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Mexico: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Mexico

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2001 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the combined discussion of the 2001 Article IV consultation with Mexico, prepared by a staff team of the IMF, following discussions that ended on **July 6, 2001,** 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 July 13, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **August 2, 2001,** updating information on recent developments.

- a Public Information Notice (PIN), summarizing the **views of the Executive Board as expressed during its August 2, 2001, discussion** of the staff report on issues related to the Article IV consultation.

- a statement by the Executive Director for Mexico.

The document(s) listed below have been or will be separately released.

Selected Issues

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MEXICO

Staff Report for the 2001 Article IV Consultation

Prepared by Western Hemisphere and Policy Development and Review Departments

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July 13, 2001

Contents Page

Glossary 3

I. Introduction 4

II. Background 4

III. Policy Discussions 13
- A. Fiscal Policy 14
- B. Monetary and Exchange Rate Policy 19
- C. Banking System 20
- D. External Sector Policies 22
- E. Medium-Term Framework 26

IV. Staff Appraisal 28

Text Boxes
1. The Global Economic Environment and Consequences for Mexico 6
2 The Tax Reform Proposal 17
3. Inflation Targeting in Mexico 21

Figures
1. Selected Economic Indicators 7
2. Selected Market Indicators 8
3. Competitiveness and Wage Indicators 9
4. External Sector 24

Tables

1. Indicators of Economic Activity....31
2. Selected Economic and Financial Indicators....32
3. Quantitative Performance Criteria....33
4. External Financing Requirements and Sources....34
5. Financial Operations of the Public Sector....35
6. Summary Operations of the Financial System....36
7. Summary Balance of Payments....37
8. External Debt and Debt-Service Indicators....38
9. Financial Operations of the Public Sector....39
10. Indicators of Domestic and External Vulnerability....40
11. Medium-Term Macroeconomic Framework....41
12. Summary Medium-Term Balance of Payments....42
13. Medium-Term External Debt and Debt-Service Indicators....43

Attachments

I. Fund Relations....44
II. Relations with the World Bank....46
III. Statistical Issues....47

Appendix Boxes

1. The Public Sector Borrowing Requirement (PSBR)....49
2. Public Liability Management....50
3. Banking Sector—Major Accomplishments Since 2000 Article IV Consultation....51
4. Summary Assessment of Financial System Stability....52
5. External Current Account Sustainability....53

Appendix Tables

I. Adjusted Overall and Augmented Public Sector Balances....54
II. Social Indicators of Development....55
III. Access of Public and Private Sectors to International Capital Markets....56

GLOSSARY

BOM	Central Bank of Mexico
CAS	Country Assistance Strategy
CETES	Mexican Short-Term Treasury Bill
CNBV	National Banking and Securities Commission
FDI	Foreign Direct Investment
FOBAPROA	Bank Savings Protection Fund
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FTA	Free Trade Agreement
FX	Foreign Exchange
GEE	Global Economic Enviroment
INEGI	National Institute of Statistics and Geography
IPAB	Bank Savings Protection Institute
ISSSTE	Social Security Institute for Public Employees
NAFTA	North American Free Trade Agreement
NIR	Net International Reserves
OSF	Oil Stabilization Fund
PEMEX	National Mexican Petroleum Corporation
PIDIREGAS	Public Investment Projects Financed and Executed by the Private Sector with Deferred Budgetary Impact
PSBR	Public Sector Borrowing Requirement
REER	Real Effective Exchange Rate
ROSC	Report on Observance of Standards and Codes
SDDS	Special Data Dissemination Standard
VAT	Value Added Tax
WEO	World Economic Outlook

I. Introduction

1. Discussions for the 2001 Article IV consultation were conducted in Mexico City during May 8–24.[1] On July 7, 1999, the Executive Board approved a 17-month Stand-By Arrangement (SBA) for SDR 3,103 million (120 percent of quota). The authorities made purchases under the arrangement equivalent to SDR 1,940 million through end-March 2000. In August 2000, Mexico prepaid its outstanding obligations to the Fund. The SBA expired in November 2000. Comprehensive economic data are available for Mexico on a timely basis, and are sufficient to conduct surveillance adequately. Mexico has subscribed to the Fund's Special Dissemination Standard and has submitted metadata, which have been posted on the Fund's Data Standard's Bulletin Board.

2. At the conclusion of the 2000 Article IV consultation on March 17, 2000 (EBS/00/40), Executive Directors commended the authorities for their prudent economic management, and noted Mexico's improved resilience to external shocks and important progress in structural reforms. However, they stressed the need to address remaining vulnerabilities in the banking system and the dependence of the public finances on oil revenues. The Executive Board reviewed developments subsequently at the time of the third review under the SBA (September 8, 2000).[2]

II. Background

3. **The economy performed well in 2000**, although economic activity and the external accounts weakened toward end-year, mainly reflecting the deterioration in the external environment (Table 1). Nonetheless, real GDP growth for the year as a whole reached nearly 7 percent (Table 2). The 12-month inflation rate declined to 9 percent in December (below the target of 10 percent), reflecting partly the strength in the value of the peso. All quantitative performance criteria for end-September 2000 (the last test date under the SBA) were met, in some cases with large margins (Table 3).[3]

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[1] The mission consisted of Messrs. Kalter (Head), Young, Velloso (all WHD), Cordoba (FAD), Pancorbo (MAE), Ms. Papi (PDR), and Mrs. Scioville (Sr. Adm. Assistant). Messrs. Loser and Bonangelino joined the mission for the final discussions. Mr. Muñiz, the Fund's senior resident representative, assisted the mission. Mr. Leone (MAE) and Mr. de la Torre (WB) (team leaders of the recent FSAP mission) joined the mission during its final days for discussions on the FSAP report. Summaries of Fund and World Bank relations with Mexico are provided in Attachments I and II, respectively. Attachment III presents Core Statistical Issues.

[2] Mexico's exchange system is free of restrictions. Mexico accepted the obligations of Article VIII in 1946.

[3] The adjusted (for higher oil revenues) indicative fiscal targets for end-December were missed due, inter alia, to higher spending on education and pensions, and by public enterprises.

4. **Although consumption expenditure remained fairly strong, real GDP contracted slightly** on a seasonally adjusted basis in the first quarter of 2001 (growing by 1.9 percent over a year ago). The authorities have revised downward projected real GDP growth to 2½ percent this year, from the originally envisaged 4½ percent. However, taking into account more recent developments, the staff is of the view that the slowdown likely will be deeper, reflecting expected developments in the U.S. economy (Box 1).[4] The 12-month inflation rate declined to 7 percent in May (Figure 1); the core inflation rate declined to 6½ percent in May from 7½ percent at end-2000.

5. **Productivity and employment indicators** were strong in 2000, but have been weakening thus far in 2001. Productivity in the manufacturing sector rose by about 4½ percent in 2000 but the pace slackened to 2 percent in the first quarter of 2001 (see Table 1). Employment, which rose by nearly 6 percent in 2000, increased by only 3½ percent (annual rate) in the first quarter of this year. After rising by nearly 6 percent in 2000, real wage increases continued strong in the first quarter of 2001 (5½ percent annual rate), as a large proportion of wage contracts were negotiated in the first two months of the year when domestic demand was still perceived to be strong.

6. **In recent months, the peso has strengthened** to a range of Mex$8.9–9.3 per U.S. dollar, compared with Mex$9.8 per U.S. dollar in January 2001 (Figure 2). Net international reserves (NIR) increased by almost US$5 billion during the first five months of 2001 (partly reflecting a front-loading of the public sector's external borrowing), following an US$8.2 billion gain during 2000. Gross international reserves amounted to over US$40 billion at the end of June, equivalent to 95 percent of short-term debt (by residual maturity) (Table 4). As of April 2001, in real effective terms the peso appreciated by 9 percent (on a 12-month basis), and is now somewhat more appreciated than its pre-crisis level. Based on relative unit labor costs, the real effective exchange rate appreciated by 13 percent, but it is still somewhat more depreciated than its pre-crisis level (Figure 3).

7. **The 2000 fiscal deficit** was 0.9 percent of GDP based on the budget definition (Table 5 and Appendix Table I). Using a comprehensive definition of the fiscal balance—the augmented balance or public sector borrowing requirement (PSBR)—the 2000 deficit was

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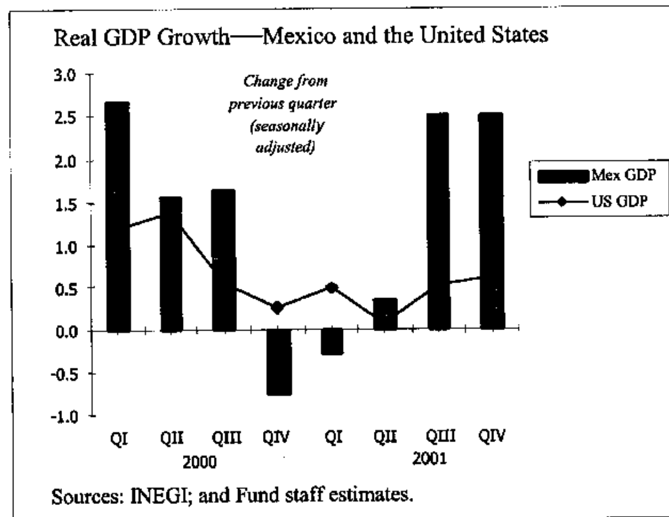
[4] The staff estimates that real GDP is at its potential level in 2001, after being above it last year (see Chapter 1 in the accompanying Selected Issues paper).

Box 1. The Global Economic Environment and Consequences for Mexico

Mexico's economy is **highly dependent on developments in the U.S.** economy. The North American Free Trade Agreement (NAFTA) has resulted in increasing exports to the U.S. market (along with a rising market share). In 2000, Mexican exports (gross basis) to the U.S. accounted for almost 90 percent of total exports and over 25 percent of GDP.

The **adverse impact of the economic slowdown in the U.S. on the Mexican economy** and exports has been somewhat stronger than anticipated. Industrial production fell by 1.3 percent in the first quarter of 2001 (annual basis), compared with growth of 3.8 percent in the last quarter of 2000. Annual employment growth (as registered with the Mexican Social Security Institute) has been decelerating, from 6.6 percent in the first quarter of 2000 to 3.6 percent in the first quarter of 2001, partly in response to rising unit labor costs (see Table 1). Fixed capital investment growth slowed sharply to 0.4 percent in the first quarter of 2001 (down from an annual average of 10 percent in 2000). First quarter real GDP fell by a seasonally adjusted 0.3 percent. However, the impact of lower demand for Mexican exports on the trade balance has been offset by slower import growth resulting from the large import component of exports and lower domestic demand.

The U.S. economic slowdown has led the Mexican authorities to **revise downward projected economic growth in Mexico to 2½–3 percent.** However, given the expected growth path in the United States for the second half of 2001, there is a significant risk that economic activity in Mexico may be weaker than currently projected (see figure).

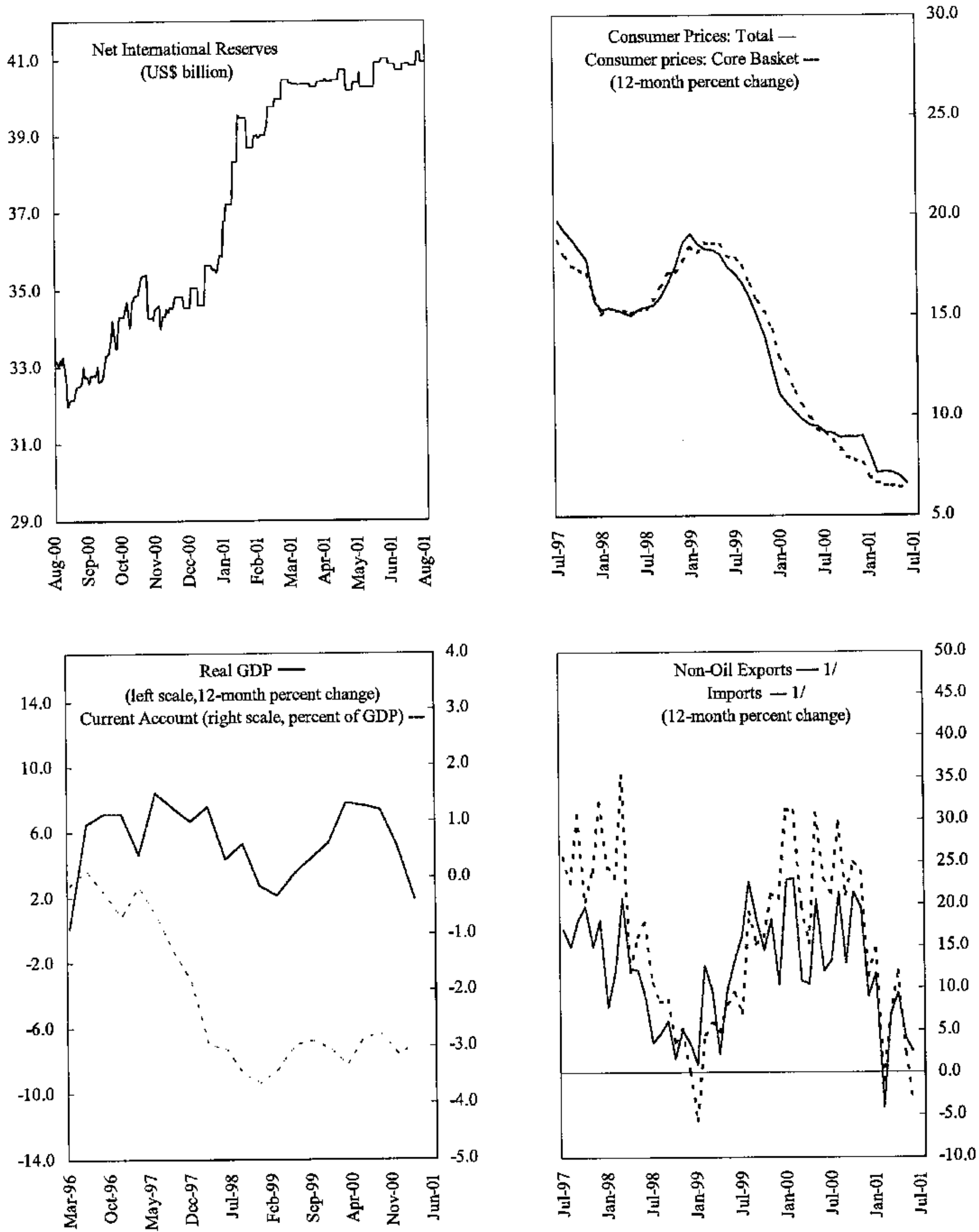


Sources: INEGI; and Fund staff estimates.

The **maintenance of prudent macroeconomic policies** in Mexico, in the face of a worsening external environment, has reinforced investor confidence in Mexico. Thus, despite the crises in several emerging markets in 2001, sovereign spreads for Mexico performed better than spreads for other emerging markets, even excluding Argentina and Turkey.

Helped by the weak demand conditions and the strength of the peso, **inflation expectations** have continued on a declining trend in 2001, and are now very close to, and in some surveys even below, the official target of 6.5 percent.

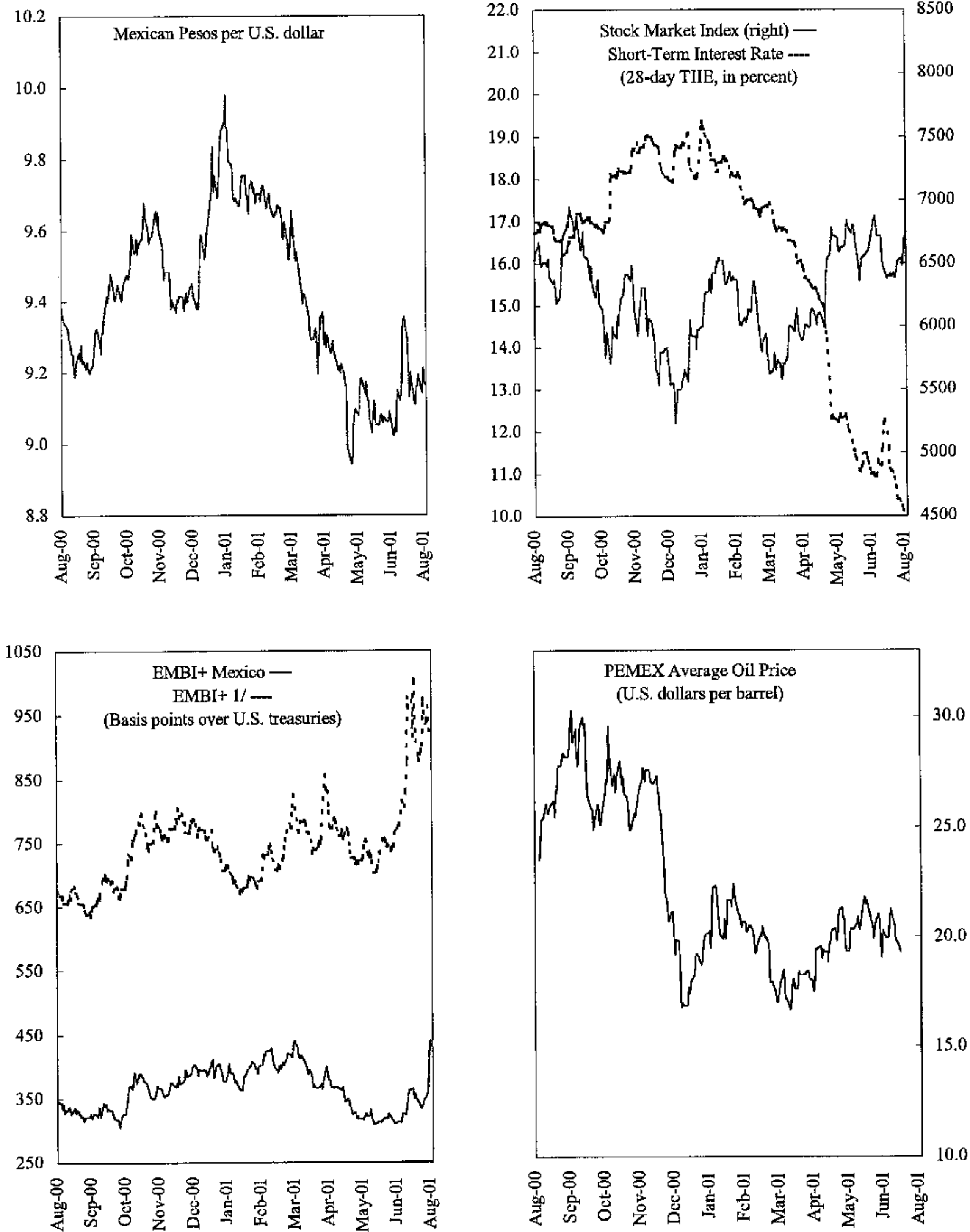
Figure 1. Mexico: Selected Economic Indicators



Sources: Bank of Mexico; and INEGI.

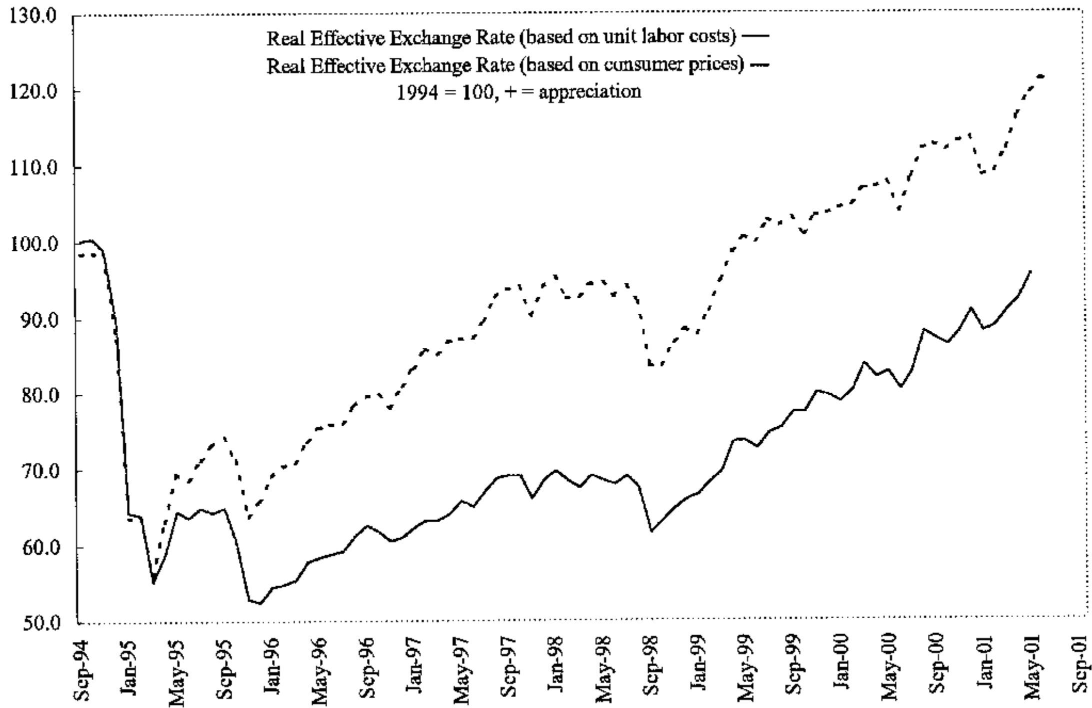
1/ Net of imports for in-bond industries.

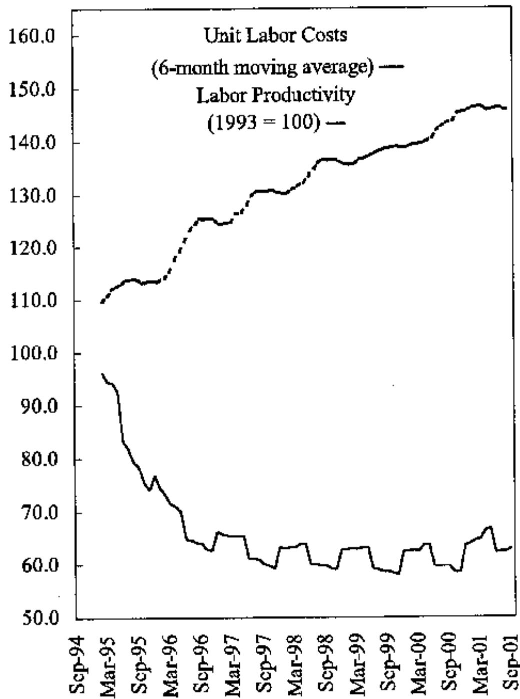
Figure 2. Mexico: Selected Market Indicators

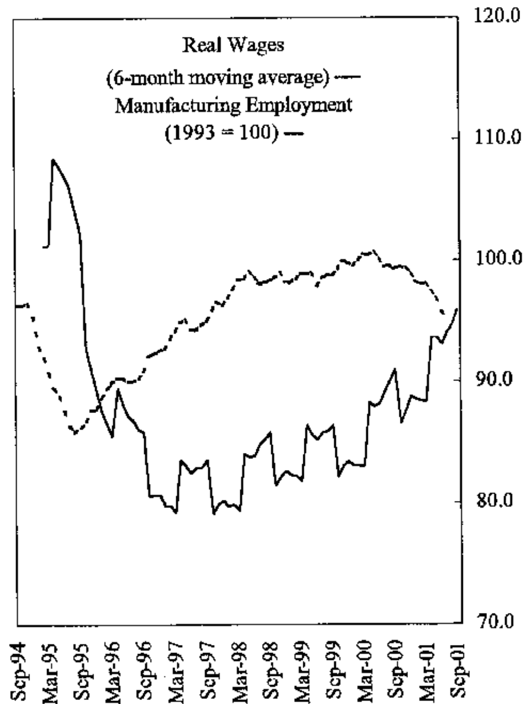


Sources: Bank of Mexico; INEGI; Reuters; and PEMEX.
1/ All countries.

Figure 3. Mexico: Competitiveness and Wage Indicators







Sources: Bank of Mexico; IMF; and INEGI.

4 percent of GDP (down from over 7 percent of GDP in 1999) (Appendix Box 1).[5] Public sector revenues were higher than budgeted, as larger oil revenues more than offset shortfalls in nonrecurring revenues (in particular from privatization).[6] Non-oil tax revenues were broadly in line with the budget (despite a substantially stronger-than-expected pace of economic activity), owing mainly to judicial decisions ordering the return of certain VAT and sales tax receipts. The excess total revenue was used to finance additional expenditures—mainly by public enterprises—and to finance the Oil Stabilization Fund (OSF) (0.2 percentage point of GDP). The primary fiscal stance (excluding oil export revenues) provided a positive impulse to the economy in 2000 estimated at 0.7 percent of GDP.

8. **The Bank of Mexico (BOM) maintained a tightening bias in 2000 and early 2001** during which the *corto* (settlement balance) was raised six times amid strong demand pressures. Domestic real short-term interest rates averaged 6 percent (in *ex ante* terms) in 2000 and increased to 10 percent in the first quarter of 2001. However, as domestic demand weakened and interest rates began to decline due to strong capital inflows, the BOM eased the monetary stance in May 2001 through a reduction in the *corto* (from Mex$400 million to Mex$350 million). This decision spurred a further reduction of interest rates and helped reduce appreciation pressures on the peso in the wake of the announcement that Citigroup would acquire Banamex.[7] Domestic real interest rates declined to 2½ percent as of mid-June 2001.

9. Despite the strong international reserve build up, **the monetary base has been within its projected levels for 2000–01**, reflecting sterilization operations by the BOM (Table 6).[8] The growth of narrow money has decelerated in line with the slowdown in

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[5] A large part of the decline stems from lower interest costs of bank and debtor-support operations.

[6] The shortfall in privatization receipts reflected, in part, delays in the sale of some regional airports, and legal (antitrust) constraints that prevented the sale of assets in an insurance company. Under the comprehensive definition of the fiscal balance, privatization receipts are treated as a financing item.

[7] In May 2001, it was announced that Citigroup would acquire Banamex (Mexico's largest locally-owned bank) for US$12½ billion (2 percent of GDP); the transaction is expected to be completed in the fourth quarter of 2001.

[8] To moderate the accumulation of international reserves, the BOM suspended, starting in June 2001, the rule-based sale of foreign exchange options that had been in place since August 1996. Purchase of foreign exchange through the option mechanism was intended to dampen the real appreciation of the peso within the context of a floating exchange rate regime. At roughly the same time, BOM also announced that it would no longer intervene to limit sharp peso depreciations by selling up to US$200 million a day if the peso were to

(continued)

economic activity, while bank credit to the private sector fell by 10 percent in real terms in 2000. Nevertheless, there are indications that real bank credit to the private sector is starting to expand when considering performing loans (excluding UDI and FOBAPROA/IPAB-restructured loans).

Adjusted Bank Credit to the Private Sector 1/
(12-month percentage change in real terms; end of period)

	1998	1999	2000				2001	
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	May
Total	**-7.7**	**-16.3**	**-10.0**	**-4.3**	**2.5**	**1.8**	**7.2**	**5.2**
Consumption	-5.3	-1.8	7.7	10.8	17.3	23.3	37.5	37.7
Housing	-10.3	-13.4	-6.8	-6.7	-5.4	-9.2	-11.9	-9.2
Commercial	-8.1	-21.3	-14.6	-7.4	1.3	0.6	5.7	2.3

Source: Bank of Mexico.

1/ Includes peforming loans, with the exception of UDI and FOBAPROA/IPAB-restructured loans.

10. **The external current account deficit remained broadly unchanged at 3.1 percent of GDP in 2000 (Table 7),** as markedly higher oil and non-oil exports were offset by stronger-than-anticipated import growth associated with the expansion of domestic demand. The non-oil current account deficit rose to 6 percent of GDP (compared with 5 percent in 1999). However, both export and import growth started to decelerate in the second half of 2000.

11. **Capital inflows** in 2000 were led by foreign direct investment (which financed about three-fourths of the current account deficit) and sizable corporate borrowing. While the public sector accounted for a US$3 billion outflow (due to substantial pre-payments of external debt) and the banking sector continued to reduce its foreign exposure (Table 7),

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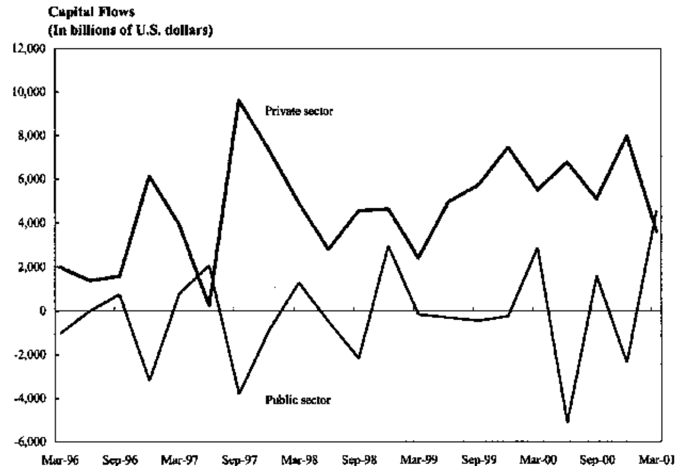
depreciate by more than 2 percent in a given day. Such sales occurred only once in 2000, and not at all so far in 2001.



private corporations attracted net inflows of over US$9 billion, mainly in the form of bank credits (see Figure). Capital inflows strengthened in the first quarter of 2001, with foreign direct investment at US$3.6 billion (an annual increase of 10 percent), despite the economic slowdown. Capital flows to the private corporate sector also were buoyant and foreign purchases of local government securities picked up strongly, responding to the high relative interest rates. The government took advantage of favorable market condition in early 2001 to raise US$2.2 billion in two bond issues, an amount more than sufficient to cover total bond redemptions in 2001.

12. **Mexican financial markets have been largely unaffected by the economic and financial turmoil in Argentina and Turkey,** in the context of the sound economic policies being pursued and an expected upgrade to investment quality by S&P.[9] Mexican yield spreads have generally outperformed those in other emerging markets, with the EMBI+ Mexican sub-index having declined by 53 basis points since end-January 2001 (to 310 basis points as of end-June 2001), compared with an increase of 92 basis points for the overall index (a decline of 1 basis point excluding Argentina and Turkey).

13. **Total gross (augmented) public sector debt declined to 46.2 percent of GDP at end-2000 (from 51 percent in 1999).**[10] Public external debt declined from 19 percent of GDP at end-1999 to 15 percent of GDP at end-2000 (excluding IMF), reflecting substantial prepayments (see Table 8 and Appendix Box 2). Domestic debt resulting from bank restructuring operations also declined as a share of GDP, as the real interest component of those liabilities was paid in cash beginning in 2001. Domestic debt of the federal government, on the other hand, rose somewhat to 13 percent of GDP, as the government increased its reliance on domestic debt instruments. Total gross (augmented) public sector debt is expected to remain about unchanged at 46 percent of GDP in 2001 (see Appendix Table I).

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[9] Moody's upgraded Mexican sovereign bonds to investment-grade status in March 2000.

[10] This is equivalent to a net (augmented) debt-to-GDP ratio of 41.7 percent at end-2000. The authorities report a net (augmented) debt-to-GDP ratio of 40.2 percent for this period; the difference is due to the authorities' use of fourth quarter (annualized) GDP compared with the staffs' use of average annual GDP.

14. **There has been a considerable improvement in the health of the Mexican banking sector since the last Article IV consultation discussions (Appendix Box 3).** Financial strength indicators show a marked improvement. The overall capital adequacy ratio, after adjustments to the book value of certain assets and liabilities by the FSAP mission,[11] complies with the minimum requirement of 8 percent of risk-weighted assets. Individually, almost all banks meet this requirement (as estimated under FSAP methodology). Asset quality indicators have improved—largely reflecting the conclusion of debtor relief programs. Finally, while bank profitability is rising, it could come under some short-run pressure if interest rates decline further.[12]

III. Policy Discussions

15. **The main focus of the discussions was on:**

- The mix of fiscal and monetary policies in light of the weakening of economic activity and the uncertain global financial market conditions.
- Progress in implementing planned structural reforms, particularly fiscal transparency, tax policy, and banking sector reform (in coordination with the FSAP mission).
- Conditions necessary for a substantial fiscal consolidation in the medium term.
- The vulnerability of the Mexican economy to shocks.

16. The staff supported the authorities' **macroeconomic policy stance,** emphasizing the need for a tight fiscal policy to reduce pressures on monetary policy and expressing concerns about the competitiveness of the economy. Moreover, the staff considers that this policy stance is warranted, in light of existing external risks (including the continued threat of financial market turbulence) to maintain investor confidence in the Mexican economy. The authorities agreed with this view, as evidenced by their recent **tightening of fiscal policy** (cyclically-adjusted) through expenditure cuts (described below) and their announcement that they will make further cuts as needed to achieve the targeted budget deficit. The staff also supported the BOM's lowering of the *corto* (which to a large degree accommodated existing downward market pressures on interest rates). It cautioned, however, that **monetary policy should remain focused on achieving the inflation target** over the longer term. This

[11] The main adjustments were the reduction of the deferred-tax assets up to the limit allowed as from January 2003, the deduction of intangible assets, and the increase of liabilities for unreserved FOBAPROA contingencies.

[12] Banks have substantial income from interest earnings on government paper. However, a reduction in interest rates would create incentives for banks to seek alternative sources of earnings, including by increasing lending to the private sector.

rebalancing of the fiscal/monetary mix should ease appreciation pressures on the exchange rate and support real economic growth.

17. The mission concurred with the authorities about the importance of early passage of the authorities' **tax reform package, which was presented to congress last April.** The authorities are committed to tax and administrative reforms needed to reduce the dependency of the tax system on petroleum revenues and enhance medium-term public debt sustainability, while enabling increased social expenditure.

18. **The recent FSAP mission did not identify systemic risks to the financial system.** It concluded that the Mexican financial system has improved its resilience to shocks in recent years. At the same time, it identified weaknesses in certain areas that would require further work to improve rules regarding troubled institutions, the operation of development banks, the framework for housing finance, as well as the observance of financial sector standards, codes, and best practices, as explained in the accompanying Financial System Stability Assessment (FSSA) report (Appendix Box 4).[13] Congress has approved a number of legal amendments that partly address weaknesses in the financial sector legal infrastructure.

A. Fiscal Policy

19. **The 2001 budget** established a deficit ceiling of 0.65 percent of GDP (equivalent to a PSBR of 4 percent of GDP).[14] During the first quarter of 2001, public sector revenue was below budget due to lower oil export volumes and lower income tax collections.[15] To compensate for the revenue shortfall, the government announced spending cuts equivalent to 0.05 percent of GDP as mandated by the automatic adjustors in the budget.[16] For the

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[13] Section II of the FSSA contains the summary assessments of compliance with internationally recognized standards, which constitute the ROSCs for the financial sector.

[14] The authorities earlier had indicated their intention of keeping the deficit at, or below, 0.5 percent of GDP, but given the economic slowdown, are now aiming for the budget deficit ceiling of 0.65 percent of GDP.

[15] VAT collections were better than budgeted—reflecting the resilience in private consumption despite the slowdown in the economy—but were insufficient to compensate for the other tax shortfalls.

[16] The 2001 budget adjustors mandate that if revenues exceed budget estimates, two-thirds of revenues would be saved and one-third could be spent on infrastructure investment projects in poor and remote areas, and for oil production. If revenues are below budget then: 1) if due to lower oil revenue, the shortfall can be compensated with resources from the OSF (for an amount not to exceed 50 percent of the OSF resources); and 2) if the oil revenue shortfall exceeds the possible use of OSF resources, or if the shortfall originates in other revenue, expenditure must be cut by an amount equivalent to the revenue shortfall.

remainder of the year, the staff projects an additional revenue shortfall of 0.3 percent of GDP. **In addition, sensitivity analysis** indicates that there are further risks to the budget, especially from lower GDP growth (see Box 1) and/or a further appreciation of the currency. The authorities concurred with the staff's estimates (presented below) and emphasized that they stand ready to implement additional expenditure cuts, as needed, to meet the budget deficit target.

Sensitivity Analysis

	Increase in Budget Deficit	Increase in External Current Account Deficit
Annualized effect of:	(In percentage points of GDP)	
1 percentage point lower GDP growth rate 1/	0.1	0.3
1 percentage point higher domestic interest rate	0.2	...
1 percentage point higher external interest rate	0.0 2/	0.1
1 percent appreciation	0.1	0.2
US$1 less per barrel of oil	0.1	0.1

Source: IMF staff estimates.

1/ The lower Mexican GDP growth is assumed to stem from lower U.S. GDP growth (2 percentage points). The effect of lower exports on the current account deficit more than offsets the effect of lower imports (due to lower domestic GDP growth).

2/ Rounded. To two decimals, figure would be 0.05.

20. Given the weaker-than-originally-envisaged growth prospects, the deficit target of 0.65 percent of GDP implies a tighter fiscal stance than in the original budget and relative to last year (see Table 5). The authorities stressed the importance of meeting the original fiscal target, despite the lower economic growth, to help rebalance the policy mix and, thereby, alleviate appreciation pressures on the exchange rate. In addition, such a policy stance, together with the approval of the tax reform, would send a strong signal to the markets about the authorities' commitment to strengthen the medium-term fiscal position. The authorities also emphasized that, even in the short term, the benefits from the resulting lower interest rates and increased market access would exceed the costs associated with the negative fiscal impulse.

21. Mexico has made considerable progress in improving **fiscal transparency** since the last Article IV consultation:

- The authorities published a comprehensive measure of the fiscal deficit (PSBR) for 1990–2000 (see Appendix Box 1); they also set a calendar for the release of fiscal data, now publishing monthly fiscal data (the budget definition) and quarterly fiscal data (the broader PSBR definition).
- The complete 2001 budget has been posted on the Internet.
- The authorities have completed the Self-Evaluation Report, and have requested technical assistance from the Fund to prepare a fiscal ROSC module.
- The authorities introduced financial incentives for sub-national governments to improve the publication of fiscal statistics.
- The authorities presented draft legislation to congress to enhance the transparency of the budgeting process (including through lengthening the period to discuss the budget in congress).

22. The **tax reform** proposed by the authorities seeks to boost revenue by eliminating most exemptions and by simplifying the system in order to facilitate compliance and its administration (Box 2). The proposed elimination of VAT exemptions and zero-rating on domestic sales of foods and medicines and of special regimes faces strong opposition in congress.

23. **The authorities estimate that the tax reform would have a net yield** of 1.2 percentage points of GDP on an annual basis (after mandated transfers to the states and the compensation program for the poor) (see Box 2). Also, by **improving tax administration**, the authorities expect to collect an additional 1.5 percentage points of GDP by 2006 (0.3 percentage point in the initial year) (Table 9). The mission cautioned that the revenue yield from administrative measures was feasible only if accompanied by a suitable tax reform. To ensure that the administrative measures are effective, the authorities indicated that they would seek technical assistance from the Fund. **The government's reform proposal includes a shift in the VAT from an accrual to a cash basis.** The staff warned that this could erode the auditing capability of the tax administration agency and encouraged the authorities to reconsider this proposal.[17]

[17] This shift would discourage the use of invoices and reduce their value as an auditing tool. It would likely result in reduced VAT collections and would place Mexico as the only OECD country using a cash basis for VAT across all taxpayers.

Box 2. The Tax Reform Proposal

The authorities presented to congress a comprehensive tax reform proposal in April 2001 that includes **changes in tax legislation, the tax code, and tax administration**. The main objectives of the tax reform are to increase tax revenues, while improving the neutrality of the system, reducing compliance costs, and reducing the fiscal barriers of entry to the formal economy. The authorities expect to collect 1.2 percentage points of GDP from the tax reform on a net annual basis and in addition, 1.5 percentage points of GDP from improvements in tax administration over the next five years.

Main elements:

eliminate most VAT exemptions and zero-rating on domestic sales, e.g., books, magazines, processed and unprocessed foods, medicines, equipment for agriculture and fishing, and land transportation;

limit the application of the reduced 10 percent VAT rate in border regions (the general rate is 15 percent);

eliminate special income tax regimes for different sectors and regions;

reduce the top personal income tax rate from 40 percent to 32 percent;

eliminate the 5 percent withholding of distributed corporate profits; and

unify the corporate income tax rate with the top marginal rate for individuals.

The streamlining of the current tax system seeks to reduce incentives for businesses to remain in the informal sector. This will be accomplished through a reduction in accounting requirements for small business, simplification of inflation adjustment calculations, promotion of electronic filing, elimination of information statements and the introduction a cash-flow concept for the income tax calculation of individuals with business activities, among other measures. The reform also introduces the possibility of claiming depreciation allowances based on the present value of the investment (for projects outside of the main industrial centers) and proposes to move the VAT from accrual to cash accounting for all taxpayers. Administrative measures intend to curtail tax evasion and fraud and to improve taxpayer services. Finally, the reform of the tax code will ensure legal stability by reducing administrative discretion.

To broadly compensate the poor from the expected negative effects of the proposed reduction of VAT exemptions and zero-rating, the government has prepared several measures to target the most vulnerable groups (approximately 5 million families). For the rural poor, cash transfers will be increased; for the urban poor with wage earners in the formal sector, the reform proposes to increase the negative income tax and to raise the income tax threshold to four times the minimum wage; and, for the urban poor whose main source of income comes from the informal sector, the authorities are working on improving targeting of in-kind transfer programs.

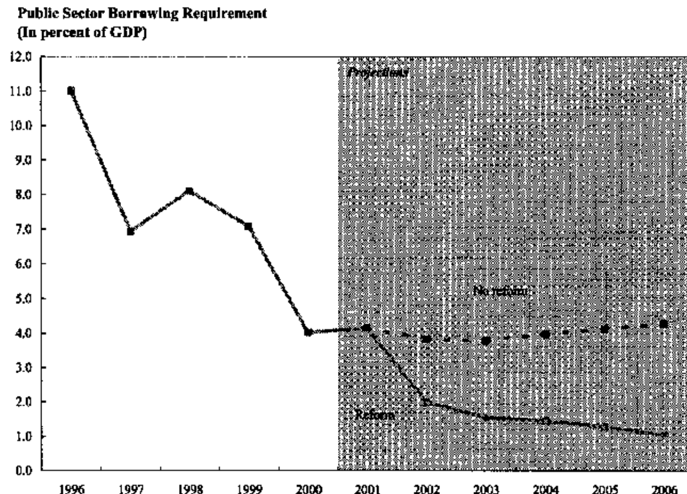
The reform proposal has faced strong opposition in congress and some parties have advanced **alternative proposals**, which include:

reducing the national VAT rate to 10–12 percent and introducing a 3–5 percent state sales tax;

eliminating only some exemptions on foods and medicines, leaving a list of exempt or zero-rated items; and

raising the corporate income tax to 35–36 percent to offset the foregone revenue from maintaining certain corporate income tax exemptions.

24. **The authorities aim at reducing significantly the PSBR over the medium term. The staff noted that, indeed, a substantial fiscal consolidation could be achieved by 2006, provided most of the revenue yield from the proposed reform is saved as envisaged by the authorities.** In this case, the PSBR would decline from 4 percent of GDP in 2000 to 1 percent in 2006, while the net (augmented) public sector debt/GDP ratio would decline from 41.7 percent to 34 percent (see Table 9) (see Figure). During 2002–06, primary expenditure would increase by 0.9 percentage point of GDP (following a contraction of 0.5 percentage point of GDP in 2001) mostly due to higher mandated transfers to the states (0.5 percentage point of GDP) and compensation programs for the poor (0.2 percentage point of GDP). Total interest payments would decline from 5.5 to 3.3 percent of GDP.[18] However, there would be little room for any additional expenditure.



25. Staff also indicated that under current trends and **in the absence of the tax reform,** the PSBR would remain at over 4 percent of GDP and the net (augmented) debt/GDP ratio would increase to over 47 percent, in part reflecting a lower real GDP growth and higher real interest rates (as a result of weaker fundamentals).[19] The authorities emphasized that even in the absence of the tax reform, they would expect considerable improvements in tax administration resulting in important additional revenue.

26. **The government is considering a reform of the electricity sector in order to allow private sector participation.**[20] The authorities indicated that, currently, they do not intend to

[18] The PSBR improves by only 3.2 percentage points of GDP, because oil and non-recurrent revenues are expected to decline by 1.4 percent of GDP.

[19] The no-reform simulation assumes that GDP growth would be closer to 4 percent a year (compared with 5½ percent with reform) and that real interest rates would average 7 percent (see Chapter 3 in the accompanying Selected Issues paper).

[20] This would require a constitutional reform as the Mexican Constitution states that the generation, transmission, and distribution of electricity as a public service will be carried out exclusively by the public sector. Private participation in the sector today is limited to self-generation and Public Investment Projects Financed and Executed by the Private Sector with Deferred Budgetary Impact (PIDIREGAS) projects, where the public sector assumes the commercial and market risks.

privatize public generation or distribution companies, but rather would rely on the private sector to undertake future investment needs. Staff mentioned that existing subsidies in electricity pricing would need to be phased out for the reform to be successful. The authorities indicated that in the coming months electricity bills would explicitly identify the subsidy received by each customer, as a means of creating awareness of the magnitude of these subsidies.

27. **The government is committed to improving the efficiency of social spending through continued support for the decentralization process and improvements in transfer programs.** Concerning decentralization, the authorities continued the process of transferring additional responsibilities to sub-national governments—the 2001 budget transferred the responsibility of technical and adult education to the states.[21] Also a special purpose fund was created in the budget for strengthening security and public safety at the local level. The authorities stressed their continuing support of PROGRESA (program of direct transfer to the poor) and are planning to expand coverage to an additional 500,000 families. This would bring total coverage to 3.2 million families and introduce the program in semi-urban areas. Also, within PROGRESA, they are expanding the education subsidy to cover the last four years of high school (previously the program only covered from 3rd grade to 9th grade). Financial discipline continues to be imposed on local governments through tight restrictions on borrowing.

B. Monetary and Exchange Rate Policy

28. The staff supported the **BOM's easing of monetary policy** in mid-May 2001 in light of the favorable outlook for inflation, the weak economic growth prospects this year, and the need to mitigate the continued appreciation pressure on the peso. The authorities stressed their determination to maintain a monetary policy stance consistent with their medium-term inflation objective. They also noted their intention to tighten monetary policy to offset any indirect (or second round) impact of the tax reform on prices, while accommodating its direct impact.

[21] Mandated transfers to the states were introduced in 2000 that formally transfer expenditure responsibilities to the states, through a transparent rules-based system (the federal budget eliminated all discretionary transfers).

29. The monetary program for 2001 further de-emphasized the importance of monetary aggregates in the **conduct of monetary policy by adopting a formal inflation-targeting framework** (Box 3).[22] End-period inflation has been targeted to decline to no more than 6½ percent in 2001, 4½ percent in 2002, and 3 percent in 2003. Monetary policy is conducted in a flexible manner with settlement balances (the *corto*) as its operational target.[23] The mission discussed with the authorities the advantages of moving toward a **direct targeting of short-term (overnight) interest rates,**[24] emphasizing that the transparency of this approach would improve signaling to financial markets and reduce short-term interest rate volatility (but would likely raise short-term exchange rate volatility). While emphasizing that the *corto* has been effective, the BOM indicated that they would only consider moving toward a direct targeting of interest rates as conditions changed. In particular, the inflationary impact of increased exchange rate volatility would become more muted as inflation declines to industrial country levels, the BOM's credibility in fighting inflation is further established, and the exchange rate pass-through to prices is reduced.

30. The mission agreed with the authorities that the ongoing efforts to strengthen the banking system should foster a healthy and broad-based **resumption of bank credit**, thereby increasing the effectiveness of monetary policy over the medium term. However, the authorities also noted that, despite the limited bank intermediation, monetary policy has been effective in controlling aggregate demand and reducing inflation, as higher short-term interest rates also tend to push up the cost of nonbank credit.

C. Banking System

31. **The Mexican banking system has been strengthened considerably in the recent past and important progress has been made in the implementation of international standards and codes,** but further actions are required to make the banking system more resilient to shocks and achieve full observance of international standards. This assessment is further developed in the FSSA report (see Appendix Box 4). The authorities indicated broad

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[22] The adoption of a formal inflation-targeting framework was announced in January 2001, when the monetary program for 2001 was released.

[23] With a view to maintaining the central bank's creditor position in its open market operations and the effectiveness of the *corto*, remunerated deposits of commercial banks in the BOM were increased in late June. Unlike previous occasions when this mechanism was used, this time the deposits are voluntary. The authorities have emphasized that this measure is not intended to change the stance of monetary policy in the near term as the liquidity withdrawn will be returned to the market through open market operations. For details on the operational aspects of monetary policy in Mexico see Box 2 in EBS/99/97, Supplement 1.

[24] Short-term interest rates are currently used as the operational target of monetary policy in all other inflation-targeting countries.

Box 3. Inflation Targeting in Mexico

Mexico announced the adoption of a formal inflation-targeting framework in January 2001, at the time of the release of the monetary program for 2001. This announcement was the culmination of a gradual process of rebuilding the credibility of the BOM, which had been damaged by the rapid rise in inflation in the aftermath of the 1994-95 peso crisis; 12-month inflation declined to single digits in 2000 for the first time since 1994. Also, the important progress in fiscal consolidation (reaffirmed in the 2001 budget) and the recent (and substantial) strengthening of the banking system influenced the timing of this announcement.

The BOM has a **legal mandate to achieve price stability** as well as the instrument independence to pursue it. Monetary policy in Mexico is conducted in a flexible manner with settlement balances as the operational target, using a mechanism known as the *corto* (short). Although Mexico is unique among countries that employ inflation targeting in its operational target (short-term interest rates are currently used in all other inflation-targeting countries), a well-documented positive correlation exists between increases in the *corto* and subsequent increases in market-determined interest rates. In addition, under a system such as Mexico's in which interest rates and the exchange rate are market determined, external shocks affecting country risk are absorbed by both variables, and short-term interest rates could move without the immediate need to change the *corto*. Exchange (interest) rate volatility would tend to be lower (higher) than under short-term interest rate targeting, and this could have important implications for inflation, especially if the exchange-rate pass through to prices were large. **A comparison between Mexico and New Zealand (which until March 1999 had an operational target similar to Mexico's and has since moved to interest rate targeting) indicates that under the *corto*, exchange rate volatility has been less than in New Zealand and short-term interest rate volatility has been greater.**

Short-Term Interest and Exchange Rate Volatility
(In percent)

	Interest Rate Volatility 1/		Exchange Rate Volatility 1/	
	New Zealand	Mexico	New Zealand	Mexico
1998H1	3.2	5.1	12.5	6.7
1998H2	14.4	57.9	15.1	11.1
1999H1	5.7	20.6	9.5	9.9
1999H2	0.3	5.3	10.1	7.1
2000Q1	1.0	6.2	11.2	5.9
2000Q2	0.9	9.1	13.5	7.2
2000Q3	0.1	11.5	11.4	9.1

Sources: Martinez, L., Sanchez, O., and Werner, A. "Consideraciones sobre la Conducción de la Política Monetaria y el Mecanismo de Transmisión en México," Discussion Paper No. 2001–02, BOM, March 2001.

1/ Volatility is measured by the coefficient of variation.

Currently, the BOM does not have an official inflation model and, hence, does not publish inflation projections. However, **the BOM is studying the use of formal inflation models**, as in other inflation-targeting countries. This has been difficult to implement in light of the **changing nature of the inflation process** in Mexico, which has evolved from being closely related to supply shocks, to being increasingly associated with aggregate demand developments. In order **to gauge the appropriateness of the monetary policy stance** the BOM compares, *inter alia*, the level and trend of inflation expectations of private analysts with the official target, and monitors aggregate demand, wage settlements, and exchange rate developments.

The **BOM communicates its views** to the market primarily through quarterly inflation reports published one month after the end of each quarter. The governor and members of the governing board of the BOM make more frequent communications with the market via public speeches. Also, whenever the *corto* is changed, a press release is made available explaining the rationale for the action.

agreement with the thrust of the FSAP recommendations and said the technical discussions provided useful inputs for their ongoing efforts to reform the financial sector.

32. **According to the FSAP, the banking sector is not likely to become a systemic problem.** The recent strengthening of capital, and improving asset quality and profitability trends support this assessment. Moreover, increased foreign participation in the banking system created greater resiliency because of the introduction of strong shareholders, competitive pressures, and more efficient credit infrastructures. Nevertheless, there was still a need to continue strengthening supervision, ensuring strict enforcement of regulations, and improving coordination with foreign supervisors. Also, vulnerabilities exist in the domestic payments system and in the open bank resolution approach. The FSAP mission also identified potential exchange rate and credit risks in the nonfinancial corporate sector as a vulnerability (see below about actions that the authorities are taking concerning these vulnerabilities).

33. **Staff noted that the main challenge for the banking sector was the resumption of broad-based and sound lending to the private sector.** Substantial bank lending to the private sector likely would require a sustained reduction in interest rates, a pick-up in the pace of economic activity, and reforms that improve credit infrastructures (including the judicial system to ensure credit rights, public registers, and the debtor information system). Risks to a resumption of credit growth include slower-than-expected progress in fiscal reform and, in the short term, a less-rapid-than-projected recovery of economic growth. The authorities were in broad agreement with this assessment, but were somewhat more optimistic about the prospects for credit growth in the near term.

34. **Staff emphasized the importance of the ongoing process of legislative reforms aimed at addressing weaknesses in the legal framework.** In particular, congress has already approved new legislation on credit institutions, securities markets, investment associations, financial groups, national saving banks, and popular savings and credit institutions. In this regard, the staff noted the authorities rapid action in creating the "Committee for the Modernization of the Financial System," which aims at identifying and following up on issues related to the structure, operation, and regulation of the financial sector, such as: an adequate framework for closing, resolving, and liquidating nonviable banks; structural reforms to modernize the state-owned development banks; structural reforms to increase the efficiency of financial conglomerates; and, an action plan to strengthen banking supervision further.

D. External Sector Policies

35. **The external current account deficit** is projected to increase to 3.5 percent of GDP in 2001, due to lower oil prices, while the non-oil current account deficit would narrow slightly to 5.6 percent of GDP (see Table 7). Both non-oil export and import growth is projected to decelerate markedly, reflecting weak demand conditions in the United States and in Mexico, leading to a broadly unchanged non-oil trade balance. At the same time, the income balance is expected to improve due to lower external interest rates and spreads.

36. **Foreign direct investment (FDI) is expected to amount to 119 percent of the 2001 current account deficit**, after the proposed Citigroup's acquisition of Banamex.[25] However, it is likely that this transaction will be largely reflected in an increase of assets abroad in 2001, partially reversed in future years. Other private capital flows are expected to moderate this year, given the narrowing interest rate differential. Although public sector net external borrowing in 2001 is projected to be nil (in accordance with the authorities' announced policy), staff are forecasting a US$5.5 billion net inflow mostly on account of the release of Brady collateral and foreign purchases of local government securities.

37. **Net international reserves** are projected to increase by US$4.7 billion in 2001, which implies a US$0.5 billion decline between the end of June and the end of the year (see Table 7). The authorities stressed that they consider the current level of reserves adequate based on stress tests carried out by the BOM and also on traditional ratios (including to short-term debt), and taking into account the flexible exchange rate regime.

38. Although the authorities recognized the possibility of a **negative credit shock in emerging markets** as a potential source of risk that could affect capital flows, they stressed that so far the crises in Argentina and Turkey may have actually had a positive effect on Mexico, which increasingly has been seen as a "safe haven" among emerging markets. They also pointed out that the public sector had already completed its market-borrowing program for 2001 and that the liability management operations conducted in the past years had helped create a smooth redemption schedule (see Appendix Box 2). Finally, they were confident that even in the event of a sharp increase in investors' risk aversion, the effects on Mexico likely would be short-lived given the country's track record of implementing prudent macroeconomic policies, including following the market turbulence in 1998.

39. The staff argued that the trend and the level of the real exchange rate pose some concerns as does the deterioration in the non-oil current account deficit (Figure 4), although other external vulnerability indicators stand at comfortable levels (Table 10). Partly mitigating these concerns, Mexican non-oil exports have been gaining market share during 1995–2000.[26] The authorities questioned the use of the real exchange rate as an external

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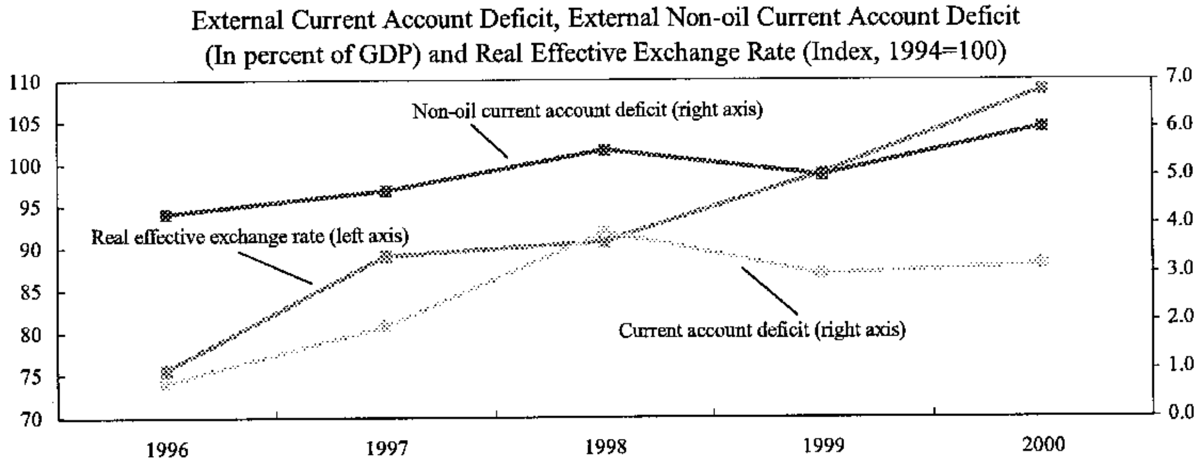
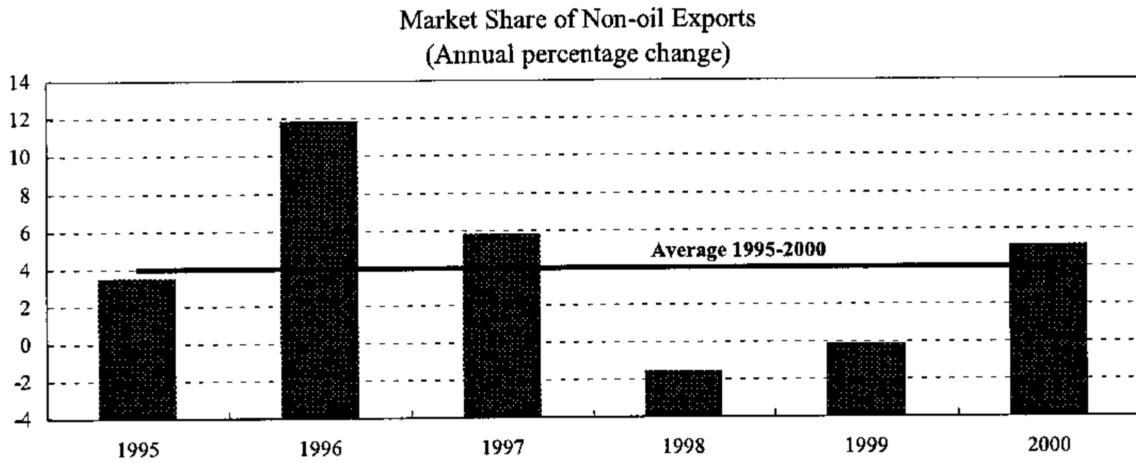
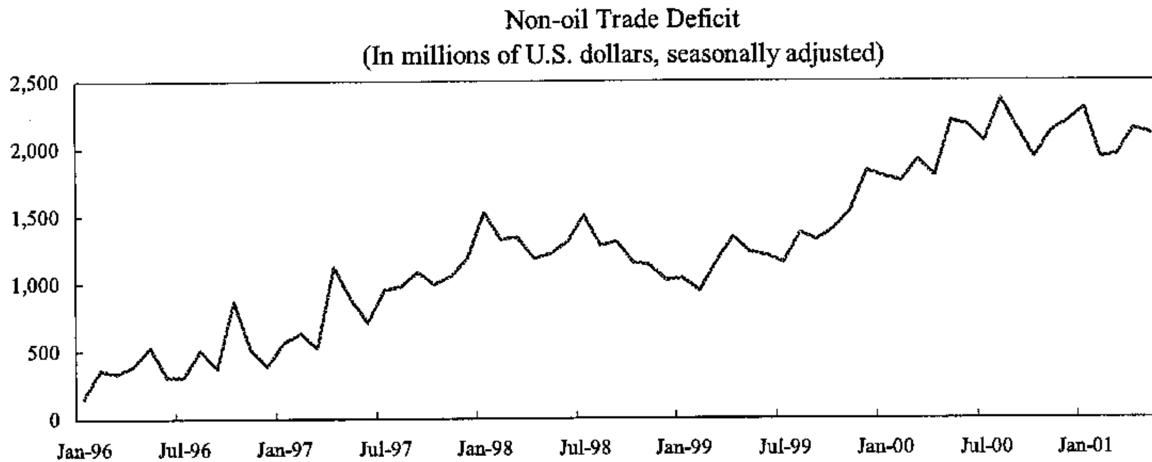
[25] Excluding the proposed Citibank acquisition, 2001 FDI would amount to over 60 percent of the current account deficit.

[26] This is calculated by comparing the real growth rate of Mexican non-oil exports to the real growth of non-oil import demand of Mexico's trading partners, as reported in the WEO GEE table.

Figure 4. Mexico: External Sector



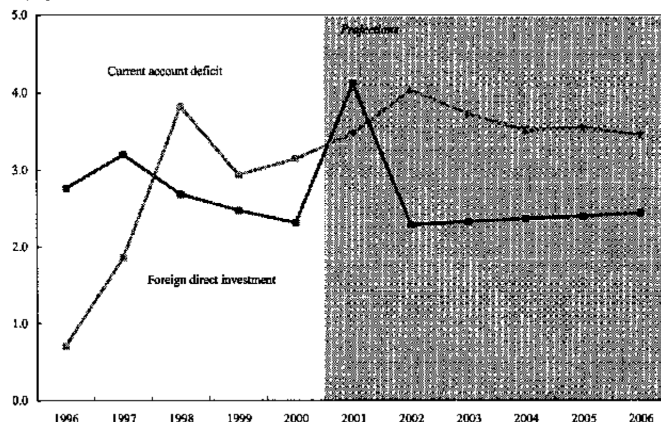




Sources: Bank of Mexico; IMF; and INEGI.

vulnerability indicator in a floating exchange rate regime, particularly given the strength of the other vulnerability indicators. They argued that the real appreciation is a reflection of the fundamental soundness of the economy (including past productivity improvements and structural reform), and that its effect on the trade balance was small and dominated by demand factors. An exercise aimed at calculating the sustainable current account deficit produced various results depending on the sustainability criterion (Appendix Box 5). According to one criterion (based on external debt/GDP) the real exchange rate is not overvalued, while other methodologies indicate that the real exchange rate is overvalued. The authorities gave the highest importance to the debt-to-GDP ratio (the first criterion, see Figure).

External Current Account Deficit and Foreign Direct Investment
(In percent of GDP)



40. Large nonbank corporations have supplanted commercial banks as the main intermediary of international capital inflows, and now are a potential source of vulnerability. The open foreign exchange (FX) position of firms quoted on the stock exchange is small relative to sales abroad, although with a short-term maturity.[27] However, this sample may not be indicative of the whole economy. Staff noted that there is a paucity of information on the exchange rate and credit risks carried by the nonfinancial corporate sector and that the experience of other countries points to the systemic implications of potential corporate distress. In this context, the staff encouraged the authorities to intensify the monitoring of private nonbank external flows and debt. **The authorities concurred with the staff on the importance of further improving private debt data to resolve differences between BOM and SHCP data for corporate sector debt.** [28] However, they argued that they hold a firm policy of no bailouts for private companies, and hence did not see much need for closer monitoring. While the authorities plan to extend the **current bank debt monitoring system** to provide monthly data on banks' total external financing, staff also encouraged the

[27] The most recent data available for December 2000 show a net liability FX position of US$12.7 billion (about 12 percent of annual sales abroad) mostly concentrated with large exporters, with 40 percent of the FX liabilities short-term (by residual maturity).

[28] At present, two sets of private external debt statistics are produced quarterly: one produced by the SHCP, is based on a debtor survey. The other, one produced by the BOM, is based on a creditor survey. The data for 2000 show contrasting trends—the SHCP data show a decline, while the BOM data point to an increase.

authorities to improve information on the exposure of nonbank firms to foreign exchange risks.[29]

41. The only change in **trade policy** that has taken place since the last Article IV consultation is the introduction of tariffs on inputs destined to be re-exported when they are not covered by a free-trade agreement: these "temporary imports" were previously exempt from tariffs. At the same time, programs of sectoral promotion were introduced for 22 manufacturing sectors.[30] The new tariffs on intermediate goods from non-FTA members increase bilateral integration (with the FTA members), but lead to increased administrative requirements and trade diversion. The staff also noted that the increase in tariffs implemented in 1999 on selected imports from non-FTA members has not been reversed. The process of tariff reduction sanctioned in the existing free-trade agreements is proceeding smoothly: by 2003, more than 99 percent of trade with NAFTA partners will fall in the 0 tariff category and by 2007, all industrial products traded with the EU (but only a limited subset of agricultural products) will also fall into the zero tariff category. Mexico has concluded 13 bilateral investment treaties with EU members and only two are still being negotiated—the authorities envisage that almost all will be operational by 2002.[31]

E. Medium-Term Framework

42. Based on the continued implementation of strong macroeconomic policies, the **baseline scenario of the medium-term framework appears favorable** (Table 11). Real GDP growth is expected to rebound strongly in 2002,[32] and assuming continued structural reform, to converge to the potential rate of growth (estimated to be about 5½ percent) over the remainder of the projection period (through 2006).[33] Inflation is projected to decline to under 3 percent in 2003, and remain in line with industrial country inflation thereafter.

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[29] The new system also includes stock and flow information on banks' net FX position, including gross assets and liabilities in FX, and FX derivative transactions. The authorities would also continue to provide weekly information on interbank credit lines, including creditor information, spreads, and roll-over rates.

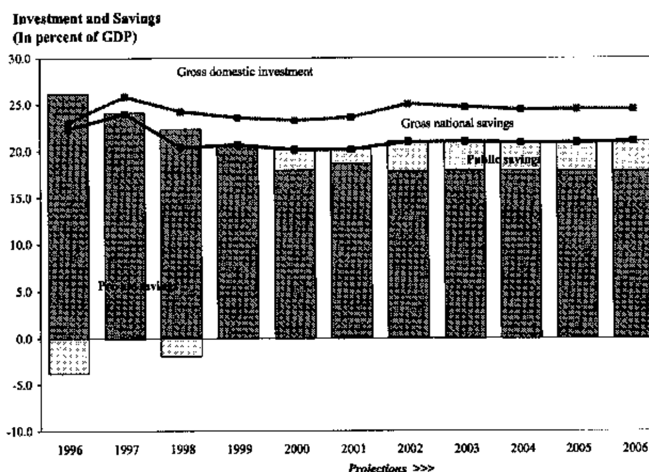
[30] For these, the import tariffs applied to intermediate imports range from 0 to 5 percent. These programs aim at not harming the maquiladora industry, while protecting some domestic manufacturing sectors and leaving the weighted average tariff unchanged at about 3 percent.

[31] Of these, the ones with Denmark, Greece, and Sweden were signed in 2000.

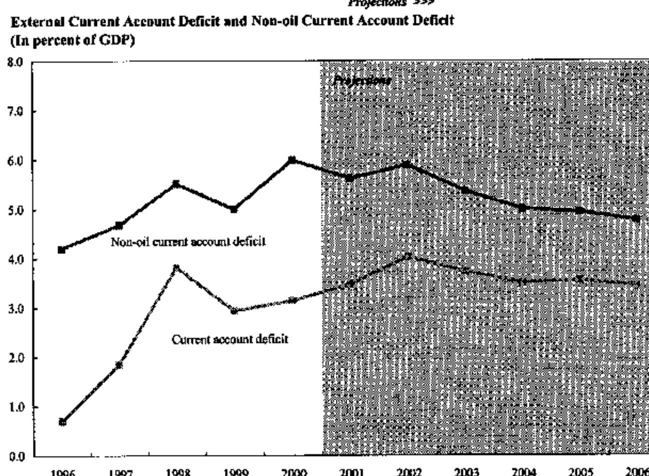
[32] Part of the rebound effect in 2002 is due to the low base in 2001.

[33] See Chapter 1 in the accompanying Selected Issues paper for an analysis of the potential output growth rate in Mexico.

43. As described above, assuming a suitable tax reform, the **augmented public sector deficit would decline to 1 percent of GDP by 2006,** which would help to contain the growth of aggregate demand, ease pressure on real interest rates, and improve external competitiveness. Private savings are projected to experience a modest decline in 2002 (reflecting the large increase in public savings), and thereafter to remain broadly stable (see Figure).



44. The **external current account deficit** would widen modestly in 2002, reflecting a pick up in domestic demand (Table 12). However, from 2003 onwards, the current account deficit is projected to narrow gradually and to stabilize at about 3.5 percent of GDP (with the non-oil current account deficit stabilizing at about 5percent) (see Figure). Total external debt service is projected to fall from 32 percent of exports of goods, services, and transfers in 2001 to 22 percent by 2006 (Table 13). FDI is expected to continue to finance on average over 60 percent of the current account deficit, as the integration between the Mexican and U.S. economies continues to strengthen. As a result, total external debt is forecast to decline to about 22 percent of GDP (99 percent of exports of goods and services) by 2006 from 26 (119) percent at end-2000.



45. While appreciably reduced in recent years, **certain vulnerabilities remain.** The staff believes that the most important risk to the medium-term outlook is posed by the non-passage of a satisfactory fiscal reform. This could undermine investors' confidence and negatively affect the economy's ability to achieve the projected potential growth rate with spillover effects on the external accounts.[34] Sensitivity analysis indicates that the direct impact of a one percentage point decline in output growth in the United States would lower Mexican output growth by about half a percentage point (see additional sensitivity analysis in table above). The authorities reiterated their intention to continue following appropriate policies, including in the event of a major external shock.

[34] Non-implementation of structural reforms, most notably the reform of the electricity sector, could also hinder the achievement of Mexico's long-term potential growth rate.

46. The Mexican authorities expressed **interest in the contingent credit line (CCL).** They indicated that the CCL would help buffer the Mexican economy from possible financial contagion. Furthermore, it would provide the BOM with a precautionary line of credit, allowing a lower gross international reserves target (than without a CCL), with associated savings as the cost of sterilizing increased reserves has been markedly higher than the return on them. The mission discussed a quarterly quantified macroeconomic framework for 2001, and reviewed the CCL's eligibility criteria as they pertain to Mexico. In view of the likely timing of the CCL (some time after the Annual Meetings), additional work would be required on the quarterly quantified program for 2002 and a quantified "stress simulation" to the capital account, and would allow time for a suitable tax reform to be passed by congress. CCL eligibility will also need to take account of the Executive Board discussion of the current Article IV consultation, as well as policies and circumstances at the time of the request.

IV. Staff Appraisal

47. The Mexican economy performed very well since the last Article IV consultation. Economic activity was strong through most of 2000. Reflecting the slowdown in the United States, real GDP growth in Mexico has moderated substantially in 2001, but activity is projected to rebound in the second-half of the year along with a revival in the U.S. economy. Inflation declined below the official target in 2000, reflecting the authorities' tight policy stance and weak demand conditions, is expected to be at (or below) the official target of 6½ percent in 2001. This favorable performance has served to distinguish Mexico so far as a "safe haven" among other emerging markets.

48. The Mexican authorities are to be commended for maintaining prudent fiscal and monetary policies in the face of financial turbulence in emerging markets and the slowdown in the United States. It is particularly noteworthy that the authorities were able to resist pressures to alter their policy stance in 2000, which was a presidential election year. The country is to be congratulated for achieving a smooth, democratic political transition within the context of macroeconomic and structural policies aimed at a sustainable strengthening of the economy.

49. The authorities are committed to hold to their budget deficit target in 2001, recognizing that this involves a further fiscal tightening on a cyclically adjusted basis, and in order to reduce pressures on monetary policy and alleviate concerns about external competitiveness and the non-oil current account deficit. This policy stance is also warranted to maintain investor confidence in the economy, which should help lower borrowing costs and promote economic growth. In this context, the authorities recent expenditure cuts and their commitment to implement additional cuts, as needed, are welcome.

50. The authorities are to be commended for their considerable progress in improving fiscal transparency. In this regard, the monthly publication of traditional fiscal data and the quarterly publication of a more comprehensive definition of the fiscal balance are noteworthy. The recent completion by the authorities of the Self-Evaluation Report and

expected participation in the fiscal ROSC later this year will facilitate further improvements in this area.

51. At the center of the authorities' medium-term economic program is their effort to reform the tax system. The present tax system yields insufficient resources for the country's needs and relies too heavily on oil proceeds. The authorities' tax reform proposal is welcome as it aims at raising additional revenue and simplifying the system in order to facilitate compliance. However, administrative measures will be fully effective only if accompanied by the proposed comprehensive tax reform. The staff supports the authorities' intention to seek technical assistance from the Fund in the area of tax administration.

52. The authorities' objective to strengthen significantly the fiscal position over the medium term is appropriate, as it would enable an important decline in the real public debt stock. This objective can only be achieved if most of the revenue yield from the proposed reform is saved. Furthermore, under current trends and in the absence of the tax reform, real public debt would likely increase and the economy would be considerably more vulnerable to external shocks and fluctuations in the price of oil.

53. The Bank of Mexico's current monetary policy stance is warranted in light of the favorable outlook for inflation, the weak prospects for economic growth, and the need to mitigate the appreciation pressure on the peso. Monetary policy should remain focused, however, on its long-term inflation targets, namely lowering inflation to 3 percent by 2003. While the *corto* has proven to be a flexible and efficient monetary policy instrument, a move toward direct interest rate targeting over the medium term would facilitate the communication of monetary policy intentions to markets, and would be appropriate once monetary policy credibility is further established.

54. The Mexican banking system has been strengthened considerably in recent years, including through the recently approved legislation, and important progress has been made in implementing international standards and codes. As a result, the banking sector is not likely to pose systemic problems. Nevertheless, further actions are required to make the banking system more resilient to shocks and to achieve full observance of international standards. The main challenge for the Mexican banking sector is the resumption of broad-based and sound lending to the private sector, which likely will occur following the expected sustained reduction in interest rates, a pick-up in the pace of economic activity, and reforms that improve credit infrastructure (including the judicial system). Rapid action by the recently formed "Committee for the Modernization of the Financial System" is encouraged to follow up on remaining issues identified in the FSSA report, including resolution procedures for nonviable banks, structural reforms to modernize the state-owned development banks, and an action plan to strengthen further banking supervision.

55. The external current account deficit is projected to increase somewhat in 2001, due to lower oil prices, while the non-oil current account deficit is expected to narrow slightly. Net capital inflows, including substantial foreign direct investment, should be able to cover external financing needs. The authorities' prudent debt strategy has aided in enabling a manageable external debt profile, providing a safeguard against potential "hard landings" in

the external environment. Nevertheless, the authorities recognize the possibility of a negative credit shock in emerging markets as a potential source of risk that could affect capital inflows. In such an event, the effects on Mexico likely would be short lived given the country's track record of implementing prudent macroeconomic policies, including following the market turbulence in 1998.

56. The present level of international reserves is adequate, almost fully covering short-term debt by residual maturity, but they fall short of full coverage of the gross financing external requirement. In this context, Mexico would benefit from having precautionary lines of credit, including from the Fund. Despite the highly successful floating exchange rate regime, the recent trend and level of the real exchange rate pose some concerns regarding the financial health of the traded goods sector. These concerns are tempered by the fundamental soundness of the economy (including past productivity improvements and structural reform); moreover, strong evidence does not exist that the external current account deficit is at unsustainable levels. Staff commend the authorities for their plan to extend the current bank debt monitoring system to provide monthly data on banks' total external financing, but the large recent recourse of the private nonbank corporations to foreign financing is creating a potential vulnerability that calls for careful monitoring.

57. Mexico's data are of good quality, timely, and adequate to conduct surveillance effectively. The authorities have expressed their intention to publish the Article IV consultation staff report.

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

Table 1. Mexico: Indicators of Economic Activity

(Annual percent change, unless otherwise indicated)

	2000				2001					
	QI	Q2	Q3	Q4	QI	Jan.	Feb.	Mar.	Apr.	May
Aggregate supply indicators										
Real GDP	7.7	7.6	7.3	5.1	1.9	...	...	...		
Real GDP (sa change)	11.1	6.4	6.7	-3.0	-0.3	...	...	...		
Coincident indicator of economic activity (sa change)	2.5	2.1	1.0	-0.8	-0.9	0.3	-0.7	-0.4	-0.7	...
Leading indicator of economic activity (sa change)	3.7	0.0	0.1	-0.8	-1.2	0.6	0.0	-1.1	-0.3	...
Global index of economic activity (sa change)	2.7	2.3	0.8	-0.2	0.0	0.2	-0.2	-0.2	0.1	...
Industrial production	8.8	7.1	6.8	3.8	-1.3	1.7	-3.6	-2.0	-3.2	...
Imports (BOP data, US$ terms) 1/	25.9	22.7	23.8	19.8	6.7	16.4	-2.3	7.3	11.0	-3.6
Aggregate demand indicators										
Private consumption	9.6	10.2	10.5	7.6	6.5		...	...	...	...
Retail sales	9.2	10.1	12.4	8.5	8.6	9.5	6.1	10.1	4.6	...
Consumer imports	43.7	39.4	33.8	33.8	29.1	35.0	18.0	34.2	29.5	29.0
Gross domestic capital formation	10.9	10.5	11.1	7.6	0.4	...	...	...	...	...
Fixed capital investment	10.9	10.5	11.1	7.6	0.4	0.4	-0.5	1.3	-1.6	...
Capital imports	16.3	13.4	18.0	21.7	7.5	1.4	5.4	15.4	9.5	-1.5
Construction	6.9	7.1	5.2	1.1	-3.7	-1.0	-5.1	-5.1	-6.3	...
Exports (BOP data, U.S. dollar terms) 1/	27.2	22.2	21.9	17.9	4.1	13.9	-5.1	5.0	7.3	-4.7
Of which: non-oil	20.6	17.5	18.9	18.0	5.6	14.9	-4.4	7.6	9.3	-3.4
Memorandum items:										
Inflation and labor markets										
Consumer price inflation	10.5	9.5	9.0	8.9	7.5	8.1	7.1	7.2	7.1	7.00
Core inflation	12.0	9.8	8.7	7.7	6.7	6.9	6.6	6.5	6.4	6.4
Open unemployment rate (percent, sa)	2.2	2.2	2.2	2.2	2.3	2.3	2.2	2.3	2.3	2.5
IMSS employment 2/	6.6	6.3	6.0	4.8	3.6	4.3	3.7	2.9	2.4	2.2
Nominal contractual wage increases	12.8	12.9	12.9	11.5	10.3	10.4	10.3	10.3	10.7	10.4
In relation to 12-month ahead expected inflation	2.4	3.4	4.1	3.5	2.7	2.4	2.7	3.0	3.2	3.7
Real manufacturing wages	4.4	6.4	6.8	5.6	5.5	7.1	4.8	4.8	3.2	...
Manufacturing labor productivity	3.6	4.0	6.0	4.0	2.2	1.8	2.5	2.2	0.9	...
Manufacturing unit labor costs	-1.2	3.2	0.1	3.2	4.4	3.5	5.9	3.7	2.0	...
Financial markets										
Real ex ante interest rate (28-day cetes, level, in percent)	5.2	5.5	6.3	8.3	10.1	11.0	10.2	9.2	7.7	4.8
External sector										
Non-oil trade balance (sa, US$ billions)	-1.8	-2.1	-2.2	-2.1	-2.1	-2.3	-1.9	-1.9	-2.1	-2.1
(in percent of GDP) 3/	-0.9	-1.0	-1.1	-1.2	-1.0	...	...	...	...	...
Real effective exchange rate										
Relative consumer prices	15.6	6.5	8.3	10.0	4.3	4.1	4.1	4.8	8.9	...
Relative unit labor costs	18.9	11.6	13.5	11.9	10.3	11.9	10.5	8.6	12.7	...

Sources: National Institute of Statistics and Geography; and IMF staff calculations.

1/ Including *maquiladora* industries.

2/ Mexican Social Security Institute. A measure of formal sector employment.

3/ Nonseasonally adjusted.

Table 2. Mexico: Selected Economic and Financial Indicators

	1997	1998	1999	Prel. 2000	Staff Projections 2001	Staff Projections 2002
(Annual percentage change, unless otherwise indicated)						
National income and prices						
Real GDP	6.8	5.0	3.7	6.9	2.5	5.3
Real GDP per capita	5.0	3.2	1.9	5.1	0.7	3.5
GDP deflator	17.7	15.3	15.1	10.7	7.6	5.5
Consumer prices (end of year)	15.7	18.6	12.3	9.0	6.5	4.5
Consumer prices (average)	20.6	15.9	16.6	9.5	7.0	5.4
External sector						
Exports, f.o.b.	13.1	1.1	14.8	21.8	0.3	10.1
Export volume	21.4	9.3	11.4	20.8	4.7	10.5
Imports, f.o.b.	24.6	12.7	10.6	23.1	5.9	13.0
Import volume	23.9	13.5	11.6	19.8	7.3	11.9
Terms of trade (deterioration -)	-1.6	-5.5	4.8	5.9	-3.0	-1.3
Exchange rates						
Nominal exchange rate (US$/Mex$) (average, depreciation -)	-4.0	-13.3	-4.4	1.1	...	...
Real effective exchange rate (CPI based) (average, depreciation -)	17.8	1.9	9.0	10.0	...	...
Real effective exchange rate (ULC based) (average, depreciation -)	12.2	1.3	10.7	13.6	...	...
Nonfinancial public sector						
Real budgetary revenue	5.9	-6.2	6.2	11.8	-0.5	11.1
Real budgetary expenditure	10.9	-4.2	5.7	10.6	-1.6	6.9
Money and credit						
Broad money (M2)	19.1	21.6	16.8	4.9	11.5	...
Monetary base	29.6	20.8	43.5	10.7	11.3	...
Monetary base end-period velocity	-3.1	0.2	-16.9	7.0	-1.4	...
Treasury bill rate (28-day cetes, in percent, annual average)	19.8	24.8	21.4	15.2	14.5	10.3
Real interest rate (in percent, annual average)	6.3	7.7	9.6	6.8	6.0	4.6
(In percent of GDP)						
Nonfinancial public sector						
Overall balance 1/	-1.0	-1.2	-1.1	-0.9	-0.7	0.2
Budgetary revenue 1/	22.8	20.4	20.9	21.8	21.2	22.4
Total expenditure 2/	23.7	21.6	22.0	22.8	21.8	22.2
Primary balance (authorities'/program definition) 3/	3.1	1.7	2.4	2.8	2.8	3.2
Augmented balance (IMF definition)	-6.9	-8.1	-7.1	-4.0	-4.1	-2.0
Non-oil augmented balance	-10.7	-10.4	-9.4	-8.1	-8.0	-5.7
Savings and investment						
Gross domestic investment	25.9	24.3	23.6	23.3	23.6	25.0
Public investment	3.1	2.6	2.9	4.0	3.8	3.9
Private investment	16.4	18.3	18.3	16.9	17.1	18.4
Change in inventories	6.3	3.3	2.4	2.4	2.8	2.8
Gross national savings	24.0	20.4	20.7	20.2	20.2	21.0
Public savings	-0.1	-2.0	-0.1	2.1	1.4	3.1
Private savings	24.1	22.4	20.8	18.0	18.8	17.9
External current account balance	-1.9	-3.8	-2.9	-3.1	-3.5	-4.0
Non-oil external current account balance	-4.7	-5.5	-5.0	-6.0	-5.6	-5.9
Net public external debt (including IMF) 4/	22.0	21.5	18.3	13.3	13.0	11.8
Net domestic nonfinancial public sector debt (end of period) 5/	9.3	10.4	12.8	14.5	14.6	13.8
Net domestic financial public sector debt (end of period) 6/	16.3	18.9	16.4	13.9	13.7	13.1
(In percent of exports of goods, nonfactor services, and transfers)						
Public external debt service 7/	36.2	21.6	22.5	26.0	16.1	12.1
(In billions of U.S. dollars, unless otherwise indicated)						
Change in net international reserves (increase -)	-13.5	-3.7	-3.9	-8.2	-4.7	-4.0
Gross official reserves in percent of short-term debt 8/	64.1	70.9	74.6	89.8	94.2	98.6
Gross external debt (in percent of GDP, end of period)	38.2	38.4	34.7	26.0	24.8	23.5
Oil export price (US$/bbl)	16.5	10.2	15.7	24.8	19.8	18.1

Sources: National Institute of Statistics and Geography; Bank of Mexico; Secretariat of Finance and Public Credit; and Fund staff estimates and projections.

1/ Includes privatization proceeds.
2/ Includes extrabudgetary balance.
3/ Treats bank restructuring transfers as interest expenditure.
4/ Includes the IMF and public development banks and trust funds net of the collateral of Brady bonds.
5/ Includes the federal government and public enterprises. Net of federal government liquid assets. Includes PIDIREGAS liabilities.
6/ Includes bank restructuring, debtor support liabilities, and the debt of public development banks and trust funds. Net of liquid assets of the federal government and IPAB. Also, net of IPAB assets from debt-support operations, in-kind loan collections, and loss-sharing agreements.
7/ Includes the IMF and public development banks and trust funds.
8/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

Table 3. Mexico: Quantitative Performance Criteria 1/

	2000			
				Indicative
	Mar.	Jun.	Sep.	Dec.
(In millions of Mexican pesos)				
Overall fiscal balance 2/				
Program floor	2,002	3,499	-7,260	-52,502
Adjusted floor	2,002	3,499	-1,228	-28,056
Outcome	8,209	26,309	11,817	-50,956
Margin	6,207	22,810	13,045	-22,899
Primary fiscal balance 3/				
Program floor	54,031	102,656	153,431	149,341
Adjusted floor	54,031	102,656	159,463	174,829
Outcome	61,653	114,684	163,002	152,488
Margin	7,622	12,028	3,539	-22,341
Change in net domestic assets 4/				
Program ceiling	-40,157	-30,647	-30,262	17,144
Adjusted ceiling	-40,157	-30,647	-30,262	17,144
Outcome	-82,628	-43,739	-91,339	-57,152
Margin	42,471	13,092	61,077	74,296
(In millions of U.S. dollars)				
Change in net international reserves				
Program floor	0	0	0	0
Adjusted floor	0	0	0	0
Outcome	4,972	2,224	6,844	8,249
Margin	4,972	2,224	6,844	8,249
Net external borrowing by the public sector 5/				
Program ceiling	3,500	3,500	3,500	3,500
Outcome	1,470	-906	-2,682	-5,099
Margin	2,030	4,406	6,182	8,599
Net short-term external borrowing by the public sector 5/ 6/				
Program ceiling	1,000	1,000	1,000	1,000
Outcome	-183	-447	-543	234
Margin	1,183	1,447	1,543	766
Monitoring items:				
Financial intermediation of the development banks and trust funds				
Program ceiling	0	1,500	5,000	10,500
Outcome	-3,601	-641	-5,949	-1,176
Primary expenditure of the nonfinancial public sector (Mex$ million)				
Program ceiling	235,469	460,592	699,421	975,822
Adjusted ceiling	241,269	471,828	723,321	1,012,126
Outcome	233,393	463,145	717,890	1,034,804
Net external borrowing by nonresident public sector entities (US$ million)				
Program ceiling	3,000	3,500	4,000	4,000
Outcome	1,127	1,434	2,155	4,098

Sources: 2000 Technical Memorandum of Understanding; Mexican authorities; and Fund staff estimates.

1/ Cumulative changes from end-1999; adjustments to the ceilings and targets are explained in the technical memorandum of understanding.

2/ Measured on a cash basis from information on the sources of financing of the public sector.

3/ Defined as the cash cost of servicing public sector debt minus the overall deficit as explained in the technical memorandum of understanding.

4/ Defined as the difference between monetary base and net international reserves of the Bank of Mexico.

5/ Excluding trade financing.

6/ With initial maturities of less than one year.

Table 4. Mexico: External Financing Requirements and Sources

(In billions of U.S. dollars)

	1999	2000	Staff Projections					
			2001	2002	2003	2004	2005	2006
1. Gross financing requirements	**60.2**	**74.7**	**70.8**	**75.1**	**78.1**	**89.4**	**94.6**	**93.6**
External current account deficit	14.1	18.1	22.2	28.3	28.2	28.7	31.3	33.0
Debt amortization	45.9	52.6	44.0	42.8	44.9	55.7	58.3	55.6
Medium- and long- term debt	27.5	33.4	29.0	26.0	26.5	35.6	36.5	32.2
Public sector 1/	11.1	19.8	13.6	10.3	10.5	11.0	10.9	9.9
International financial institutions 2/	1.7	1.9	1.9	2.0	1.7	1.7	1.9	2.2
Other official creditors	1.4	1.0	0.7	0.7	0.6	0.6	0.6	0.6
Bonds	1.5	2.8	1.6	3.5	2.9	3.8	3.4	1.5
Other	6.5	14.1	9.3	4.1	5.3	5.0	5.1	5.6
Commercial banks	5.3	4.1	3.8	3.2	3.2	4.5	3.9	3.9
Corporate private sector	11.1	9.5	11.6	12.5	12.7	20.1	21.7	18.4
Short-term debt	13.3	13.7	15.1	16.8	18.4	20.1	21.8	23.4
Public sector	4.4	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Commercial banks	3.6	2.4	2.4	2.6	2.7	2.8	2.9	3.0
Corporate private sector	5.3	7.0	8.4	9.9	11.4	13.0	14.5	16.1
IMF repurchases	5.1	5.5	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves accumulation	0.2	4.0	4.7	4.0	5.0	5.0	5.0	5.0
2. Available financing	**60.2**	**74.7**	**70.8**	**75.1**	**78.1**	**89.4**	**94.6**	**93.6**
Foreign direct investment	11.9	13.3	26.3	16.1	17.6	19.3	21.2	23.3
Debt financing from private creditors	54.6	45.5	47.2	52.3	54.3	64.9	66.5	66.0
Medium- and long-term financing	40.9	30.5	30.4	33.8	34.2	43.1	44.8	42.6
Public sector	9.3	11.6	10.9	13.0	13.1	13.8	13.7	12.6
Bonds	6.2	6.9	7.5	9.4	7.9	8.8	8.4	6.8
Of which: bop financing	4.5	4.9	3.2	9.4	7.9	8.8	8.4	6.8
Other	3.1	4.7	3.4	3.6	5.1	5.0	5.4	5.9
Commercial Banks	7.2	1.4	4.1	3.4	3.5	4.3	4.4	4.8
Corporate private sector	24.4	17.5	15.3	17.4	17.6	25.1	26.7	25.1
Short-term financing	13.7	15.1	16.8	18.4	20.1	21.8	21.8	23.4
Official creditors	1.8	2.8	2.3	2.3	2.0	2.0	2.4	2.8
International financial institutions 2/	1.3	2.5	2.0	2.0	1.7	1.7	2.0	2.3
Other official creditors	0.4	0.3	0.3	0.3	0.3	0.4	0.4	0.5
Other flows 3/	-9.5	11.8	-4.9	4.4	4.1	3.1	4.5	1.6
IMF purchases	1.4	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Gross international reserves (eop) 4/	31.9	35.6	40.3	44.3	49.3	54.3	59.3	64.3
Percent of short-term debt (by residual maturity) 5/	74.6	89.8	94.2	98.6	88.5	93.1	106.6	112.3
Percent of financing requirement 6/	52.4	57.6	56.7	60.6	58.4	60.6	66.9	72.6
Net capital inflows 7/	15.7	18.0	25.8	31.3	32.1	32.6	35.3	36.9
Private creditors	20.7	22.4	26.1	31.6	32.4	32.8	35.4	37.0
Foreign direct investment	11.9	13.3	26.3	16.1	17.6	19.3	21.2	23.3
Other	8.8	9.1	-0.1	15.6	14.8	13.5	14.2	13.7
Official creditors	-5.1	-4.4	-0.4	-0.4	-0.2	-0.2	-0.1	-0.1
IMF	-3.7	-4.3	0.0	0.0	0.0	0.0	0.0	0.0
Other	-1.4	-0.1	-0.4	-0.4	-0.2	-0.2	-0.1	-0.1

Sources: Mexican authorities and Fund staff estimates and projections.

1/ For historical data, it includes pre-payments of external debt.

2/ Excluding the IMF.

3/ Including net equity investments, net increase in assets abroad, and net errors and omissions.

4/ Excludes balances under bilateral payments accounts.

5/ Short-term debt excludes pre-payments of public sector debt.

6/ The gross external financing requirement includes the current account deficit and short-term debt by residual maturity, excluding pre-payments of public sector debt starting from 1999

7/ Corresponding to the external capital account balance including the IMF.

Table 5. Mexico: Financial Operations of the Public Sector 1/

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	Prel. 2000	Staff Proj. 2001
Budgetary revenue	**23.0**	**22.8**	**20.4**	**20.9**	**21.8**	**21.2**
Oil revenue 2/	8.2	7.4	6.1	6.2	6.8	6.6
PEMEX	2.9	2.4	2.1	2.2	2.0	2.0
Federal government	5.3	4.9	3.9	4.0	4.8	4.5
Non-oil revenue	14.8	15.4	14.3	14.6	15.0	14.6
Federal government	10.3	10.9	10.3	10.7	11.1	10.8
Tax revenue	8.1	8.7	8.9	9.5	9.4	9.3
Of which						
Income taxes	3.9	4.3	4.4	4.7	4.7	4.6
VAT	2.9	3.1	3.1	3.3	3.5	3.5
Other	2.1	2.2	1.3	1.2	1.7	1.4
Of which						
Privatization receipts	0.0	0.6	0.3	0.1	0.2	0.2
Central bank profits	0.8	0.1	0.0	0.3	0.0	0.0
Debt buyback profits	0.3	0.0	0.0	0.0	0.1	0.1
Public entities	4.5	4.5	4.1	3.9	3.9	3.9
Budgetary expenditure	**22.8**	**23.7**	**21.6**	**22.0**	**22.8**	**21.9**
Current expenditure	19.6	20.5	18.7	19.5	20.2	19.5
Of which						
Revenue sharing	2.8	3.0	3.0	3.1	3.3	3.2
Interest expenditure	3.6	2.8	2.6	3.0	3.1	2.7
Cash cost of bank and debtor support	0.8	1.3	0.3	0.5	0.6	0.7
Capital expenditure 3/	3.2	3.2	2.9	2.6	2.6	2.4
Extrabudgetary balance	0.1	0.0	0.0	0.1	0.0	0.0
Statistical discrepancy	0.1	-0.1	0.0	-0.1	0.0	0.0
Traditional overall balance	**0.3**	**-1.0**	**-1.2**	**-1.1**	**-0.9**	**-0.7**
Financing	-0.3	1.0	1.2	1.1	0.9	0.7
External	-0.3	-0.8	0.5	0.2	0.0	0.0
Domestic	-0.1	2.0	0.8	1.0	0.9	0.7
Memorandum items:						
Traditional Measures						
Primary balance (staff definition)	3.9	1.9	1.4	1.9	2.2	2.1
Primary balance 4/	4.7	3.1	1.7	2.4	2.8	2.8
Non-oil overall balance 5/	-4.2	-4.8	-3.5	-3.5	-5.0	-4.5
Adjusted measures						
Augmented balance 6/	**-11.0**	**-6.9**	**-8.1**	**-7.1**	**-4.0**	**-4.1**
Augmented balance (authorities' definition) 7/	-5.6	-5.6	-6.3	-6.3	-4.0	-3.9
Primary balance 4/	3.5	2.2	0.4	1.0	1.5	1.4
Non-oil balance 5/	-15.6	-10.7	-10.4	-9.4	-8.1	-8.0
Non-oil primary balance 4/	-1.6	-2.0	-2.2	-1.6	-2.9	-2.7
Gross public sector debt	**54.4**	**50.9**	**54.9**	**50.9**	**46.2**	**46.0**
External 8/	29.6	22.0	21.9	19.2	14.7	13.8
Domestic	8.4	9.3	10.4	11.6	13.0	13.3
Bank restructuring and debtor-support liabilities 9/	16.4	19.3	21.4	17.7	15.8	15.5
PIDIREGAS	0.1	0.3	1.1	2.4	2.8	3.5
Net public sector debt 10/	**49.8**	**46.6**	**50.0**	**46.7**	**41.7**	**41.3**
Net public sector debt (authorities' estimates) 11/	41.5	41.4	45.0	45.8	42.4	n.a.
Fiscal impulse 12/	1.2	0.6	0.9	0.1	-0.9	-0.8
Primary fiscal impulse 12/	0.7	1.1	0.9	-0.5	0.7	-0.1
Oil stabilization fund	0.0	0.0	0.0	0.0	0.2	0.2
Social expenditure	8.3	8.6	9.0	9.3	9.6	n.a.

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

1/ Refers to traditional budget balance. See Appendix Table I for details of augmented public sector balance.
2/ Oil revenue series has been revised to exclude VAT payments from PEMEX.
3/ Excludes contributions to Oil Stabilization Fund in 2000.
4/ Treats bank restructuring transfers and debtor-support as interest expenditure.
5/ Overall balance less PEMEX's overall balance before taxes and transfers.
6/ The augmented balance is the overall balance less the net cost of bank restructuring and debtor-support operations (capital and interest cost, less budget transfers, asset recoveries, and insurance fees), and the inflation adjustment to the principal on indexed securities. It excludes privatization income and includes net PIDIREGAS expenditures (See Appendix Table I).
7/ Historical series of the augmented balance differs from staff's because the authorities only include asset recoveries but not asset purchases and exclude liabilities of intervened banks before 2000. For 2001, it refers to the original authorities' projection.
8/ Includes the debt of the federal government, public entities, and external debt of development banks.
9/ Includes gross bank restructuring and debtor-support liabilities of IPAB and toll roads (FARAC). Excludes contingent debtor-support liabilities and, since 2000, it excludes loans from NAFIN and BOM for Mex$69 billion which will be written off.
10 / Net of liquid assets, loan collections in-kind and loss-sharing agreements of the federal government and IPAB.
11/ Corresponds to the authorities' published net debt at end-year, expressed as a percentage of year GDP.
12/ Excludes oil export revenue.

Table 6. Mexico: Summary Operations of the Financial System

	1997	1998	1999	Prel. 2000	Staff Proj. 2001
	(In billions of Mexican pesos)				
Bank of Mexico					
Net international reserves 1/	161.6	235.2	264.2	347.4	391.7
In U.S. dollars	19.8	23.5	27.4	35.6	40.3
Net domestic assets 1/	-52.5	-103.7	-75.4	-138.4	-159.1
Net credit to non-financial public sector	-87.1	-98.7	-193.2	-287.5	-307.4
Net credit to financial public sector	57.0	64.9	82.3	95.9	102.1
Net credit to commercial banks	-36.5	-58.8	10.5	43.4	54.3
Other	14.1	-11.1	24.9	9.8	-8.1
Monetary base	109.1	131.5	188.8	208.9	232.6
Banking system					
Net foreign assets 2/	33.0	67.4	69.5	92.6	95.1
Net domestic assets 2/	1126.1	1343.5	1474.7	1525.6	1679.2
Net credit to non-financial public sector	184.1	219.5	228.7	238.1	262.0
Credit to private sector	647.6	746.4	749.0	733.7	807.6
Credit to FOBAPROA/IPAB and cetes especial	496.3	607.8	632.8	555.8	567.5
Other net	-201.8	-230.2	-135.9	-2.0	42.1
Medium and long term foreign obligations 2/	279.4	329.0	288.6	277.3	284.7
Other net liabilities 2/	-45.4	-65.7	-13.5	19.1	15.8
Liabilities to private sector 2/	925.1	1147.7	1269.1	1321.9	1473.9
	(Annual percentage change, unless otherwise indicated)				
Memorandum items:					
Real monetary base	12.3	1.6	27.8	1.6	4.6
Real M1a 2/ 3/	14.5	1.0	12.5	6.2	3.4
of which					
Currency in circulation	9.9	3.8	26.1	1.8	4.6
Checking accounts	13.5	-1.8	7.0	5.5	2.8
Real M2	10.0	4.5	1.0	-3.7	4.7
Real M2a 2/ 4/	15.2	6.2	8.0	3.9	...
Real M3a 2/ 5/	14.4	5.6	7.8	4.1	...
Real M4a 2/ 6/	11.5	4.8	6.3	3.0	...
Monetary base velocity (GDP to monetary base) 2	-3.3	0.4	-16.9	7.0	-1.4
M2a velocity (GDP to M2a) 2/	-5.8	-3.9	-1.7	4.6	...
Real credit to the private sector 2/	1.6	-2.8	-10.7	-10.1	3.4
Real adjusted credit to the private sector 2/ 7/	9.5	-0.2	-9.2	-14.4	1.9
	(In percent)				
Commercial banks financial ratios 8/					
Liquid assets to assets	25.4	26.2	28.2	25.7	...
Finance margin to assets	3.0	5.1	6.1	5.7	...
Cash finance margin to assets 9/	2.4	-1.4	-0.4	1.0	...
Return on equity before taxes	-89.4	-2.5	-2.0	14.2	...
Operating expenses to loan portfolio 10/	28.8	32.3	34.3	30.1	...
Nonperforming loans to total loans 11/	16.9	15.5	8.5	5.0	...
Loan-loss provisions to nonperforming loans 11	78.5	73.4	102.3	119.3	...

Sources: Bank of Mexico; National Banking and Securities Commission; and Fund staff estimates and projections.

1/ Different from annual projections, since the latter are based on fixed nominal exchange rates.
2/ From January 1997 onwards, monetary aggregates are based on resident financial institutions only, including deposits of the public sector.
3/ Currency in circulation, checking accounts, and debits card accounts.
4/ M1a plus time deposits, securities issued by the public sector, securities issued by the private sector, and saving accounts outside SIEFORES.
5/ M2a plus deposits held by no-residents.
6/ M3a plus deposits held in no-resident affiliates and branches of Mexican banks.
7/ Including assets sold to FOBAPROA and assets converted in UDI.
8/Through December 1998: Banamex, Bancomer, Banorte, BBV, Bital, Citibank, Confia, Inverlat, Santander Mexicano. From January 1999: Banamex, Bancomer, Banorte, BBV, Bital, Santander Mexicano, Serfin.
9/ Excluding interest income from IPAB/FOBAPROA notes and before loan-loss provisions.
10/ Interest expenditure plus administrative costs to loan portfolio (excluding assets sold to FOBAPROA).
11/ Stricter accounting rules were introduced in January 1997.

Table 7. Mexico: Summary Balance of Payments

	1997	1998	1999	2000	Staff Proj. 2001	Staff Proj. 2002
	(In billions of U.S. dollars)					
Current account	**-7.4**	**-16.1**	**-14.1**	**-18.1**	**-22.2**	**-28.3**
Merchandise trade balance, f.o.b.	0.6	-7.9	-5.6	-8.0	-14.3	-19.2
Exports	74.1	74.9	86.0	104.7	105.1	115.7
Of which						
Petroleum and derivatives	11.3	7.1	9.9	16.4	13.7	13.1
Manufactures 1/	58.5	63.5	71.7	83.6	86.9	97.7
Imports	-73.5	-82.8	-91.6	-112.7	-119.4	-134.9
Factor income	-12.8	-13.3	-13.0	-14.7	-13.5	-14.1
Other services and transfers	4.7	5.1	4.5	4.7	5.7	5.0
Financial account	**19.3**	**18.4**	**19.3**	**22.3**	**25.8**	**31.3**
Public sector	-1.9	1.6	-1.2	-3.1	5.5	5.6
Medium and long-term borrowing	-3.3	1.5	0.0	-5.4	-0.3	5.0
Disbursements	15.1	13.2	11.1	14.4	13.2	15.3
Amortization 2/	18.4	11.7	11.1	19.8	13.6	10.3
Other, including short term borrowing	1.4	0.1	-1.2	2.4	5.8	0.7
Private sector	21.1	16.9	20.5	25.4	20.3	25.6
Direct investment 3/	12.8	11.3	11.9	13.3	26.3	16.1
Bonds and loans 4/	3.7	5.4	6.3	6.6	5.8	6.9
Banking system	-1.8	-1.0	-1.7	-2.7	0.6	0.4
Corporate sector	5.5	6.4	8.0	9.4	5.2	6.5
Equity investments and change in assets abroad	4.6	0.2	2.4	5.5	-11.7	2.7
Equity investments	3.2	-0.7	3.8	0.4	1.0	1.3
Change in assets abroad 3/	1.4	0.9	-1.4	5.0	-12.7	1.4
Errors and omissions and valuation adjustments	1.7	1.3	-1.4	4.0	1.0	1.0
Net international reserves (increase -)	-13.5	-3.7	-3.9	-8.2	-4.7	-4.0
	(In percent of GDP, unless otherwise indicated)					
Memorandum items:						
Current account balance	-1.9	-3.8	-2.9	-3.1	-3.5	-4.0
Non-oil current account balance	-4.7	-5.5	-5.0	-6.0	-5.6	-5.9
Non-oil trade balance	-2.7	-3.6	-3.2	-4.2	-4.4	-4.6
Merchandise exports	18.5	17.8	17.9	18.2	16.5	16.5
Merchandise imports	18.3	19.7	19.1	19.6	18.7	19.2
Gross financing needs (billions of US$) 5/	76.6	63.8	60.2	74.7	70.8	75.1
Gross international reserves 6/						
End-year (billions of US$)	28.9	31.9	31.9	35.6	40.3	44.3
Months of imports of goods and services	3.6	3.6	3.0	3.1	3.1	3.1
Months of imports plus interest payments	3.1	3.1	2.6	2.8	2.8	2.8
Percent of short-term debt (by residual maturity) 7/	64.1	70.9	74.6	89.8	94.2	98.6
Percent of financing requirement 8/	47.3	54.0	52.4	57.6	56.7	60.6
IMF (net purchases, billions of US$)	-3.5	-1.1	-3.7	-4.3	0.0	0.0
Crude oil export volume (millions of bbl/day)	1.7	1.7	1.6	1.68	1.73	1.80
Crude oil price (US$/bbl)	16.5	10.2	15.7	24.8	19.8	18.1
Gross total external debt	38.2	38.4	34.7	26.0	24.8	23.5
Of which: Public external debt 9/	24.3	23.9	20.2	14.7	13.8	12.5
Gross total external debt (billions of US$)	153.3	161.5	166.4	149.3	158.2	165.2
Of which: Public external debt 9/	97.4	100.7	96.8	84.6	87.7	87.9
Public external debt service (in percent of exports of goods, services, and transfers) 9/	36.2	21.6	22.5	26.0	16.1	12.1
	(Annual percentage change)					
Export volume	21.4	9.3	11.4	20.8	4.7	10.5
Non-oil exports	23.5	10.6	14.9	23.0	4.7	11.2
Import volume	23.9	13.5	11.6	19.8	7.3	11.9
Consumer goods	39.3	19.9	10.6	33.4	15.9	8.7
Intermediate goods	17.8	11.7	9.2	18.7	6.0	11.0
Capital goods	37.6	15.4	19.5	14.9	5.2	16.8

Sources: Bank of Mexico; Secretariat of Finance and Public Credit; and Fund staff projections.

1/ Includes net proceeds from in-bond industries.
2/ Includes pre-payment of external debt.
3/ In 2001, FDI includes the US$12.5billion Citibank acquisition of Banamex. This is reflected in an equal increase in private sector assets in the same year, followed by partial drawdown in the following years.
4/ Includes financing of PIDIREGAS.
5/ Defined here as the sum of the current account deficit, debt amortization (including pre-payments, short-term debt and IMF repurchases), and gross reserves accumulation.
6/ Excludes balances under bilateral payments accounts.
7/ From 1999, short-term debt excludes pre-payments of public sector debt.
8/ The gross external financing requirement includes the current account deficit and short-term debt by residual maturity, excluding pre-payments of public sector debt starting from 1999
9/ Includes the IMF and public development banks and trust funds.

Table 8. Mexico: External Debt and Debt-Service Indicators

	1997	1998	1999	Prel. 2000	Staff Proj. 2001
	(In billions of U.S. dollars)				
External debt outstanding 1/	**153.3**	**161.5**	**166.4**	**149.3**	**158.2**
Public debt	97.4	100.7	96.8	84.6	87.7
Direct debt	88.3	92.3	92.3	84.6	87.7
Medium-and long-term	84.3	87.9	88.0	80.3	83.4
Short-term	4.1	4.4	4.3	4.3	4.3
IMF	9.1	8.4	4.5	0.0	0.0
Commercial banks	16.8	15.8	14.1	11.4	12.0
Nonbank private sector 2/	39.1	45.0	55.5	53.3	58.5
Public financial assets 3/	9.0	10.1	8.9	8.0	4.9
Net external public sector debt 4/	88.4	90.6	87.9	76.6	82.8
Public sector external debt service	**32.8**	**19.9**	**23.4**	**32.6**	**20.6**
Amortization	25.4	12.8	16.2	25.4	13.6
Interest	7.4	7.1	7.2	7.3	7.0
Private sector external debt service	**23.9**	**24.4**	**22.2**	**20.3**	**19.9**
Amortization	18.9	19.0	16.4	13.5	15.4
Interest	5.0	5.4	5.8	6.7	4.5
Net resource transfer 5/	**5.3**	**-2.8**	**-1.1**	**-3.3**	**-8.7**
	(In percent of GDP)				
Total external debt	**38.2**	**38.4**	**34.7**	**26.0**	**24.8**
Public sector	24.3	23.9	20.2	14.7	13.8
Medium-and long-term	21.0	20.9	18.3	14.0	13.1
Short-term (excluding IMF)	1.0	1.0	0.9	0.7	0.7
IMF	2.3	2.0	0.9	0.0	0.0
Private sector	13.9	14.4	14.5	11.3	11.1
Medium-and long-term	11.6	12.3	12.5	9.4	9.1
Short-term	2.3	2.1	2.0	1.9	2.0
Net external public sector debt	22.0	21.5	18.3	13.3	13.0
Interest obligations on external public sector debt	1.9	1.7	1.5	1.3	1.1
Net resource transfer	1.3	-0.7	-0.2	-0.6	-1.4
	(In percent of exports of goods, services, and transfers)				
Total external debt	169.2	174.6	160.0	119.0	123.7
Of which					
Public sector	107.5	108.9	93.0	67.4	68.6
Of which					
IMF	10.0	9.1	4.3	0.0	0.0
Total external debt service	62.6	47.9	43.9	42.1	31.6
Of which					
Public sector debt 6/	36.2	21.6	22.5	26.0	16.1

Sources: Secretariat of Finance and Public Credit; Bank of Mexico; and Fund staff estimates and projections.

1/ Excludes claims on the Mexican government held by nonresidents which are payable in pesos (cetes, bondes, etc.). Also excludes liabilities of nonresident affiliates of Mexican public sector entities, such as Pemex Finance.

2/ These data are from the Secretariat of Finance and Public credit. Data from the Bank of Mexico creditor survey show an increase in the debt stock of the private corporate sector between 1999 and 2000: these are also consistent with BOP flow data.

3/ Includes the U.S. treasury zero-coupon bonds purchased by the Mexican government to enhance the bonds issued in the context of the debt-conversion operations carried out in February 1988 and March 1990.

4/ Difference between the external public sector debt (including the IMF) and the government's financial assets.

5/ Balance on merchandise trade, services, and transfers. Reflects the net transfer of resources to (-) or from (+) Mexico arising from capital flows (net of income payments) and changes in net international reserves.

6/ Includes the Fund.

Table 9. Mexico: Financial Operations of the Public Sector 1/

(In percent of GDP)

		Prel.	Staff Projections					
	1999	2000	2001	2002	2003	2004	2005	2006
Budgetary revenue	**20.9**	**21.8**	**21.2**	**22.4**	**22.3**	**22.3**	**22.3**	**22.5**
Federal government revenue	**14.7**	**15.9**	**15.3**	**16.4**	**16.3**	**16.4**	**16.5**	**16.7**
Tax revenue	11.4	10.7	10.5	10.4	10.3	10.3	10.3	10.2
Of which: Income tax	4.7	4.7	4.6	4.6	4.6	4.6	4.6	4.6
Of which: VAT	3.3	3.5	3.5	3.4	3.4	3.4	3.4	3.4
Tax reform revenue	**0.0**	**0.0**	**0.0**	**2.0**	**2.3**	**2.6**	**2.9**	**3.2**
Reform	0.0	0.0	0.0	1.7	1.7	1.7	1.7	1.7
Administrative measures	0.0	0.0	0.0	0.3	0.6	0.9	1.2	1.5
Nontax revenue	3.3	5.3	4.8	4.0	3.7	3.5	3.4	3.3
Rights of nonrenewable resources	2.5	3.9	3.6	3.4	3.2	3.1	3.1	3.0
Capital income (Aprovechamientos)	0.7	1.3	1.1	0.5	0.3	0.2	0.2	0.2
Other	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Public enterprises	6.2	5.9	5.9	6.0	6.0	5.9	5.8	5.8
PEMEX	2.2	2.0	2.0	2.2	2.1	2.0	2.0	1.9
Other	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Budgetary Expenditure	22.0	22.8	21.9	22.2	22.0	22.0	21.9	21.8
Primary	18.8	19.0	18.4	19.2	19.2	19.3	19.3	19.3
Programmable	15.6	15.5	15.1	15.5	15.5	15.5	15.5	15.5
Current	12.9	12.8	12.6	12.9	12.9	12.9	12.9	12.9
Capital 2/	2.7	2.7	2.5	2.7	2.7	2.7	2.7	2.7
Nonprogrammable	3.2	3.5	3.4	3.7	3.7	3.7	3.8	3.8
Of which: Participations to states	3.1	3.3	3.2	3.1	3.0	3.0	3.0	3.0
Of which: Additional part from tax reform	0.0	0.0	0.0	0.4	0.4	0.5	0.5	0.6
Interest payments and other	3.6	3.7	3.4	3.0	2.8	2.7	2.6	2.4
Transfers to IPAB	0.5	0.6	0.7	0.7	0.8	0.8	0.8	0.8
Interest	3.0	3.1	2.7	2.3	2.0	1.9	1.8	1.7
Extrabudgetary balance	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Traditional overall balance	-1.1	-0.9	-0.7	0.2	0.3	0.3	0.4	0.7
Traditional primary balance 3/	2.4	2.8	2.8	3.2	3.1	3.1	3.1	3.2
Adjustments to traditional balance								
- Net PIDIREGAS expenditures	1.0	0.9	1.0	1.0	1.0	0.9	0.9	0.9
- Imputed interest payments	4.2	2.4	2.1	1.0	0.9	0.8	0.8	0.9
PIDIREGS (net of budget payments)	0.1	0.1	0.1	0.1	0.1	0.2	0.3	0.3
IPAB & debtor support programs	3.4	1.8	1.6	0.8	0.6	0.4	0.4	0.4
FARAC	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Indexed bonds	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0
- Privatization and other nonrecurrent income	0.4	0.4	0.3	0.2	0.0	0.0	0.0	0.0
+ Financial requirements of development banks	0.3	0.0	-0.2	0.0	0.0	0.0	0.0	0.0
+ Capital recoveries from IPAB	-0.7	0.5	0.1	0.0	0.0	0.0	0.0	0.0
Augmented balance (IMF)	**-7.1**	**-4.0**	**-4.1**	**-2.0**	**-1.5**	**-1.5**	**-1.3**	**-1.0**
Augmented primary balance 3/	**1.0**	**1.5**	**1.4**	**2.1**	**2.1**	**2.1**	**2.2**	**2.3**
Memorandum items:								
Total interest cost	7.8	6.1	5.5	4.0	3.7	3.6	3.4	3.3
Non-oil balance	-9.4	-8.1	-8.0	-5.7	-5.0	-4.7	-4.4	-4.1
Operational balance	-3.0	-1.9	-2.4	-0.8	-0.8	-0.9	-0.8	-0.6
Gross public sector debt	50.9	46.2	46.0	43.1	41.6	40.2	38.7	37.1
Net public sector debt	46.7	41.7	41.3	39.4	38.0	36.8	35.5	34.1

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

1/ Assumes authorities' estimates of revenue gains from tax reform and administrative measures.

2/ Excludes contributions to Oil Stabilization Fund in 2000.

3/ Treats transfers to IPAB as interest payments.

Table 10. Mexico: Indicators of Domestic and External Vulnerability
(12-month percentage change, unless otherwise indicated)

	Dec. 1998	Dec.. 1999	Dec. 2000	2001 Jan.	Feb.	Mar.	Apr.	May	Jun.
Market indicators									
Exchange rate (per U.S. dollar, end period)	9.87	9.50	9.61	9.68	9.70	9.49	9.25	9.18	9.07
(year-to-date percent change)	22.4	-3.7	1.0	1.2	1.4	-0.8	-3.3	-4.1	-5.2
28-day treasury auction rate (percent; period average)	31.2	16.3	17.6	18.2	16.8	15.4	13.9	10.8	9.0
Spread of benchmark Euro-liabilities (basis points; end of period)	741	370	392	363	428	414	366	326	310
Stock exchange index in U.S. dollar terms (year-to-date percent change)	-38.0	86.7	-21.2	13.8	5.7	1.7	9.4	22.9	24.6
Financial system									
Bank of Mexico net international reserves (US$ billion)	23.5	27.4	35.6	39.5	39.2	40.3	40.4	40.7	40.9
Monetary base	20.8	43.5	10.7	15.8	17.4	15.1	9.9	13.1	9.2
Real M2a 1/	6.2	8.0	3.9	4.3	5.3	5.6	5.6	...	...
Real private sector credit 1/	-2.8	-10.7	-10.1	4.2	7.9	...	...	...	...
Real adjusted credit to the private sector 2/	-0.2	-9.2	-14.4	-14.7	-12.7	...	...	...	...
Commercial banks' nonperforming loans (percent of total loans) 3/	15.5	8.5	5.0	5.1	5.2	...	...	...	...
Commercial banks' loan-loss provision (percent of nonperforming loans) 3/	73.4	102.3	119.3	117.1	117.5	...	...	...	...
Prices									
Consumer prices	18.6	12.3	9.0	8.1	7.1	7.2	7.1	7.0	6.6
Terms of trade (percent change; 12-month basis)	-4.5	13.5	-5.3	-1.0	-2.3	-2.3	-0.2	...	...
Pemex crude export price (year-to-date average; US$/barrel)	10.2	15.7	24.6	20.7	20.4	...	...	...	...
Real effective exchange rate (CPI based; year-to-date average) 4/	1.9	9.0	10.0	4.1	4.1	4.3	5.5	...	...
Real effective exchange rate (ULC based; year-to-date average) 4/	1.3	10.7	13.6	12.0	11.7	11.6	11.3	...	...
Economic activity									
Industrial production (real)	3.4	5.7	-0.5	1.7	-3.6	-2.0	-3.2	...	...
Retail sales (real)	-0.2	7.4	7.2	9.5	6.1	10.1	4.6	...	...
Manufacturing employment	2.0	1.6	-1.0	-1.4	-2.0	2.5	3.1	...	...
Real wage growth (year-to-date average)	2.8	1.5	5.8	7.1	5.9	5.5	...	...	...
External sector 5/									
Exports (year to date, annual percentage change) 6/	1.1	14.8	21.8	10.7	2.1	2.5	3.4	2.8	...
Of which									
Non-oil	3.3	10.3	8.9	11.7	-4.2	6.8	9.3	3.8	...
Imports (year to date, annual percentage change) 6/	12.7	10.6	23.1	14.6	6.5	6.5	7.8	6.5	...
Of which									
Consumer goods	19.1	9.6	37.1	35.0	26.1	29.1	29.2	29.2	...
Capital goods	14.6	18.5	17.5	1.4	3.4	7.5	8.0	5.9	...
Trade balance (US$ billion; year-to-date)	-7.9	-5.6	-8.0	-0.9	-1.5	-2.2	-3.0	-3.7	...
Nonfinancial public sector external debt (percent of GDP) 7/	21.9	19.2	14.7	14.5	14.3	15.0	15.0	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 7/ 8/	1.0	0.9	0.7	0.7	0.8	0.8	0.8	...	...
Private sector external debt (percent of GDP)	14.4	14.5	11.3	...	...	...	...	...	...
Commercial banks' foreign credit lines (roll-over rates in percent)	106.6	96.8	119.9	132.1	103.9	70.3	87.1	56.6	...
Of which									
Banks domiciled in the U.S. and Canada	132.6	67.5	178.8	120.1	171.6	71.6	51.0	53.5	...
Banks domiciled in the European Union	73.4	94.5	122.2	165.3	92.0	86.2	120.7	22.6	...
Memorandum items:									
Gross international reserves to short-term debt (by residual maturity, percent) 9/	70.9	74.6	89.8	...	...	106.8	...	...	...
Monetary base to gross international reserves (percent)	45.1	61.9	62.0	47.1	46.2	45.0	44.9	46.0	46.8

Sources: Bank of Mexico; National Banking and Securities Commission; National Institue of Statistics and Geography; Infosel; Reuters; Secretariat of Finance and Public Credit; and Fund Staff estimates.

1/ From January 1997 onwards, monetary aggregates are based on resident financial institutions only. M2a equals currency in circulation, checking accounts, time deposits, securities issued by the public sector, securities issued by the private sector, and saving accounts outside SIEFORES.

2/ Includes assets sold to FOBAPROA/IPAB.

3/ From January 1997 stricter accounting rules were introduced. Through December 1998 includes Banamex, Bancomer, Bital, Banorte, BBV, Citibank, Confia, Inverlat, Santander, and Serfin. From January 1999 includes Banamex, Bancomer, Bital, Banorte, BBV, Santander, and Serfin.

4/ Increase = appreciation.

5/ Credit ratings: Standard's & Poor's downgraded Mexico from BB+ to BB on February 10, 1995, revised Mexico's outlook from stable to positive on September 15, 1999, and upgraded Mexico to BB+ on March 10, 2000. Moody's upgraded Mexico from Ba1 (August 10, 1999) to Baa3 (March 7, 2000).

6/ In U.S. dollar terms net of maquila.

7/ Includes development banks.

8/ Based on original maturity.

9/ The short-term debt by residual maturity includes pre-payment of debt. In particular, the 2000 figure includes the prepayment of US$3.3 billion of Brady bonds: excluding the latter, this ratio would have been 101 percent.

Table 11. Mexico: Medium-Term Macroeconomic Framework

	Prel.	Projections					
	2000	2001	2002	2003	2004	2005	2006
	(Annual percentage change, unless otherwise indicated)						
National income and prices							
Real GDP	6.9	2.5	5.3	5.0	5.3	5.5	5.5
Consumer prices (end of year)	9.0	6.5	4.5	3.0	2.5	2.5	2.5
Consumer prices (average)	9.5	7.0	5.4	3.8	2.8	2.5	2.5
External sector							
Exports, f.o.b.	21.8	0.3	10.1	11.8	12.1	11.6	11.8
Imports, f.o.b.	23.1	5.9	13.0	10.1	10.6	11.4	10.9
Terms of trade (deterioration -)	5.9	-3.0	-1.3	-1.2	-0.6	-0.3	-0.1
Interest rates							
Treasury bill rate (average 28-day cetes)	15.2	14.5	10.3	9.4	9.3	9.4	9.4
Real interest rate	6.8	6.0	4.6	5.5	6.3	6.5	6.5
	(In percent of GDP)						
Nonfinancial public sector							
Augmented balance 1/	-4.0	-4.1	-2.0	-1.5	-1.5	-1.3	-1.0
Overall balance 2/	-0.9	-0.7	0.2	0.3	0.3	0.5	0.8
Savings and investment							
Gross domestic investment	23.3	23.6	25.0	24.7	24.4	24.5	24.5
Fixed investment	20.9	20.9	22.3	22.0	21.7	21.7	21.7
Public	4.0	3.8	3.9	3.9	3.9	3.8	3.8
Private	16.9	17.1	18.4	18.1	17.8	17.9	17.9
Inventories	2.4	2.8	2.8	2.8	2.8	2.8	2.8
Gross national saving	20.2	20.2	21.0	21.0	20.9	20.9	21.1
Public sector	2.2	1.5	3.2	3.2	3.0	3.0	3.3
Private sector	17.9	18.7	17.8	17.8	17.9	17.9	17.8
External current account balance	**-3.1**	**-3.5**	**-4.0**	**-3.7**	**-3.5**	**-3.6**	**-3.5**

Sources: Bank of Mexico; National Institute of Statistics and Geography; Secretariat of Finance and Public Credit; and Fund staff projections.

1/ The augmented balance is the overall balance less the net cost of bank restructuring and debtor-support operations and the inflation adjustment to the principal on indexed securities.

2/ Includes privatization proceeds.

Table 12. Mexico: Summary Medium-Term Balance of Payments

	2000	2001	2002	2003	2004	2005	2006
			Staff Projections				
	(In billions of U.S. dollars)						
Current account	**-18.1**	**-22.2**	**-28.3**	**-28.2**	**-28.7**	**-31.3**	**-33.0**
Merchandise trade balance, f.o.b.	-8.0	-14.3	-19.2	-19.3	-19.4	-21.3	-22.1
Exports	104.7	105.1	115.7	129.3	145.0	161.8	181.0
Of which:							
Petroleum and derivatives	16.4	13.7	13.1	12.4	12.2	12.3	12.6
Manufactures 1/	83.6	86.9	97.7	111.4	126.6	142.7	160.9
Imports	-112.7	-119.4	-134.9	-148.6	-164.4	-183.1	-203.1
Factor income	-14.7	-13.5	-14.1	-14.4	-15.3	-16.4	-17.7
Other services and transfers	4.7	5.7	5.0	5.5	6.0	6.4	6.8
Financial account	**22.3**	**25.8**	**31.3**	**32.1**	**32.6**	**35.3**	**36.9**
Public sector	-3.1	5.5	5.6	4.9	5.1	5.5	5.8
Medium and long-term borrowing	-5.4	-0.3	5.0	4.6	4.8	5.2	5.5
Disbursements	14.4	13.2	15.3	15.1	15.8	16.1	15.4
Amortization 2/	19.8	13.6	10.3	10.5	11.0	10.9	9.9
Other, including short term borrowing	2.4	5.8	0.7	0.3	0.3	0.3	0.3
Private sector	25.4	20.3	25.6	27.2	27.5	29.8	31.1
Direct investment 3/	13.3	26.3	16.1	17.6	19.3	21.2	23.3
Bonds and loans 4/	6.6	5.8	6.9	6.9	6.4	7.1	7.6
Banking system	-2.7	0.6	0.4	0.4	-0.1	0.6	0.9
Corporate sector	9.4	5.2	6.5	6.5	6.5	6.5	6.7
Equity investments and change in assets abroad	5.5	-11.7	2.7	2.7	1.8	1.5	0.2
Equity investments	0.4	1.0	1.3	1.4	1.5	1.6	1.6
Change in assets abroad 3/	5.0	-12.7	1.4	1.4	0.3	0.0	-1.3
Errors and omissions and valuation adjustments	4.0	1.0	1.0	1.0	1.0	1.0	1.0
Net international reserves (increase -)	-8.2	-4.7	-4.0	-5.0	-5.0	-5.0	-5.0
	(In percent of GDP, unless otherwise indicated)						
Memorandum items:							
Current account balance	-3.1	-3.5	-4.0	-3.7	-3.5	-3.6	-3.5
Non-oil current account balance	-6.0	-5.6	-5.9	-5.4	-5.0	-4.9	-4.8
Non-oil trade balance	-4.2	-4.4	-4.6	-4.2	-3.9	-3.8	-3.6
Merchandise exports	18.2	16.5	16.5	17.1	17.8	18.3	19.0
Merchandise imports	19.6	18.7	19.2	19.7	20.2	20.8	21.3
Gross financing needs (billions of US$) 5/	74.7	70.8	75.1	78.1	89.4	94.6	93.6
Gross international reserves 6/							
End-year (billions of US$)	35.6	40.3	44.3	49.3	54.3	59.3	64.3
Months of imports of goods and services	3.1	3.1	3.1	3.2	3.1	3.1	3.0
Months of imports plus interest payments	2.8	2.8	2.8	2.8	2.8	2.7	2.7
Percent of short-term debt (by residual maturity) 7/	89.8	94.2	98.6	88.5	93.1	106.6	112.3
Percent of financing requirement 8/	57.6	56.7	60.6	58.4	60.6	66.9	72.6
IMF (net purchases, billions of US$)	-4.3	0.0	0.0	0.0	0.0	0.0	0.0
Crude oil export volume (millions of bbl/day)	1.68	1.73	1.80	1.86	1.91	1.97	2.03
Crude oil price (US$/bbl)	24.8	19.8	18.1	16.6	15.9	15.5	15.5
Gross total external debt	26.0	24.8	23.5	23.4	23.0	22.7	22.3
of which: Public external debt 9/	14.7	13.8	12.5	12.2	11.9	11.6	11.3
Gross total external debt (billions of US$)	149.3	158.2	165.2	176.6	187.8	200.1	213.3
of which: Public external debt 9/	84.6	87.7	87.9	92.4	97.2	102.4	107.9
Public external debt service (in percent of exports of goods, services, and transfers) 9/	26.0	16.1	12.1	11.2	10.6	9.7	8.4
	(Annual percentage change)						
Export volume	20.8	4.7	10.5	11.7	11.4	10.7	10.8
Non-oil exports	23.0	4.7	11.2	12.6	12.3	11.3	11.4
Import volume	19.8	7.3	11.9	8.7	9.3	10.1	9.7
Consumer goods	33.4	15.9	8.7	11.3	11.9	12.2	12.0
Intermediate goods	18.7	6.0	11.0	10.6	11.1	11.0	10.5
Capital goods	14.9	5.2	16.8	1.5	2.0	5.2	4.5

Sources: Bank of Mexico; Secretariat of Finance and Public Credit; and Fund staff projections.

1/ Includes net proceeds from in-bond industries.
2/ Includes pre-payment of external debt.
3/ In 2001, FDI includes the US$12.5billion Citibank acquisition of Banamex. This is reflected in an equal increase in private sector assets in the same year, followed by partial drawdown in the following years.
4/ Includes financing of PIDIREGAS.
5/ Defined here as the sum of the current account deficit, debt amortization (including pre-payments, short-term debt and IMF repurchases), and gross reserves accumulation.
6/ Excludes balances under bilateral payments accounts.
7/ Short-term debt excludes pre-payments of public sector debt.
8/ The gross external financing requirement includes the current account deficit and short-term debt by residual maturity, excluding pre-payments of public sector debt starting from 1999
9/ Includes the IMF and public development banks and trust funds.

Table 13. Mexico: Medium-Term External Debt and Debt-Service Indicators

	Prel.	Staff Projections					
	2000	2001	2002	2003	2004	2005	2006
	(In billions of U.S. dollars)						
External debt outstanding 1/	**149.3**	**158.2**	**165.2**	**176.6**	**187.8**	**200.1**	**213.3**
Public debt	84.6	87.7	87.9	92.4	97.2	102.4	107.9
Direct debt	84.6	87.7	87.9	92.4	97.2	102.4	107.9
Medium and long term	80.3	83.4	83.6	88.1	92.9	98.1	103.6
Short term	4.3	4.3	4.3	4.3	4.3	4.3	4.3
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	11.4	12.0	12.3	12.7	12.6	13.3	14.1
Nonbank private sector 2/	53.3	58.5	65.0	71.5	78.0	84.5	91.2
Public financial assets 3/	8.0	4.9	5.1	5.4	5.7	6.0	6.4
Net external public sector debt 4/	76.6	82.8	82.7	87.0	91.5	96.3	101.5
Public sector external debt service	**32.6**	**20.6**	**16.9**	**17.4**	**18.5**	**18.8**	**18.2**
Amortization	25.4	13.6	10.3	10.5	11.0	10.9	9.9
Interest	7.3	7.0	6.6	6.9	7.5	7.9	8.4
Private sector external debt service	**20.3**	**19.9**	**20.1**	**21.3**	**30.9**	**32.5**	**29.8**
Amortization	13.5	15.4	15.6	15.9	24.6	25.6	22.3
Interest	6.7	4.5	4.5	5.3	6.3	6.9	7.4
Net resource transfer 5/	**-3.3**	**-8.7**	**-14.2**	**-13.7**	**-13.4**	**-15.0**	**-15.3**
	(In percent of GDP)						
Total external debt	**26.0**	**24.8**	**23.5**	**23.4**	**23.0**	**22.7**	**22.3**
Public sector	14.7	13.8	12.5	12.2	11.9	11.6	11.3
Medium and long term	14.0	13.1	11.9	11.7	11.4	11.1	10.9
Short term (excluding IMF)	0.7	0.7	0.6	0.6	0.5	0.5	0.4
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	11.3	11.1	11.0	11.1	11.1	11.1	11.0
Medium and long term	9.4	9.1	9.0	9.0	9.0	8.9	8.9
Short term	1.9	2.0	2.0	2.1	2.1	2.2	2.2
Net external public sector debt	13.3	13.0	11.8	11.5	11.2	10.9	10.6
Interest obligations on external public sector de	1.3	1.1	0.9	0.9	0.9	0.9	0.9
Net resource transfer	-0.6	-1.4	-2.0	-1.8	-1.6	-1.7	-1.6
	(In percent of exports of goods, services, and transfers)						
Total external debt	119.0	123.7	118.3	113.4	107.9	103.3	98.6
Of which							
Public sector	67.4	68.6	62.9	59.3	55.8	52.8	49.9
Of which							
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt service	42.1	31.6	26.5	24.8	28.3	26.5	22.2
Of which							
Public sector debt 6/	26.0	16.1	12.1	11.2	10.6	9.7	8.4

Sources: Secretariat of Finance and Public Credit; Bank of Mexico; and Fund staff estimates and projections.

1/ Excludes claims on the Mexican government held by nonresidents which are payable in pesos (cetes, bondes, etc.). Also excludes liabilities of nonresident affiliates of Mexican public sector entities, such as Pemex Finance.

2/ These data are from the Secretariat of Finance and Public credit. Data from the Bank of Mexico creditor survey show an increase in the debt stock of the private corporate sector between 1999 and 2000: these are also consistent with BOP flow data.

3/ Includes the U.S. treasury zero-coupon bonds purchased by the Mexican government to enhance the bonds issued in the context of the debt-conversion operations carried out in February 1988 and March 1990.

4/ Difference between the external public sector debt (including the IMF) and the government's financial assets.

5/ Balance on merchandise trade, services, and transfers. Reflects the net transfer of resources to (-) or from (+) Mexico arising from capital flows (net of income payments) and changes in net international reserves.

6/ Includes the Fund.

MEXICO: FUND RELATIONS

(As of May 31, 2001)

I. **Membership Status**: Joined December 31, 1945; Article VIII.

II. **General Resources Account**:	**SDR Million**	**Percent of Quota**
Quota	2,585.80	100.0
Fund holdings of currency	2,585.47	100.0
Reserve position in Fund	0.34	0.0

III. **SDR Department**:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	290.02	100.0
Holdings	282.77	97.5

IV. **Outstanding Purchases and Loans**	**SDR Million**	**Percent of Quota**
Stand-by arrangements	0.0	0.0
Extended arrangements	0.0	0.0

V. **Financial Arrangements**:

Type of Arrangement	Approval Date	Expira-tion Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	07/07/99	11/30/00	3,103.00	1,939.50
Stand-By	02/01/95	02/15/97	12,070.20	8,758.02
EFF	05/26/89	05/25/93	3,729.60	3,263.40

VI. **Projected Obligations to the Fund**: (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue		Forthcoming			
	05/31/01	**2001**	**2002**	**2003**	**2004**	**2005**
Charges/interest		0.1	0.3	0.3	0.3	0.3
Total		**0.1**	**0.3**	**0.3**	**0.3**	**0.3**

VII. **Exchange Rate Arrangement**: Mexico has a floating exchange rate regime since December 22, 1994.

VIII. **Article IV Consultation**: The last Article IV consultation was concluded by the Executive Board on March 7, 2001. The relevant staff reports were EBS/00/40. In the context of the 2001 Article IV consultation, a joint Bank-Fund mission visited Mexico City in March 2001 under the Financial Sector Assessment Program.

IX. **Resident Representative**: A resident representative has been stationed in Mexico City since May 1995.

X. **Technical Assistance**: January 31–February 14, 1996: STA (with WHD participation) on money and banking statistics; June 22–July 10, 1995: FAD on fiscal strategy for promoting growth and stability; July 3–15, 1996: FAD on reform of treasury operations; and April 21–23, 1997: STA on money and banking statistics to follow up the status of the recommendations made by the early 1996 STA mission; October 1997: BCS expert began a six-month assignment at the Mexican treasury to help redesign the Integrated Treasury Information System; In May, July, and November 1997: FAD provided advice on reform of treasury operations; October 10, 1997–April 10, 1998: BCS on new public expenditure systems; November 30–December 3, 1998: PDR (with WHD participation) on external debt monitoring; November 25–December 4, 1998: STA provided follow-up advice on money and banking statistics; April 4–14, 2000: FAD on government pensions of the state of Veracruz.

MEXICO: RELATIONS WITH THE WORLD BANK

The World Bank continues to support closely and successfully Mexico's development progress. The Bank's current Country Assistance Strategy (CAS) for Mexico, as discussed by its Board in June 1999, focussed on three core objectives: 1) social sustainability; 2) removing obstacles to growth and maintenance of macroeconomic stability in the context of globalization; and 3) effective public governance. Using the program flexibility built into the CAS, the Bank was able to deliver, over the last three years, assistance both at the broad reform agenda and at the sectoral level. New lending committed during the three-year CAS period (FY99–FY01) remained at a strong US$4.1 billion, though within the CAS envelope and maintaining a manageable country exposure. The Bank's analytical work carried out over the past few years in support of its lending program and policy dialogue with the Mexican government was summarized in a collection of Policy Notes,[1] covering more than 30 different sectors and themes, that served as a highly appreciated, analytical bridge across administrations.

Support has been delivered, over the past three years, at several critical reform junctions, such as decentralization, state fiscal adjustment, and financial sector reform. Decentralization gained important momentum with states and municipalities now controlling some 60 percent of total primary government spending. The Bank assisted the Mexican government in the establishment of a framework for a "hard budget" constraint on subnational finances through a combination of bank regulation, budgetary rules and transparency, as well as providing assistance to states in their adjustment to the new framework of fiscal discipline. In the area of financial sector reform, Bank support following the establishment of IPAB in 1999 is closely related to the resolution of intervened and failed banks under its purview. In parallel, project interventions with direct poverty reduction impact at the sectoral level were launched in areas such as rural development, health, housing, gender, disaster management, and road maintenance. As of July 2001, the Bank's portfolio consists of 23 active projects with a total undisbursed balance of US$3.3 billion. Average annual disbursements over the past three years of US$1.4 billion have led to a slight increase in exposure to Mexico, currently at US$11.5 billion, though still within the Bank's nominal indicative ceiling of US$13.5 billion.

The design and discussion of the Bank's next CAS is tentatively scheduled for May 2002. This will allow time for the new administration to define more fully its medium-term development strategy and to identify areas of comparative advantage for World Bank assistance. In the meantime, the existing CAS objectives remain highly relevant and will continue to guide the Bank's assistance program. The new government's initial demand for Bank assistance, both lending and nonlending, vastly surpasses the Bank's capacity which will require the continued application of the flexibility and selectivity underlying the existing CAS. During this period, the Bank will focus on supporting major reforms as they are brought forward (such as fiscal, financial sector, ISSSTE health, state adjustment and labor reform) while, at the same time, addressing some of the direct roots of poverty through the support of public investment and expenditure programs.

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[1] Giugale, M., O. Lafourcade, and V. Nguyen, eds., 2001, *Mexico—A Comprehensive Development Agenda for the New Era*, World Bank Publication, Washington D.C.

MEXICO: STATISTICAL ISSUES

Core data are published on a timely basis and are of good quality. The timeliness, periodicity, and coverage of published economic statistics and other data made available to the Fund have improved considerably since 1995. Mexico was among the first countries to subscribe to the Fund's Special Data Dissemination Standard (SDDS). Data revisions are part of the normal process for producing information. Recent data revisions have been reasonable and have not changed substantially the staff's assessment of economic policy in Mexico. Regarding fiscal data, both the preliminary (available with a 45-day lag following the end of each quarter) and the final (available in mid-August of the subsequent year) data are published and submitted to congress, ensuring that revisions are transparent and subject to public scrutiny.

Several measures to improve **external debt statistics**, consistent with the recommendations of the fifth edition of the *Balance of Payments Manual*, have been carried out as envisaged in the last SBA, including the compilation of data on external liabilities of publicly-traded companies registered with the Mexican stock exchange (external debt outstanding, annual amortization schedule for the next four years broken down by maturity, and type of instrument). The BOM has also started to produce a quarterly repayment schedule for a portion of private corporate debt. However, other commitments under the last SBA have yet to be met, including (i) projections for external debt service of commercial banks;[1] and (ii) the compilation of two series of external liabilities of the banking system, one on the basis of residency and the other on the basis of domicile. The authorities are reporting **international reserves** according to the guidelines established under the second review of the SDDS.

On the fiscal area, staff identified as an outstanding statistical issue the treatment of **public investment projects with deferred recording in the fiscal accounts (PIDIREGAS)**. The recording of direct investment PIDIREGAS projects deviates from the *Manual of Government Finance Statistics* and associated liabilities are not fully reflected in the debt statistics. Also, while information is available, official statistics do not consolidate in the public sector the interest cost of public sector liabilities associated with bank restructuring and debtor support programs. The authorities have announced that, beginning in 2001, they will begin reporting an augmented fiscal balance that will encompass the direct net cost of PIDIREGAS as well as the interest cost on government liabilities not currently recorded. This move would resolve these issues and would improve the accuracy of fiscal statistics.

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[1] The authorities are working on a complete redemption schedule for commercial bank debt beyond the information already provided on interbank credit lines.

Mexico: Core Statistical Indicators

As of May 31, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	May 31	May 25	May 25	May 30	End-April	May 31	May 15	April	First quarter 2001	First quarter 2001	First quarter 2001	Fourth quarter 2000
Date Received	May 31	May 29	May 29	May 31	May 20	May 31	May 24	May 23	May 31	May 31	May 15	Feb. 15
Frequency of Data 1/	D	W	W	D	M	D	Bi-W	M	Q	Q	Q	M
Frequency of Reporting 1/	D	W	W	D	M	D	Bi-W	M	Q	Q	Q	Q
Source of Update 2/	A	A	N	A	N	N	N	N	N	N	N	N
Mode of Reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 1/	D	W	W	D	M	D	Bi-W	M	Q	Q	Q	Q

1/ D-daily, W-weekly, M-monthly, Q-quarterly, Bi-W-bi-weekly.
2/ A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication and press release.
3/ E-electronic data transfer, C-facsimile.
4/ B-for use by the staff and the Executive Board, C-for unrestricted use.

Box 1. The Public Sector Borrowing Requirement (PSBR)

The **traditional measure of the fiscal balance** used in Mexico deviates from international practice in four main aspects (see EBS/00/40; 3/7/00 for a previous discussion of this issue):

- revenues from privatization and unrealized capital gains on international reserves and debt buy-back operations are recorded as income;
- the inflation component of indexed bonds is not reported as interest;
- spending on some public investment projects carried out and financed fully by the private sector (PIDIREGAS) is recorded when the financial obligations are serviced and not when the investment is made, and;
- the costs of quasi-fiscal operations are not reported.

However, since May 2001 the authorities have also been publishing a more comprehensive measure of the public sector balance which is broadly in line with the one used by the staff to measure the augmented fiscal balance. This **adjusted measure of the fiscal balance** corrects the shortcomings of the traditional measure, by excluding the revenue components indicated above and by including expenditures associated with the latter three items. The cost of quasi-fiscal operations includes the interest cost (on an accrual basis) of liabilities issued for bank restructuring and debtor-support programs as well as the net capital cost of these programs (bonds issued for new programs, if any, minus asset recovery).

Box 2. Public Liability Management

Mexico has made substantial progress in improving liability management and developing a domestic public debt market. In 2000, the government continued its policy of retiring Brady bonds in exchange for either global bonds or cash, and prepaying loans maturing in 2001–03, partly using the collateral released by the retirement of Brady bonds—these operations amounted to US$7 billion. In the first five months of 2001, US$4.3 billion in Brady bonds were retired in exchange for global bonds, which resulted in the release of US$2 billion in collateral. On the domestic front, the government managed to extend the average maturity of their public debt instruments—from 400 days at the beginning of 1999 to over 550 days in 2000)—and in 2001 is moving towards increasing the share of fixed-rate instruments, including through the issuance of 10-year bonds beginning in July 2001. Also in 2000, IPAB (Bank Savings Protection Institute) began to issue 3- and 5-year bonds to begin refinancing its liabilities with market instruments.

The policy of reducing external indebtedness has served Mexico well and has helped reduce external vulnerability. However, when considering total public sector debt—including IPAB and other bank restructuring liabilities—the risk characteristics of the debt portfolio could be improved, including through increasing the share of longer-term, fixed-rate instruments (along the lines of the transaction mentioned above). Until recently, the relatively high reliance on domestic debt (70 percent of total debt portfolio), forced the government to rely on variable-interest-rate and short-maturity instruments, because the market for medium- and long-term, fixed-interest-rate domestic debt instruments is under developed. This exposes the debt structure to considerable interest rate and, to a lesser extent, refinancing risks.

Box 3. Banking Sector—Major Accomplishments Since 2000 Article IV Consultation

Improvements in the system's ability to absorb shocks. Following the economic expansion of 2000, the banking system improved its capital adequacy through retained earnings, capital injections, sales of assets, and improvement in asset quality. Although capital adequacy is not uniform across banks, those institutions with capital below desirable levels are in the process of bridging the gap.

Improvements in the legal framework aimed at protecting creditor rights. In April 2000, congress passed new secured lending and bankruptcy laws aimed at enhancing creditor rights and the efficiency of loan collections. In April 2001, congress passed legislative reforms that facilitate direct bill payment from bank accounts, tighten related lending rules, improve supervisory practices, and cover gaps on corporate governance.

Improvements in the regulatory framework to foster transparency and tighten asset valuation. Banks are now required to show the full effect on their balance sheets of all regulatory forbearance received. New accounting standards, including loan classification and provisioning rules, have been introduced following sound practices.

The IPAB *(Bank Savings Protection Institute)* **has taken decisive steps toward the strengthening of the banking sector.** Such steps include progress in resolving the status of banks under its control (of which *Bancrecer* and *Banco Atlántico* seem to be close to final resolutions) and an orderly and transparent asset sale process.

Box 4. Summary Assessment of Financial System Stability

The Mexican financial system has improved its resilience to shocks in recent years. The main factors behind the improved resilience include:

- **Mexico's macroeconomic indicators have generally improved and links (real and financial) to the U.S. economy have strengthened.** Strong economic growth resumed, inflation declined, and net international reserves increased, notwithstanding a real appreciation of the peso and a widening of the non-oil external current account deficit. The main risks facing the economy, and hence the financial system, are a slowdown in U.S. economic activity and a larger-than-expected decline in oil prices. Also, the increasing foreign borrowing by the private sector in recent years has made it more vulnerable to the risks of capital reversals.

- **Indicators of bank soundness have improved and banks do not pose a systemic risk to financial stability.** The banking sector has strengthened its capital base in the last two years, in part reflecting debt restructuring operations, as well as increased foreign participation. Broad-based and sound lending to the private sector still needs to recover from recent lows in order to reinvigorate the financial intermediation role of banks and to diversify their profits base by making them less dependent on income from holdings of government securities.

- **The nonbank financial sectors are not expected to be a source of systemic risk.** Private securities markets in Mexico are still underdeveloped. The local institutional investor base is nascent (growing, but small relative to other countries) and the retail investor base is miniscule. Finally, the insurance sector is relatively small, but it is financially sound and subject to modern management.

- **Financial sector supervision is improving and efforts are underway to address remaining shortcomings.** The autonomy of supervisory agencies needs to be strengthened; fragmentation of supervisory powers weakens accountability and the enforcement of rules and regulations, and investor confidence needs to be reinforced. Improvements underway are aimed at bringing the regulatory framework more in line with best international practices.

- **Some structural weaknesses remain.** There are no clear rules to prevent a troubled institution, without proper guarantees, from having continued access to central bank financing. There are weaknesses in the operation of the payments systems and the absence of clear procedures for bank closure. The operation of development banks has been traditionally problematic, but the authorities are addressing these problems through legal reforms and tighter monitoring. Finally, the existing framework for housing finance requires a major overhaul.

- **Substantive progress regarding transparency of financial policies has been made in recent years, although with uneven observance among agencies.** Roles and institutional mandates of regulatory agencies are generally well defined, but coordination could be improved in day-to-day supervisory activities and to level the regulatory playing field for like financial services across financial institutions. Transparency of monetary policy has improved markedly in recent years and it was further strengthened with the adoption of an inflation-targeting framework in 2001. Accountability and disclosure vis-à-vis companies' boards of directors are generally good, but disclosure vis-à-vis the public at large still needs to be improved (see FSSA for a broader description of the observance of standards and codes for the financial sector).

Box 5. External Current Account Sustainability 1/

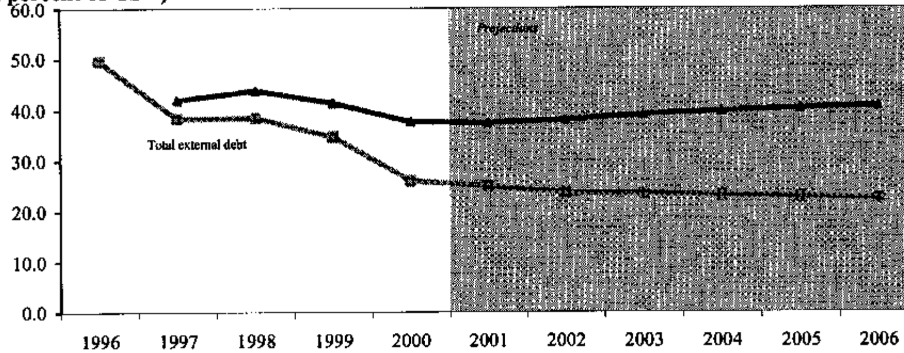
The equilibrium real exchange rate (RER) can be defined as the exchange rate that would bring about a sustainable current account. The staff's analysis to assess the RER produced varied results depending on the criterion used to define sustainability.

The projected level of the current account deficit over the medium term is sustainable according to the criterion of a constant or declining external debt-to-GDP ratio from its end-2000 level (see figure below which reports the staff's medium-term projections).

The current account deficit would need to be somewhat lower (less than one percent of GDP lower) to satisfy the criterion of a constant net-foreign-liabilities-to-GDP ratio.[2] In the staff's medium-term projections, the net-foreign-liability-to-GDP ratio rises modestly from its end-2000 level, due to projected sizable foreign direct and equity investment. This criterion would suggest that given the export and import elasticities, a modest real effective depreciation of the peso would be needed to reduce the current account deficit to the sustainable level. However, neither criterion takes into account the appropriateness of the initial ratio of net foreign liabilities to GDP or the initial external-debt-to-GDP ratio.

A study conducted by the Research Department, based on current account norms estimated from medium-run saving-investment balances, estimated that Mexico's sustainable current account deficit would be 1½ percent of GDP.[3] However, the sample period used in this study ended in 1995, and thus, does not take into account the structural improvements in Mexico in the last five years and the greater access to international capital markets.

Total External Debt and Net Foreign Liabilities
(In percent of GDP)



1/ This topic is examined in detail in the Selected Issues paper "External Competitiveness and Current Account Sustainability."

2/ Net foreign liabilities is defined as foreign liabilities—the main components of which are external debt, foreign direct investment, and foreign equity investment—minus foreign assets.

3/ See the paper "Methodology for Current Account and Exchange Rate Assessments," SM/01/152; and forthcoming Occasional Paper.

Mexico: Adjusted Overall and Augmented Public Sector Balances 1/

(In percent of GDP)

	1997	1998	1999	2000 Prel.	2001 Staff Proj.
Overall balance (authorities' definition) 2/	**-1.0**	**-1.2**	**-1.1**	**-0.9**	**-0.7**
Minus : Revenue adjustments					
Privatization receipts	0.6	0.3	0.1	0.2	0.2
Unrealized valuation gains 3/	0.2	0.0	0.3	0.1	0.1
Central bank profits	0.1	0.0	0.3	0.0	0.0
Debt buyback profits	0.0	0.0	0.0	0.1	0.1
Plus : Expenditure adjustments					
Interest adjustment on indexed debt 4/	0.4	0.5	0.3	0.2	0.1
Net interest cost of bank and debtor support 5/	2.6	3.7	3.8	2.0	1.8
Net expenditures on direct PIDIREGAS projects 6/	0.2	0.9	1.1	1.0	1.2
Net financial requirements of developmend banks	-1.0	-0.4	-0.3	0.0	0.2
Adjusted balance	**-3.9**	**-6.3**	**-6.4**	**-4.6**	**-4.3**
Minus : Net capital cost of bank restructuring and debtor support 7/	3.0	1.8	0.7	-0.5	-0.1
Augmented balance	**-6.9**	**-8.1**	**-7.1**	**-4.0**	**-4.1**
Memorandum items:					
Interest expenditure					
Cost of social security reform					
Adjusted overall balance, excluding social security reform					
Authorities' augmented balance 8/	-5.6	-6.3	-6.3	-4.0	-3.9
Gross public sector debt	50.9	54.9	50.9	46.2	46.0
External	22.0	21.9	19.2	14.7	13.8
Of which : Development banks	2.3	2.2	1.7	1.5	1.4
Domestic	9.3	10.4	11.6	13.0	13.3
Bank restructuring and debtor-support liabilities 9/	19.3	21.4	17.7	15.8	15.5
PIDIREGAS	0.3	1.1	2.4	2.8	3.5
Net public sector debt 10/	46.6	50.0	46.7	41.7	41.3

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

1/ Public sector includes the federal government, and public enterprises and entities (under direct and indirect budgetary control), IPAB bank restructuring and debtor-support programs and direct public investment projects financed via PIDIREGAS. Excludes subnational governments.

2/ Authorities' nonfinancial public sector balance is measured on cash basis and includes the federal government and public enterprises and entities (under direct and indirect budgetary control).

3/ Unrealized valuation gains component of central bank profits, and debt buyback profits.

4/ Inflation adjustment on the principal of indexed government securities (Udibonos, Ajustabonos, and SAR).

5/ Includes interest cost on gross IPAB liabilities, net of federal government transfers, imputed interest on FARAC debt and on debtor-support programs.

6/ Executed direct public investment PIDIREGAS projects and accrued interest on associated liabilities (net of budgetary transfers).

7/ Capital cost of bank restructuring and debtor-support operations net of asset recoveries.

8/ Historical series of the augmented balance differs from staff's because the authorities only include asset recoveries, but not asset purchases and exclude liabilities of intervened banks before 2000. For 2001, it refers to the original authorities' projection.

9/ Includes gross bank restructuring from IPAB and FARAC liabilities. Excludes IPAB liabilities with NAFIN and BOM and contingent debtor-support liabilities.

10/ Net of liquid assets, loan collections in-kind and loss-sharing agreements of the federal government and IPAB.

Mexico: Social Indicators of Development

	Mexico		Latin America and Caribbean
	(most recent estimates)	(15-20 years ago)	(most recent estimates)
Demographic			
Area (square kilometers)	1,908,700	1,908,700	20,504,830
Population (millions)	96.6	75.5	508.2
Urban (percent of total)	74.2	69.6	74.9
Density (population per sq. kilometer)	50.6	34.0	24.8
Population annual growth rate (percent)	1.4	2.2	1.6
Of which			
Urban	1.1	4.2	2.2
Crude birth rate (per thousand population)	26.6	33.0	23.2
Crude death rate (per thousand population)	5.1	7.0	6.5
Fertility rate (births per women)	2.8	4.5	2.7
Labor force			
Economically active population (millions)	40.6	22.0	217.2
Agriculture (percent of economically active population)	22.6	36.6	25.5
Manufacturing (percent of economically active population)	28.3	29.0	24.0
Health			
Infant mortality (per thousand live births)	29.0	43.0	30.0
Mortality rate under 5 years of age (per thousand live births)	36.0	74.0	38.0
Life expectancy at birth (years)	72.0	69.0	70.0
Population per physician	1.6	0.9	1.4
Population per hospital bed	1.1	...	...
Immunized under 5 months (percent of group)			
Measles	94.0	64.0	90.0
DPT	96.0	40.0	87.0
Oral rehydration therapy under 5 years of age (percent of cases)	87.0	...	61.0
Access to safe water (percent of population)			
Urban	94.0	95.0	93.0
Rural	63.0	50.0	62.0
Nutrition			
Cereal imports (thousands of metric tons)	6,223.0	4,780.0	27,659.0
Food production per capita (index 1979-1981 = 100)	97.0	102.0	101.0
Daily calorie intake (calories per person)	3,097.0	...	2,726.0
Daily protein supply (grams per person)	82.5	...	68.0
Prevalence of malnutrition under 5 years of age (percent of age group)	8.0	...	9.0
Education			
Gross enrollment ratios (percent of school age group) 1/			
Primary	114.4	120.0	113.0
Secondary	64.0	49.0	51.7
Pupil/teacher ratio (pupils per teacher)			
Primary	28.0	34.0	24.6
Secondary	16.0	18.0	26.0
Pupils reaching fourth grade (percent of cohort)	86.0	83.0	64.0
Illiteracy rate (percent of population over 15 years)	9.0	15.0	12.0
Newspaper circulation (per thousand of population)	113.0	133.0	83.0
Women			
Gross enrollment ratio (percent of school age group) 1/			
Primary	113.2	122.0	...
Secondary	61.3	55.0	...
Illiteracy rate (percent of population over 15 years)	10.9	18.0	13.8
Life expectancy (years)	75.2	73.0	72.9
Labor force (percent of total)	32.3	27.0	34.2

Sources: World Bank Social Indicators of Development; and Inter-American Development Bank.

1/ Includes over and underage students.

Mexico: Access of Public and Private Sectors to International Capital Markets

	Private Sector			Public Sector 1/			Private and Public Sectors		
	Bonds	Loans	Total	Bonds	Loans	Total	Bonds	Loans	Total
	(In billions of U.S. dollars)								
1997	**4.8**	**6.7**	**11.5**	**10.2**	**3.2**	**13.3**	**15.0**	**9.9**	**24.9**
First half	**3.1**	**2.0**	**5.0**	**7.5**	**0.0**	**7.5**	**10.6**	**2.0**	**12.6**
1st quarter	1.0	0.1	1.2	2.8	0.0	2.8	3.9	0.1	4.0
2nd quarter	2.1	1.8	3.9	4.7	0.0	4.7	6.7	1.8	8.6
Second half	**1.7**	**4.7**	**6.5**	**2.7**	**3.2**	**5.8**	**4.4**	**7.9**	**12.3**
3rd quarter	1.2	2.3	3.5	2.3	0.7	3.0	3.5	3.0	6.5
4th quarter 2/	0.5	2.4	3.0	0.4	2.5	2.9	0.9	4.9	5.8
1998	**3.2**	**8.5**	**11.7**	**5.6**	**2.8**	**8.4**	**8.8**	**11.3**	**20.1**
First half	**3.1**	**5.7**	**8.8**	**2.5**	**1.2**	**3.7**	**5.6**	**6.9**	**12.5**
1st quarter	1.9	1.8	3.7	2.2	0.1	2.3	4.1	1.9	6.0
2nd quarter	1.2	3.9	5.2	0.3	1.1	1.4	1.5	5.1	6.6
Second half	**0.1**	**2.8**	**2.9**	**3.1**	**1.6**	**4.7**	**3.2**	**4.4**	**7.6**
3rd quarter	0.0	2.6	2.6	1.0	1.2	2.2	1.0	3.9	4.9
4th quarter	0.1	0.2	0.2	2.1	0.4	2.5	2.2	0.5	2.7
1999	**4.0**	**8.8**	**12.8**	**7.5**	**3.1**	**10.6**	**11.5**	**11.9**	**23.4**
First half	**2.5**	**5.0**	**7.5**	**4.3**	**1.8**	**6.1**	**6.8**	**6.8**	**13.6**
1st quarter	0.7	2.0	2.6	2.3	0.0	2.3	3.0	2.0	4.9
2nd quarter	1.8	3.0	4.9	2.0	1.8	3.8	3.8	4.9	8.7
Second half	**1.6**	**3.8**	**5.3**	**3.2**	**1.3**	**4.4**	**4.7**	**5.0**	**9.8**
3rd quarter	0.5	2.2	2.7	2.3	0.5	2.8	2.8	2.8	5.5
4th quarter	1.1	1.5	2.6	0.9	0.8	1.6	2.0	2.3	4.3
2000	**2.2**	**5.3**	**7.4**	**4.9**	**1.4**	**6.3**	**7.1**	**6.7**	**13.7**
First half	**1.0**	**2.2**	**3.2**	**3.0**	**0.6**	**3.6**	**3.9**	**2.8**	**6.7**
1st quarter	1.0	0.9	1.9	2.5	0.1	2.6	3.4	1.0	4.5
2nd quarter	0.0	1.3	1.3	0.5	0.5	1.0	0.5	1.8	2.3
Second half	**1.2**	**3.1**	**4.3**	**2.0**	**0.8**	**2.7**	**3.2**	**3.8**	**7.0**
3rd quarter	0.7	0.8	1.5	2.0	0.1	2.1	2.7	1.0	3.6
4th quarter	0.5	2.3	2.8	0.0	0.6	0.6	0.5	2.9	3.4
2001									
First half									
1st quarter	2.2	0.4	2.6	2.2	0.1	2.3	4.4	0.5	4.9

Sources: Loanware and Bondware; and Fund staff estimates.

1/ The public sector includes the federal government, public enterprises, plus their nonresident special-purpose affiliates, such as PEMEX Finance.

2/ Including the contracting of a US$2.5 billion line of credit.

Statement by the IMF Staff Representative
August 2, 2001

1. Economic indicators released since the staff report (SM/01/223) was issued suggest a continued weakness of the economy. In light of this, staff now projects that real GDP growth in 2001 would be under 2 percent. The thrust of the staff appraisal is unchanged by these developments.

Recent economic developments

2. Recent indicators point to continued weakness of domestic economic activity, reinforcing the downside risk to output growth mentioned in the staff report. In the 12 months to May 2001, the global index of economic activity fell 0.4 percent, retail sales expanded by a modest 3.5 percent; and real manufacturing wages rose by 5.5 percent; in the 12 months to June, employment growth fell to only 1.1 percent. At the same time, inflation expectations have continued to decline. According to one survey (Infosel), expected inflation during 2001 was 5.6 percent as of July 27, which is below the official target of 6.5 percent.

3. The public sector had a budget surplus of Mex$32 billion (0.5 percent of annual GDP) in the first five months of 2001, which taking seasonal factors into account, is in line with the end-year target. Preliminary information indicates that tax and public enterprise revenues were 0.2 percentage point of GDP lower than budgeted through end-June. Despite higher-than-projected oil prices during the period, PEMEX revenues were constrained by reduced export volumes, in line with international production cuts. The authorities indicated in public statements that with the expenditure cuts already announced in May and with proposed budget savings in current expenditures for the remainder of the year (0.1 percentage point of GDP), they were on track to meeting the end-year budget deficit ceiling.[1]

4. The seasonally adjusted non-oil trade deficit narrowed considerably in June, falling from an average of US$2.1 billion in the first five months of the year to US$1.7 billion. Both export and import growth decelerated further in June—non-oil exports increased by 2.4 percent year-on-year compared with a cumulative 5.7 percent in January–May. Imports declined by 3.4 percent in June (year-on-year), compared with a cumulative 6.8 percent increase in January–May.

Recent financial market developments

5. The peso depreciated to a low of Mex$9.3=US$1 on July 13. It has since appreciated to a range of Mex$9.1–9.2=US$1 as of end-July. The real exchange rate (on the basis of

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[1] Traditional measure of the fiscal balance. Information on the augmented balance will be published on August 4.

relative consumer prices) appreciated by 11 percent in May 2001 (12-month basis). Domestic real interest rates have risen to 3.9 percent as of mid-July.

6. Sovereign bond spreads widened to 364 basis points in mid-July (from 310 basis points at end-June), but have subsequently narrowed to 353 basis points as of July 30. Mexico's spreads have been less affected by the recent market turbulence than those of the other emerging market economies.

7. Gross international reserves have been stable (at approximately US$41 billion).

Other information

8. In light of the continued weakness of economic activity, staff now projects that real GDP growth in 2001 would be under 2 percent. The lower growth reflects the expectation that the rebound of domestic economic activity in the second half of the year will be somewhat weaker than initially forecast. In line with the lower GDP growth, the external current account deficit in 2001 (3 percent of GDP) would be about half a percentage point of GDP less than previous projections.

9. On July 24, the government auctioned for the first time a fixed-rate ten-year bond (for the equivalent of about US$100 million) in the domestic market. The yield came in at 10.9 percent (compared with 9.4 percent on 28-day *cetes* in the weekly July 26 auction) and demand exceeded supply by three to one. The issuance of longer-term bonds is in line with the authorities' strategy of improving the debt profile through a lengthening of maturities.

10. On July 31, the Bank of Mexico lowered the *corto* by Mex$50 million to Mex$300 million. This move reflects, in part, the favorable inflation performance, including the continuing downward trend in inflation expectations, and lower domestic demand.

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

IMF Concludes 2001 Article IV Consultation with Mexico

On August 2, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

The Mexican economy performed well in 2000, although economic activity and the external accounts weakened toward end-year, mainly reflecting the deterioration in the external environment. Output growth decelerated during the fourth quarter from the rapid pace seen earlier in the year, bringing real GDP growth for the year as a whole to nearly 7 percent. The 12-month inflation rate declined to 9 percent in December (below the official target of 10 percent), associated partly with strength in the value of the peso.

Real GDP contracted slightly on a seasonally adjusted basis in the first quarter of 2001 (growing by 1.9 percent over a year ago). The authorities have revised downward projected real GDP growth to 2½ percent in 2001, from the originally envisaged 4½ percent. There are risks that the slowdown could be deeper, reflecting expected developments in the U.S. economy. The 12-month inflation rate declined to 6.6 percent in June; the core inflation rate declined to 6.4 percent in June from 7½ percent at end-2000. After growing by nearly 6 percent in 2000, real wage growth continued strong in the first quarter of 2001, as a large proportion of wage contracts were negotiated in the first two months of the year when domestic demand was still perceived as strong.

The 2000 fiscal deficit (0.9 percent of GDP) was broadly in line with the official target. Using a comprehensive definition of the fiscal balance—the "augmented balance" or "public sector borrowing requirement"—the 2000 deficit was 4 percent of GDP (down from over 7 percent of GDP in the previous year). Public sector revenues were higher than budgeted, as stronger oil

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[1] Under Article IV of the IMF's 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 discussion by the Executive Board. 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. This PIN summarizes the views of the Executive Board as expressed during the August 2, 2001 Executive Board discussion based on the staff report.

revenues more than offset shortfalls in nonrecurring revenues (in particular from privatization). Non-oil tax revenues were broadly in line with the program (despite a substantially stronger-than-expected pace of economic activity), owing mainly to judicial decisions ordering the return of certain VAT and sales tax receipts. The excess total revenue was used to finance additional expenditures—mainly by public enterprises—and to finance the Oil Stabilization Fund.

The BOM maintained a tightening bias in 2000 and into early 2001 during which time monetary policy was tightened six times amid strong demand pressures. Domestic short-term interest rates averaged 6 percent (in real *ex ante* terms) in 2000 and increased to 10 percent in the first quarter of 2001. However, as domestic demand weakened and domestic interest rates began to decline, the BOM reduced (in May and July 2001) the "corto" (commercial banks' settlement balances with the BOM). These decisions spurred a further reduction of interest rates and helped reduce appreciation pressure on the peso. Despite the strong international reserve build up, the monetary base has been within the expected range of its projected levels for 2000–01. Bank credit to the private sector fell 10 percent in real terms in 2000. Nevertheless, there are indications that bank credit is resuming in 2001.

The overall external current account deficit remained broadly unchanged at 3.1 percent of GDP in 2000, as markedly higher oil and non-oil exports were offset by stronger-than-anticipated import growth associated with the rapid expansion of domestic demand. The non-oil current account deficit rose to 6 percent of GDP (compared with 5 percent in 1999). However, both export and import growth started to decelerate in the second half of 2000. Capital inflows in 2000 were led by foreign direct investment (which financed about three-fourths of the current account deficit) and sizable corporate borrowing. Capital inflows strengthened in the first quarter of 2001, with foreign direct investment at US$3.6 billion, despite the economic slowdown. The level of international reserves almost covers external short-term debt by residual maturity but falls short of full coverage of the annual gross financing requirement (which also includes the external current account deficit).

There has been a considerable improvement in the health of the Mexican banking sector since the last Article IV consultation discussions. Financial strength indicators show a marked improvement, although with some limitations. The overall capital adequacy ratio, after adjustments to the book value of certain assets and liabilities by the FSAP mission, complies with the minimum requirement of 8 percent of risk-weighted assets. Asset quality indicators have improved in recent years—largely reflecting the conclusion of debtor relief programs.

Executive Board Assessment

Directors commended the authorities for maintaining prudent fiscal and monetary policies in the face of recent financial turbulence in emerging markets, the slowdown of economic growth in the United States, and the elections of 2000. They congratulated the authorities for achieving a smooth, democratic political transition. Directors noted that investor confidence in Mexico remains buoyant, with capital inflows holding strong and sovereign debt spreads being affected little by the turbulence in some other emerging markets. As a result, international reserves have increased and the peso has strengthened.

Directors commended the authorities for the strong performance of the Mexican economy through most of 2000, although economic activity had stagnated in the later part of the year, reflecting the slowdown in the United States. In light of the authorities' strong commitment to macroeconomic stability and the projected revival of the U.S. economy, many Directors expected economic activity to rebound later this year. However, some Directors felt that the rebound might be somewhat weaker

than the previous estimate of 2.5 percent real GDP growth by the authorities, and they noted the staff's downward adjustment of the real GDP growth forecast in 2001. Directors supported the shift to a formal inflation-targeting framework in the context of the strong domestic banking sector, and commended the authorities for their success in lowering inflation, noting that expected inflation is now below the official target of 6.5 percent during 2001. Noting the importance of maintaining competitiveness, they emphasized the desirability of wage restraint to curb the recent rise in unit labor costs.

Directors welcomed the authorities' commitment to stick to the budget deficit target in 2001, recognizing that this will require further fiscal tightening on a cyclically adjusted basis. They concurred that this policy stance is warranted to maintain investor confidence, lower borrowing costs, and promote economic growth. They also commended the authorities for the considerable progress made in improving fiscal transparency, including through the monthly publication of traditional fiscal data and the quarterly publication of a more comprehensive measure of the fiscal balance and the augmented debt. Directors considered it desirable that the authorities complete a ROSC module on fiscal transparency.

Directors attached considerable importance to the authorities' efforts to reform the tax system, emphasizing that these efforts are critical for medium-term fiscal sustainability, reduced reliance on oil proceeds, and to lower the debt burden. They cautioned, however, that the planned administrative measures would be fully effective only if they are accompanied by a comprehensive tax reform. Directors noted the authorities' motivation for shifting the value-added tax from an accrual to a cash basis, but generally agreed with the staff that this change should be carefully considered since it potentially makes enforcement more difficult.

Directors endorsed the Bank of Mexico's current monetary policy stance in view of the favorable outlook for inflation and the weak prospects for economic growth in 2001. They felt that monetary policy should remain focused on achieving the long-term inflation target, namely, lowering inflation to 3 percent by 2003. While Directors agreed that the *corto* has proven to be a flexible and efficient monetary policy instrument, most considered that a move toward direct interest rate targeting over the medium-term will facilitate the communication of monetary policy intentions and will be appropriate once monetary policy credibility is sufficiently well established.

Directors welcomed the FSAP mission's main findings, namely, that the banking system does not pose a risk to financial stability and that other sectors of the financial system are not expected to be sources of systemic risk in the near future. They also commended the progress in the observance of international standards, practices, and codes. Nevertheless, Directors agreed with the authorities that additional actions are required to increase the financial system's resilience to shocks and to achieve full observance of international standards. In this sense, they considered that the FSAP mission took place at an opportune moment, when major legal reforms were under way. They encouraged the authorities to quickly follow up on remaining issues identified by the mission, including resolution procedures for nonviable banks, structural reforms to modernize the state-owned development banks, and an action plan to further strengthen banking supervision. Directors saw the main challenge for the banks as the resumption of broad-based and sound lending to the private sector, and expected that this will be facilitated by a sustained reduction in interest rates and by reforms to improve the credit infrastructure.

Directors regarded the present level of international reserves as satisfactory, as it almost fully covers external short-term debt by residual maturity, but noted that it falls short of full coverage of the annual gross financing requirement. Given its overall sound economic management, Directors felt that Mexico would benefit from having precautionary lines of credit, including possibly a contingency credit line (CCL). Several Directors encouraged the authorities to follow up with the Fund on this, including with the preparation of appropriate actions. Several Directors observed that, despite the successful floating exchange rate regime, the level of the real exchange rate poses some concerns for external competitiveness. In this respect, they supported the rebalancing of the policy mix, which will be reinforced further through the planned fiscal reform. Directors commended the authorities for their plan to extend a current bank debt monitoring system to provide monthly data on banks' total external financing. In addition, however, they advised the authorities to monitor carefully the debt of private nonbank corporations, as this is a potential source of vulnerability.

Directors noted that net capital inflows, including foreign direct investment, are expected to cover external financing needs. They commended the authorities for their prudent debt management strategy, which is leading to a manageable external debt profile and will provide protection against turbulence in international capital markets. Notwithstanding the generally favorable outlook, Directors observed that a negative credit shock in emerging markets would pose a risk to capital inflows for Mexico. They welcomed the authorities' awareness of this risk and their willingness to take prompt action, and agreed that any adverse impact should be short-lived in view of the country's impressive track record of implementing prudent macroeconomic policies.

Directors noted that Mexico's data are of good quality, timely, and adequate to conduct surveillance effectively.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Mexico: Selected Economic and Financial Indicators

	1997	1998	1999	Prel. 2000
Real economy (annual percentage change)				
Real GDP	6.8	5.0	3.7	6.9
Real GDP per capita	5.0	3.2	1.9	5.1
Gross domestic investment (in percent of GDP)	25.9	24.3	23.6	23.3
Gross national savings (in percent of GDP)	24.0	20.4	20.7	20.2
Consumer prices (end of year)	15.7	18.6	12.3	9.0
External sector (annual percentage change)				
Exports, f.o.b.[1]	13.1	1.1	14.8	21.8
Imports, f.o.b.	24.6	12.7	10.6	23.1
External current account (in percent of GDP)	-1.9	-3.8	-2.9	-3.1
Change in net international reserves (in billions of U.S. dollars)	13.5	3.7	3.9	8.2
Outstanding external debt (in percent of GDP)	38.2	38.4	34.7	26.0
Public external debt service (in percent of exports of goods, services, and transfers)	36.2	21.6	22.5	26.0
Nonfinancial public sector (in percent of GDP)				
Overall balance	-1.0	-1.2	-1.1	-0.9
Augmented balance	-6.9	-8.1	-7.1	-4.0
Net public external debt (including IMF)	22.0	21.5	18.3	13.3
Money and credit (annual percentage change)				
Monetary base	29.6	20.8	43.5	10.7
Broad money	19.1	21.6	16.8	4.9
Treasury bill rate (28-day cetes, in percent, annual average)	19.8	24.8	21.4	15.2

Sources: National Institute of Statistics and Geography; Bank of Mexico; Secretariat of Finance and Public Credit; and IMF staff estimates.

[1] Includes net proceeds from in-bond industries.

Statement by Mr. Mario Beauregard, Advisor to the Executive Director for Mexico
August 2, 2001

My Mexican authorities would like to acknowledge the valuable support from staff and management during the Article IV consultation and the FSAP recently conducted in Mexico. The documents prepared for today's discussion provide a thorough evaluation of Mexico's economic performance and a comprehensive review of the country's policy options for consolidating recent macroeconomic gains.

1. Background

Last December 1st, Mexico experienced a smooth change of political power. This is the first time in more than two decades that a change in administration is not characterized by deep economic and financial crises. The adoption of a prudent macroeconomic policy over the last few years, the efforts made in order to reduce the economy's vulnerability to sudden changes in the availability of external financing, together with an orderly and democratic electoral process and a smooth transition period, reinforced both national and international investor's confidence in Mexico, consolidating its position among emerging market economies.

After taking office, the Fox administration negotiated with Congress the 2001 fiscal budget. A fiscal deficit target of 0.65 percent of GDP was set and, for the first time since 1990, a ceiling of zero external net indebtedness was established. To further assure the administration's commitment to conduct a prudent fiscal policy, an automatic mechanism geared to adjust public sector expenditures, should federal government's revenues decrease, is in place. In May 2001 this mechanism was used as a result of the reduction in public sector revenues versus programmed figures.

In 2000 Mexico grew 6.9 percent, the highest rate in the last 19 years, and the central bank succeeded in bringing the inflation rate down to 8.96 percent, well below the upper limit of the target set for the year (10 percent or less). Relative to GDP, the current account deficit in 2000 stood at the same level as in 1999 (3.1 percent), while the flow of Foreign Direct Investment (FDI) represented approximately three fourths of that deficit.

With regard to Mexico's quantitative performance criteria under the last Stand-by Agreement (SBA), paragraph 3 of the staff report mentions that all quantitative performance criteria for end-September 2000, which was the last test date under the SBA, were met with large margins. However, footnote 3 and Table 3 show that the adjusted (for higher oil revenues) indicative fiscal targets for end-December were missed due to higher spending on education and pensions, and by public enterprises. On this point, it is worth emphasizing that the higher than targeted fiscal expenditure alluded above resulted mainly from the beginning of contributions to the Oil Stabilization Fund and the creation of provisions for future pension payments.

2. The Mexican Authorities' Reaction to the Economic Growth Deceleration

The Mexican economy started to decelerate during the first quarter of 2001, particularly influenced by the slowdown of economic activity in the US. The reduction in excess aggregate demand contributed to subdue the inflationary pressures experienced during the last four months of 2000, and the inflation rate regained its former downward trend.

Fiscal Policy

My authorities' commitment to set a fiscal deficit limit equivalent to 0.65 percent of GDP for 2001 took into account a set of macroeconomic assumptions that, early into the year, became outdated due to the speed of adjustment of the US economy and its obvious consequences on Mexico's economy. However, they responded to the new external environment by adopting a set of measures aimed at achieving said limit. Thus, in May they announced a cut in programmable public sector expenditures equivalent to the loss of fiscal revenues (3,400 million pesos or about US$380 million). Furthermore, in order to rationalize and make government's expenditures more efficient, a set of measures to increase public sector's productivity and savings, and to promote transparency in the use of resources, was adopted.

Even though programmable revenues were lower than originally envisaged in the budget and despite the economic deceleration in Mexico, during the first five months of the year public sector revenues have increased 1.8 percent in real terms while net expenditures have risen only 0.9 percent. This favorable evolution in revenues reflects the positive response to several measures introduced by the current administration to enhance compliance with tax payments and to fight illegal trade. As a result, during this year 1.4 million new tax declarations have been submitted. In particular, tax revenues have increased 4.0 percent; where income tax collections have increased 5.9 percent and VAT revenues raised 7.2 percent.

Public sector liability management, both in domestic and foreign currency, has successfully improved Mexico's debt maturity profile. In January, my authorities issued a Global Bond to cover virtually all market-related public sector external obligations due in 2001. In addition, other bond issues were placed in the market in order to replace old external debt with less favorable conditions and also as part of the liability management strategy of the government. On the domestic front, they have lengthened the duration and maturity of public debt by issuing longer maturity instruments. In 2000, three- and five-year fixed coupon instruments were issued and last July 24th, a ten-year bond was also issued.

In order to increase fiscal transparency, the new administration produced, according to international standards, more comprehensive fiscal indicators. Thus, the concept of Public Sector Borrowing Requirements (PSBR) and an augmented definition of Net Public Sector Debt are now published. (It is important to clarify, however, that all components necessary to calculate both the PSBR and the augmented debt were already public information). In addition, monthly fiscal reports have been published since May of this year.

Monetary Policy

Although the inflation rate target for 2000 was achieved, from September to December price pressures were building up due mainly to an excess of aggregate demand. Furthermore, contractual wage negotiations that took place during the first months of 2001, and that served as guidelines for future wage negotiations, resulted in real wage increases above expected labor productivity gains. Besides the negative effects on the competitiveness of the economy and on the labor market, these wage increases were seen as a potential threat to the inflation target for 2001 (6.5 percent or less). In addition, the international environment was also uncertain. The main elements perceived as negatively affecting Mexico's external accounts that could have affected the development of the domestic economy and the decline of the inflation rate were (i) the perception of a deceleration of the United States' economy, (ii) a potential sharp reduction of the international price of crude oil and (iii) a possible reduction, or even a reversion, of capital flows to emerging markets due to increased risk aversion. It was expected that if any of these situations materialized, the nominal exchange rate would have depreciated to facilitate the transition towards a new equilibrium real exchange rate with its obvious consequences on inflation expectations. As a result, the central bank tightened monetary policy on January 12, reaffirming its commitment to achieve the inflation target.

However, throughout the year several factors have contributed to a reduction in inflationary pressures. Among them, the economic deceleration has nearly eliminated the aggregate demand pressures and the appreciation of the exchange rate has helped drive inflationary expectations towards the central bank's target and additional reductions are anticipated. Thus, the central bank loosened its monetary policy in mid May, but still maintained a tightening bias in order to reaffirm its medium term inflationary objective.

Finally, given the continued reduction of both the inflation rate and the inflation expectations in the last few months, the central bank further reduced the "short" in July 31st. The year over year inflation rate in June was 6.57 percent, while the private sector expects that at the end of 2001 domestic prices will increase less than 6 percent. The factors that support the decision to reduce the "short" are: (i) a reduction in excess aggregate demand, (ii) the influx of foreign capital to the Mexican economy, particularly FDI, and (iii) the fiscal adjustment during the year (preliminary estimates indicate that the public sector has reached in the first five months of 2001 a surplus 10.5 percent higher in real terms relative to the same period last year). My monetary authorities have emphasized they will continue assessing all factors that determine the evolution of the inflation rate in Mexico and, if pressures arise, they will take the necessary steps to achieve the inflation target.

In sum, a prudent fiscal and monetary policies and the reduction in inflationary pressures and expectations, have allowed interest rates to come down sharply. During the year short-term interest rates have decreased 800 basis points, or 910 basis points if measured relative to their highest level in the year.

3. Inflation Targeting in Mexico and the Monetary Policy Instrument

With the adoption of the floating exchange rate regime following the balance of payments crisis in 1994-1995, the exchange rate ceased to function as the policy instrument that guided inflation expectations in Mexico. In turn, monetary policy became the nominal anchor of the economy.

In the last six years, the monetary policy scheme has been adjusted in order to increase its effectiveness and transparency in light of the changes that the Mexican economy has undergone. This evolution has led to a gradual convergence towards an inflation-targeting regime with short- and medium-term inflationary objectives.

My authorities have stressed that even if the monetary policy stance adopted is the appropriate one, in the short-term prices can be influenced by fluctuations in various key prices, such as the exchange rate, wages and the prices of goods and services provided or regulated by the public sector. One additional factor in the short-run could be the approval of the fiscal reform that is being negotiated with Congress and the Executive branch. Should these fluctuations materialize, monetary policy actions might not be able to offset them fast enough to meet the short-term inflation target. It is precisely under such circumstances that the medium term target shall play its role as nominal anchor of the system.

On the instrument to conduct monetary policy, the "short" or "corto" has proven to be very effective in distributing the impact of external shocks between the exchange rate and interest rates. This is an enormous advantage in an open economy like Mexico, which is subject to external shocks and has experienced large exchange rate pass through effects on prices. The "short" has also significantly contributed to the process of lowering inflation due to the fact that nominal and real interest rates have reacted very well to movements in the level of this instrument. My authorities have analyzed other monetary policy instruments but, given Mexico's large exchange pass-through history on domestic prices, the exposure of the economy to external shocks and the high volatility of domestic markets, they have not found any superior alternative.

4. Vulnerability Indicators

My authorities would like to commend staff's thorough analysis of the External Competitiveness and the Current Account Sustainability in Mexico.

Although repetitive of what staff has outlined as important factors to take into account when analyzing the real appreciation of the exchange rate, I would like to emphasize the existence of a flexible exchange rate regime, the improvements in the economy's fundamentals and financial strength (including the fiscal consolidation process that has taken place since the mid-1990's), the much greater access to international capital markets and the structural reforms that have taken place in Mexico during the last six years. Furthermore, although the recent deceleration of Mexican exports is explained by the US economic slowdown, the fall in demand for Mexican exports in the US has been lower than the fall in exports from other

countries to the US market. In the first six months of 2001, Mexican non-oil exports have increased 3.1 percent relative to last year's first semester.

Staff also notes the increasing level on the non-oil current account deficit. Although in the first five months of this year such deficit has risen, it has increased at a lower rate than originally expected at the beginning of the year. This is explained by the high import component of our exports and the reduction in domestic demand. Furthermore, "trend indicators" show that starting this year both total and non-oil trade deficits have shown a steady contraction. In addition, it is also important to note that the current account deficit has been financed primarily by FDI flows, which were enough to cover 82 percent of the deficit registered during the first quarter of 2001.

Finally, in paragraph 40 the staff discusses private non-bank external flows and debt, stressing the importance of resolving debt data differences between BOM and SHCP. It also mentions Staff comments regarding the paucity of information on exchange rate and credit risks carried by the non-financial corporate sector. Although we concur with the staff's remarks about the differences in data reports from BOM and SHCP, it would be convenient to emphasize that these disparities result from the methodologies and the sources of information used in the elaboration of these statistics. Regarding the possible exchange rate risks from the non-financial corporate sector, most of the firms that have had access to external financing are export firms that generate their cash flows in foreign currency. This certainly limits the exchange rate risks on the non-financial corporate sector.

5. Structural Reforms

The incoming administration recognizes the importance of promoting decisive structural reforms to consolidate Mexico's macroeconomic gains and to enhance its economic growth potential.

The Financial Sector Assessment Program and the Financial Reform in Mexico

The FSAP carried out recently in Mexico was important because it served to confirm that the financial system no longer represents a source of systemic risk to the economy. This is evidenced by the recent announcement of Citigroup to buy Banamex, one of the largest banks in Mexico. This decision was perceived by the investor's community as a sign of strength of Mexico's financial system and good economic prospects.

I would like to emphasize that this is a very important financial sector reform in Mexico. Its objectives are to increase the amount of savings that are channeled through the financial system, in particular by the banking system and securities markets; to boost popular and long-term savings and to enhance banking credit to all sectors of the economy. The reform also promotes much needed competition among financial intermediaries, strengthens the corporate governance structures of financial institutions and public issuers, protects minority shareholder interests and reinforces supervisory and regulatory systems.

My Mexican authorities are certain that the financial reform submitted to Congress represents an important step in the consolidation of the financial system. The approved financial reform package includes legal amendments regarding banking institutions, mutual funds, popular financial institutions, corporate governance, financial sector standards and codes, minority rights, and private debt markets, among others. In addition, the package contemplates a number of amendments that are pending of discussion in Congress, including reforms to development banks' operations and the creation of an institution specialized in housing finance. Furthermore, financial authorities have implemented important legal modifications that do not require Congress approval. As a consequence, many of the weaknesses in the financial sector legal infrastructure alluded in the report have been already addressed.

Finally, a Financial Sector Modernization Committee was set up to discuss the implementation of recently approved reforms and further development issues. Financial sector authorities and market participants integrate this committee. My authorities are confident that the reforms recently approved by Congress and the ones to be approved by year-end would help promote the much-needed participation of the financial system in the economy.

Fiscal Reform

The new administration has acknowledged that if the government is to efficiently work in fulfilling social demands and in promoting a better income distribution and an economic environment that enhances private sector participation, a fiscal reform is of utmost importance. This reform is aimed at strengthening the government's fiscal stance and reducing the public sector's borrowing requirements; reducing the vulnerability of public sector revenues to changes in international oil prices; increasing social expenditures in key areas such as education, health and infrastructure; and promoting an environment of low interest rates, an essential component in attaining sustainable economic growth.

In the staff report, paragraph 23 includes a discussion about the shift in the VAT system from an accrual to a cash basis in which the report stresses the possibility of an erosion in the auditing capability of the tax administration agency due to the reduction in value of invoices as an auditing tool. On this point, my authorities would like to mention the motivations behind the reform, as well as the mechanisms that will be implemented to avoid the erosion in auditing capabilities. In particular, it is worth mentioning that this reform has been proposed as a means to alleviate the profound liquidity problem faced by small and medium size firms. Under the accrual basis scheme, firms are required to pay the VAT at the time any service or merchandise is exchanged. However, in a majority of cases these firms do not obtain their cash receipts until several months in the future, resulting in an important liquidity crunch for the firm and, in some cases, in the evasion and elusion of VAT payments. This situation has inhibited growth and investment in small firms. The shift to a cash basis would allow firms to pay VAT obligations only when they receive the financial resources required to do so.

Regarding the possible erosion of auditing capabilities, the reform incorporates a number of instruments designed to prevent tax evasion and elusion. On the one hand, the reform includes a simplified system for small taxpayers that allow the calculation of VAT obligations through very accessible formulas. On the other hand, the reform contemplates the use of the banking system as an auditing tool, requiring the use of checks with VAT annotations to credit VAT payments, allowing authorities to monitor closely those financial operations that are relevant to VAT collection.

My authorities have completed a self-evaluation on the fiscal area and a fiscal ROSC has been requested. Finally, technical assistance to improve tax collection will be carried on as soon as the fiscal reform is approved.

Negotiations are currently under way among the federal government and political parties to achieve a consensus about key changes to strengthen the fiscal position of the public sector. This process is difficult and lengthy, but the different political parties all agree that this reform is necessary. My authorities remain confident that this reform will be approved by year-end.

6. Free Trade

Mexico's commitment to free trade is assured by the fact that as of this year 10 Free Trade Agreements (FTAs) have been signed. These treaties allow secure and preferential access of Mexican products to markets in 31 countries in 3 continents. FTAs are an essential part of Mexico's economic strategy. They help to better place the country into an increasingly competitive world trade environment and contribute to sustained long-term economic growth.

Mexico's international trade is concentrated with the United States. Close to 90 percent of our imports and exports are traded with our northern neighbor. This is understandable given the geographical situation of both countries and the fact that both countries complement each other. However, as more free trade agreements are signed, it is expected that Mexican exports will gain market share in other economies, thus increasing and diversifying the country's sources of external growth. In that respect, last January 1st a FTA with the European Union took effect and a treaty with Japan has also been proposed recently by Mexico.

7. Conclusions

In recent years, Mexico has taken important steps to improve its macroeconomic fundamentals. The resilience shown by financial markets in Mexico despite the uncertainty in some emerging markets proves that Mexico's efforts are paying off. My authorities are convinced that it is essential to continue advancing in the same direction. Important challenges still remain, fiscal reform being one of them. Other reforms aimed at improving the infrastructure of the economy and enhancing its competitiveness are also essential and the new administration is committed to advance these other areas. A necessary, but certainly not

sufficient, condition needed to improve income distribution and human development of our population clearly depends, to a great extent, on our ability to grow at higher and sustainable rates.