for its reform. In staff's view, the framework should have a strong nominal anchor, and the structural spending rule should cover a broader expenditure envelope. Additional desirable features would include adequately designed correction mechanisms, a modern medium-term budgeting framework, and an adequately-sourced fiscal council with a formal mandate to provide an independent evaluation of fiscal policy.

A. Introduction

1. The authorities plan to revamp the fiscal framework. As part of the draft 2020 budget, the authorities have proposed five elements that could guide the design of a new framework. They include (i) an explicit public debt ceiling as a nominal anchor; (ii) a structural spending rule that could help stabilize the economic cycle; (iii) less discretionary use of escape clauses; (iv) a countercyclical fund; and (v) a fiscal council.

2. This note discusses the existing framework and evaluates the authorities' suggestions. First, it summarizes the main features of the 2006 Fiscal Responsibility Law (FRL) as well as subsequent changes to the law in 2014. Second, it analyzes the performance of the enhanced fiscal framework since 2014. Third, it evaluates the authorities' proposals and presents a set of detailed recommendations.

B. The 2006 Fiscal Responsibility Law

3. The 2006 FRL aimed at locking in low fiscal deficits and better managing oil revenues over the commodity cycle. Over 2004–2006, Mexico maintained fiscal deficits—measured by the traditional balance—of close to zero. The FRL aimed at locking in this performance by introducing a permanent zero-balance target as a nominal anchor. It also introduced a reference oil price to be used for revenue projections to smooth the impact of short-term fluctuations in oil prices on the budget. Excess oil revenues were to be used to compensate for certain budgetary overruns and—through several stabilization funds—to be saved as a buffer in case of revenue shortfalls.

4. The framework also increased the accountability and transparency of fiscal policy. The law called for annual budgets to be presented in the context of a long-term quantitative framework, with projections for the next five years, and mandated an assessment of the fiscal costs associated with new legal initiatives. Other provisions to strengthen expenditure management included greater transparency and controls over the use of trust funds, greater accountability in the selection of investment projects and social programs through cost-benefit analyses, and steps toward performance-based budgeting, requiring the establishment of indicators to measure outcomes.

Box 1. Mexico's Fiscal Framework

The current fiscal framework includes three rules and two revenue stabilization funds, one for the federal government (FEIP) and one for the states and municipalities (FEIEF).

Fiscal Rules

1. Balanced Budget Rule (since 2006): The federal budget—which includes the budgetary central government, two social security funds, and the two major non-financial public corporations—must be balanced on a cash basis after discounting up to 2 percent of GDP in Federal government, CFE and Pemex investment (a loosening of the rule instituted in 2009). In addition to PEMEX investment, the traditional balance usually excluded some expenditure items and included the drawing of financial resources outside the budget as revenue—i.e., one-off financing operations through the stabilization funds, asset revaluations, and above par issuance of sovereign bonds—to finance spending.

An escape clause establishes that under exceptional circumstances there can be deviations from the rule. The regulations to the FRL (Article 11) include five specific triggers for deviations: (i) an increase in interest rates which would raise the government's debt servicing costs by more than 25 percent; (ii) a natural disaster with a fiscal cost of more than 2 percent of programmable spending, after the resources of the natural resources disaster fund have been exhausted; (iii) fiscal liabilities carried over from the previous fiscal year of more than 2 percent of programmable spending; (iv) a fall in non-oil tax revenues of more than 2.5 percent; (v) a fall in oil prices of more than 10 percent compared to the assumed price in the budget. Moreover, these regulations also allow the deficit to be increased if the government introduces a new policy which incurs short-term fiscal costs, but which yields net fiscal benefits over the long-term. The escape clause was used in 2010, 2011,2012, and could be used again next year as suggested by the 2020 draft budget proposal.

2. Public Sector Borrowing Requirement Rule (added in 2014): the PSBR target was introduced to strengthen the link between the fiscal balance and public debt dynamics. It includes all public sector entities except subnational governments and the central bank. Current legislation does not specify a long-term ceiling for the PSBR but instead requires that a target for the current year and indicative targets for the medium-term are specified in the budget documents. The level of the PSBR target is to be set to achieve a non-increasing path of net public debt as a percentage of GDP.

3. Structural Current Spending Rule (added in 2014): a cap on the real growth rate of structural current spending equal to potential growth (average of past and projected growth rates) was introduced to limit the pro-cyclicality of fiscal policy. Structural current spending is defined as programmable spending excluding interest payments, cost of fuels for electricity generation, physical and financial investment of the federal government, pensions, and the expenditures of CFE and Pemex. The target has so far never been binding.

Box 1. Mexico's Fiscal Framework (concluded)

Revenue Stabilization Funds

There are two sources of inflows for the FEIP and the FEIEF:

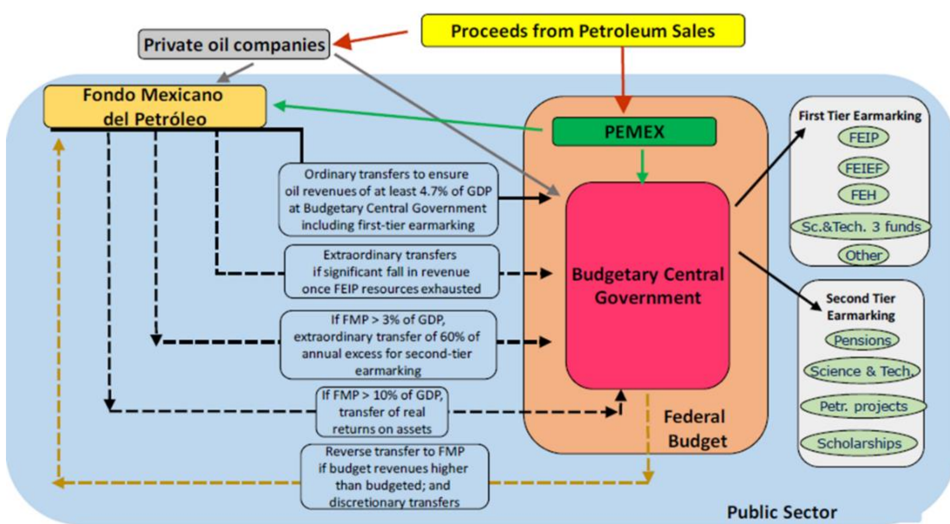
I. The FEIP and FEIEF receive 2.2 and 0.64) percent, respectively, of annual oil revenues through the oil fund (FMP).

II. Any over-performance in non-oil revenues is first allocated to some possible unplanned expenditures and, if there are additional funds, to the FEIP (65 percent), the FEIEF (25 percent) and the fund for subnational infrastructure development (FIES).

There are two reasons why the funds in the FEIP and the FEIEF could be used:

I. The two funds have capitalization ceilings as a function of the sum of tax revenues and transfers from the FMP (8 percent in case of the FEIP and 4 percent in case of the FEIEF). Resources exceeding these ceilings can be used to finance the budget, amortize federal debt or capitalize the National Infrastructure Fund—in the case of the FEIP—and to fund the subnational governments' pension system—in the case of the FEIEP.

II. The FEIP can be used to compensate for a reduction in Federal Government oil and non-oil revenues with respect to those approved for the budget, but only after shortfalls in some categories have been compensated by overperformance in others and after any proceeds from oil hedges have been used. For any fiscal year the maximum use is up to 50 percent of the capitalization ceiling of the fund. The FEIEF, in turn, can be used to compensate for shortfalls in revenues earmarked to subnational entities.

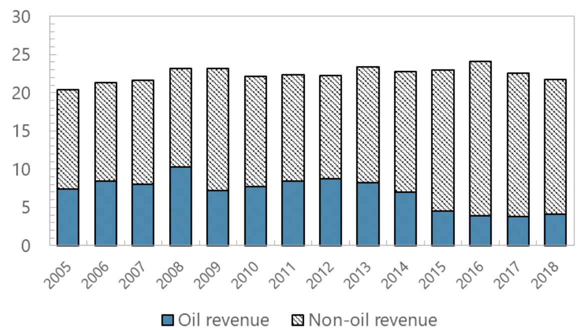


Source: SHCP; and legislation.

5. The 2014 amendments added two additional fiscal rules. The traditional fiscal balance rule was too narrow to establish a strong link with public debt dynamics and to allow for an appropriate assessment of the fiscal stance. Moreover, the target was later relaxed to exclude investments made by Pemex and CFE (Box 1). To address this weakness, the amendments introduced the PSBR as an additional—and more comprehensive—deficit target, as well as a cap on the real growth rate of structural current spending (from 2015 onwards), set initially at 2 percent, and equal to potential output growth from 2017.

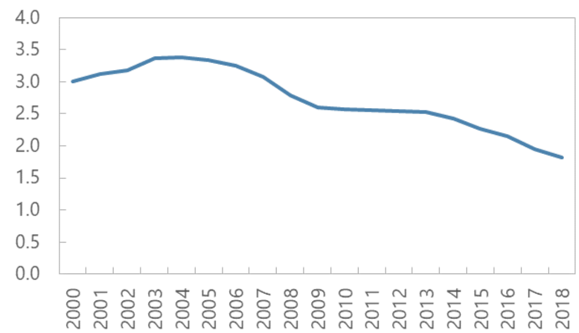
6. A Mexican Oil Fund was also created to manage hydrocarbons-related revenues starting in 2015. The FMP now manages all oil-related revenues and payments (except for taxes) and makes transfers to the Federal Government for up to 4.7 percent of GDP per year. Revenues exceeding this level would be saved. Once such long-term savings reach 3 percent of GDP, part of the additional inflows can be spent under certain circumstances. However, total annual oil revenues currently fall far short of the 4.7 percent, implying that there is no build-up of long-term savings.

Oil and Non-Oil Revenue
(In percent of GDP)



Source: Authorities' data and staff calculations

Crude Oil Production
(Million Barrels per Day)

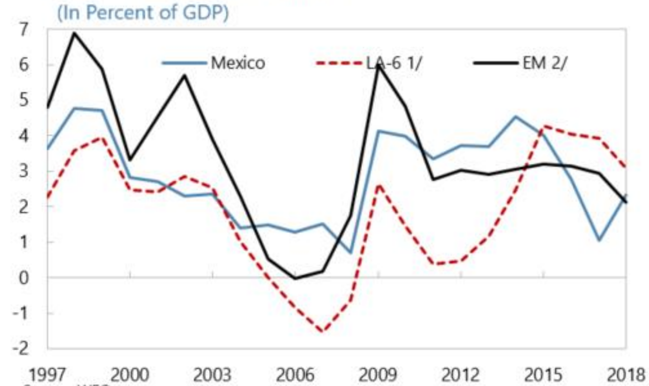


Source: Authorities' data and staff calculations

C. Performance of the Amended Fiscal Framework (Since 2015)

7. The overall deficit has declined following the expansion during the global financial crisis but with a long delay. The overall deficit (i.e., PSBR) reached an average level of 1.7 percent of GDP during the period 2001-08 on the back of strong oil revenues. The counter-cyclical policy response during the global financial crisis increased the deficit to an average of 4.1 percent in 2009–10. This policy response was warranted by the significant growth shock and was broadly in line with the size of fiscal easing in Mexico's regional and emerging market peers. However, during the subsequent four years, which were characterized by a high average GDP growth rate of 2.9 percent and buoyant oil revenues, the deficit remained elevated at an average level of 3.8 percent. Since 2015—and in the context of the amended fiscal responsibility law—deficits have come down to an average of 2.5 percent. The average deficit would, however, everything else equal, have declined significantly less in the absence of extraordinary revenues from the oil hedge program and Banxico's surpluses totaling 0.7,

Overall Public Sector Deficit
(In Percent of GDP)

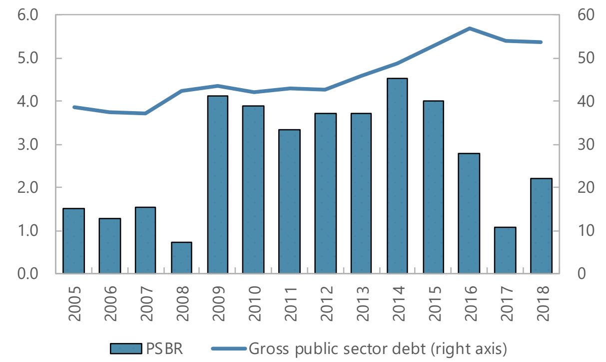


Source: WEO
1/ The LA6 countries included here are Brazil, Chile, Colombia, Peru and Uruguay.
2/ The EM comparator countries included here are India, Indonesia, Poland, Russia, Thailand and Turkey.

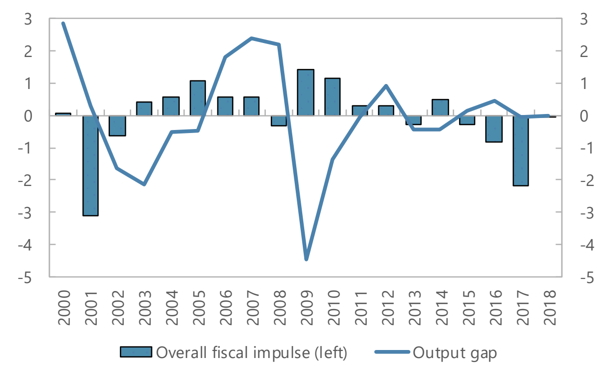
1.5 and 1.5 percent of GDP in 2015, 2016 and 2017, respectively. Out of the 13 years that the fiscal rules framework has been in place, full compliance was observed in 5 years.

8. Public debt increased by 4.7 percentage points of GDP since 2014, largely driven by peso depreciation and asset accumulation. At end-2018, gross debt as a percentage of GDP was 16.3 percent higher than in 2006 and 4.8 percent higher than in 2014. Debt increased by 7.9 percentage points between end-2014 and end-2016, with 5.2 percentage points owing to exchange rate depreciation. Of the remaining 2.7 percentage points, 1.9 percent were due to asset accumulation including valuation changes (The pension reform of PEMEX and CFE securitized 1.6 percent of implicit pension liabilities). Between 2016 and 2018, the debt ratio declined by 3.1 percentage points—of which the exchange rate depreciation explained about 0.9 percentage points.

Gross Debt and PSBR in Percent of GDP



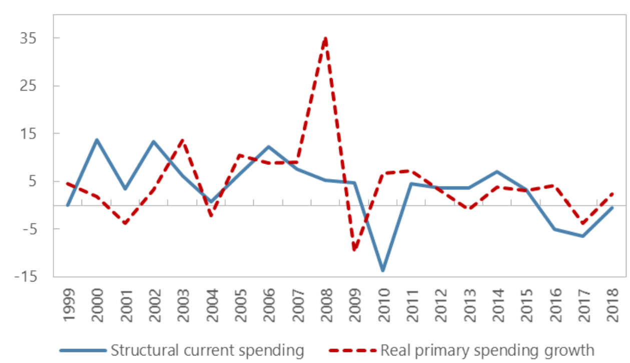
Fiscal Impulse in Percent of GDP



9. There is no evidence that fiscal policy has been pro-cyclical in the aftermath of the 2014 reforms. During the period 2014–18, the output gap has been non-negative in staff's assessment. At the same time, the fiscal impulse (the change in the structural primary balance) has been negative each year except in 2018 when it was close to zero. Fiscal policy has thus, if anything, been notably counter-cyclical since the latest amendments to the Fiscal Responsibility Law. The same is true for the period immediately following the global financial crisis, while policy was somewhat procyclical during the initial years of the original law in 2006–07 as well as, to a lesser extent, in 2012–13.

10. The coverage of structural current spending is narrow. Structural current spending according to the rule's definition accounts for only 53 percent of programmable, 39 percent of budgetary and 36 percent of total public sector expenditures. At such a low coverage, the success of the structural current spending rule in preventing pro-cyclical policies will depend on the evolution of other spending items. The experience thus far suggests that the excluded items do not track the evolution of structural current spending closely (they even grew faster).

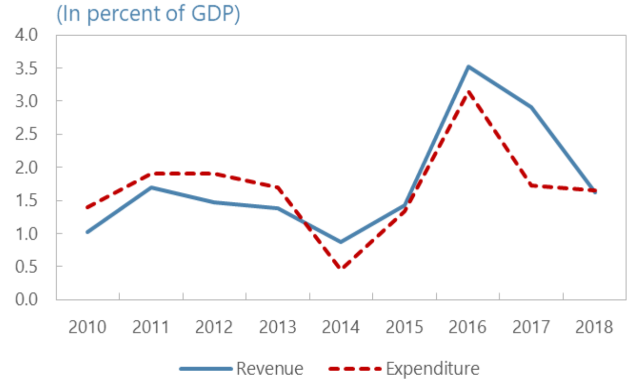
Mexico: Expenditure growth
(Y/Y real growth in percent)



Source: WEO

11. The stabilization funds' mandate to stabilize revenues relative to projections has been hampered by systematic under-projection of revenues. The stabilization funds were not designed to smooth revenues over the cycle but rather to compensate for unexpected shortfalls in revenues relative to the budget (Box 1). Given the systematic under-projection of revenues (and expenditures) in recent years, the FEIP has not been used to stabilize revenues and accumulated assets of about 1.3 percent of GDP as of end-2018. The FEIP has been used in 2019 to compensate for revenue shortfalls, with 0.5 percent of GDP expected to be transferred by year-end.

Actual minus Budgeted
(In percent of GDP)



Source: Authorities data and author's

D. Potential Avenues for Reform

12. A careful review of the fiscal framework is warranted but should entail broad public consultation. Regular reviews of the framework are welcome to determine whether it is achieving its objectives but should be carefully communicated. Such reviews should involve independent experts or bipartisan committees to avoid politicization and be sufficiently comprehensive to sidestep partial or incremental reforms that lead to suboptimal outcomes (Eyraud and others, 2018).

13. Any reform of the fiscal framework should be combined with the introduction of a modern medium-term budget framework. Currently, Congress does not have to approve proposals by the government for in-year adjustments to the budget although these changes are substantial (on average, around 7 percent of the approved budget). Macroeconomic and fiscal forecasts are prepared but focus mainly on one-year ahead-projections and are subject to substantial deviations compared to outturns. There is also a tendency for published forecasts to overestimate GDP growth (since 2013) and inflation. Mechanisms for validating that the government complies with its fiscal targets and fiscal rules, have not been developed. Moreover, no information is currently published on the reconciliation of current forecasts with previous vintages (see Mexico Fiscal Transparency Evaluation, 2018).

14. This section evaluates the authorities' five proposals to revise the fiscal framework. Several of these proposals are in line with previous Fund advice (see for example the 2015 Selected Issues Paper for Mexico). Building on the earlier analysis in this annex, this sub-section assesses each of the suggestions, drawing on previous Fund work on fiscal rules, in particular Eyraud and others (2018).

Suggestion 1: *The framework should have a long-term public debt ceiling as a nominal anchor.*

15. Staff agrees that the fiscal framework would benefit from a nominal anchor in the form of an explicit and well-calibrated permanent debt ceiling. The analysis in the previous section shows that debt has increased in the context of both the 2006 framework and following its amendment in 2014. A potential debt ceiling should be calibrated to strike the right balance between containing the risk of debt distress (i.e., it should be set prudently low to leave a large-enough buffer between the ceiling and the debt limit above which distress is likely to emerge) and leaving enough space for financing development needs including investment spending.[1] The buffer should also reflect the likelihood and incidence of shocks that affect debt dynamics.

16. Staff also suggests pairing the debt ceiling with an adequate correction mechanism. While increasing debt levels since 2014 were due in large part to factors unrelated to the deficit, the framework provides no guidance for whether and how to return to lower levels of debt. A potential debt correction mechanism could usefully entail several intermediate thresholds (above the ceiling) that would trigger progressively tighter fiscal adjustments when debt surpasses them. The highest threshold should be set below or at the debt limit. Breaching a threshold would trigger an adjustment aimed at reducing debt by a certain amount per year. The pace of debt reduction would increase at higher thresholds. Such step-wise adjustment mechanisms following a breach of the ceiling can be useful to avoid drifting away from the anchor while not derailing recoveries.[2]

Suggestion 2: *The framework should entail elements that help stabilize the economic cycle, such as a structural spending rule.*

17. Staff agrees that a structural spending rule can be an effective operational target in limiting pro-cyclicality, but the coverage of expenditure in the rule should be expanded. Sticking with the structural spending rule as an operational target to smooth spending over the cycle—rather than moving to a cyclically adjusted balance rule—would be appropriate.[3] However, the current structural spending rule only covers little more than a third of total public spending, and growth rates of broader spending categories deviate significantly from structural spending. The rule in its current form is thus unlikely to successfully smooth total spending over the cycle. Staff will recommend including all budgetary spending in the spending rule (potentially except for interest expenditures to the extent that the authorities consider them too volatile).

18. The structural spending rule could also be equipped with a correction mechanism. This second correction mechanism —in addition to the one related to breaches of the debt ceiling—is necessary to correct deviations from the spending cap even if debt remains below thresholds. This is

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[1] In the original 2006 framework, the permanent zero-balance target on the traditional deficit meant to serve as a nominal anchor. However, its effectiveness was eroded by revisions to its definition and the narrowness of its scope.

[2] The German "debt brake," for example, requires corrective action only during periods of economic expansion (Eyraud and others, 2018).

[3] Expenditure rules are generally better suited to emerging markets: first, they are simple and transparent in comparison to cyclically adjusted balance rules that are not always easy to communicate; second, cyclically adjusted deficit rules require pinning down the output gap which can be elusive in economies with less well defined business cycles; third the complexity of implementing cyclically adjusted deficit rules can open avenues to circumventing the rule which is especially problematic in countries with less reliable monitoring capacity; fourth, cyclically adjusted deficit rules are prone to policy errors as real-time estimates of the output gap are subject to large measurement errors (Eyraud and others, 2018).

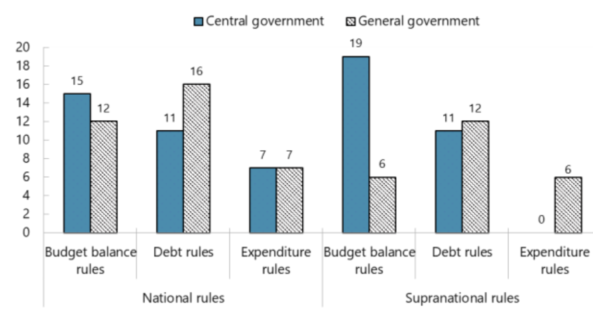
warranted both to strengthen the rule's credibility, and to prevent deviations from the operational rule from having a permanent impact on the debt trajectory. If a spending growth cap becomes the only operational limit, the correction mechanism would have to specify if the deviation needs to be corrected in growth rate, or in levels. The correction mechanism on the operational rule should be kept simple (e.g. a requirement to adjust spending under the expenditure rule to return to target in three years) to avoid jeopardizing the rule's transparency.

Suggestion 3: *There should be less discretion in invoking escape clauses than in the current framework.*

19. Staff agrees on the need to significantly tighten the triggers that invoke escape clauses. Eyraud and others (2018) suggest that, to avoid abuse, escape clauses should have (i) a limited and clearly defined set of events triggering the operation of the clause, (ii) time limits on how long fiscal policy can deviate from the targets in the rule, and (iii) a requirement for fiscal policy to return to the targets after the operation of the escape clause is terminated. Escape clauses should also only be triggered in the case of events that are outside the government's control. In the case of Mexico's fiscal framework, escape clauses can be triggered even under relatively mild shocks. The framework also leaves significant discretion to the government once a shock hits, both in terms of when and how much the fiscal stance can deteriorate and how it should be brought back to equilibrium. The triggers should be significantly tightened so that the clause is only invoked for natural disasters and major shocks that threaten economic stability.[4]

20. However, with a debt ceiling and an enhanced spending rule, the deficit targets could be dropped altogether. A simple framework that combines a debt rule as a nominal anchor with a small set of operational rules that are fully in the control of policymakers is desirable. A good option would be to rely on the debt ceiling and an enhanced spending rule alone and to drop the two existing deficit rules.[5] The main downside of the expenditure rule as a sole operational target is that it does not cover the revenue side and thus cannot, on its own, ensure fiscal sustainability. Appropriately defined correction mechanisms would thus be needed in addition to the

Coverage of Fiscal Rules in EMDEs, 2015
(Number of countries)



Source: IMF fiscal rules dataset.

[4] Two options could be considered: first, the magnitude of the shock can be specified (for example, natural disaster with 'x' fiscal cost, or growth that is 'x' points below projections). In this case, it is appropriate to put a cap on the deviation; second, the law could permit discretion but insert language in the law that makes clear that the shock must be exceptional. The escape clause would also need to indicate the maximum time limit for the rule suspension, the institutional procedures for activating the suspension (for example, the executive requests it but parliament must approve), which part of the FRL is suspended, and a correction mechanism (which might be the same as the one for the operational target).

[5] At end 2015, 59 emerging market and developing economies had fiscal rules (out of which 16 had national debt rules and another 12 had subnational debt rules at the general government level).

targets in case these are breached (see Suggestions 1 and 2).[6] Staff would discourages the authorities from keeping the deficit targets as additional targets, both to keep the framework simple and because the combination of the two operational targets could lead to unintended consequences (in the case of a negative shock, the deficit target is likely to bind, forcing an undue tightening of spending into a downturn).

Suggestions 4: *A countercyclical fund should be created that allows saving in good times and spending during downturns.*

21. Staff believes that consideration could be given to simplifying the rules of the FEIP and/or gearing it towards stabilizing revenues across the cycle. The current administration has discontinued the practice of systematically under-projecting revenues. In fact, the FEIP has already begun to fulfill its intended role of stabilizing revenues relative to projections this year. Changing the rules of the fund to gear it towards stabilizing revenues over the cycle instead of relative to budget projections could be an option. Such a change may be a better justification for the existence of the stabilization fund, which would normally rely on the argument that the fund provides buffers to shield the government against potentially imperfect access to credit markets during economic downturns. Staff would also recommend simplifying the rules of the fund.[7]

22. However, staff considers the case for the existence of a revenue stabilization fund in its current form in Mexico as relatively weak. First, Mexico runs fiscal deficits, implying that it needs to borrow to save which is costly; second, there is no evidence that revenues in Mexico are particularly volatile, including because the share of oil revenues has notably declined in recent years; third, Mexico already has an oil hedge program that insures its revenues fully for oil price fluctuations; fourth, Mexico has maintained adequate market access even during severe shock episodes such as the GFC; fifth, even if had not, the size of the fund in its current form is too small to make a meaningful difference during a major shock episode.

Suggestions *5:* *An independent fiscal council should be created to strengthen fiscal transparency.*

23. Staff agrees that the creation of a non-partisan, adequately resourced fiscal council with a mandate to provide an independent evaluation of fiscal policy would be crucial. By providing independent medium-term fiscal projections to contrast with those presented by the Executive Branch at the time of the budget discussion, or assessments of structural positions, a non-

[6] Another concern is potential side effects such as in the composition of the budget (for example if investment spending were included in the rule and would then be cut to comply with it). If these concerns are significant, additional operational targets (e.g. a floor on capital expenditure) could be considered (Eyraud and others, 2018).

[7] The design of funds is complicated, and includes three important limitations: (i) resources in the funds are subject to accumulation caps; (ii) some items are deducted from the pool of resources before they are transferred to the funds—i.e., shortfalls in revenues with respect to the budget, changes in energy costs not reflected in domestic electricity tariffs, and costs of natural disasters and outlays resulting from changes in interest or exchange rates; and (iii) there are complicated rules to distribute resources in the funds. These adjustments and rules operate as de facto earmarking over oil revenue windfalls. Unification of the different funds; elimination of accumulation ceilings; and simplification of the transfer rules of revenue to the funds would be welcome.

partisan fiscal council with analysis from reputable experts could strengthen the fiscal policy debate. Even in the absence of binding recommendations, a fiscal council would help raise awareness and increase the political cost of fiscal indiscipline.

24. A rapidly growing number of countries have introduced independent fiscal councils over the last decade to encourage better fiscal policies (see Debrun and others, 2013 for details). Latest adopters include several European Union member states, as well as emerging and developing economies such as Colombia, Uganda, South Africa, and, more recently Peru (Debrun and Kinda, 2014). Eyraud and others, 2018 argue that, in some cases, fiscal councils have helped enhance budget transparency by strengthening the credibility of the fiscal accounts and forecasts and providing long-term sustainability assessments and policy analyses (for example, in the Netherlands). Fiscal councils can also mitigate the complexity inherent in certain rules through direct inputs, such as estimates of structural balances (for example, in Chile), or public assessment of compliance with over-the-cycle rules (for example, in Sweden).

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Eyraud, L., X. Debrun, A. Hodge, V. Lledó, and C. Pattillo. 2018. SDN on Second-Generation Fiscal Rules. IMF Staff Discussion Note No.18/04, International Monetary Fund, Washington, DC.

Debrun, Xavier, Tidiane Kinda, Teresa Curristine, Luc Eyraud, Jason Harris, and Johann Seiwald, 2013, "The Functions and Impact of Fiscal Councils," IMF Policy Paper.

Debrun, Xavier and Tidiane Kinda, 2014, "Strengthening Post-Crisis Fiscal Credibility— Fiscal Councils on the Rise. A New Dataset," IMF Working Paper No 14/58, Washington, DC: International Monetary Fund.

Mexico: Fiscal Transparency Evaluation, 2018. IMF Country Report No. 18/289, International Monetary Fund, Washington, DC.

Annex V. Public Investment Management Assessment

The assessment identified strengths and weaknesses and provided recommendations and an operational priority action plan to improve public investment management in the short-to-medium term. The table shows how Mexico compares to other countries in the areas forming part of the PIMA.

A. Planning	**Institutional Strength**	**Effectiveness**	**Reform Priority**
1. Fiscal targets and rules	Medium	Medium	High
2. National and sectoral planning	Medium	Low	High
3. Coordination between entities	Low	Low	High
4. Project appraisal	High	High	Low
5. Alternative infrastructure financing	Medium	Medium	Medium
B. Allocation	**Institutional Strength**	**Effectiveness**	**Reform Priority**
1. Multi-year budgeting	Medium	Low	High
2. Budget comprehensiveness and unity	Medium	Medium	Low
3. Budgeting for investment	Medium	Medium	Low
4. Maintenance funding	Low	Medium	High
5. Project selection	High	Medium	Low
C. Implementation	**Institutional Strength**	**Effectiveness**	**Reform Priority**
1. Procurement	High	Medium	High
2. Availability of funding	Medium	Medium	Medium
3. Portfolio management and oversight	Medium	Medium	Medium
4. Management of project implementation	Medium	Medium	Medium
5. Monitoring of public assets	Medium	Low	Medium

Main recommendations include:

- Strengthen fiscal discipline by improving the Medium-Term Fiscal Framework (MTFF), the application of fiscal rules and establishing independent oversight of fiscal planning.
- Improve the effectiveness of national and sector strategies to guide investment project planning.
- Strengthen medium-term budget planning.
- Improve the co-ordination between the federation and states.
- Develop a standard methodology for determining maintenance funding requirements for all types of infrastructure assets, and budget for them.
- Promote a more competitive tendering and pro-competition culture among public procurement officials.
- Improve the comprehensiveness and quality of public investment planning.
- Improve the predictability of funding for major capital projects.
- Strengthen the monitoring of cost overruns and project delays.
- Enhance capital projects management and control during the execution stage.
- Improve accounting and valuation of assets.

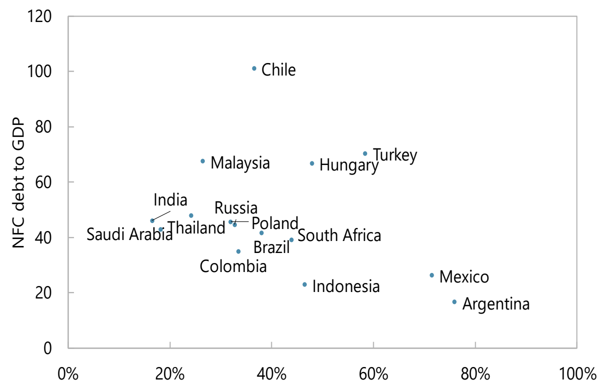
Annex VI. Household and Corporate Sector Health

This Annex discusses household and corporate sector health. It finds that corporate debt is low with limited unhedged exchange rate exposures. The largest Mexican corporates are relatively resilient to significant to interest rate, growth and exchange rate shocks. Household debt also remains very low.

A. Non-Financial Corporates

1. At 26 percent of GDP, corporate debt is among the lowest in emerging economies. Corporate debt has increased by around 6 percentage points over the last five years, but it remains low when compared with other emerging economies. Debt in foreign currency remains high, but most large corporations have largely hedged these exposures. Among the largest 50 private corporations the debt-weighted FX share is close to 68 percent, but many firms have a combination of "natural" hedges from foreign currency revenues and derivatives. Foreign currency revenue accounts for around 50 percent of total revenue, weighed by outstanding debt. The 2016 FSAP found that most companies use derivatives to hedge their FX and project financing debts close to their maturity and actively use short term currency forwards to hedge FX cashflow mismatches.

EM Corporate Debt and FX share
(percent of GDP and share, Q1 2019)



Sources: BIS and IIF

2. Although fundamentals have deteriorated over the last few years, debt servicing capacity remains strong for large corporates. Corporates with international bond issuance still enjoy comfortable market access and there has been limited spillovers from the recent Pemex selloff as markets have differentiated based on their stronger fundamentals.

Sensitivity Analysis on Large Corporations

3. Staff conducted a sensitivity analysis for the 50 largest corporations by outstanding debt to gauge their vulnerability to exchange rate, earnings and interest rate shocks. Collectively, the debt of the top 50 companies (excluding Pemex and CFE) by debt stock in the sample amounts to 12 percent of GDP. In comparison PEMEX and CFE debt sums up to 11 percent of GDP and total NFC debt to GDP is 26 percent. This exercise considers three scenarios: (i) with "natural" hedges; (ii) with "natural" and financial hedges; and (iii) without hedges. Details are as follows:

Shocks

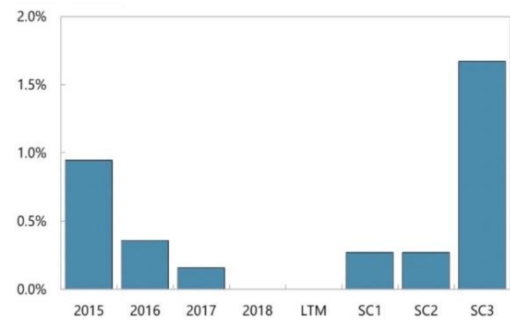
- An increase in borrowing costs similar to the increase during the GFC, to take into account the risk of sharp spikes in credit spreads during times of heightened global uncertainties and market dislocation.

- A peso exchange rate depreciation of 30 percent against the U.S. dollar, similar to the peso depreciation in mid-2014/end-2015 during the global dollar rally and oil price decline.
- Earnings shocks of one standard deviation for each firm in line with the scenarios undertaken in the analysis during previous AIV consultations.

Hedges

- "Natural" hedges from exports in foreign currencies are proxied by the ratio of foreign currency revenues to total revenues for each firm.[1]
- Financial hedges on exchange rate risk were derived based on a simple assumption that 50 percent of FX debt interest expense is hedged through derivatives. This takes into consideration the availability and effectiveness of the hedges.[2]

Debt-at-Risk (in percent of GDP) 1/



Sources: Bloomberg and IMF staff estimates

1/ SC1: Natural hedges; SC2: SC1 + 50% financial hedge; SC3: No hedges

4. **The results show that large nonfinancial corporations are resilient, and spillovers to the banking sector are low.** Debt-at-risk, defined as debts with interest coverage ratio (ICR) below 1, would remain below 0.5 percent of GDP, assuming hedges and rise to around 1.5 percent assuming no hedges.

B. Households

5. **Mexico's household debt at 16 percent of GDP is among the lowest in EMEs** and has remained relatively stable at around 15 percent over the last decade, while other EMEs have seen significant increases.

- **Mortgage credit is close to 10 percent of GDP.** The main mortgage issuer is Infonavit while banks have historically provided around one third of the total.
- **Consumer credit is close to 6 percent of GDP.** Although banks continue to be the main creditors for consumer loans, the share of non-bank financial intermediaries has almost tripled in the last five years and a large share is due to non-regulated entities. These entities tend to serve sectors of the population outside of the banking sector or customers with higher credit risk.

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[1] Based on information from Banco de Mexico as of 2019:Q1.

[2] While FX hedging instruments and markets are more developed now than during the late-1990 crises, it is important to note that some of these instruments are complex. For example, some currency hedges would terminate when the exchange rate depreciates beyond a certain "knock-out" threshold, thus rendering the hedge worthless. Moreover, firms are exposed to liquidity and rollover risks when these contracts expire.

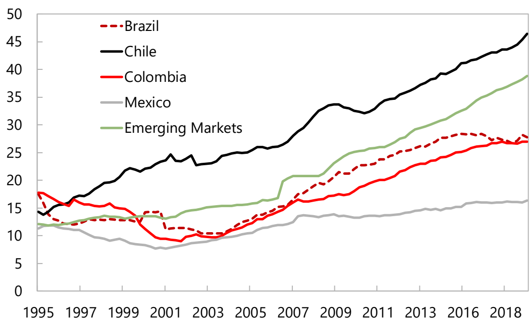
6. NPLs for both housing and consumer loans have generally been stable and low in both banks and non-banks. Sectors that have shown increasing NPLs for non-banks, include car loans but despite a large rise since early 2018 they are at comparable levels with bank NPLs. Payroll loans have very low NPLs, given that repayments are automatically deducted from the borrower's paycheck. Finally, some microfinance entities like Sofipos have relatively high NPLs but they are still a very small share of the overall consumer loan market.

7. The banking system is relatively robust to an increase in NPLs given high consumer loan provisioning and low levels of the overall consumer loan portfolio. The 2016 FSAP stress tests found that the banking system remains generally resilient to adverse and severe macro-financial shocks, although smaller banks could experience large declines in capital adequacy. Non-bank entities are susceptible to funding risks (e.g., rollover of bank loans and bond issuance) given that they don't rely on a stable deposit base.

Figure 1. Household Debt

Household debt remains low and has been relatively stable over the last decade

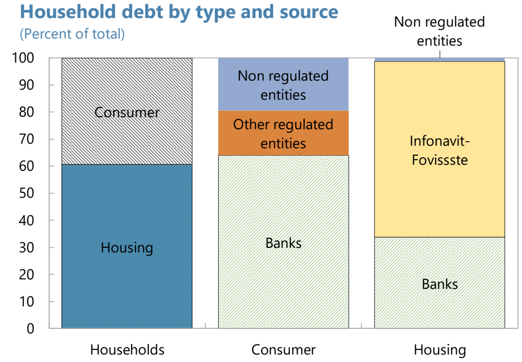
Household Debt
(Percent of GDP)



Sources: IIF

... Consumer debt is just 6 percent of GDP but the share of provisioning from non-bank entities has been on the rise

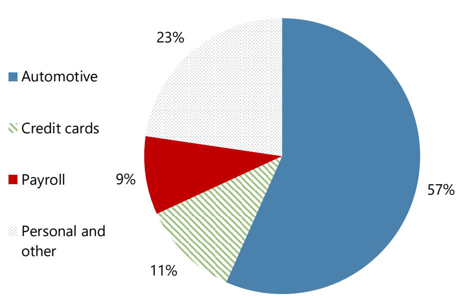
Household debt by type and source
(Percent of total)



Sources: Banxico

Most of these loans are for cars, credit cards, personal and payroll loans.

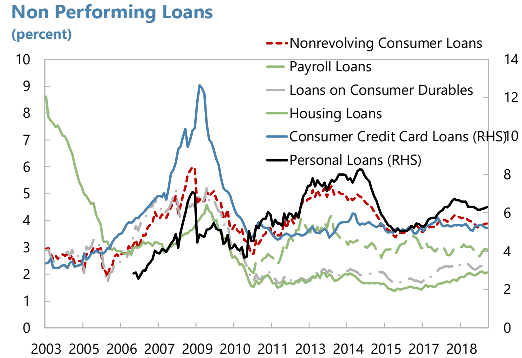
Breakdown of consumer loans by non-bank entities
(Percent)



Sources: Banxico

NPLs have been stable

Non Performing Loans
(percent)



Sources: SHCP

INTERNATIONAL MONETARY FUND

MEXICO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 18, 2019

Prepared By	The Western Hemisphere Department (in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of August 31, 2019)

The 2019 Article IV discussions were held in Mexico City during September 19–30. The mission comprised Costas Christou (head), Julia Bersch and Christian Saborowski (WHD), Richard Berkhout (LEG), Balazs Csonto (SPR), Dimitris Drakopoulos (MCM), and Mehdi Raissi (FAD). Krishna Srinivasan (WHD) joined the concluding meetings. Mr. Guerra and Ms. Arevalo Arroyo (OEDCE) also participated. The mission met with Bank of Mexico Governor Diaz de Leon, Secretary of Finance and Public Credit Herrera, Energy Secretary Nahle, other senior officials, and representatives of the business community, other IFIs, and academics. Juan Pablo Cuesta and Irina Sirbu (WHD) contributed to the preparation of this report.

Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4. Comprehensive economic data are available for Mexico on a timely basis. It subscribes to the SDDS, and economic data are adequate to conduct surveillance.

Membership Status: Joined December 31, 1945

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	8,912.70	100.00
Fund holdings of currency	7,057.79	79.19
Reserve position in Fund	1,854.95	20.81
New Arrangement to Borrow	192.79	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	2,851.20	100.00
Holdings	2,921.90	102.48

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Arrangement Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
FCL	Nov. 29, 2017	Nov. 28, 2019	62,388.90[1]	0.00
FCL	May 27, 2016	Nov. 28, 2017	62,388.90	0.00
FCL	Nov 26, 2014	May 26, 2016	47,292.00	0.00
FCL	Nov. 30, 2012	Nov. 25, 2014	47,292.00	0.00
FCL	Jan. 10, 2011	Nov. 29, 2012	47,292.00	0.00
FCL	Mar. 25,2010	Jan. 09, 2011	31,528.00	0.00
FCL	Apr 17, 2009	Mar. 24, 2010	31,528.00	0.00

[1] Access was reduced to 53,476.20 SDR million on November 26, 2018.

Projected Payments to the Fund (SDR million):

	Forthcoming				
	2019	2020	2021	2022	2023
Principal					
Charges / Interest	0.00	0.04	0.04	0.04	0.04
Total	0.00	0.04	0.04	0.04	0.04

Exchange Rate Arrangement: Mexico's de-jure and de-facto exchange rate arrangements are free-floating. Mexico maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on November 5, 2018. The staff report was published as IMF Country Report No. 18/307.

Technical Assistance

Year	Dept.	Purpose
2018	FAD	Public Investment Management Assessment
2018	FAD	Tax policy and Compliance
2018	FAD	Fiscal Transparency Evaluation
2017	STA	Government Financial Statistics
2017	FAD	Tax policy
2017	MCM	Central Securities Depositories
2017	FAD	Revenue Administration
2016	FAD	Revenue Administration
2015	STA	Balance of Payments
2015	FAD	Supervision of Subnational Finances
2014	FAD	Tax Policy and Compliance
2014	FAD	Treasury
2014	STA	Sectoral Balance Sheets
2014	STA	National Accounts
2014	STA	Balance of Payments
2013	MCM	Post-FSAP Follow Up
2012	FAD	Pension and Health Systems
2012	FAD	Tax Regimes for PEMEX

Resident Representative: None

RELATIONS WITH THE WORLD BANK

https://www.worldbank.org/en/country/mexico

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National accounts: The national accounts statistics generally follow the recommendations of the *System of National Accounts, 2008 (2008 SNA)*. Source data and statistical techniques are sound and most statistical outputs sufficiently portray reality. A broad range of source data are available, with economic censuses every five years and a vast program of monthly and annual surveys. For most surveys, scientific sampling techniques are used. Nonetheless, most samples exclude a random sample of small enterprises. Some statistical techniques need enhancement. For example, taxes and subsidies on products at constant prices are estimated by applying the GDP growth rate, a deviation from best practice. The 2014 data ROSC reassessment found that national accounts statistics are generally of a high quality, adequate to conduct effective surveillance and adequately meet users' needs. Since 2010, Mexico has made significant improvements on the methodological and dissemination aspects of data quality. Nevertheless, areas for further improvement and refinement exist, in particular, on the resources devoted to collecting state and local government source data and seasonally-adjusted data, explaining data revisions, and on compiling data on changes in inventories and on the volume of taxes on products. INEGI publishes annual and quarterly GDP statistics and sectoral accounts and balance sheets.
Prices: The concepts and definitions for both the CPI and PPI meet international standards. The PPI is based on 2012 weights and covers about 80 percent of Mexican production. It excludes trade and some services.
Government finance statistics: The authorities compile fiscal statistics following national concepts, definitions, and classifications that make international comparison difficult. These fiscal statistics are comprehensive and timely, except for the subnational sector. Moreover, pension liabilities (47 percent of GDP) are partially reported, while government securities are only reported at face value. The new government accounting law mandates accounting standards that follow international standards for all levels of government, and that consider the information needs of international organizations and national accounts. A full adoption of uniform accounting standards at the sub-national level will be crucial to obtain a precise measure of public fixed investment in national accounts, among others. The authorities have reported GFS time series data for 2008 to 2018 to the IMF's annual GFS database. The official debt statistics do not include the stock of T-bonds issued to Banxico for liquidity management purposes. Furthermore, the accounting practices adopted by the federal government and Banxico differ. Finally, the authorities should consider reporting the HBPSBR debt statistics in gross terms for international comparisons.

Monetary and financial statistics: The methodological foundations of monetary statistics are generally sound. Availability of data on other financial intermediaries such as insurance companies and pension funds allow for the construction of a financial corporation's survey with full coverage of the Mexican financial system, which is published on a monthly basis in International Financial Statistics. **Financial sector surveillance:** Mexico is reporting Financial Soundness Indicators (FSIs) for Deposit Takers and other financial corporations on a monthly basis. No FSIs are reported on the non-financial corporations sector. Mexico reports data on some key series and indicators to the Financial Access Survey (FAS), including gender disaggregated data on the use of basic financial services and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) of the U.N. Sustainable Development Goals.
External sector statistics (ESS): The quality of ESS has improved. In 2017, Banco de Mexico migrated balance of payment and international investment statistics to the *sixth edition of the Balance of Payments and International Investment Position Manual (BPM6*) and adopted a structure consistent with *BPM6* in national publications. The authorities strengthened their data collection and compilation system for foreign direct investment, financial derivatives, bank accounts used in foreign exchange operations, capital account, financial intermediation services indirectly measured, and private sector debt. Recent improvements include better coverage of nonbank financial intermediaries. There are ongoing efforts to compile manufacturing services on physical inputs own by others, and to improve the coverage and level of detail of capital account transactions and nonfinancial private sector transactions and positions.

II. Data Standards and Quality	
Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). In a number of cases, the periodicity and timeliness of disseminated data exceed SDDS requirements.	A data ROSC update was completed on June 24, 2015 and was published as IMF Country Report No. 15/176.

Mexico: Table of Common Indicators Required for Surveillance

As of Oct. 16, 2019	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Data Quality-Methodological Soundness[8]	Data Quality Accuracy and Reliability[9]
Exchange Rates	Oct. 2019	Oct. 2019	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct. 2019	Oct. 2019	W	W	W		
Reserve/Base Money	Oct. 2019	Oct. 2019	D	D	D	LO, O, O, LO	LO, O, O, O, O
Broad Money	Aug. 2019	Oct. 2019	M	M	M		
Central Bank Balance Sheet	Oct. 2019	Oct. 2019	W	W	W		
Consolidated Balance Sheet of the Banking System	Aug. 2019	Oct. 2019	M	M	M		
Interest Rates[2]	Oct. 2019	Oct. 2019	D	D	D		
Consumer Price Index	Sep. 2019	Oct. 2019	Bi-W	Bi-W	Bi-W	O, O, LNO, O	LO, LNO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3]–Gen. Government[4]	Aug. 2019	Oct. 2019	M	M	M	LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Aug. 2019	Oct. 2019	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug. 2019	Oct. 2019	M	NA	M		

Mexico: Table of Common Indicators Required for Surveillance (concluded)

External Current Account Balance		Q2 2019	Sep. 2019	Q	Q	Q	LO, LO, LNO, LO	LO, O, O, O, LO
Exports and Imports of Goods and Services		Aug. 2019	Sep. 2019	M	M	M		
GDP/GNP		Q2 2019	Aug. 2019	Q	Q	Q	O, O, O, LO	LO, O, LO, LO, O
Gross External Debt		Q2 2019	Sep. 2019	Q	Q	Q		
International Investment Position[6]		Q2 2019	Sep. 2019	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC completed on July 2014, except consumer prices which is based on the ROSC completed on 2012. For the dataset corresponding to the variable in each row, the assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, assessment and validation of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.