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Mexico: 2004 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 the 2004 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 1, 2004, 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 September 24, 2004. 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 October 18, 2004 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 18, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Mexico.

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

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representative for the 2004 Consultation with Mexico

Approved by Caroline Atkinson and G. Russell Kincaid

September 24, 2004

Discussions for the 2004 Article IV consultation with Mexico took place in Mexico City during June 21–July 1, 2004. The staff team comprised G. Meredith (Head), E. Faal, V. Moissinac (all WHD); A.Bulir (PDR); and M.Vera Martin (ICM). Ms. Atkinson joined the mission for the final discussions, and Mr. Schwartz (Alternate to the Executive Director) also participated. Discussions were held with Finance Secretary Gil Diaz; Bank of Mexico Governor Ortiz and other members of the Policy Board; officials from the Ministry of Finance, the Bank of Mexico, the Ministry of Economy, the Ministry of Social Services; and supervisors of financial institutions. The team also met with the Mexican Stock Exchange, financial institutions and credit rating agencies, and political analysts.

The 2003 Article IV consultation was concluded on October 15, 2003, and the Staff Report was issued as IMF Country Report No. 04/250 on August 13, 2004. In concluding the consultation, Directors commended the authorities for policies that continued to underpin macroeconomic stability and investor confidence. Directors welcomed the authorities' commitment to further fiscal consolidation and endorsed their medium-term fiscal goals, which call for further fiscal adjustment to lower ratios of public debt to GDP. Directors stressed the need to reinvigorate the structural reform agenda, where recent progress had been disappointing owing to difficulties in forging the needed political consensus.

Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4, and does not have restrictions on payments for current international transactions (Appendix I).

Comprehensive economic data are available for Mexico on a timely basis, and are adequate to conduct surveillance. Mexico has subscribed to the Special Data Dissemination Standard, and its metadata are posted on the Fund's Data Standards Bulletin Board. The data module of the ROSC for Mexico was completed in May 2003 and published as IMF Country Report No. 03/150.

Contents

Annexes

I. Overview and Key Issues

1. **Mexico is experiencing a broad-based economic recovery following three years of weak activity** (Text Table 1). Both private and official growth estimates for 2004 have risen steadily since the beginning of the year to stand at around 4 percent by mid-year. The pick up in activity has been associated with the U.S. economic recovery, and in particular the impact on Mexican exports of the strong upturn in U.S. manufacturing activity beginning in the second half of 2003. In addition, growth in Mexican final domestic demand has accelerated to 4 percent in the first half of 2004 over the same period in 2003. Along with a continuing expansion of private consumption and residential construction, activity has been boosted by a recovery in business fixed investment, following a decline of 15 percent from the peak in 2000 through 2003.

Text Table 1. Mexico: Growth of Real GDP by Component (1993 prices)
(4-quarter percentage change, unless otherwise indicated)

	2001	2002	2003	*2004*	2003				2004	
				Proj.	Q1	Q2	Q3	Q4	Q1	Q2
Gross domestic product	**-0.1**	**0.7**	**1.3**	***4.0***	**2.5**	**0.1**	**0.6**	**2.0**	**3.7**	**3.9**
Of which:										
Total domestic demand	0.6	0.7	0.5	*3.3*	1.5	-0.7	0.3	1.1	3.2	3.1
Final domestic demand	0.3	0.7	2.3	*4.1*	2.9	0.2	3.5	2.7	3.5	4.5
Consumption	1.9	1.1	3.0	*3.7*	3.5	1.1	4.1	3.1	3.2	4.2
Private	2.5	1.3	3.0	*4.2*	3.7	0.8	4.3	3.2	3.7	5.4
Public	-2.0	0.3	2.6	*0.2*	1.4	3.1	2.6	2.8	-0.3	-5.0
Fixed investment	-5.6	-1.1	-0.4	*5.6*	0.5	-3.6	0.8	0.8	4.5	5.8
Private	-5.9	-4.0	-5.7	*5.0*	-2.1	-8.1	-4.4	-8.6	4.0	6.8
Public	-4.2	14.2	22.4	*7.5*	16.8	22.1	26.8	22.7	7.1	1.6
Inventory change (contribution)	0.3	0.0	-1.7	*-0.7*	-1.3	-0.9	-3.2	-1.6	-0.2	-1.4
Net exports (contribution)	-0.7	0.0	0.7	*0.7*	1.0	0.9	0.3	0.8	0.5	0.8

Source: Authorities and Fund staff estimates and projections.

2. **While the near-term growth outlook is favorable, important policy challenges remain.** Political fragmentation since congressional elections in July 2003 has blocked legislative initiatives, and most observers believe it unlikely that major actions will be possible before the 2006 elections. Absent further progress on structural reforms, prospects for robust economic growth beyond 2004 have become less favorable. In the fiscal area, markets have been reassured by the government's ability to meet its objectives for the traditional deficit, despite spending pressures, and the public debt structure has been strengthened further. Yet the spending of "windfall" oil revenues in recent years has made the fiscal position more vulnerable to a decline in oil prices. Even if oil prices do not decline sharply, significant spending compression will be needed to meet medium-term budget targets in the absence of tax measures that would boost non-oil revenues. Public debt edged up in 2003, largely reflecting exchange rate depreciation, leaving gross public debt at around 51 percent of GDP compared with 47¾ percent in 2001.

3. **Inflation has been brought down to the low single-digit range.** More recently, however, headline inflation has risen above the upper bound of the Bank of Mexico's (BOM)

2–4 percent “variability interval.” While supply shocks have played an important role in boosting headline inflation, core inflation has been resistant to further declines, stabilizing in a range around 3½ percent, while expectations of headline inflation over the next 12 months have edged up to over 4 percent. The main challenge is to maintain the credibility of the BOM’s commitment to reducing inflation to 3 percent, while not choking off the nascent recovery.

4. **The Fund’s policy advice to Mexico has focused on the need to consolidate further the broad fiscal position, lower inflation to the medium-term target, advance structural and financial reforms, and promote measures to crisis-proof the economy.** Progress in several of these areas has been impressive, notably in lowering inflation, modernizing the financial system, allowing the exchange rate to float freely, meeting targets for the traditional fiscal deficit, and strengthening the structure of public debt. Mexico has participated in an FSAP, and was the first major emerging market country to issue bonds with collective action clauses (CACs) in 2003. On the other hand, after successes in the latter half of the 1990s, recent progress in fiscal consolidation is mostly due to higher oil prices, and structural reforms have been limited (Box 1).The authorities broadly share the Fund’s views on the priorities in these areas, but political constraints have hindered passage of necessary legislation, as it has been difficult to channel the longer-term benefits of these policies into broad popular support.

5. **Against this background, the 2004 consultation focused on the following issues:**

- **Fiscal policy.** Success in meeting deficit targets has recently been aided by windfall oil revenues. Moving ahead, staff emphasized the need to save a significant portion of future windfalls to avoid increasing dependence of the budget on oil revenues. The authorities agreed, but noted the political difficulties in resisting spending pressures when revenues were strong—at the same time, they underscored Mexico’s demonstrated ability to cut spending if needed to meet deficit targets. Staff observed that, even if oil prices did not fall sharply, meeting medium-term fiscal targets would be challenging without measures to boost non-oil revenues. The authorities agreed that, in such a case, significant further spending restraint would be needed.

- **Monetary policy.** Staff noted that monetary conditions remained relatively easy, due in part to peso weakness, and agreed with the authorities that, with headline inflation remaining above the BOM’s target, tightening would be appropriate. The magnitude and timing, however, would depend on an ongoing assessment of the impact of supply shocks on underlying inflationary pressures, and also that of external monetary actions on domestic markets. Staff noted the problems in communicating policies when inflation was above target, and suggested that publication of an official inflation forecast could help in this regard. The BOM observed that further refinements to the inflation targeting framework would be considered in due course. It was premature, however, to consider publishing an inflation forecast, particularly given the indirect relationship between existing monetary instruments and market conditions, as well as uncertainties about the inflation outlook.

Box 1. Mexico: The Administration's Structural Reform Agenda, 2002–06[1]

1. **Energy sector reform** aimed to increase the efficiency of public producers and allow broader private sector participation. The latter is needed both to acquire needed expertise, as well as to expand capital investment. The constitution, however, bars most private-sector participation in this sector.

   Status: The government has taken incremental steps to expand private participation. In 2002, PEMEX introduced multiple service contracts, which allow private firms some operational responsibilities in gas fields. While a limited degree of private investment is allowed in electricity generation, only state companies can distribute power. No changes have occurred in the oil sector. At this stage, constitutional changes in the energy area appear highly unlikely, and the administration is focusing on establishing legal certainty for the agreements already in place.

2. **Labor market reform** aimed to increase productivity and employment in the formal sector by reducing rigidities. The objectives of the reform were to: lower sizable nonwage and dismissal costs; make work hours and probation periods more flexible; and improve union governance.

   Status: A reform was submitted to congress in 2002 based on a consensus between employers, unions, and the Labor Secretariat. In any case, it did not address major rigidities to hiring in Mexico, notably high nonwage and dismissal costs. The authorities still envisage a reform that would allow for, inter alia, more flexible work arrangements, and would facilitate the transfer of workers from the informal to the formal sector. Observers believe, however, that the current proposal may be too watered down to meaningfully increase flexibility.

3. **Telecommunications reform** was intended to: increase coverage and quality of services; lower costs; promote a competitive environment; and encourage new technologies and services. Telmex controls 96 percent of the fixed-line network and its sister company, Telcel, controls 80 percent of the mobile market. Internet penetration is limited by a lack of fixed-line capacity.

   Status: The government and a congressional commission began working on a bill in 2002 that would strengthen regulatory authority; spectrum planning and administration; concessions and permits; satellite services; dominant carrier regulation; consumer protection; and fines. No significant progress has been made, however. In late 2003, the government announced plans to give COFETEL greater regulatory powers to boost competition. In March 2004 the WTO ruled that Telmex's sole authority to set domestic connection charges breached its obligations under the WTO services agreement.

4. **Financial market reform** aimed to promote savings, modernize the financial system to reactivate bank lending, deepen capital markets, and modernize development banks.

   Status: Congress passed several measures designed to achieve the authorities' objectives, including legislation on credit guarantees, bank supervision, and the payments system. The closure of government banks and the sale of government shares in private banks has reduced government participation in the sector.Foreign ownership of banks and nonbank financial intermeidation have increased significantly, and oversight of banks has strengthened.

5. **Judical reform** aimed to strengthen governance by improving the quality of public administration through improving the legal and regulatory framework, reducing corruption, and increasing the accountability of civil servants.

   Status: A number of initiatives have been sent to congress, and a law enabling public access to government information was approved in April 2002. Legislation improving corporate governance and protecting minority shareholder rights has also been enacted. In 2003, legislation protecting creditor rights was approved.

[1] Source: "Plan Nacional de Desarollo, 2001–2006," Government of Mexico, 2002.

- **Structural reforms.** Discussions focused on: the prospects for reviving the reform agenda; smaller-scale reforms that might be politically feasible and/or did not require legislation; and the effects of a lack of reforms on the medium-term outlook. The authorities were optimistic that tax and pension reforms proposed by the National Fiscal Convention had a greater chance of success than previous initiatives; the passage of fiscal responsibility legislation was also possible in the fall session of congress. In contrast, there was no public consensus for further reforms in the energy sector. Staff noted that liberalization of the telecommunications sector could have a catalytic effect on growth; it could also be accomplished by executive action as opposed to legislation.

- **Competitiveness.** Discussions focused on concerns about a possible loss of competitiveness in U.S. markets. The authorities pointed to several industry-specific factors that explained the stagnation of Mexico's market share in recent years, and saw the recent recovery in the *maquiladora* sector as a sign of renewed confidence in Mexico's prospects. There was general agreement, however, that Mexico would need to take active measures to keep pace with other fast-growing emerging market countries in export markets.

II. Recent Economic Developments

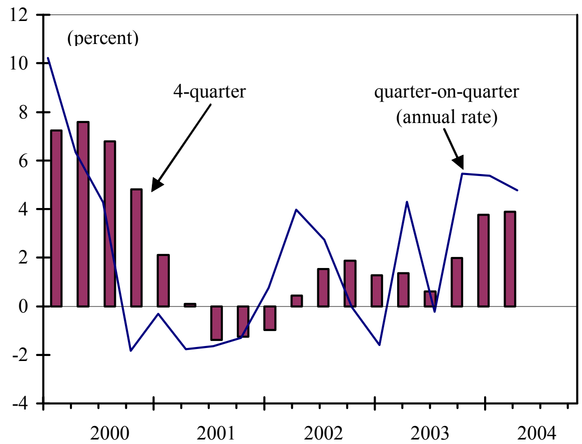
6. **Economic activity started picking up in late 2003** (Figure 1; Table 1). Following real GDP growth of only 1.3 percent in 2003, growth accelerated to 3.8 percent in the first half of 2004 over the previous year. This recovery is partly attributable to strengthening U.S. industrial production, as reflected in growth in Mexican manufactured exports of 10½ percent in the first seven months of 2004 over the same period in 2003. Consumption growth has also increased in response to lower interest rates and rising credit availability. Spurred by the recovery in exports and strong domestic sales, business investment began to pick up in late 2003, with gross private fixed investment rising by 5½ percent in the first half of 2004 over the previous year.

7. **The broad-based recovery has led to rising capacity utilization and higher employment**. Capacity utilization in manufacturing has recovered above mid-2001 levels, while the staff's estimate of the output gap has narrowed to slightly below 2 percent of GDP.[1] Formal employment in the private sector increased by 185,000 in the first half of 2004, reaching its highest level since mid-2001; most of the increase is accounted for by permanent employment. The seasonally adjusted unemployment rate edged down to 3.7 percent in July after peaking at 3.9 percent in February.

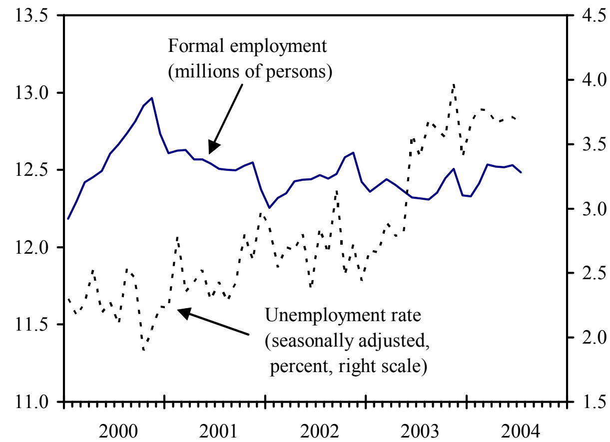
[1] The staff's methodology for constructing the output gap is discussed in an accompanying selected issues paper.

Figure 1. Mexico: Real Sector Developments

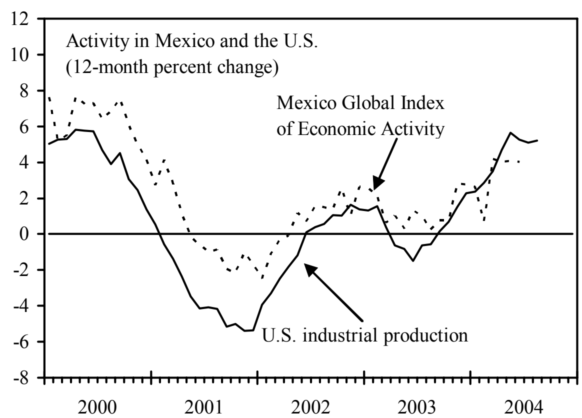
Real GDP growth has rebounded strongly in recent quarters ...



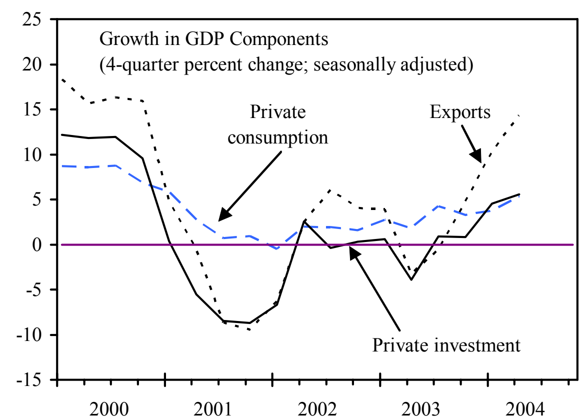
... and conditions in the labor market have shown signs of improvement ...



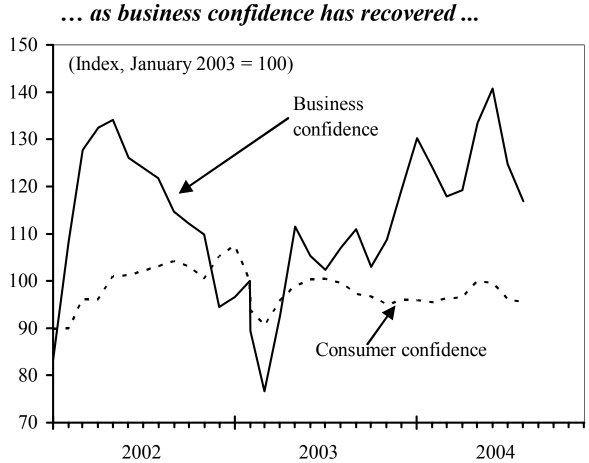
... as external demand increases in line with a pick-up in U.S. industrial activity.



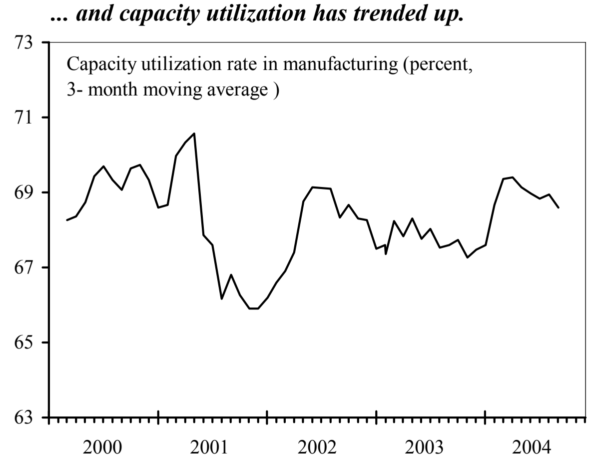
Domestic demand has also strengthened as private investment shows signs of recovery ...



... as business confidence has recovered ...



... and capacity utilization has trended up.

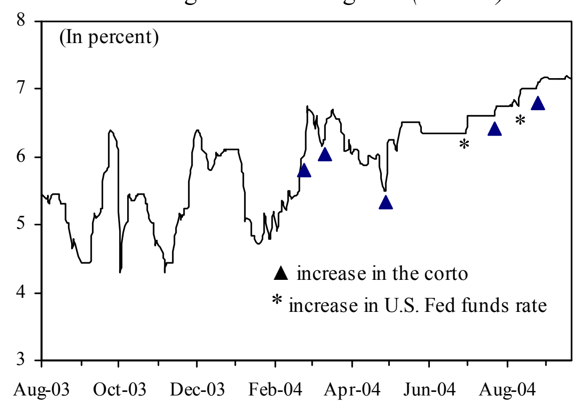


Sources: Mexican authorities, U.S. Federal Reserve, and Fund staff estimates.

8. **Headline CPI inflation reached a record low of just under 4 percent at end-2003 (12-month basis), but rose above the BOM's variability interval of 2–4 percent in early 2004** (Figure 2). Inflation has been boosted by supply shocks, including a temporary suspension of some meat imports from the United States, as well as increases in administered prices. As a result, the headline measure rose to 4.8 percent in August (12-month basis). Core inflation was lower, at 3.7 percent, but has shown no signs of decelerating since early 2003. Inflation expectations for the next 12 months stood at 4.1 percent in August. Contractual wage settlements averaged 4.5 percent in the first eight months of 2004, broadly unchanged from the second half of 2003.

9. **The BOM has tightened policy five times since the beginning of 2004 via increases in the *corto* (the borrowed reserves objective)** (Figure 2). In addition, domestic market conditions have been affected by two increases in the U.S. federal funds target rate. Starting in May—around the time the BOM streamlined its monthly press statement to more clearly communicate its views to markets—day-to-day volatility in the overnight inter-bank (*fondeo*) interest rate declined markedly. The *fondeo* has also responded more systematically to domestic and U.S. policy actions since May. In the event, it rose from an average of just over 5 percent in the second half of 2003 to slightly over 7 percent by mid-September 2004. Long-term interest rates rose by a similar amount over this period, with the 10-year government bond yield increasing from about 8½ percent in January to just over 10½ percent in September.

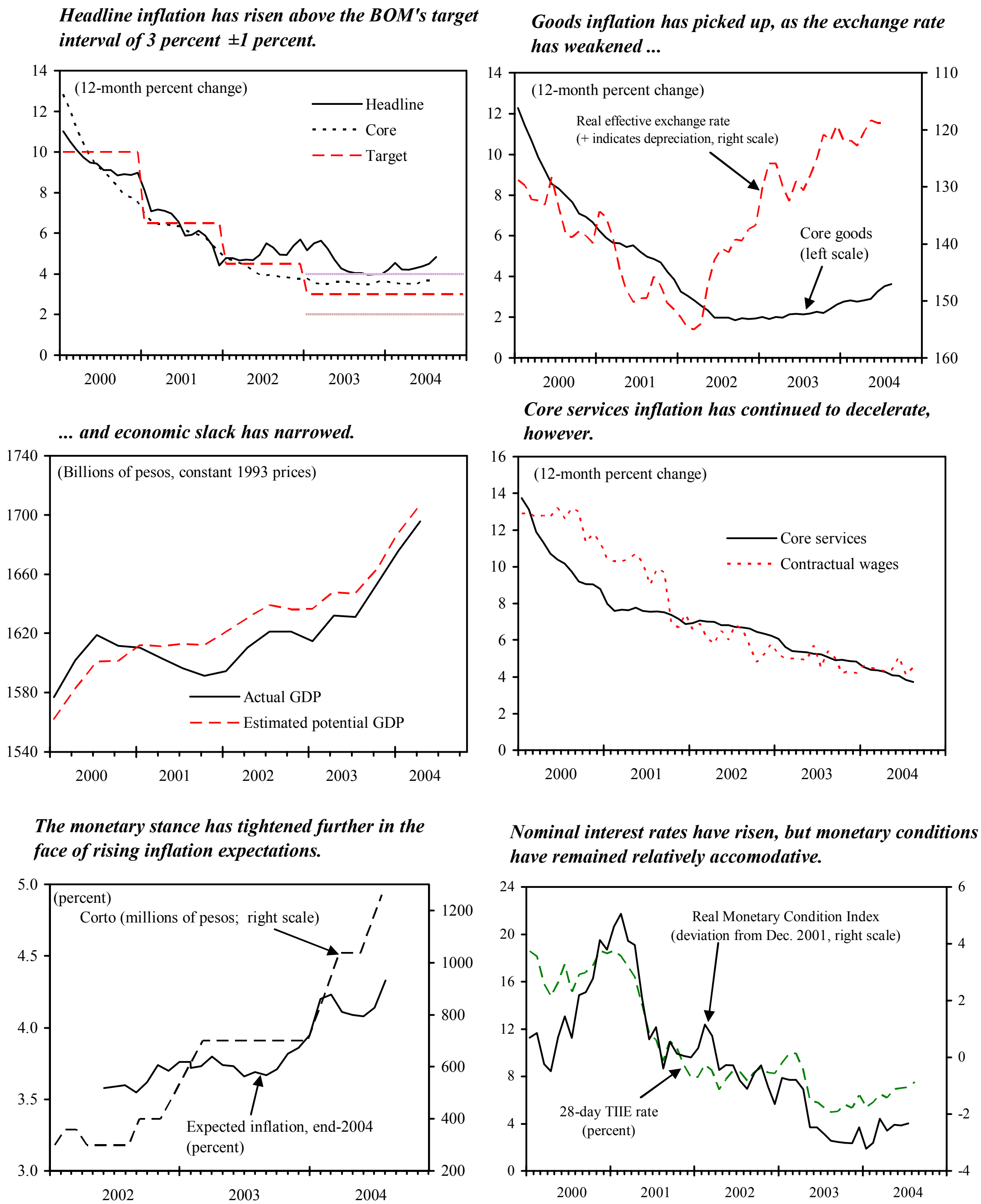
Overnight Bank Funding Rate *(Fondeo)*



Source: Bank of Mexico

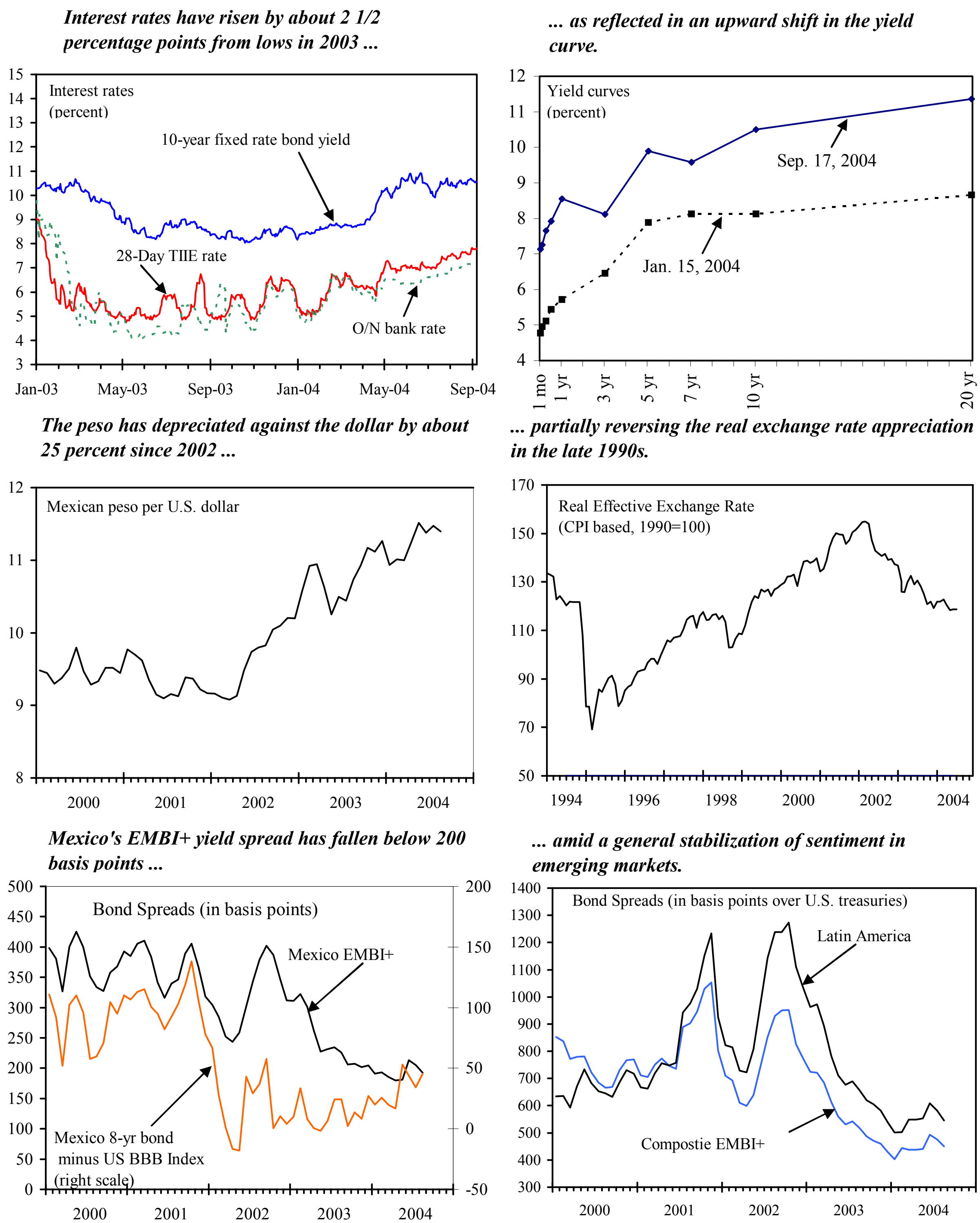
10. **Nevertheless, monetary conditions remain relatively easy, due in part to weakness in the peso** (Figures 2 and 3). After falling by 7½ percent against the U.S. dollar through 2003, the peso depreciated by a further 3 percent through mid-September, partly reflecting concerns about the effects of U.S. monetary tightening on emerging markets. The real effective exchange rate depreciated by 13 percent through 2003, and a further 1 percent in the first seven months of 2004. The weakness of the peso in 2003, combined with a drop in real short-term interest rates through the year of about 2½ percentage points, led to a significant easing in monetary conditions. Part of this easing has been reversed by rising interest rates in 2004, but monetary conditions remain substantially more accommodative than at the beginning of 2003.

Figure 2. Mexico: Inflation and Monetary Policy



Sources: Mexican authorities, and IMF staff estimates.

Figure 3. Mexico: Financial Market Developments



Sources: Mexican authorities, and Fund staff estimates.

11. **Fiscal consolidation was modest in 2003, despite higher-than-budgeted oil prices** (Figure 4 and Table 2). The augmented deficit fell slightly to 3 percent of GDP from 3¼ percent in 2002, primarily because of lower off-budget financing requirements arising from falling interest rates.[2] The traditional deficit, at ½ percent of GDP, was broadly in line with the 2003 budget target and the 2002 outturn.[3] Windfall gains from higher oil revenues and public enterprise profits were used to offset shortfalls in non-oil tax revenues and finance higher-than-budgeted capital outlays, wages, severance payments, and interest charges. As a result, the non-oil augmented deficit deteriorated further, reaching 9½ percent of GDP in 2003 compared with 8 percent in 2002. A small contribution of 0.1 percent of GDP was made to the Oil Stabilization Fund (OSF). In the first seven months of 2004, higher oil prices led to total revenue growth of 9 percent over the same period in 2003, while overall spending grew by 7 percent. Programmable current spending also rose by 7 percent, compared with the budget assumption of no nominal increase for the year as a whole.

12. **Public debt edged up further in 2003, but its structure continued to improve.** The ratio of gross augmented public debt to GDP rose by 1¼ percentage point in 2003 to reach 51 percent, largely due to peso depreciation. The authorities have already completed their external financing program for 2004 on favorable terms. Several liability management operations, including an exchange of global bonds in early 2004, have helped to improve the efficiency of the yield curve. Domestic public debt management has concentrated on extending maturities, improving the liquidity of benchmark issues, and deepening domestic financial markets.[4]

13. **In July, banks and the government agreed on the exchange of FOBAPROA debt for new bonds, ending a long period of uncertainty for the financial system.** FOBAPROA notes were issued to banks after the 1994–95 financial crisis, but the government's ultimate liability remained in dispute as their maturity approached in 2005–06. Of the original gross amount of about 3¼ percent of GDP, it is tentatively estimated that banks will receive about 1½ percent of GDP in new bonds issued by the deposit insurance agency (IPAB), with the difference reflecting recovered loans, loss sharing covered by banks, and related credits banks will pay.

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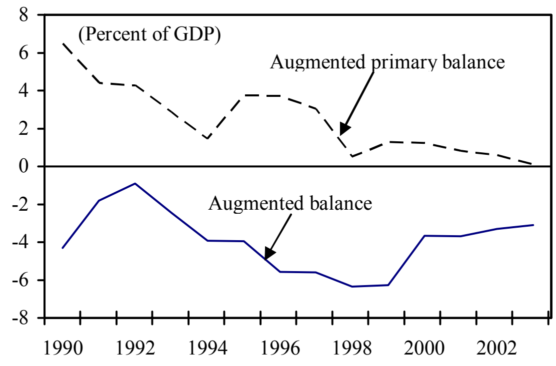
[2] The augmented deficit is defined as the public sector borrowing requirement (PSBR) less nonrecurring revenues. The differences between the augmented and traditional deficits reflect: off balance sheet public investment projects (PIDIREGAS); servicing costs of off balance sheet public debt related to bank and toll road restructuring; the financing needs of government development banks; and the exclusion of non-recurring revenues from the augmented measure (these factors are quantified in Table 2).

[3] The 2002 outturn is adjusted for exceptional transfers related to the closure of Banrural. These transfers did not affect augmented public debt, as they were offset by an equal reduction in development banks' financing needs.

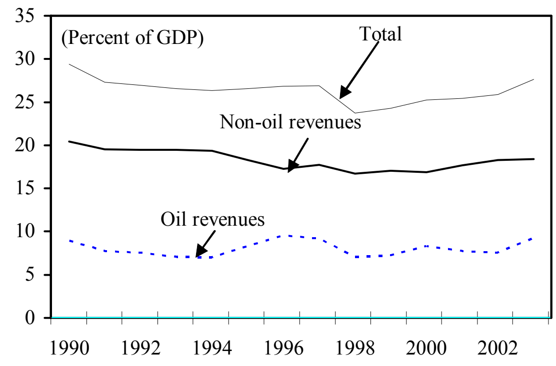
[4] The structure of Mexico's public debt is analyzed in an accompanying selected issues paper.

Figure 4. Mexico: Fiscal Sector

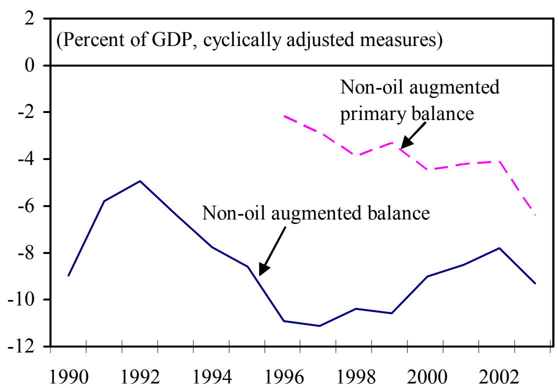
Fiscal consolidation was modest in 2003, and reflected lower debt-servicing costs.



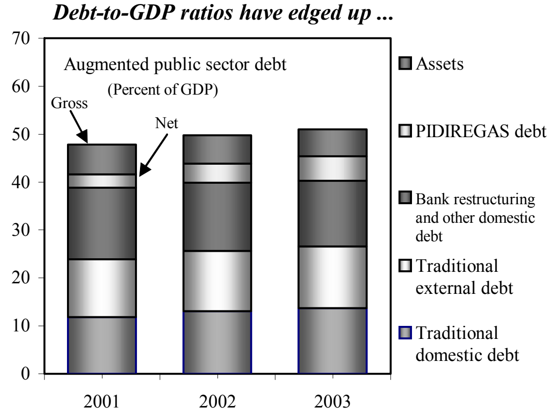
Non-oil revenue remains low ...



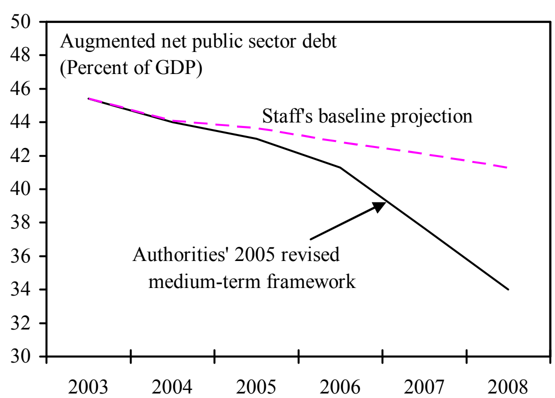
... and the non-oil balances worsened in 2003.



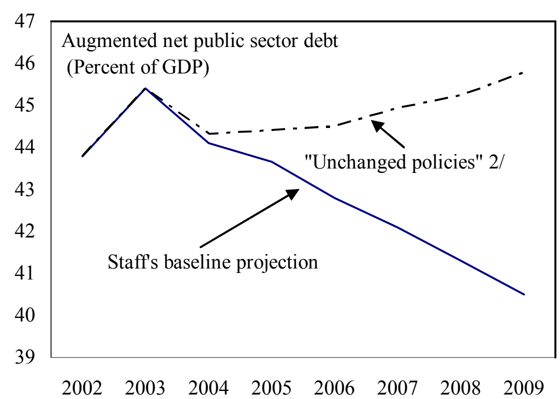
Debt-to-GDP ratios have edged up ...



... but the augmented ratio would decline if objectives for the traditional deficit are met.



It would rise, however, under the staff's "unchanged policies" scenario.



Sources: Mexican authorities, and Fund staff estimates.
1/ Augmented balance excluding oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, IEPS on gasoline) and PEMEX operational expenditure.
2/ Assumes constant non-oil tax revenues and primary spending in relation to GDP (except for public sector energy costs).

14. **Indicators of external vulnerability remain favorable.** The current account deficit narrowed to 1½ percent of GDP in 2003, and was more than matched by FDI inflows (Figure 5; Tables 3 and 4). Net international reserves rose to US$58.2 billion at end-July 2004 from US$48 billion at end-2002, reflecting strong PEMEX receipts. Gross reserves at end-August are estimated at 170 percent of short-term external debt by residual maturity. After a short-lived spike to 250 basis points in mid-May as U.S. interest rates rose, Mexico's EMBI+ spread had fallen back below 200 basis points by end-August.

15. **Larger corporates have taken steps to improve their debt structure by issuing peso-denominated fixed-rate debt in local capital markets.** Small- and medium-sized firms continue to face difficulties in obtaining bank credit and market financing, while large companies in good financial health (mainly exporters) have relatively easy financing conditions. While there have been bond defaults and financial difficulties in a few enterprises, the authorities and market participants attribute these to problems in individual firms as opposed to systemic factors.

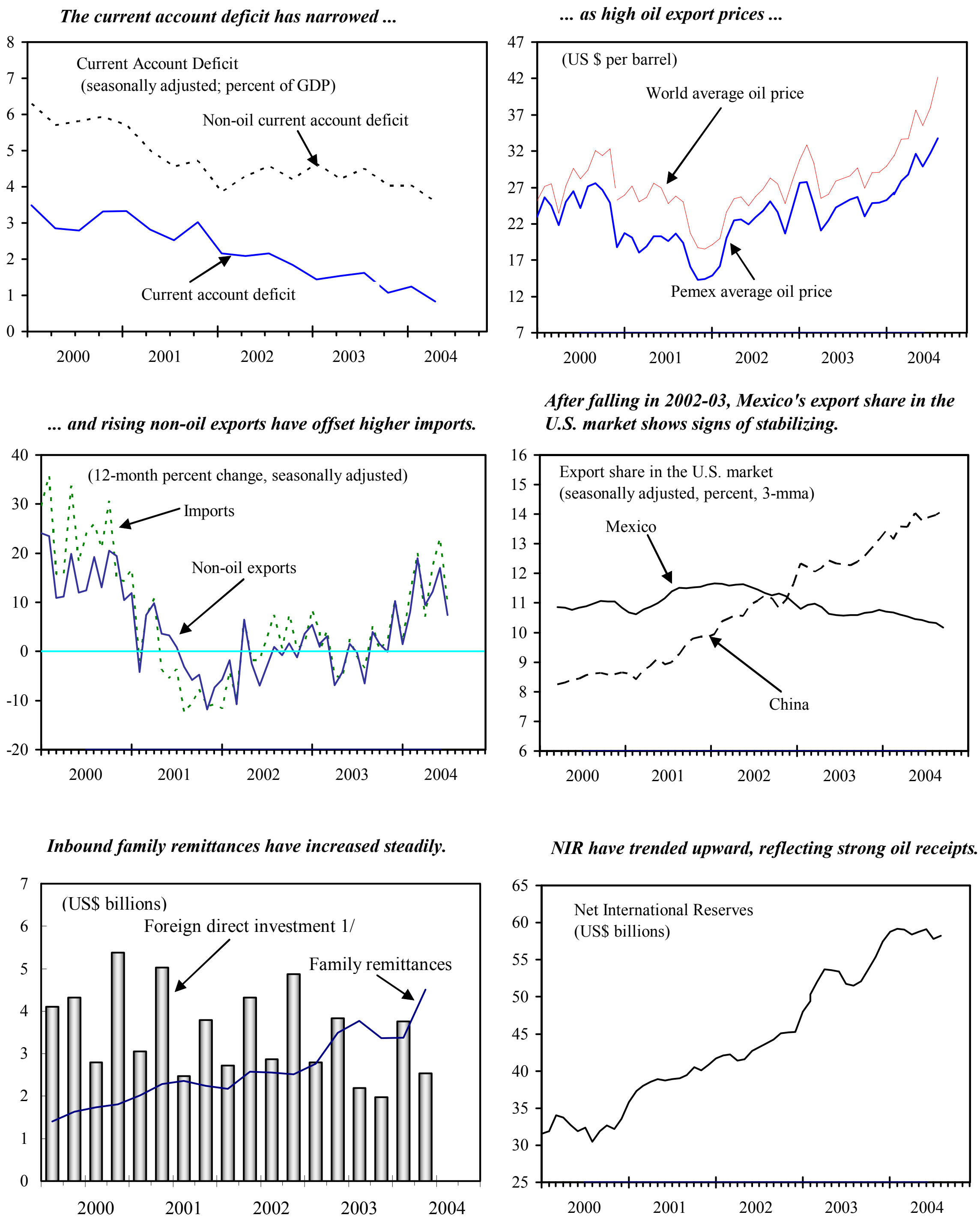
16. **The authorities modified the mechanism for auctioning international reserves in March 2004.** The BOM continues to pre-announce the amount of dollars to be sold in the market, equal to 50 percent of net reserve accumulation in the previous 3-month period. The sales will now, however, be spread over the following 12 months, as opposed to 3 months, to reduce volatility in the foreign exchange market.

III. Economic Outlook

17. **The staff growth projection for 2004 has been revised up to 4 percent from 3½ percent in the April WEO.**[5] Economic recovery is expected to continue in the second half of the year, albeit at a more moderate pace than in the first half. Although U.S. forecasts have edged down recently, most still call for growth of around 4¼ percent this year. Recent domestic indicators, notably for exports, industrial production, and employment, also point to continued expansion. The impact of higher interest rates on spending is expected to be modest given improved corporate balance sheets and increasing credit availability to households and businesses, while exporters will continue to benefit from the past weakening in the peso.

[5] The consensus forecast released in August was also 4 percent.

Figure 5. Mexico: External Sector

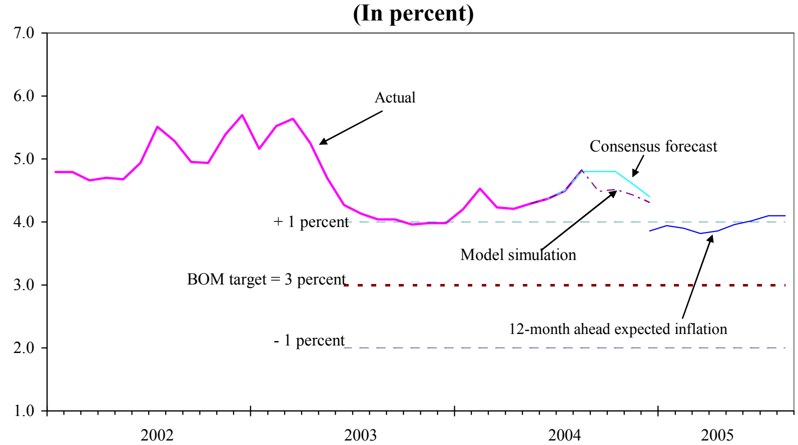


Sources: Mexican authorities, and Fund staff estimates.

1/ FDI excludes the US$12.5 billion Citibank acquisition of Banamex in 2001Q3 and the US$4 billion BBVA acquisition of Bacomer in 2004Q1.

18. **CPI inflation is expected to remain above the 4 percent upper bound of the BOM's variability interval in the near term**. Shocks to agricultural prices have persisted and fed through to processed food prices, while administered prices have continued to rise quickly; in addition, the pass-through of peso depreciation and higher oil prices is still being felt. The staff's projection calls for an inflation rate of 4.3 percent (12-month basis) by end-2004, consistent with both the consensus forecast and the projection produced by the staff's structural model of wage-price dynamics.

Actual and Forecast Inflation, 2002–04
(In percent)



Source: Bank of Mexico and Fund staff estimates.

19. **Staff believes that the risks to near-term growth are roughly balanced**. Given the low starting point for business investment, a sustained increase in private-sector confidence could well lead to a more powerful rebound than the 5 percent private fixed investment growth currently projected. On the external side, the recent turnaround in the *maquiladora* sector could signal a reversal of Mexico's loss of U.S. market share, reflecting both the recovery in U.S. industrial production and the weakness of the peso versus the dollar. On the downside, a continuing political stalemate could dampen confidence. In addition, recent U.S. indicators have been mixed, and Mexico would be particularly vulnerable to a renewed downturn in U.S. manufacturing activity. The balance of risks to the near-term inflation outlook could be slightly on the upside given the trends in the recent data, although it is too early to judge the full impact of monetary tightening on actual and expected inflation.

20. **Medium-term growth prospects are clouded by the stalled reform process.** Staff has revised down its baseline projection for GDP growth over the 2005–09 period to an annual average of slightly over 3 percent, assuming the absence of significant reforms (Text Table 2). Even this performance is estimated to require trend total factor productivity growth of about ½ percent per year, above the average pace since 1980, but below that in the 1960s and 1970s (Box 2). Staff has also constructed a more optimistic scenario in which medium-term growth averages 4½ percent, and a downside scenario with growth of slightly over 2 percent. In discussing these projections with the authorities, staff acknowledged the considerable uncertainty attached to any such calculations. Estimates of both output gaps and potential growth were

Box 2. Mexico: Productivity, Potential Output, and Medium-Term Growth

Mexico has experienced sharply different growth episodes since 1960, with GDP increasing at an average rate of 6½ percent during 1960–79, falling to only 2½ percent during 1980–2003. This raises the question of the factors underlying historical GDP growth in Mexico, and the implications looking ahead. We use an aggregate production function to decompose growth into its cyclical and trend components, and explore alternative medium-term growth scenarios (the analysis is described in more detail in an accompanying selected issues paper).

A. Growth Accounting

The growth accounting exercise is performed over the 1960–2003 period, assuming a Cobb-Douglas production function with shares of labor and capital of 67 and 33 percent respectively. Capital is derived from national accounts data on gross private investment using the perpetual inventory method, with an assumed depreciation rate of 10 percent. The labor input is defined as the economically active population aged 15 and over. Total factor productivity (TFP) is derived as a residual. Box Table 1 shows the resulting contributions of the three factor inputs from 1960 to 2003. From 1960 to 1979, real GDP grew at an average rate of 6.5 percent, while TFP rose by 2.1 percent. From 1980 to 2003, however, real GDP growth slowed to 2.6 percent. Most of this decline is explained by lower TFP growth—indeed, the *level* of TFP declined at an average rate of 0.5 percent over this period. While the performance during the more recent 1996–2003 subperiod is somewhat more favorable, with trend TFP showing a mild increase, the outturn still seems modest relative to the structural changes that were implemented, including significant trade and financial liberalization.

Box Table 1. Mexico: Sources of Growth, 1960–2003

	1965–79	1980–2003	1996–2003
Real GDP growth	6.5	2.6	3.5
Factor growth rates (percent)			
Capital	6.1	3.4	3.8
Labor	3.6	3.0	2.4
TFP	2.1	-0.5	0.7
Factor contributions (in percentage points)			
Capital	2.0	1.1	1.1
Labor	2.4	2.0	1.6
TFP	2.1	-0.5	0.7
Memorandum items:			
Potential output growth	6.4	2.7	3.5
Trend TFP growth	2.0	-0.4	0.7

Sources: INEGI and Fund staff estimates.

B. Medium-Term Projections

Our medium-term projections assume that growth in the capital stock is consistent with keeping the capital-output ratio constant at 1.5. As a result, the capital contribution is higher as we move from a low to a higher growth scenario because more investment is needed to maintain the fixed capital-ratio with faster growth. The labor force grows by 2.4 percent, and baseline trend TFP growth is assumed to be 0.3 percent. The latter is above the average pace since 1980, but below that in the 1960s and 1970s. It is also below the 0.7 percent rate experienced in 1996-2003, based on the assumption by staff that growth was temporarily boosted during that period by the effects of NAFTA and other structural reforms. We derive potential output as the sum of trend TFP and the contributions of capital and labor inputs. Based on these assumptions, projected GDP grows at an average rate of 3.2 percent during 2005–09, while potential output grows by 2.9 percent (Box Table 2). The difference reflects the unwinding of the output gap estimated to exist in 2004. The alternative "high" scenario shows the TFP growth rate that would be needed to support GDP growth of 4½ percent—the mid-point of the two PRONAFIDE growth paths constructed in 2002. The implied TFP growth rate of 1½ percent appears optimistic given the historical experience. The "low" scenario extrapolates the 1980–2003 record of declining TFP, resulting in GDP growth of only slightly over 2 percent.

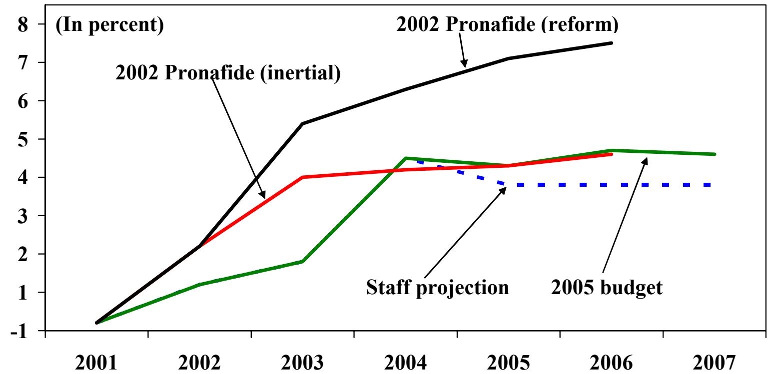
Box Table 2. Mexico: Medium-Term Growth Projections
2005–09— Alternative TFP Growth Rates

	Low scenario	Baseline	High scenario
Real GDP growth	2.1	3.2	4.5
Factor contributions (in percentage points)			
Capital	0.8	1.1	1.5
Labor	1.5	1.5	1.5
TFP	-0.2	0.6	1.5
Potential output growth	1.8	2.9	4.2
Trend TFP growth	-0.5	0.3	1.2

Sources: Fund staff estimates.

subject to large revisions in the face of actual developments, and the pace and impact of structural reforms was hard to judge. With these uncertainties in mind, staff advocated caution in forecasting medium-term growth to undercore the need for policies to bolster financial stability and promote growth. The authorities, in contrast, were more optimistic, believing that financial sector reforms would provide a significant boost to growth in the period ahead.

Medium-Term Growth Forecasts



Source: Mexican authorities and staff estimates.

Text Table 2. Mexico: Baseline Medium-Term Projection

	Projections					
	2004	2005	2006	2007	2008	2009
	(Annual percentage change, unless otherwise indicated)					
National income and prices						
Real GDP	4.0	3.2	3.3	3.2	3.1	3.1
Consumer prices (end-year)	4.3	3.8	3.0	3.0	3.0	3.0
	(In percent of GDP)					
Savings and investment						
Gross domestic investment	21.8	21.2	20.9	21.0	20.8	20.7
Gross national saving	20.7	19.9	19.4	19.4	19.0	18.8
Nonfinancial public sector						
Augmented balance (PSBR excl. nonrecurring revenues)	-3.1	-2.6	-2.3	-2.1	-2.0	-2.0
Augmented primary balance	0.3	1.0	1.2	1.1	1.1	1.1
External sector						
Current account balance	-1.1	-1.3	-1.5	-1.6	-1.8	-1.9

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

IV. Policy Discussions

A. Fiscal Policy

21. **The authorities reiterated their commitment to achieving deficit targets, noting that success in this area had underpinned policy credibility.** Deficits based on the traditional definition had been kept close to the 2002 PRONAFIDE targets in recent years, despite political pressures for greater spending.[6] For 2004, the budget figure of 0.3 percent of GDP for the traditional deficit remained realistic, as possible shortfalls in non-oil revenues and spending overruns would be more than offset by high oil revenues. Indeed, they felt it would be possible to save some of the latter in the form of a transfer to the OSF. The authorities noted that spending beyond budget estimates in 2003 (and probably again in 2004) resulted largely from adjusters that allocated windfall oil revenues to public capital spending, or covered increased costs in the public sector associated with higher energy prices.[7] Thus, spending in these areas would automatically compress if oil prices were to fall.

22. **Staff agreed that the authorities had established a strong reputation for fiscal prudence as a result of the sustained achievement of deficit targets.** Concern was expressed, however, about the role that high oil revenues had played in meeting these targets in recent years in the face of non-oil revenue shortfalls and spending overruns. In the event, little of the excess oil revenues would be saved in the medium term, which appeared to contradict the spirit of the budget adjusters as originally envisaged. However, updated information shows that the authorities expect substantially higher savings of excess oil revenues in 2004 than suggested by the staff estimates, part of which will finance later investment spending (Text Table 3).[8] While higher spending was partly due to the operation of the adjusters and higher energy costs, overruns in current spending exceeded the amounts attributable to these factors. Staff observed that the budget figures exhibited a pattern of overestimating non-oil revenues, while underestimating nondiscretionary expenditures. This provided room for congress to include more programmable spending in the budget, even with a low oil price assumption—excess oil revenues could then be used, in effect, to finance programmable spending. Due to spending of excess oil revenues, the fiscal impulse in 2004 was expected to be slightly stimulative, implying a pro-cyclical stance given the recovery underway.

23. **Staff emphasized the need for a framework that would promote greater medium-term savings of excess oil revenues**. This was needed for three reasons: to avoid inefficient

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[6] PRONAFIDE stands for *Programa Nacional de Financiamiento de Desarollo,* which is the fiscal framework associated with the government's medium-term development plan.

[7] The 2004 budget law specifies that PEMEX be returned the tax it pays on excess oil export revenues (the authorities thought that much of this rebate should be considered fiscal saving for 2004, as it would be held to meet financing needs in 2005). Remaining excess oil revenues would then be used to finance overruns in nonprogrammable spending and shortfalls in non-oil revenues. Any remaining excess oil revenue would then be divided equally between transfers to states and fiscal savings (via transfers to the OSF and debt reduction).

[8] See Chapter II of IMF Country Report No. 04/250 for a discussion of the adjusters.

spending at times of high world oil prices; to reduce fiscal dislocations that could result from a drop in oil prices; and to take advantage of favorable conditions to reduce public debt. Staff recommended incorporating an objective assumption for oil prices in the budget (for instance, based on futures markets), and explicitly earmarking a significant portion (at least one half) of the difference between the oil revenues associated with this price and an assumed long-term price for saving—preferably in the form of a lower traditional deficit, given the attention paid to this concept. Deviations through the year between actual and assumed prices would then be subject to the same savings rule (possibly via transfers to/from the OSF). Such a framework would have two advantages. Firstly, explicitly incorporating saving of excess oil revenues in the target for the traditional deficit could increase the political commitment to achieving these savings. Secondly, the savings would take precedence over other fiscal developments through the year, such as higher spending or shortfalls in non-oil revenues. The authorities, in contrast, felt that the tending toward a conservative oil price assumption still played a useful role in containing spending pressures, and thus was more likely to deliver the desired fiscal restraint. They also did not believe that a different mechanism of adjusters would offset political pressures to spend excess revenues. They agreed, however, that the operation of the adjusters had left only modest scope for saving oil revenues. Looking ahead, they were hopeful that the OSF would accumulate a meaningful surplus if oil prices remain high.

Text Table 3. Mexico: Saving of Windfall Oil Revenues

				Staff Projection		Authorities' Estimate
	2001	2002	2003	2004	Total: 2001–04	2004
Oil price versus budget (US$/barrel)	0.6	3.6	6.4	11.4	n/a	9.2
Windfall oil revenues (in percent of GDP) 1/	-0.4	0.2	1.0	1.9	2.7	1.6
Savings (in percent of GDP)	0.0	-0.1	0.1	0.1	0.1	0.7
OSF	0.0	-0.1	0.1	0.1	0.1	0.1
Traditional balance	0.0	0.0	0.0	0.0	0.0	0.1
Trust funds (PEMEX and infrastructure)	…	…	…	0.0	0.0	0.5

1/ On a gross basis. The net revenue impact would be partially offset by higher fuel prices for public enterprises and higher prices for imported gasoline.

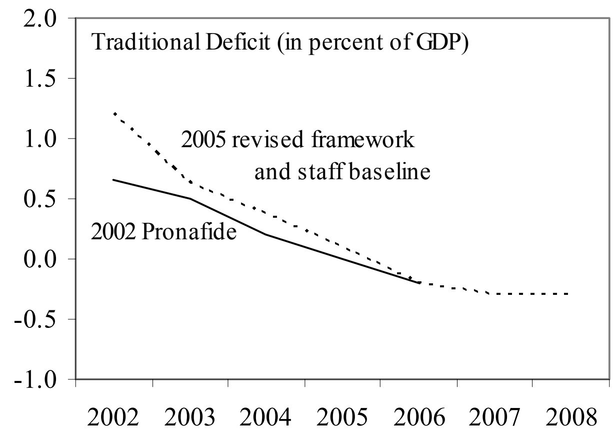
Sources: Authorities and IMF staff estimates.

24. **The mission welcomed the revision to the authorities' medium-term fiscal framework in the 2004 budget, and their intention to update it in the 2005 exercise (Box 3).**[9] Staff observed that meeting the objective for the augmented deficit of about 1½ percent

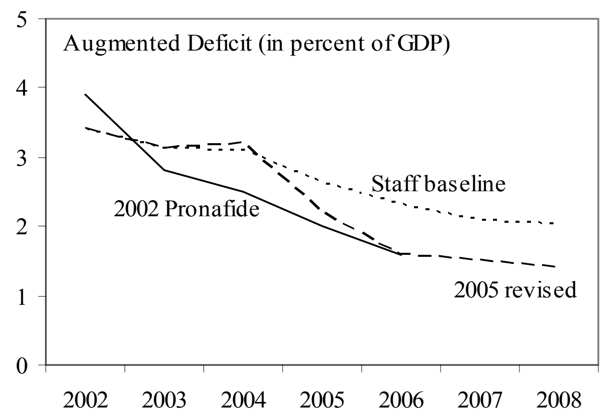
[9] These updates to the medium-term framework are discussed in an accompanying selected issues paper.

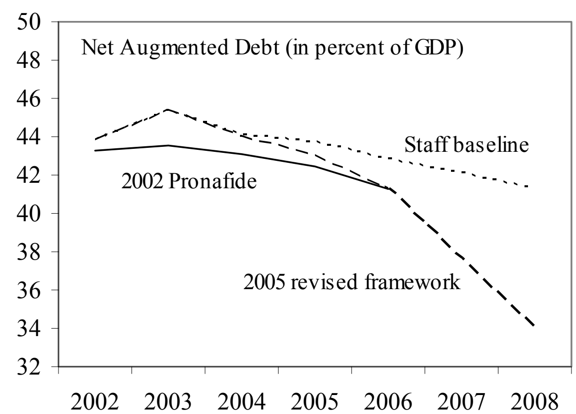
Box 3. Mexico: Medium-Term Fiscal Scenarios

The 2004 budget updated for the first time the authorities' medium-term fiscal framework, and it was revised again in the draft budget for 2005. The original version, presented in the 2002 PRONAFIDE, linked the pace of fiscal adjustment during 2002–06 to progress in structural reforms. With only modest reforms, the augmented deficit was to fall from 4 percent of GDP in 2002 to 1.6 percent in 2006, bringing down net public debt by 2 percentage points to 41½ percent of GDP. This program has gone off-track, however, as the augmented deficit is expected to reach 3.1 percent of GDP in 2004 vs. 2½ percent of GDP in PRONAFIDE. Public debt edged up through 2003, as a result of the higher deficit, low growth, and peso depreciation.



The latest framework maintains the original deficit targets for 2006, while underscoring the need for fiscal reforms. The adjustment effort is now concentrated in 2005–06, however. The traditional balance improves by ½ percent of GDP over these years, and off-budget financing is projected to fall by 1 percent of GDP. Based on a strong growth outlook (average GDP growth of 4.1 percent in 2005–08) but a low oil price assumption (US$20.8 per barrel for the Mexico mix), tax reform is seen as necessary to meet these objectives. The scope for spending reductions is limited; new pressures for social spending are foreseen (estimated by staff at 1½–2 percent of GDP); and the government is expected to service the debt of rising PIDIREGAS projects upon completion. In addition, the framework emphasizes the need for pension reform to prevent the pension bill from spiraling out of control after 2008. In staff's view, the framework's reliance on reducing off-budget financing to lower the augmented deficit is problematic. The projection assumes financing only of existing PIDIREGAS projects, whereas a continued stream of new projects appears more likely.





The staff's baseline fiscal scenario is based on the authorities' commitment to meeting targets for the traditional balance. It assumes higher oil prices (averaging $29.7 per barrel in 2005–08) and lower growth. The augmented deficit remains above the authorities' target, however, as off-budget financing is compressed by less. The decline in augmented public debt is also slower than in the authorities' plan. Higher oil prices would lessen the need for spending cuts, but the underlying adjustment during 2005–07, at 1½ percent of GDP, would still be substantial in an environment of rising spending pressures in the areas of health, education, and pensions.

of GDP in 2007 would require an estimated 1¾ percent of GDP in net consolidation measures, assuming a mild easing in world oil prices.[10] This would be particularly challenging in the absence of tax reforms that would raise new revenues, and in the face of medium-term spending pressures in the areas of health, education, and pensions. The authorities agreed that important fiscal challenges lay ahead. Tax reform remained on the agenda, although, even if passed, it might not raise significant new revenues at the federal level.[11] This underscored the need to continue efforts to raise the yield from the existing tax structure, implement pension reform, and compress spending in noncritical areas.[12] They noted that Mexico had a track record of cutting spending when required to meet deficit targets, and that this option remained available. Staff agreed that spending compression had allowed past budget targets to be met, but noted that the last instance of significant cuts was in 1998. The authorities argued that, notwithstanding the changing political environment, there remained a strong consensus for prudent policies in Mexico.

25. **Staff expressed concern about the possibility of "drift" in updating medium-term fiscal plans—in particular, the risk that objectives could be pushed off into the future.** In this context, updates to the 2002 PRONAFIDE had postponed objectives for the augmented deficit, in spite of the assumption of higher oil prices. The recent increases in public debt ratios since 2001 also stood in contrast to the downward paths envisaged in the original PRONAFIDE. Staff reiterated the view that a gross public debt ratio of about 50 percent of GDP was uncomfortably high for a country still in the process of establishing full policy credibility. The staff's debt sustainability analysis indicates that the ratio of augmented debt to GDP would fall under the baseline scenario of further fiscal consolidation, but would remain near current levels if the augmented deficit is not reduced over time (Annex IV). A combination of adverse shocks could result in a rising debt ratio under a pessimistic scenario. The authorities emphasized that public debt ratios had risen because of temporary shocks, and were still expected to decline this year and beyond. They maintained that concerns about the level of gross debt did not take into account the strengthening of the debt structure, and Mexico's overall financial stability and market credibility.

26. **Subsequent to the policy discussions, the authorities presented a draft budget for 2005 to congress in early September, along with estimates of the 2004 outturn.** Market

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[10] Staff projects a decline in the price of the Mexico mix in line with futures prices.

[11] A reform plan that has been widely discussed would lower the general VAT rate from 15 to 12 percent, introduce a 4 percent rate on food (previously untaxed), and allow states to levy a 3 percent consumption tax. "Static" estimates suggest that this plan would be roughly revenue-neutral at the federal level.

[12] The authorities estimate that the pension system has a deficit in net present value terms of 116 percent of 2003 GDP. A step toward reform was taken in August 2004 in the form of a bill that reduces pension and other benefits for new employees at the social security institute (IMSS). Because it applies only to new workers, however, it will take some time for the benefits to be felt.

reaction was generally favorable—the traditional deficit would fall slightly to 0.1 percent of GDP in 2005 from 0.3 percent in 2004 (excluding payments for the voluntary retirement plan), while the augmented deficit would drop by about 1 percentage point to 2.2 percent of GDP (Table 2).[13]
The budget is predicated on a decline in oil prices for the Mexican mix to $23 per barrel next year, and real GDP growth of 3.8 percent—these compare with staff assumptions based on futures market prices in early September, and GDP growth of 3.2 percent. With oil revenues falling, the budget assumes a sharp drop in programmable current spending to achieve the deficit target. Staff welcomes the commitment to fiscal discipline reflected in the budget targets, and in particular the projected decline in the augmented balance, while noting that they would be challenging to meet, even if oil prices do not fall sharply. The staff projection for 2005, based on oil prices remaining near current levels, assumes across-the-board spending restraint that reduces programmable spending by ½ percent of GDP to achieve an outturn for the augmented balance of 2.6 percent of GDP. Congress is scheduled to pass a final budget law by November 15.

27. **The authorities anticipated that fiscal responsibility legislation would be advanced in the next session of congress.** It could include provisions that spending initiatives be matched by revenue measures, and that the budget (traditional definition) be balanced over the business cycle. They were also hopeful that the proposals of the National Fiscal Convention for pension and tax reform would allow progress in these areas. The mission encouraged these steps, while noting that it would be desirable to emphasize augmented measures of the budget position in fiscal responsibility principles. These measures were more relevant from the point of view of financial stability and debt sustainability; focusing on augmented measures would also avoid any incentive to transfer fiscal activity to off-balance-sheet areas.

28. **Staff expressed the view that limited government control over the operations of some public enterprises, including PEMEX, undermined efficiency and added uncertainty to the fiscal situation.** PEMEX's costs exceeded those of other major international oil companies, partly due to rigid labor contracts, generous pay scales, and inefficiencies in operations. The authorities agreed that further efforts were needed to strengthen corporate governance in public enterprises and bring labor compensation in line with market conditions. Pension reform was also needed to ensure the solvency of public enterprises. The mission welcomed the establishment of an independent audit committee for PEMEX, which should allow for a more transparent monitoring of its financial performance.

29. **Subnational government debt in Mexico has increased since the early 1990s, but still represents less than 2 percent of GDP**.[14] While the federal government has taken steps to

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[13] The projection for 2004 in Table 2 is a staff estimate based on data for the first seven months of the year, and implies somewhat higher levels of revenue and spending than the assumed outturn in the draft budget, but the same deficit figure. The authorities now project a somewhat lower augmented deficit, reflecting higher 2004 savings of excess oil revenues.

[14] Issues relating to subnational finances are discussed in an accompanying selected issues paper.

promote fiscal prudence at the subnational level since the bailouts of the mid-1990s, rigidities in state finances still make it difficult for them to absorb shocks. Own revenues of most states are less than 10 percent of total revenues, with the rest mostly reflecting federal transfers. Staff noted the importance of maintaining tight controls on the borrowing of subnational entities, particularly given the risk associated with any perception that the federal government would bail out state governments. The authorities agreed, but noted that such bailouts were proscribed by the current framework, and that the role of market-based evaluations of state creditworthiness has strengthened significantly since 2000.

B. Monetary and Exchange Rate Policy

30. **The challenge for monetary policy has been to complete the process of bringing inflation down to the 3 percent target.** The authorities attributed the rise in headline inflation in the first half of 2004 primarily to price shocks, notably to increases in commodity, meat, and administered prices. Demand pressures did not appear to be a contributing factor, although this situation would require careful monitoring given possible declines in economic slack if growth remained strong. They noted that core services inflation, which primarily reflected domestic costs, had continued to fall.

31. **Staff generally agreed with this assessment, while observing that price shocks could prove persistent, especially given pressures in global commodity markets.** The central question was how long the BOM could allow headline inflation to remain above the variability interval without endangering policy credibility—a risk that was heightened by signs of rising inflation expectations. Staff noted that monetary conditions remained relatively easy through the first half of the year, in spite of increases in the *corto.* Against this background, staff and the authorities agreed that some further tightening in monetary conditions would likely be needed, with the main issue being its source, pace, and timing. Staff questioned if the gradual rise in U.S. interest rates expected in markets would have a sufficient impact on Mexico to forestall inflationary risks. BOM officials pointed to recent policy statements, which indicated that domestic market conditions should reflect "at least" the degree of tightening expected in U.S. policy. Subsequent to the discussions, the domestic overnight rate rose in line with the two increases in the U.S. fed funds target rate, and also when the BOM increased the *corto* in late July and late August.

32. **BOM officials noted that press statements on policy had been streamlined and shortened starting in May to signal BOM views more clearly to markets.** Staff observed that conditions in domestic money markets also had become more stable since May, and that the overnight interest rate had moved more systematically in response to domestic and U.S. policy actions. On the issue of formally shifting from the *corto* to an interest rate as an operating instrument, the authorities observed that it was difficult to identify the size of the interest rate channel given volatility in the historical data and the changing structure of the financial system.

Until greater confidence was established in estimates of the effect of interest rates on activity and inflation, it would be difficult to communicate the precise intent of policy actions using an interest rate tool. Staff noted that some uncertainty about interest rate effects was inevitable, but believed that policy transparency could be enhanced in the period ahead by moving in this direction.

33. **The authorities acknowledged the difficulties in communicating what a "continuous" inflation target of 3 percent meant with headline inflation running at over 4 percent.** Increasing emphasis had been placed in policy statements on underlying inflation, and on explaining the nature of price shocks. Staff suggested that publishing an inflation forecast, as most other inflation-targeting central banks now were doing, could help to motivate the policy stance and perhaps influence private inflation expectations. BOM officials agreed that this approach had some merits, but noted disadvantages in the existing circumstances. Given considerable uncertainty about future inflation, a forecast that turned out to be too low could jeopardize the BOM's credibility, while one that was too high could unduly delay the disinflationary process through its effect on expectations.

34. **The authorities remain firmly committed to allowing the exchange rate to be market-determined.** They expressed the view that the peso depreciation since February was not based on fundamentals, but rather reflected market uncertainty about the effects of U.S. policy tightening. They saw no evidence of "Dutch disease" arising from high oil prices, as both nominal and real exchange rates have depreciated over the past two years, and oil exports were small in relation to GDP. Staff endorsed the transparent approach to exchange rate management, noting that exchange rate volatility did not appear to be unduly complicating policy formation or undermining macroeconomic performance.

35. **The authorities and staff agreed that the rules-based mechanism for accumulating international reserves was consistent with a noninterventionist approach to reserves management**. The present level of reserves was adequate, both in terms of coverage of short-term external debt and Mexico's gross financing needs. The mission welcomed the willingness to refine the mechanism in light of experience, as reflected in the lengthening of the reserve sales period starting in March 2004.

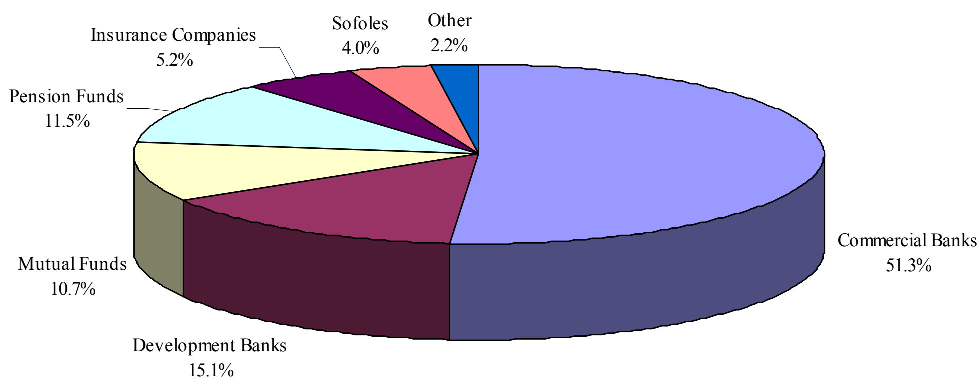
C. Financial Sector

36. **The authorities noted that the resilience of the financial system to shocks has increased in recent years, and systemic problems are unlikely.** Banks' financial indicators are sound, with adequate levels of profitability, loan provisions, and capital adequacy. The share of bank intermediation in the financial system has been falling, however. Bank credit to consumers has increased significantly, but business lending has stagnated in recent years. Nonbank intermediaries have been particularly active in the mortgage sector, which is growing rapidly (Box 4). The lack of dynamism in the banking sector was attributed in part to the existence of

Box 4. Mexico. Growing Role of Finance Companies in Financial Intermediation

Finance companies (the so-called *SOFOLES*) are playing an increasing role in the Mexican financial system. While the share of commercial banks in the financial system has declined in recent years, pension funds, insurance companies, and *sofoles* are becoming more important. *Sofoles* accounted for 4 percent of total financial assets (about 2½ percent of GDP) in March 2004.

Figure 1: Mexico. Asset Distribution in the Financial System, March 2004



Source: Comisión Nacional Bancaria y de Valores (CNBV)

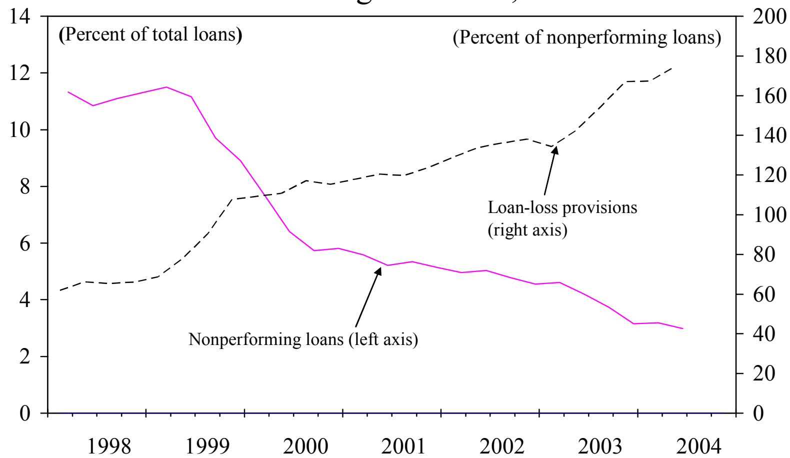
As of March 2004, most assets under management are concentrated in *sofoles* that are independent of financial groups, and dedicated to mortgage financing. Most assets are held by independent *sofoles* (66 percent of total assets), while 14 percent of assets are in the hands of *sofoles* affiliated with domestic financial groups, and 20 percent within foreign groups, respectively. Mortgage lending accounts for 65 percent of total assets, followed by automobile credit (26 percent).

***Sofoles* are financed through bank loans, development funds, and bonds issued in local debt markets**. Loans from commercial banks and other institutions (mainly through the public mortgage development bank *Sociedad Hipotecaria Federal* (SHF) represent 77 percent of total financing. These sources are mostly captured by *sofoles* dedicated to mortgage lending and construction credit (80 percent). Other s*ofoles*—mainly dedicated to the automobile lending—have also benefited from development of the local debt market, with outstanding bonds of MXN25 billion in 2004Q1.

[1/] By finance companies, this box refers to non-deposit financed credit institutions specialized in lending in a specific sector.

comfortable profit margins on various fees, as well as the adjustment of foreign-owned banks to domestic market practices and regulations. Another issue has been weak creditor rights, a problem that wasaddressed through reforms in 2003 to facilitate the recovery of loan collateral. The authorities believed that these impediments were fading in importance, as reflected in the 6 percent increase in commercial lending by banks in June 2004 over the previous year. Staff concurred that direct action to force changes in banks' behavior or fee structures was not appropriate, and that the foundation was in place for a sound and sustained recovery in financial intermediation.

Mexico: Banking Indicators, 1998-2004



Source: Mexican authorities

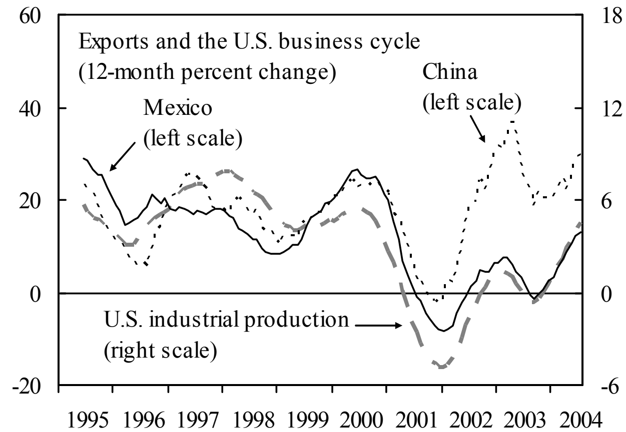
37. **In the area of financial supervision, a prompt corrective action system has been put in place to deal with banks in financial difficulty.** Discussions on a resolution mechanism for failed banks have not yet been concluded, however. The authorities emphasized the high priority attached to strengthening oversight of nonbank institutions. They noted that there are no signs of instability in the nonbank sector, but that rapid growth in recent years warrants close attention to avoid inappropriate risk-taking. Staff observed that nonbank mortgage institutions were a potential source of problems, as most of their funding was provided by the *Sociedad Hipotecaria Federal* (SHF), and thus was not subject to market scrutiny; the SHF also guaranteed the mortgages. More generally, staff expressed concern about the potential for hidden liabilities to build up in the development banks, and suggested a review of their role and operations. The authorities noted that the development banks were subject to supervisory oversight, and their balance sheets were sound. Neither did they pose a drain on the operating budget of the federal government. Nevertheless, a rationalization of the operations could be considered in light of the changing financial environment.

D. External Sector

38. **Concerns have eased about slow growth in exports and the edging down of Mexico's share in the U.S. market, as exports have accelerated significantly in 2004** (Figure 3 and Box 5). The authorities believed that past losses of U.S. market share reflected factors specific to the U.S. industrial sectors to which Mexican exports were directed, and were likely to be transitory. In this context, they pointed to the recent upsurge of FDI in Mexico's export industries and signs of revival in the *maquiladora* sector. They underscored that Mexico enjoyed

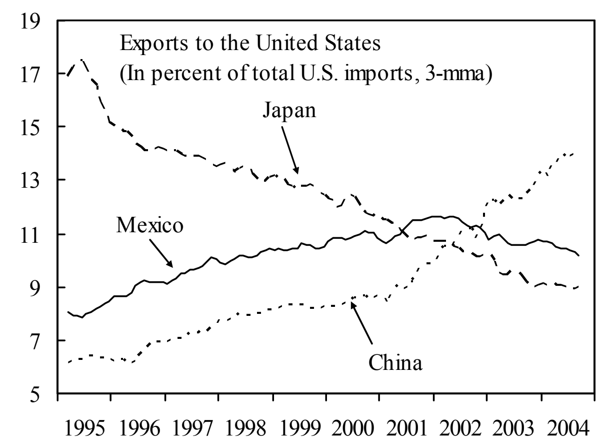
Box 5. Mexico: Developments in Mexico's External Competitiveness

Growth in Mexico's exports has closely followed cycles in U.S. activity since the mid-1990s. China's export growth also showed a close correspondence up until early 2002. Since then, China's exports to the U.S. have grown much more quickly than the historical relationship would suggest, and its U.S. market share has expanded rapidly.

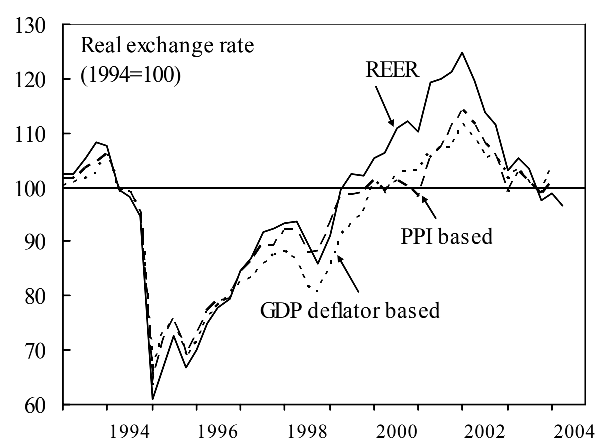


Specific structural factors appear to explain the shifts in U.S. trade shares:

- Much of China's gain in market share appears to be the result of Japanese firms moving production to China, particularly after China's accession to the WTO.
- Mexico's export share losses have been related to an orientation on small- and medium-sized cars, and those produced by U.S. manufacturers. Both segments of the U.S. car market were relatively weak during the U.S. downturn.
- Some Mexican industries—especially those with low shipping costs—declined as goods became "commoditized," no longer requiring fast shipment between the U.S. parent and Mexican plants. As a result, production of toys and some electronic products shifted to countries with lower wages. Similarly, garment makers moved to Central America, where wages can be one fourth of those in Mexico after including social security and other benefits.



The strength of the peso during 1999-2002 may also have played a role in reducing Mexico's market share. With the real effective exchange rate having depreciated by about 25 percent from its peak in 2001, however, price competitiveness has substantially increased. This is consistent with the decline in the non-oil current account deficit from about 6 percent of GDP in 2000 to 4¼ percent in 2003.



More recently, there have been signs of revival in sectors that exploit Mexico's locational advantage to the U.S. market. In particular, exporters specializing in "just in time" delivery and close integration with U.S. companies have flourished. Non-oil exports grew by over 10 percent in the first seven months of 2004, the strongest rise in almost four years.

advantages, notably proximity to the U.S. market, that resulted in continued specialization toward exports that either needed to be delivered quickly or were expensive to transport. Staff expressed the view that, with a freely floating exchange rate and a modest current account deficit, competitiveness was not an issue from the point of view of macroeconomic imbalances. But
Mexico would need to actively pursue reforms that would raise underlying productivity to ensure that maintaining competitiveness was consistent with robust growth in real incomes. These reforms included improving the public infrastructure and lowering its cost (particularly in the energy, transportation, and communication sectors), making the labor market more flexible, and improving the legal system.

39. **The authorities have concluded a trade agreement with Japan.** While Mexico's trade with Japan is limited, staff estimates suggest a modest increase in bilateral trade and Mexican welfare.[15] While the free trade agreement negotiated between the United States and Central American countries (CAFTA) could affect Mexico's *maquiladora* sector, the authorities believed the impact would be minimal given the small size of these countries and because the sector most affected—low value-added textiles—had largely moved abroad. The elimination of quotas under the Multi-Fibre Agreement (MFA) is likely to have a larger negative impact on Mexico than CAFTA, as it opens further the U.S. market to exports from Asia.

E. Vulnerabilities

40. **The authorities and the staff agreed that the economy remains generally well placed to absorb adverse shocks.** Mexico's investment-grade rating was well-established, and some agencies saw the possibility of further upgrades. Financial reforms were beginning to pay off in the form of higher credit growth and diversification of financial instruments. Corporate and financial sector balance sheets have strengthened significantly, as evidenced by their resilience to recent swings in exchange and interest rates. Particularly notable was the continuing development of the peso-denominated fixed-rate debt market for corporate issuance, underpinned by growth in institutional funds that could invest in these instruments. The stock market, in contrast, remained stagnant as a funding source. Small- and medium-sized firms still faced important financing constraints, but there was optimism that bank lending in this area was reviving.

41. **Staff welcomed the authorities' steps to strengthen further the public debt structure.** External debt management operations have aimed at reducing debt-service costs and lengthening maturities by prepaying debt obtained at less favorable conditions, broadening the investor base, and diversifying financing sources. Domestic debt management has focused on increasing maturities and raising the share of fixed-rate debt, thus reducing refinancing risks and promoting financial market development. Favorable market conditions and increased investor

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[15] An accompanying selected issues paper discusses model-based estimates of the impact of various trade policy initiatives on Mexico.

confidence allowed the introduction of a 20-year fixed-rate bond in October 2003, lengthening the peso yield curve. In addition, the agreement with banks to exchange FOBAPROA for IPAB debt has allowed the authorities to smooth the amortization profile.

42. **Some vulnerabilities remain in public financing.** About 35 percent of augmented debt is external, while about 60 percent of domestic debt is still either short-term or linked to short-term interest rates. Furthermore, gross financing needs of the public sector, estimated at close to 12 percent of GDP in 2004, are sizable. The authorities emphasized their intention to continue strengthening the debt structure. Staff noted that, in recent years, these efforts had been facilitated by declines in both global interest rates and emerging market spreads. As a result, debt-service costs had fallen at the same time as the structure was strengthened. Looking ahead, the tradeoff could be more challenging. The authorities underscored their intention to pursue a disciplined, pre-announced strategy to debt issuance—the schedule for the rest of 2004 had been reaffirmed in spite of changes in market conditions.

43. **Mexico's gross external financing requirements create moderate vulnerabilities to adverse shifts in market sentiment.** For 2004, gross external financing requirements are estimated at US$48 billion, equivalent to around 7 percent of GDP. Mexico has enjoyed favorable external conditions, as high oil prices, record remittance inflows, and low interest rates lowered the current account deficit to only 1½ percent of GDP. Of course, a sharp drop in oil prices could cause an abrupt widening in both the external and fiscal deficits. Immediate risks are low, however, as the government has already met its external financing requirement for the year and liquid market conditions resulted in strong capital inflows to the private sector during the first half of the year.

44. **Staff and the authorities agreed that a projected medium-term current account deficit of close to 2 percent of GDP was manageable, as long as confidence in policies was maintained** (Table 3). About 70 percent of the deficit would be financed by FDI, and the remainder by public and private sector borrowing (including PIDIREGAS) and portfolio inflows. With Mexico's net external liabilities projected to remain stable at about 40 percent of GDP, and debt-service payments falling as debt is rolled over on more favorable terms, medium-term external sustainability did not appear to be a problem, provided a prudent policy framework was maintained (Annex IV).

45. **Overall, staff expressed the view that Mexico was well protected against a sudden financial crisis.** Remaining vulnerabilities nevertheless left scope for market pressures to impact on financing costs, and could slow progress in further raising the sovereign credit rating. It was important to continue the process of crisis-proofing the economy to fully establish market confidence and provide room for policy actions to buffer shocks.

F. Structural Reforms

46. **The structural reform agenda has been stalled by a lack of political consensus.** Of the major elements of the reform agenda, the authorities believed that further energy reform was

least feasible, as there was significant popular opposition to further participation by the private sector. The emphasis in the period ahead would be on entrenching the progress that had already been made, notably in the areas of electricity generation and natural gas exploration. The authorities observed, however, that continued legal challenges for gas multiple-service contracts created political and legal risks for new arrangements. These contracts were also losing attractiveness for service-providing companies, as rising energy prices increased their incentive to explore in areas where they would capture the upside benefits.

47. **The authorities agreed with staff that there was scope for reform outside the legislative arena, including regulatory reforms.** Competition in the telecommunication sector could be increased considerably. The authorities acknowledged that telecommunications tariffs are high by international standards and that efforst should be made to promote more competition in this market. Recent attempts at leveling the playing field had produced limited results, but the government was considering new initiatives, including broadening the services provided by cable operators.

G. Other Issues

48. **Despite declines in average per capita real incomes during 2001–03, Mexico has made further progress in reducing poverty** (Table 6). The authorities attributed this to the reprioritization of social spending under the strategy for social development (CONTIGO), which focuses on better organization and targeting of government programs to reduce poverty. High remittance inflows have also played a role. Mexico is broadly on track to achieve its Millennium Development Goals, except for a few indicators, which were expected to improve slowly.

49. **Mexico is party to the major anti-terrorism conventions**. It has endorsed the methodology adopted by the IMF, World Bank, and FATF for assessing systems to prevent money laundering and terrorist financing. Mexico is also party to the OECD convention; a final report on actions in this area is expected to be submitted by June 2004. The main source of illegal proceeds of funds remains drug trafficking, where progress is impeded by corruption and the financial resources of traffickers. Nevertheless, progress has been made by strengthening prosecution and financial reporting.

V. Staff Appraisal

50. **The broad-based recovery underway this year provides encouraging evidence that the factors holding back Mexico's growth during 2001–03 were temporary.** Business confidence and investment have risen, FDI inflows are strengthening, exports have picked up, and market perceptions of Mexico remain favorable. Objectives for the traditional fiscal balance have continued to be met, albeit with the help of rising world oil prices, and the public debt structure has improved further. While inflation has risen moderately above the authorities' objective, it remains far below levels historically experienced by Mexico, and does not present a risk to financial stability. Progress in modernizing the financial sector has continued, and balance sheets appear healthy.

51. **With these positive factors in place, sustaining robust growth w completing the task of fully establishing market confidence, while providing a supportive environment for private activity.** Raising market confidence requires continued pursuit of

sound macroeconomic and financial sector policies, and demonstrating the capacity to take advantage of favorable conditions to reduce vulnerabilities. Not only would this increase Mexico's ability to absorb negative shocks, it would create scope to actively offset them through policy measures. Yet financial stability is necessary but not sufficient for sustained growth. The private sector also needs confidence in the commitment to push ahead with a structural reform agenda that promotes competition, increases legal certainty and public security, reduces market rigidities, and harnesses Mexico's resources—particularly in the energy sector—as fully and efficiently as possible. Continuing progress in these areas is needed to place Mexico firmly in the group of fast-growing emerging market economies.

52. **In the area of fiscal policy, the government has met deficit targets, but the budget has become increasingly reliant on oil revenues, and public debt has edged up.** Lowering the augmented deficit is central to reducing fiscal vulnerabilities. Meeting targets for the traditional deficit does not ensure a gradual decline in the ratio of augmented public debt to GDP, as indicated by the experience in 2002–03. More binding medium-term targets are needed for the augmented deficit and public debt. While recent success in meeting deficit targets is welcome, it does not address the increasing dependency of the budget on volatile oil revenues. Stronger mechanisms are needed to ensure that a substantial portion of windfall oil revenues is saved, which in turn requires either greater spending discipline or tax measures to achieve appreciable increases in non-oil revenues. Postponing these choices through the spending of excess oil revenues is likely to increase the size of the needed fiscal adjustment, and perhaps make its timing less favorable.

53. **Staff welcome the commitment to fiscal discipline represented by the lower deficit targets in the draft budget for 2005.** Meeting them, however, is likely to require more spending restraint than has been evident in recent years, even if oil prices remain high. In such a case, the authorities are encouraged to aim at saving significantly more of the excess oil revenues for the medium term than is expected in 2004. A decline in oil prices to the level assumed in the budget, on the other hand, would provide a challenging test of the government's ability to cut spending in the face of adverse shocks.

54. **In either case, fiscal reforms would play an important role in achieving further consolidation.** Formal fiscal responsibility principles could help, for instance, to reduce the spending of windfall oil revenues, but would be more effective if they focused on augmented fiscal measures, and contained provisions to avoid slippages in meeting medium-term targets. Tax reform to raise non-oil revenues is needed to avoid budget cuts that would jeopardize spending in social areas and on public infrastructure. Pension reform is also essential to put the fiscal accounts on a sound path. Finally, action to enhance the accountability and efficiency of some public enterprises, including PEMEX, is needed to strengthen the fiscal position and raise the quality of Mexico's infrastructure.

55. **After considerable success in bringing down inflation, monetary policymakers currently face a challenging environment for both formulating and communicating policies.** Although the long-term target is close to being met, taking the last step is proving to be problematic in an environment of repeated price shocks. Notwithstanding the temporary nature of most of these shocks, they pose a risk of prolonging the disinflationary process and make it more costly. Against this background, the BOM has appropriately tightened policy to ensure the credibility of its commitment to lowering inflation to 3 percent. Staff believe that a tightening bias in policy, including allowing the full pass-through of U.S. policy actions to Mexican markets, is appropriate until there are clear signs that inflation expectations are declining toward the long-term objective.

56. **Staff supports efforts to refine monetary policy announcements in a way that more directly signals the BOM's views to markets**. Steps in this direction have led to more stable short-term interest rates in recent months, as well as more predictable market responses to domestic and external policy actions. In the staff's view, further transparency and predictability in policy implementation could be achieved over time by moving to an interest rate instrument. In terms of the inflation-targeting framework, staff believes that progress toward publication of an official inflation forecast would be desirable to clearly motivate policy actions and anchor private-sector expectations. Yet staff recognizes that there may be drawbacks to such a step in the immediate circumstances, given the evolving nature of monetary instruments and the risks of adding to uncertainty about policy intentions at a critical time.

57. **Mexico's flexible exchange rate regime has been effective in cushioning the economy from external shocks in recent years.** The recent level of external competitiveness appears to be broadly consistent with a sustainable balance of payments position. International reserves remain adequate in the context of a flexible exchange rate, both in their coverage of short-term external debt and Mexico's gross annual financing needs. Staff agrees that the rules-based mechanism for accumulating foreign reserves is consistent with the authorities' transparent approach to reserves management and commitment to a market-determined exchange rate. Recent actions demonstrate a desirable degree of flexibility in adjusting the mechanism to ensure it is functioning soundly.

58. **Mexico's financial system is generally sound and well-regulated.** The staff welcomes the steps already taken, as well as those under consideration—including a framework for bank resolution—to strengthen supervision. The banking system as a whole has a sound level of profitability and capital adequacy. Nevertheless, staff agrees with the authorities that a significant challenge in the period ahead is to deepen financial activity without excessive risk-taking, and to streamline financial regulation to encourage innovation and competition. Staff supports the high priority attached by the authorities to strengthening oversight of nonbank institutions, which have grown rapidly in recent years. A review of the operations of development banks would be desirable to ensure that their continuing role is well motivated, and that they do not present a source of hidden financial risks.

59. **Staff supports the authorities' commitment to continue reducing vulnerabilities relating to public debt.** In addition to sustained progress with fiscal consolidation, the debt

structure would be strengthened by further increasing issuance of fixed-rate domestic-currency instruments, extending the domestic yield curve, and diversifying the investor base. Regarding vulnerabilities linked to private debt, the deepening of the domestic bond market associated with the rapid growth of institutional investors should diversify financing sources, lowering liquidity and contagion risk and reducing foreign currency mismatches in firms' balance sheets.

60. **Mexico's data are generally of high quality, and are adequate to conduct surveillance.** The authorities are encouraged to implement the recommendations of the 2003 statistical ROSC.

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

Table 1. Mexico: Selected Economic and Financial Indicators

									Proj.	
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(Annual percentage change, unless otherwise indicated)									
National accounts in constant prices										
Real GDP	5.2	6.8	5.0	3.6	6.6	0.0	0.6	1.3	*4.0*	*3.2*
Net exports (contribution)	30.7	17.7	15.4	-0.5	-1.8	-0.7	0.0	0.7	*0.7*	*0.5*
Total domestic demand	5.6	9.6	6.2	4.1	8.3	0.7	0.6	0.5	*3.3*	*2.7*
Private consumption	2.2	6.5	5.4	4.3	8.2	2.5	1.3	3.0	*4.2*	*2.5*
Public consumption	-0.7	2.9	2.3	4.7	2.4	-2.0	0.1	2.5	*0.1*	*1.0*
Gross fixed private investment	26.7	23.5	13.8	7.2	9.0	-5.9	-4.0	-5.7	*5.0*	*4.0*
Gross fixed public investment	-14.8	10.1	-7.5	10.7	25.2	-4.2	14.2	22.4	*7.5*	*-10.1*
External sector										
Exports, f.o.b.	22.7	13.1	1.1	14.8	21.8	-3.7	0.6	4.3	*19.1*	*7.8*
Export volume	20.1	22.1	10.2	9.6	19.7	2.3	-3.3	-2.0	*8.7*	*6.1*
Imports, f.o.b.	27.4	24.6	12.7	10.6	23.1	-1.7	-1.3	1.9	*19.1*	*7.3*
Import volume	24.7	22.5	12.4	11.3	19.1	-1.9	-0.9	-0.5	*8.3*	*7.0*
Terms of trade (deterioration -)	0.1	-8.9	-7.3	4.1	-1.5	-6.9	4.4	4.0	*-0.3*	*1.4*
Exchange rates										
Nominal exchange rate (US$/Mex$)										
(average, depreciation -)	-14.6	-4.0	-13.3	-4.4	1.1	1.2	-3.4	-11.7	...	...
Real effective exchange rate (CPI based)										
(average, depreciation -)	12.9	17.8	1.9	9.0	10.0	8.3	-0.2	-12.8	...	...
Employment and inflation										
Consumer prices (end of year)	27.7	15.7	18.6	12.3	9.0	4.4	5.7	4.0	*4.3*	*3.8*
Formal sector employment	0.7	7.4	8.0	6.8	5.9	1.0	1.0	-0.7	...	...
Real manufacturing wages	26.1	6.4	2.8	1.5	5.8	6.4	2.2	1.2	...	...
Money and credit										
Broad money (M4a)	31.7	28.3	25.1	19.6	12.9	16.0	10.7	13.3	...	...
Treasury bill rate (28-day cetes, in percent, annual average)	31.4	19.8	24.8	21.4	15.2	11.3	7.1	6.2	*6.8*	*7.5*
Real interest rate (in percent, annual average)	7.2	6.3	7.7	9.6	6.6	7.0	1.5	2.3	*2.3*	*3.2*
	(In percent of GDP)									
Nonfinancial public sector										
Augmented balance	-5.6	-5.6	-6.3	-6.3	-3.7	-3.7	-3.3	-3.1	*-3.1*	*-2.6*
Non-oil augmented balance	-11.0	-11.0	-10.2	-10.5	-8.9	-8.6	-8.0	-9.4	*-10.3*	*-9.7*
Augmented primary balance	3.7	3.0	0.5	1.3	1.2	0.8	0.6	0.1	*0.3*	*0.9*
Traditional balance	0.0	-0.7	-1.2	-1.1	-1.1	-0.7	-1.2	-0.6	*-0.4*	*-0.1*
Savings and investment										
Gross domestic investment	23.1	25.9	24.3	23.5	23.7	21.1	20.8	19.8	*21.8*	*21.2*
Public investment	3.0	3.1	2.8	3.0	3.6	3.6	4.2	5.0	*5.2*	*4.5*
Private investment	14.9	16.4	18.1	18.2	17.8	16.3	15.2	14.3	*14.5*	*14.7*
Change in inventories	5.2	6.3	3.4	2.3	2.3	1.2	1.5	0.5	*2.0*	*2.0*
Gross national savings	22.4	24.0	20.5	20.5	20.6	18.2	18.6	18.4	*20.7*	*19.9*
Public savings	-2.6	-2.5	-3.5	-3.3	-0.1	-0.1	0.8	1.9	*2.1*	*1.9*
Private savings	24.9	26.5	24.0	23.8	20.7	18.4	17.8	16.5	*18.6*	*18.0*
External current account balance	-0.8	-1.9	-3.8	-2.9	-3.1	-2.9	-2.1	-1.4	*-1.1*	*-1.3*
Non-oil external current account balance	-4.3	-4.7	-5.5	-5.0	-6.0	-5.0	-4.4	-4.3	*-4.7*	*-4.8*
	(In percent of exports of goods, nonfactor services, and transfers)									
Public external debt service 1/	38.6	36.3	21.6	22.4	27.1	20.0	15.9	16.9	*10.9*	*13.2*
	(In billions of U.S. dollars, unless otherwise indicated)									
Net international reserves	17.5	28.0	30.1	30.7	33.6	40.9	48.0	57.4	*62.4*	*67.4*
Gross official reserves in percent of short-term debt 2/	33.4	59.0	72.9	68.3	82.8	96.8	117.1	163.9	*156.8*	*155.5*
Gross external debt (in percent of GDP, end of period)	47.1	37.5	39.1	37.0	28.3	26.1	25.2	26.1	*24.8*	*24.5*
Oil export price (US$/bbl)	18.9	16.5	10.1	15.7	24.6	18.6	21.5	24.7	*31.4*	*31.5*

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

1/ Includes the IMF and public development banks and trust funds net of the collateral of Brady bonds.
2/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

Table 2. Mexico: Financial Operations of the Public Sector

(In percent of GDP)

				Budget	Staff Proj.	Draft budget	Staff Projections				
	2001	2002	2003	2004	2004	2005	2005	2006	2007	2008	2009
Budgetary revenue	**21.8**	**22.2**	**23.7**	**22.7**	**23.9**	**21.6**	**23.7**	**23.4**	**23.2**	**23.0**	**22.7**
Federal government revenue	16.1	15.8	16.8	16.5	16.9	15.3	16.7	16.2	16.1	15.9	15.8
Tax revenue	11.2	11.6	11.3	11.6	10.7	10.8	10.7	12.1	12.0	12.0	11.9
Nontax revenue 1/	4.9	4.2	5.4	4.9	6.2	4.5	5.9	4.1	4.1	4.0	3.9
Public enterprises	5.7	6.4	6.9	6.2	6.9	6.3	7.0	7.2	7.1	7.0	7.0
PEMEX	1.8	2.4	2.6	2.2	2.8	2.3	2.8	3.0	2.9	2.8	2.8
Other	3.9	4.0	4.3	4.1	4.2	4.0	4.2	4.2	4.2	4.2	4.2
Budgetary expenditure	**22.5**	**23.3**	**24.4**	**23.0**	**24.2**	**21.7**	**23.8**	**23.2**	**22.9**	**22.7**	**22.4**
Primary	19.3	20.5	21.6	20.0	21.3	18.8	20.8	20.3	20.2	20.0	19.9
Programmable	15.8	16.9	18.0	16.4	17.6	15.4	17.2	16.6	16.5	16.4	16.3
Current 2/	13.2	13.8	15.0	14.3	14.8	...	14.6	14.3	14.2	14.1	14.0
Capital 3/	2.6	3.2	3.0	2.1	2.8	...	2.5	2.3	2.3	2.3	2.2
Nonprogrammable	3.5	3.5	3.6	3.6	3.7	3.5	3.6	3.7	3.7	3.6	3.6
Of which: revenue sharing	3.4	3.4	3.3	3.4	3.4	...	3.4	3.5	3.4	3.4	3.4
Interest payments and other 4/	3.2	2.8	2.8	3.0	2.9	2.9	3.0	2.9	2.7	2.7	2.6
Extrabudgetary balance (incl. statistical discrepancy)	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Traditional balance	**-0.7**	**-1.2**	**-0.6**	**-0.3**	**-0.4**	**-0.1**	**-0.1**	**0.2**	**0.3**	**0.3**	**0.3**
Adjustments to the traditional balance	**3.0**	**2.1**	**2.5**	**3.0**	**2.7**	**2.1**	**2.5**	**2.5**	**2.4**	**2.3**	**2.3**
PIDIREGAS	0.8	0.8	1.1	1.5	1.4	1.0	1.2	1.2	1.1	1.1	1.0
IPAB	0.9	0.5	0.3	0.3	0.3	0.2	0.3	0.4	0.3	0.3	0.3
Budgetary adjustments	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
FARAC	0.1	0.4	0.0	0.1	0.2	0.0	0.1	0.1	0.1	0.1	0.1
Debtor support	0.0	-0.1	0.0	-0.1	-0.1	0.1	0.1	0.0	0.0	0.0	0.0
Development banks 5/	0.1	-0.4	0.4	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Excluding nonrecurring revenue	0.7	0.7	0.6	0.6	0.5	0.1	0.4	0.4	0.4	0.4	0.4
Augmented balance (PSBR excl. nonrecurrent revenue)	**-3.7**	**-3.3**	**-3.1**	**-3.3**	**-3.1**	**-2.2**	**-2.6**	**-2.3**	**-2.1**	**-2.0**	**-2.0**
Augmented primary balance 6/	**0.8**	**0.6**	**0.1**	**0.1**	**0.3**	**...**	**0.9**	**1.2**	**1.1**	**1.1**	**1.1**
Memorandum items:											
Fiscal stance											
Cyclically adjusted augmented balance	-3.6	-3.1	-3.0	-3.2	-3.0	...	-2.5	-2.2	-2.1	-2.0	-2.0
Cyclically adjusted non-oil augmented primary balance	-4.2	-4.1	-6.4	-5.4	-7.1	...	-6.4	-5.8	-5.7	-5.5	-5.3
Non-oil primary impulse 7/	-0.5	0.2	1.0	-0.5	0.2	...	-0.4	-0.4	0.0	-0.1	0.0
Non-oil augmented balance 8/	-8.6	-8.0	-9.4	-8.8	-10.3	...	-9.7	-9.1	-8.6	-8.3	-8.0
Cyclically adjusted non-oil augmented balance	-8.5	-7.8	-9.2	-8.7	-10.2	...	-9.6	-9.0	-8.6	-8.3	-8.0
Revenues											
Oil revenue	6.6	6.5	7.9	7.1	8.7	7.3	8.6	8.3	8.1	7.8	7.6
Non-oil tax revenue 9/	9.7	9.8	10.1	10.1	9.8	9.6	9.8	10.0	10.0	10.0	10.0
Non-oil non-tax revenue	5.4	5.8	5.7	5.5	5.3	4.7	5.2	5.2	5.2	5.2	5.2
Expenditures											
Real primary expenditure growth (incl. PIDIREGAS) 10/	-2.1	4.8	14.1	-3.3	4.8	...	-0.8	1.0	2.4	2.0	2.2
Net transfers to the Oil Stabilization Fund	0.0	-0.1	0.1	0.0	0.1	...	0.0	0.0	0.0	0.0	0.0
Public debt											
Gross public sector debt	47.8	49.7	51.0	51.3	49.3	...	48.7	47.5	46.7	45.6	44.7
Net public sector debt	41.5	43.8	45.4	45.9	44.1	...	43.7	42.8	42.1	41.3	40.5
Macroeconomic assumptions											
Real GDP growth	0.0	0.6	1.3	3.1	4.0	3.8	3.2	3.3	3.2	3.1	3.1
CPI inflation (average)	6.4	5.0	4.5	3.0	4.4	3.5	4.1	3.4	3.0	3.0	3.0
28-day CETES rate	11.3	7.1	6.2	...	6.8	7.8	7.5	7.1	6.7	6.7	6.7
Oil price (Mexican mix, US$/bbl)	18.6	21.5	24.7	20.0	31.4	23.0	31.5	29.8	29.2	28.5	28.1
Nominal GDP (in billions of Mexican pesos)	5,829	6,262	6,755	7,084	7,359	7,934	7,875	8,409	8,939	9,488	10,080

Sources: Mexican authorities; and IMF staff estimates.

1/ Includes MEX$11billion (0.2 percent of GDP) in 2002 and Mex$8 billion (0.1 percent of GDP) in 2003 in nonrecurring revenues taken from unclaimed pension provisions.
2/ For 2003 includes MEX$6 billion, or 0.1 percent of GDP, in additional outlays for the voluntary separation program.
3/ For 2002 includes MEX$49 billion, or 0.8 percent of GDP, in transfers to development banks associated with the cost of closing Banrural. For 2003 includes MEX$30 billion, or 0.5 percent of GDP, in projected infrastructure outlays and transfers to the Oil Stabilization Fund on account of higher-than-prorammed revenues, as well as MEX$9 billion for the capitalization of BANOBRAS.
4/ Also includes transfers to IPAB and the debtor support programs
5/ Includes a reduction in the net financial requirements of development banks of MEX$49 billion, or 0.8 percent of GDP, in 2002—effectively offsetting the effect of closing Banrural on the overall PSBR.
6/ Treats transfers to IPAB as interest payments.
7/ Revenue excludes oil export revenue and nonrecurrent income. Expenditure excludes interest payments and the financial requirements of development banks.
8/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, IEPS on gasoline) and PEMEX operational expenditure.
9/ Total tax revenue excluding IEPS on gasoline.
10/ Excludes Banrural spending in 2002.

Table 3. Mexico: Summary Balance of Payments, 2002–09

	2002	2003	2004	2005	2006	2007	2008	2009
			Projected					
	(In billions of U.S. dollars)							
Current account	**-14**	**-8.9**	**-7.2**	**-9.1**	**-11.1**	**-12.1**	**-14.9**	**-16.6**
Merchandise trade balance, f.o.b.	-7.9	-5.6	-6.7	-6.6	-8.1	-8.6	-11.4	-11.3
Exports	101.5	105.9	126.1	135.9	143.3	152.5	160.2	168.4
Of which:								
Petroleum and derivatives	14.5	18.7	24.0	24.6	23.6	23.7	23.1	22.8
Manufactures 1/	82.7	82.0	95.7	104.9	113.3	122.2	130.1	138.2
Imports	-109.4	-111.5	-132.8	-142.5	-151.4	-161.1	-171.6	-179.7
Factor income	-12.1	-12.7	-13.6	-14.6	-13.2	-13.3	-13.5	-15.6
Other services and transfers	6.2	9.4	13.2	12.1	10.1	9.8	10.0	10.3
Financial account	**17.3**	**13.1**	**12.1**	**14.2**	**16.0**	**17.0**	**19.6**	**21.2**
Public sector	-3.0	-3.3	3.9	4.3	5.0	5.1	5.3	5.0
Medium- and long-term borrowing	-2.4	0.0	2.4	2.6	3.3	3.4	3.5	3.2
Disbursements	10.9	15.6	12.6	17.0	16.4	15.1	14.9	14.5
Amortization 2/	13.2	15.6	10.2	14.4	13.0	11.7	11.4	11.3
Other, including short-term borrowing	-0.6	-3.3	1.5	1.7	1.7	1.7	1.8	1.8
Private sector	20.3	16.4	8.2	9.8	11.0	11.9	14.3	16.2
Direct investment	14.8	10.8	14.4	15.1	15.7	16.4	17.2	18.0
Bonds and loans 3/	-4.9	-2.7	2.9	3.1	2.9	3.4	3.4	3.4
Banking system	-3.0	-0.2	-0.1	0.1	-0.1	-0.1	-0.1	-0.1
Corporate sector	-1.9	-2.5	3.0	3.0	3.0	3.5	3.5	3.5
Equity investments and change in assets abroad	10.4	6.7	-9.2	-8.3	-7.6	-8.0	-6.2	-5.1
Equity investments	-0.1	-0.1	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4
Change in assets abroad	10.5	6.8	-8.9	-8.0	-7.3	-7.6	-5.8	-4.7
Errors and omissions and valuation adjustments	3.6	5.2	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-7.1	-9.5	-4.9	-5.1	-4.9	-4.9	-4.8	-4.6
	(In percent of GDP, unless otherwise indicated)							
Memorandum items:								
Current account balance	-2.1	-1.4	-1.1	-1.3	-1.5	-1.6	-1.8	-1.9
Nonoil current account balance	-4.4	-4.3	-4.7	-4.8	-4.7	-4.6	-4.7	-4.6
Nonoil trade balance	-3.5	-3.8	-4.6	-4.5	-4.3	-4.2	-4.2	-4.0
Merchandise exports	15.6	16.7	18.9	19.5	19.5	19.7	19.7	19.6
Merchandise imports	16.9	17.6	19.9	20.4	20.6	20.8	21.1	20.9
Gross financing needs (billions of US$) 4/	67.2	61.6	48.1	51.8	56.2	61.5	65.7	68.9
Gross international reserves 5/								
End-year (billions of US$)	50.7	59.0	63.9	62.5	67.4	72.3	77.1	81.7
Months of imports of goods and services	4.7	4.7	4.8	4.3	4.5	4.5	4.5	4.6
Months of imports plus interest payments	4.2	4.2	4.3	3.9	4.0	4.0	4.1	4.1
Percent of short-term debt (by residual maturity) 6/	117.1	163.9	156.8	155.5	164.4	159.1	163.9	168.1
Percent of gross financing requirent 7/	97.1	136.7	136.9	121.8	131.4	127.8	126.4	127.2
Crude oil export volume (millions of bbl/day)	1.7	1.8	1.89	1.91	1.95	2.00	2.00	2.00
Crude oil price (US$/bbl)	21.5	24.7	31.4	31.5	29.8	29.2	28.5	28.1
Gross total external debt	25.2	26.1	24.8	24.5	24.2	23.9	23.6	23.3
Of which: Public external debt	15.8	16.4	15.8	15.6	15.3	15.0	14.8	14.5
Gross total external debt (billions of US$)	163.6	165.6	164.9	171.1	177.9	185.1	192.5	199.7
Of which: Public external debt	102.3	104.1	105.5	108.7	112.5	116.4	120.4	124.1
Public external debt service (in percent of exports of goods, services, and transfers)	15.9	16.9	10.9	13.2	12.4	11.3	10.7	10.6
	(Annual percentage change)							
Export volume	-3.3	-2.0	8.7	6.1	6.8	7.3	6.0	5.8
Non-oil exports	-3.4	-3.6	9.6	6.6	7.5	7.8	6.6	6.4
Import volume	-0.9	-0.5	8.3	7.0	6.4	6.3	5.8	3.8
Consumer goods	7.6	-0.8	18.4	11.0	11.0	11.0	6.0	3.0
Intermediate goods	-1.6	1.4	8.7	7.2	6.4	5.3	6.4	3.9
Capital goods	-6.3	-6.0	17.7	2.0	1.1	3.9	3.2	4.4

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/ Includes financing of PIDIREGAS.
4/ Defined as the sum of the current account deficit, debt amortization (including short-term debt), and gross reserves accumulation.
5/ Excludes balances under bilateral payments accounts.
6/ Short-term debt excludes pre-payments of public sector debt.
7/ The financing requirement excludes pre-payments of public sector debt and reserve accumulation.

Table 4. Mexico: Indicators of External Vulnerability

(12-month percentage change, unless otherwise indicated)

	2001	2002	2003				2004			
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Jul.	Aug.
Market indicators										
Exchange rate (per U.S. dollar, end-period)	9.14	10.31	10.77	10.48	10.93	11.24	11.15	11.41	11.48	11.37
(year-to-date percent change)	-4.5	7.7	4.4	1.6	6.0	9.0	-0.7	1.6	2.2	1.2
28-day treasury auction rate (percent; end-period)	6.8	7.0	8.4	5.1	4.5	6.0	6.1	6.8	7.2	7.3
EMBI+ Mexico (basis points; end of period)	308	331	291	237	212	199	183	215	200	183
Stock exchange index in U.S. dollar terms (year-to-date percent change)	18.0	-14.8	-7.6	13.3	20.5	31.7	20.5	15.1	12.6	15.3
Financial system										
Bank of Mexico net international reserves (US$ billion)	40.9	48.0	52.0	53.4	52.1	57.4	59.0	59.1	57.8	58.2
Real credit to the private sector 1/	-17.7	18.5	3.0	-2.8	-4.4	-3.9	3.7	3.4	...	...
Commercial banks' nonperforming loans (percent of total loans)	5.1	4.6	4.6	4.2	3.7	3.2	3.2	3.0	...	...
Commercial banks' loan loss provision (percent of nonperforming loans)	123.8	138.1	134.3	142.5	154.3	167.1	167.4	174.5	...	...
External sector										
Terms of trade (percent change)	-0.0	4.5	-0.5	0.7	1.0	6.8	8.2	5.5	...	...
Pemex crude export price (year-to-date average; US$/barrel)	18.6	21.5	26.7	24.6	24.7	24.7	26.8	28.4	28.9	29.5
Real effective exchange rate (CPI based; year-to-date average) 2/	8.3	-0.2	-17.4	-14.7	-12.9	-12.8	-4.0	-6.4	-6.8	...
Exports (year to date, annual percentage change) 3/	-3.7	0.6	11.4	5.0	3.5	4.3	8.7	12.6	12.2	...
Of which										
Non-oil	-3.0	0.4	1.3	-1.6	-1.5	-0.0	11.8	13.7	12.8	...
Imports (year to date, annual percentage change) 3/	-1.7	-1.3	4.4	1.7	1.4	1.9	10.0	12.0	11.9	...
Of which										
Consumer goods	-4.7	-2.0	13.9	1.9	1.8	1.6	4.6	13.1	13.3	...
Capital goods	-6.8	-6.8	-5.5	-7.5	-4.7	-3.7	6.0	7.1	8.2	...
Trade balance (US$ billion; year-to-date)	-10.0	-7.9	-0.1	-1.5	-3.0	-5.6	-0.4	-1.4	-2.2	...
Nonfinancial public sector external debt (percent of GDP) 4/	12.3	11.9	12.7	11.7	12.3	12.2	11.6	11.9	11.9	11.9
Nonfinancial public sector short-term external debt (percent of GDP) 4/ 5/	0.6	0.4	0.7	0.6	0.6	0.3	0.6	0.6	0.6	0.6
Private sector external debt (percent of GDP)	10.3	9.6	10.1	9.5	10.2	9.6	8.6	9.3	9.3	9.3
Private sector short-term external debt (percent of GDP)	2.9	2.5	2.5	2.5	2.5	2.5	3.1	3.3	3.3	3.3
Commercial banks' foreign credit lines (roll-over rates in percent)	17.3	29.4	77.5	123.5	64.9	74.5	20.0	57.6	...	...
Of which										
Banks domiciled in the United States and Canada	22.4	13.4	46.1	57.1	105.4	107.7	73.5	80.2	94.9	143.3
Banks domiciled in the European Union	12.4	165.2	26.5	139.7	4.3	113.0	3.6	73.5	26.0	108.9
Memorandum items:										
Gross international reserves to short-term debt (by residual maturity, percent) 5/	96.8	117.1	150.0	157.5	150.5	163.9	153.2	170.6	...	...
Monetary base to gross international reserves (percent)	50.3	52.1	44.1	43.4	43.5	51.4	43.4	46.1	46.7	45.6

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

1/ Does not include loans associated with FOBAPROA/IPAB debt-restructuring programs.
2/ Increase = appreciation.
3/ In U.S. dollar terms net of maquila.
4/ Includes development banks. Excludes PIDIREGAS which at end-2001were equivalent to $18 billion (2.9 percent of GDP).
5/ The short-term debt by residual maturity includes pre-payment of debt.

Table 5. Mexico: Summary Operations of the Financial System

	1999	2000	2001	2002	2003	June 2004
	(In billions of Mexican pesos)					
Bank of Mexico						
Net international reserves	292	322	375	501	645	681
In U.S. dollars	31	34	41	48	57	59
Net domestic assets	-103	-114	-149	-237	-342	-403
Net credit to nonfinancial public sector	-41	-77	-65	-12	-62	-145
Net credit to financial institutions 1/	34	70	11	-15	-69	-64
Other	-97	-106	-94	-210	-211	-194
Monetary base	189	209	226	264	304	279
Financial system						
Net foreign assets	367	484	612	710	734	774
Net domestic assets	1,778	1,533	1,439	1,776	1,882	2,038
Net credit to nonfinancial public sector	1,206	1,378	1,492	1,602	1,651	1,691
Net holdings of government securities	-94	-141	-46	-35	0	0
Net holdings of Bank of Mexico securities	0	20	61	78	62	103
Credit to private sector	938	1,007	933	1,179	1,248	1,301
Other net	-272	-731	-1,001	-1,047	-1,079	-1,057
Medium and long term foreign obligations	290	279	246	264	275	263
Other net liabilities	-418	-827	-1,172	-1,073	-1,391	-1,351
Liabilities to the private sector	2,272	2,566	2,977	3,295	3,732	3,900
	(In annual percentage change)					
Memorandum items:						
Growth of credit to the private sector	2.7	7.4	-7.3	26.3	5.8	4.3
of which						
Banking Sector	0.7	5.9	-14.1	25.2	-0.1	2.0
Nonbank financial institutions	17.8	16.0	30.7	43.4	23.1	9.3
	(In percent)					
Banks nonperforming loans to total loans 2/	8.9	5.8	5.1	4.6	3.2	3.0
Banks loan-loss provisions to nonperforming loans 2/	107.8	115.4	123.8	138.1	167.1	174.5

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

1/ From January 1997 onwards, monetary aggregates are based on resident financial institutions, and deposits of the public sector.
2/ For 2004, actual data through June.

Table 6. Mexico: Baseline Medium-Term Projection

	2000	2001	2002	2003	Staff Projections 2004	2005	2006	2007	2008	2009
	(Annual percentage change, unless otherwise indicated)									
National income and prices										
Real GDP	6.6	0.0	0.6	1.3	*4.0*	*3.2*	*3.3*	*3.2*	*3.1*	*3.1*
Consumer prices (end of year)	9.0	4.4	5.7	4.0	*4.3*	*3.8*	*3.0*	*3.0*	*3.0*	*3.0*
Consumer prices (average)	9.5	6.4	5.0	4.5	*4.4*	*4.1*	*3.4*	*3.0*	*3.0*	*3.0*
External sector										
Exports, f.o.b.	21.8	-3.7	0.6	4.3	*19.1*	*7.8*	*5.5*	*6.4*	*5.1*	*5.1*
Imports, f.o.b.	23.1	-1.7	-1.3	1.9	*19.1*	*7.3*	*6.2*	*6.4*	*6.6*	*4.7*
Terms of trade (deterioration -)	-1.5	-6.9	4.4	4.0	*-0.3*	*1.4*	*-1.1*	*-1.0*	*-1.6*	*-1.6*
Interest rates										
Treasury bill rate (average 28-day cetes)	15.2	11.3	7.1	6.2	*6.8*	*7.5*	*7.1*	*6.7*	*6.7*	*6.7*
Real interest rate	6.6	7.0	1.5	2.3	*2.3*	*3.2*	*3.6*	*3.6*	*3.6*	*3.6*
	(In percent of GDP)									
Nonfinancial public sector										
Augmented balance	-3.7	-3.7	-3.3	-3.1	*-3.1*	*-2.6*	*-2.3*	*-2.1*	*-2.0*	*-2.0*
Augmented primary balance	-1.1	0.8	0.6	0.1	*0.3*	*0.9*	*1.2*	*1.1*	*1.1*	*1.1*
Savings and investment										
Gross domestic investment	23.7	21.1	20.8	19.8	*21.8*	*21.2*	*20.9*	*21.0*	*20.8*	*20.7*
Fixed investment	21.4	19.9	19.3	19.3	*19.7*	*19.3*	*19.0*	*18.9*	*18.8*	*18.7*
Public	3.6	3.6	4.2	5.0	*5.2*	*4.5*	*4.3*	*4.3*	*4.1*	*4.1*
Private	17.8	16.3	15.2	14.3	*14.5*	*14.7*	*14.7*	*14.7*	*14.7*	*14.7*
Inventories	2.3	1.2	1.5	0.5	*2.0*	*2.0*	*1.9*	*2.0*	*1.9*	*2.0*
Gross national saving	20.6	18.2	18.6	18.4	*20.7*	*19.9*	*19.4*	*19.4*	*19.0*	*18.8*
Public sector	-0.1	-0.1	0.8	1.9	*2.1*	*1.9*	*2.0*	*2.2*	*2.1*	*2.1*
Private sector	20.7	18.4	17.8	16.5	*18.6*	*18.0*	*17.3*	*17.2*	*16.8*	*16.7*
Current account balance	**-3.1**	**-2.9**	**-2.1**	**-1.4**	***-1.1***	***-1.3***	***-1.5***	***-1.6***	***-1.8***	***-1.9***

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

1/ The augmented balance is the overall balance less the net cost of bank restructuring and debtor-support operations, net PIDIREGAS expenditures and the inflation adjustment to the principal on indexed securities. Excludes privatization and other nonrecurrent revenues.

2/ Refers to the traditional budgetary public sector overall balance. Includes privatization proceeds as revenue.

Table 7. Mexico: Millenium Development Goals

	1990	1995	2001	2002
1. Eradicate extreme poverty and hunger	*2015 target = halve 1990 $1 a day poverty and malnutrition rates*			
Population below $1 a day (%)	..	..	9.9	..
Poverty gap at $1 a day (%)	..	..	3.7	..
Percentage share of income or consumption held by poorest 20%	..	..	3.1	..
Prevalence of child malnutrition (% of children under 5)	16.6	16.9	7.5	..
Population below minimum level of dietary energy consumption (%)	5	5	5	..
2. Achieve universal primary education	*2015 target = net enrollment to 100*			
Net primary enrollment ratio (% of relevant age group)	100	100	99.4	..
Percentage of cohort reaching grade 5 (%)	79.5	85.6	88.5	..
Youth literacy rate (% ages 15-24)	95.2	96.2	96.6	..
3. Promote gender equality	*2005 target = education ratio to 100*			
Ratio of girls to boys in primary and secondary education (%)	98.5	98.2	101.3	..
Ratio of young literate females to males (% ages 15-24)	98.4	98.9	99.7	..
Share of women employed in the nonagricultural sector (%)	35.3	35.9	37.2	..
Proportion of seats held by women in national parliament (%)	..	14	..	..
4. Reduce child mortality	*2015 target = reduce 1990 under 5 mortality by two-thirds*			
Under 5 mortality rate (per 1,000)	46	36	30	29
Infant mortality rate (per 1,000 live births)	37	30	25	24
Immunization, measles (% of children under 12 months)	78	90	95	96
5. Improve maternal health	*2015 target = reduce 1990 maternal mortality by three-fourths*			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	83	..
Births attended by skilled health staff (% of total)	..	85.7	..	..
6. Combat HIV/AIDS, malaria and other diseases	*2015 target = halt, and begin to reverse, AIDS, etc.*			
Prevalence of HIV, female (% ages 15-24)	..	..	0.1	..
Contraceptive prevalence rate (% of women ages 15-49)	..	65	..	..
Number of children orphaned by HIV/AIDS	..	..	27,000	..
Incidence of tuberculosis (per 100,000 people)	..	..	34	33.1
Tuberculosis cases detected under DOTS (%)	..	15	95	73
7. Ensure environmental sustainability	*2015 target = various (see notes)*			
Forest area (% of total land area)	32.2	..	28.9	..
Nationally protected areas (% of total land area)	..	3.7	3.5	10.2
GDP per unit of energy use (PPP $ per kg oil equivalent)	4.1	4.7	5.8	..
CO2 emissions (metric tons per capita)	3.7	4	4.3	..
Access to an improved water source (% of population)	80	..	88	..
Access to improved sanitation (% of population)	70	..	74	..
Access to secure tenure (% of population)	..	..	..	..
8. Develop a Global Partnership for Development	*2015 target = various (see notes)*			
Youth unemployment rate (% of total labor force ages 15-24)	5.4	9.6	4.1	4.9
Fixed line and mobile telephones (per 1,000 people)	65.6	101.2	354	401.2
Personal computers (per 1,000 people)	8.2	25.6	68.7	82

Source: World Development Indicators database, April 2004

Note: In some cases the data are for earlier or later years than those stated.Note: In some cases the data are for earlier or later years than those stated.

Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2 target: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

Goal 3 target: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

Goal 4 target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6 targets: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum

Goal 8 targets: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

MEXICO—FUND RELATIONS

(As of July 31, 2004)

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	2,585.80	100.00
Fund holdings of currency	2,032.54	78.60
Reserve position in Fund	553.31	21.40
Financial transaction plan transfers (net)	87.00	

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	290.02	100.00
Holdings	294.96	101.70

IV. Outstanding Purchases and Loans: **None**

V. Financial Arrangements: **None**

VI. Projected Obligations to the Fund: **≤ SDR 50,000** (annually 2004–07)

VII. Exchange Rate Arrangement: Mexico has a floating exchange rate regime since December 22, 1994. Mexico maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

VIII. Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on September 23, 2002. The relevant staff report was IMF Country Report No. 02/237. Mexico participated in the Financial Sector Assessment Program in 2001. The related Financial System Stability Assessment (FSSA) was discussed by the Executive Board together with the Staff Report for the 2001 Article IV Consultation in August 2001. The FSSA was published (Country Report 02/192, October 2001).

IX. Resident Representative: None.

MEXICO—STATISTICAL ISSUES

Core data are published on a timely basis and are of good quality. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). Regarding fiscal data, both the preliminary (available with a 45-day lag following the end of each quarter) and the final (available mid-year of the subsequent year) data are published and submitted to congress, ensuring that revisions are transparent and subject to public scrutiny.

Although some of the **balance of payments statistics** conform to the fifth edition of the Balance of Payments Manual, a full transition has not yet been completed. Several measures to improve **external debt statistics** have been carried out, 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), but a projection of the total external debt service of commercial banks is still not available. **International reserves** data are compiled according to the Operational Guidelines for the Data Template on International Reserves and Foreign Currency Liquidity of the IMF (October 1999).

In the fiscal area, the authorities have reported since 2001 a comprehensive measure of the fiscal balance—the Public Sector Borrowing Requirement—that encompasses the direct net cost of public investment projects with deferred recording in the fiscal accounts (PIDIREGAS) as well as the interest cost on a number of government liabilities that had not been previously recorded.

A data ROSC for Mexico was completed on May 23, 2003 and was subsequently published as IMF Country Report No. 03/150. The overall quality of Mexican statistics is good. In a number of cases, the periodicity and timeliness of disseminated data exceeded SDDS requirements However, there are various areas where improvements could be made. The authorities are aware of this situation and are continuing work in this regard.

Mexico—Relations with the World Bank

The World Bank continues to support closely and successfully Mexico's development progress. The Bank's Country Assistance Strategy (CAS) for Mexico, as discussed by its Board in May 2002, focuses on five strategic objectives: 1) consolidating the macroeconomic framework; 2) accelerating growth through competitiveness; 3) human capital development; 4) balancing growth and poverty reduction with environmental protection; and 5) building an efficient, transparent, and accountable government. The Bank will retain a rich program of analytical work and offer a three-year (FY2003–05), US$5 billion lending envelope (half of which in fast-disbursing operations) that balances macro- and micro-oriented activities, and caters to the three levels of government (federal, state, and municipal). Support will depend on the conduciveness of legal and regulatory environments and, when necessary, on the political consensus for the required reforms; lacking that consensus, lending will be correspondingly lower.

Using the program flexibility built into the 1999 CAS, the Bank was able to deliver, over the past four years, assistance both at the broad reform agenda and at the sectoral level. New lending committed during the FY1999–2002 period remained at US$4.8 billion. 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.

Recently, the Bank extended several loans to deliver support for the five objectives in the CAS. In education, the second phase of a plan to strengthen the Government of Mexico's compensatory education program is being supported through a US$300 million loan. In support of the recent reforms in the area of taxation, especially the corporate and personal income tax, and to improve tax compliance and reduce tax evasion, the Bank extended two loans to an amount of US$355 million. The Bank also continues to support the further strengthening of Mexico's financial sector, in particular through a US$64.6 million loan that focuses on increasing the access of rural low-income population to financial services. Strengthening the ongoing decentralization in Mexican public finance, the Bank also supports a program aimed at increasing the efficiency of small-scale social and productive, municipal infrastructure investments, through a US$400 million loan that enhances the administrative and technical capacity of municipalities.

As of July 2002, the Bank's portfolio consists of 24 active projects with a total undisbursed balance of US$3.6 billion. Average annual disbursements over the past four years of US$1.2 billion have led to a slight decrease in exposure to Mexico, currently at US$11 billion, within the Bank's nominal indicative, single-borrower exposure ceiling of US$13.5 billion.

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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: Sustainability Assessment Frameworks

Public sector debt

The sustainability of Mexico's public sector debt remains vulnerable to a worsening of the economic environment and fiscal consolidation delays.

Mexico's public sector gross debt is projected to remain above 50 percent of GDP in three different scenarios (Figure 1.A). Under the baseline scenario, high oil prices and the authorities' fiscal consolidation plans would bring about a gradual reduction in the debt ratio, down to about 45 percent of GDP by 2009. However, public debt is projected to stay around its current level if oil prices were to fall abruptly to $20 per barrel or fiscal adjustment did not take place.[1] A combination of these shocks together with higher interest rates would produce a steady rise in the debt ratio, up to close to 60 percent of GDP by 2009.

One-off shocks, alone, would not put the debt ratio on an unsustainable path (Figure 1.B). However, slower growth and exchange rate depreciation, based on the historical volatility of these variables, would result in rapid increases in the public debt ratio—by about 4 percentage points of GDP within a two-year period.

External debt

The sustainability of Mexico's external debt appears resilient to a worsening of the economic environment.

Mexico's vulnerability to external shocks is low under the baseline and a scenario combining higher interest rates and lower oil prices (Figure 2).[2] The external debt-to-GDP ratio would remain in the 23–26 percent of GDP range throughout the period. In the scenario combining higher interest rates and lower oil prices, gross external financing need would increase moderately in US dollar terms compared to the baseline scenario.

Under the two most extreme shocks—depreciation of the peso by 2 standard deviations in the historic data, or about 24 percent in 2005 and 2006, and a mix of higher nominal interest rates, lower GDP growth rates, and exchange rate depreciation by 1 standard deviation—Mexico's external situation would worsen dramatically.[3] External debt would approach 45 percent of GDP and 2006 gross external financing needs would double in US$ terms as compared to 2004.

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[1] The no policy change scenario assumes no net fiscal savings over the medium-term.

[2] The country-specific scenario assumes domestic interest rates higher by 100 basis points in 2005-2006 and a sharp decline in the price of Mexican oil to US$20 per barrel.

[3] Sample standard deviations are high because the historic series include Tequila crisis. Excluding 1994-96 lowers the 2006 projected debt-to-GDP ratio under the most extreme shock to below 38 percent of GDP.

Table 1. Mexico: Public Sector Debt Sustainability Framework, 1999-2009
(in percent of GDP, unless otherwise indicated)

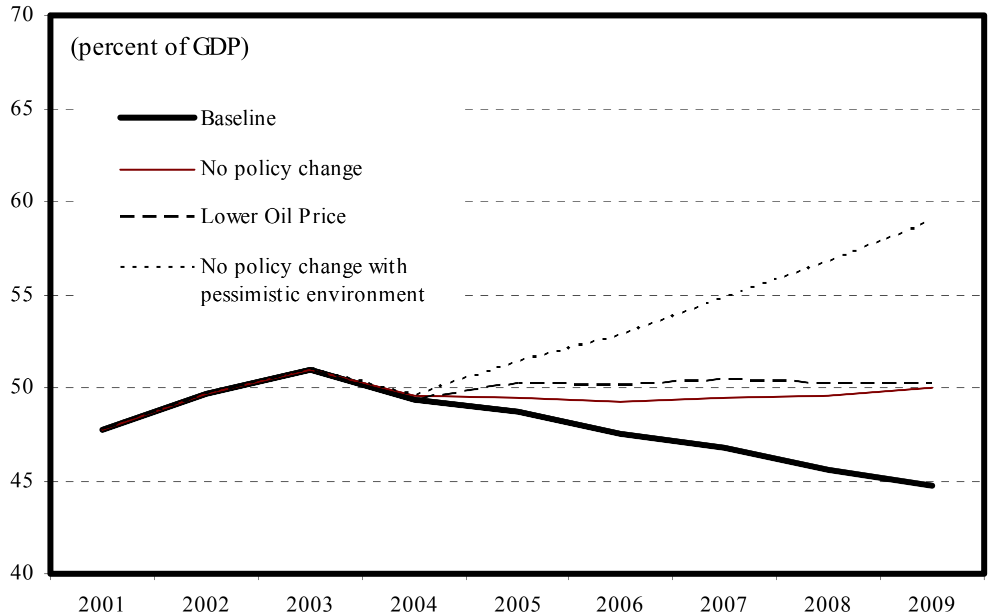
	1997	1998	1999	2000	2001	2002	2003	5-Year Historical Average	5-Year Standard Deviation	2004p	2005p	2006p	2007p	2008p	2009p	Average 2004–09
A. Gross public sector debt	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	48.7	47.5	46.7	45.6	44.7	47.1
Of which : foreign currency denominated	22.8	24.8	21.5	17.5	15.3	16.9	17.9			17.2	17.1	17.0	16.9	16.8	16.5	16.9
Of which : domestic currency denominated	28.6	31.8	29.3	31.8	32.4	32.9	33.1			32.2	31.6	30.5	29.8	28.8	28.2	30.2
Change in gross public sector debt from previous period	-4.0	5.3	-5.9	-1.5	-1.5	2.0	1.3			-1.6	-0.6	-1.2	-0.8	-1.1	-0.9	-1.0
Net debt creating flows	-4.1	-3.0	-3.3	-5.0	0.2	-0.8	-1.1			-1.4	-1.0	-1.2	-1.1	-1.1	-1.1	-1.2
Augmented primary deficit 1/	-3.0	-0.5	-1.3	-1.2	-0.8	-0.6	-0.1			-0.3	-0.9	-1.2	-1.1	-1.1	-1.1	-0.9
Total revenue 2/	22.0	20.0	20.4	21.1	21.0	21.4	23.1			23.4	23.3	23.0	22.8	22.6	22.3	22.9
Total expenditure 3/	27.6	26.3	26.7	24.7	24.7	24.7	26.3			26.5	25.9	25.3	24.9	24.6	24.3	25.3
Total primary expenditure	18.9	19.5	19.1	19.8	20.2	20.8	23.0			23.2	22.3	21.9	21.7	21.5	21.3	22.0
Total Interest cost 4/	8.7	6.8	7.6	4.9	4.5	3.9	3.2			3.4	3.6	3.5	3.2	3.1	3.0	3.3
Nondebt creating inflows	1.1	0.4	0.4	0.4	0.7	0.7	0.6			0.5	0.4	0.4	0.4	0.4	0.4	0.4
Nonrecurrent revenue (incl. Privatizations)	1.1	0.4	0.4	0.4	0.7	0.7	0.6			0.5	0.4	0.4	0.4	0.4	0.4	0.4
Total interest rate and GDP growth effect ((i-g-(p+pg))/(1+g+p+gp) * D)	0.0	-2.1	-1.6	-3.4	1.7	0.5	-0.4			-0.7	0.3	0.4	0.4	0.4	0.4	0.2
Adjustment factor (1+g+p+gp)	1.3	1.2	1.2	1.2	1.1	1.1	1.1			1.1	1.1	1.1	1.1	1.1	1.1	1.1
Combined interest rate and GDP growth effects ((i-g-(p+pg)) * D)	0.0	-2.6	-1.9	-4.1	1.8	0.5	-0.4			-0.8	0.4	0.4	0.4	0.4	0.4	0.2
Residual	0.1	8.3	-2.5	3.5	-1.7	2.7	2.4			-0.2	0.4	0.0	0.3	0.0	0.2	0.1
Public sector debt-to-revenue ratio 5/			248.4	232.0	226.2	231.7	220.7			210.8	209.2	206.4	204.8	202.1	200.4	205.6
Gross financing need 6/			...	...	12.0	11.4	12.8			11.8	11.9	13.9	14.9	14.8	15.4	13.8
in billions of U.S. dollars			...	...	74.7	74.1	80.2			78.5	83.0	101.9	115.4	120.8	132.6	105.3
Debt-stabilizing augmented primary balance			-4.6	-0.3	-0.7	2.5	1.4			-1.4	0.3	0.0	0.3	0.0	0.2	-0.1
B. Key Macroeconomic and Fiscal Assumptions																
Real GDP growth (in percent)			3.6	6.6	0.0	0.6	1.3	2.4	2.7	4.0	3.2	3.3	3.2	3.1	3.1	3.3
Average nominal interest rate on public debt (in percent)			16.0	11.5	9.8	8.5	7.0	10.6	3.5	7.4	7.7	7.6	7.2	7.1	7.1	7.3
Average real interest rate (in percent)			0.6	-0.6	3.3	1.8	0.5	1.1	1.5	2.6	3.9	4.0	4.0	4.0	3.9	3.8
Nominal appreciation (increase in US dollar value of local currency, in percent)			-4.4	1.1	1.2	-3.2	-10.5	-3.2	4.8	...	...	...	...	...	...	...
GDP deflator (in percent)			15.3	12.2	6.3	6.6	6.5	9.4	4.1	4.7	3.6	3.4	3.0	3.0	3.0	3.5
Growth of real primary spending			1.5%	4.8%	-2.1%	4.8%	14.1%	4.6%	6.0%	4.8%	-0.8%	1.0%	2.4%	2.0%	2.2%	1.9%
Primary deficit			-1.3	-1.2	-0.8	-0.6	-0.1	-0.8	0.5	-0.2	-0.9	-1.2	-1.1	-1.1	-1.1	-0.9
C. Bound tests 7/																
1.- If effective nominal interest rate, real GDP growth, GDP deflator growth primary balance and non-debt flows are at five-year average	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	47.7	45.8	44.1	42.2	40.5	44.9
2.- If effective real interest rate in 2005 and 2006 is on baseline plus 2 STD	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	50.1	50.4	49.6	48.5	47.7	49.3
3.- If real growth in 2005 and 2006 is on average minus 2 STD	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	51.9	54.1	53.4	52.3	51.5	52.1
4.- If GDP deflator in 2005 and 2006 is on average minus 2 STD	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	50.0	49.9	49.1	48.0	47.2	48.9
5.- If augmented primary balance in 2005 and 2006 is on average minus 2 STD	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	50.0	50.2	49.4	48.4	47.5	49.1
6.- Combined one standard deviation shock to real GDP growth, effective real interest rate and primary balance in 2005 and 2006	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	51.8	54.1	53.4	52.3	51.5	52.1
7.- Combined two standard deviation shock to real GDP growth, effective real interest rate and primary balance	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	54.5	59.9	59.2	58.2	57.4	56.4
8.- One time 30 percent depreciation in 2005, everything else at baseline except primary deficit	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	53.9	52.8	52.0	50.9	50.1	51.5
9.- Increase of debt ratio in 2005 by 10 percent of GDP	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	58.7	57.6	56.9	55.9	55.1	55.6
D. Alternative scenarios																
10- No policy change scenario	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.5	49.4	49.3	49.5	49.6	50.0	49.6
11- Price of Mexican oil exports falls to 20 US$/bbl in 2005 and remains at that level	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.3	50.2	50.2	50.4	50.3	50.3	50.1
12- No policy change scenario in pessimistic environment 8/	51.4	56.6	50.8	49.3	47.8	49.7	51.0			49.5	51.3	52.8	54.9	56.7	58.9	54.0

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

1/ Negative value indicates surplus.
2/ Budgetary revenue excluding non-recurrent income, capital gains on debt buy-backs and premia on par bonds.
3/ Budgetary expenditure + PIDIREGAS financing requirement + IPAB financing requirement+ FARAC financing requirement + development banks financing requirement + inflation component of indexed bonds + reserves of IMSS and ISSSTE + debtor support programs.
4/ Budgetary financing cost + accrued interest IPAB + net interest PIDIREGAS + inflation component of indexed bonds + FARAC financing requirement + debtor support programs.
5/ Excluding nonrecurrent revenue (e.g., privatization).
6/ Gross financing need is here defined as the sum of the public sector's deficit and public debt amortization, both domestic and external, using augmented definitions. It is therefore larger than the Public Sector Borrowing Requirement (PSBR) monitored by the Mexican authorities, which does not reflect debt amortization oblligations.
7/ Projection assumes a constant residual at the baseline level.
Symbols: i=effective nominal interest rate; g=real GDP growth rate; p=growth rate of GDP deflator; D=debt-to-GDP ratio; year t=2002; year t+1=2003.
8/ Combines passive policies, $20 oil price, and effective nominal interest rate higher than in the baseline by 100 bps.

Figure 1. Mexico: Gross Public Debt, 2001-2009

A. Baseline Scenario Versus Passive Fiscal Policies and Oil Price Decline



B. Debt Sustainability Shocks 1/

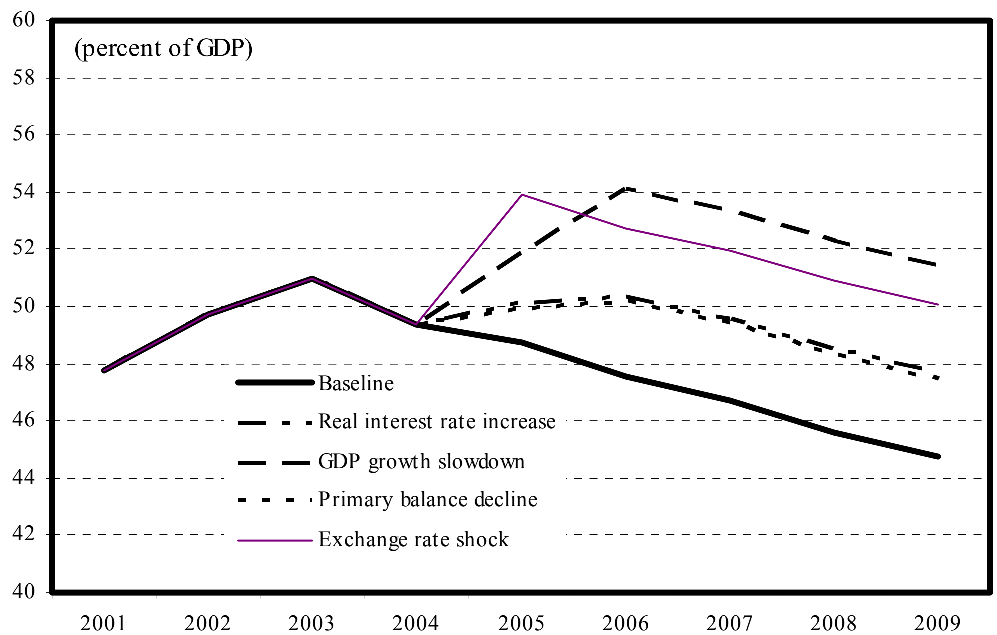
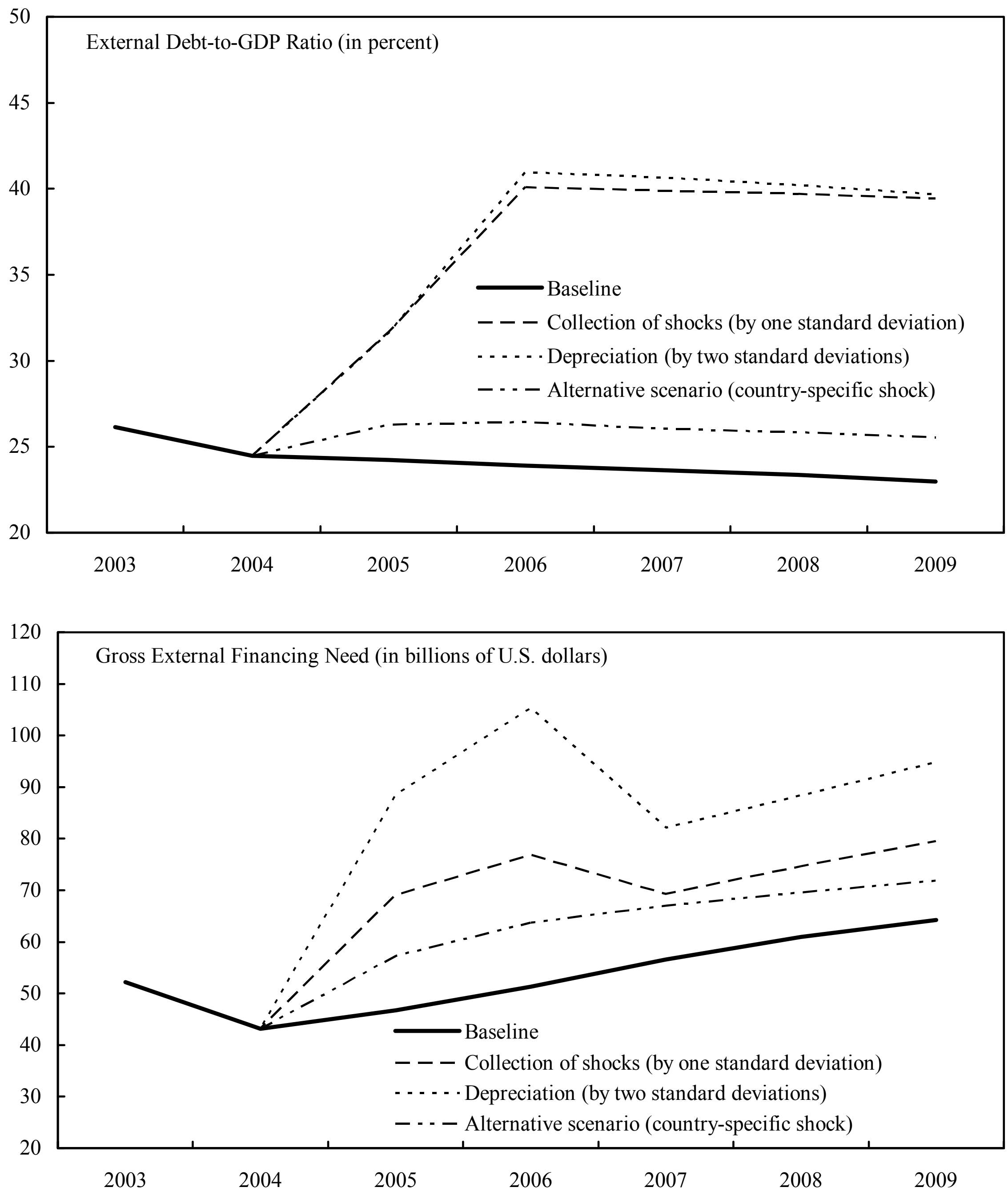


Table 2. Mexico: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
										I. Baseline Projections				**Debt-stabilizing non-interest current account 7/**
External debt	36.9	28.4	26.1	25.2	26.1			**24.5**	**24.2**	**23.9**	**23.6**	**23.4**	**23.0**	**-0.7**
Change in external debt	-2.1	-8.5	-2.3	-0.8	0.9			-1.7	-0.2	-0.3	-0.3	-0.3	-0.4	
Identified external debt-creating flows (4+8+9)	-4.2	-5.1	-2.3	-0.8	1.0			-1.5	-1.1	-0.8	-0.7	-0.4	-0.3	
Current account deficit, excluding interest payments	0.2	0.8	0.9	0.7	-0.1			-0.6	-0.5	-0.3	-0.3	0.0	-0.1	
Deficit in balance of goods and services	1.5	1.8	2.2	1.8	1.6			1.6	1.5	1.7	1.7	1.9	1.8	
Exports	20.3	20.4	18.2	17.6	18.7			20.8	21.3	21.3	21.5	21.5	21.4	
Imports	21.8	22.2	20.4	19.4	20.3			22.4	22.8	23.0	23.2	23.4	23.3	
Net non-debt creating capital inflows (negative)	-2.2	-1.8	-3.2	-2.0	-1.3			-1.6	-1.6	-1.6	-1.6	-1.5	-1.5	
Automatic debt dynamics 1/	-2.1	-4.0	0.1	0.5	2.4			0.6	1.0	1.1	1.1	1.1	1.3	
Contribution from nominal interest rate	2.7	2.4	2.0	1.4	1.5			1.6	1.8	1.8	1.8	1.8	2.0	
Contribution from real GDP growth	-1.2	-2.0	0.0	-0.1	-0.3			-1.0	-0.8	-0.7	-0.7	-0.7	-0.7	
Contribution from price and exchange rate changes 2/	-3.6	-4.4	-2.0	-0.8	1.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.0	-3.5	0.0	0.0	-0.1			-0.1	0.8	0.5	0.5	0.2	-0.1	
External debt-to-exports ratio (in percent)	181.9	139.3	143.3	143.3	139.8			117.6	113.8	112.2	109.9	108.8	107.3	
Gross external financing need (in billions of US dollars) 4/	59.2	72.4	71.1	60.1	52.2			43.2	46.7	51.3	56.6	61.0	64.3	
in percent of GDP	12.3	12.5	11.4	9.3	8.2			6.4	6.6	6.9	7.2	7.4	7.4	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.6	6.6	0.0	0.6	1.3	2.7	3.9	4.0	3.2	3.3	3.2	3.1	3.1	3.3
GDP deflator in US dollars (change in percent)	10.1	13.4	7.4	3.3	-4.7	2.5	12.2	2.3	1.5	2.0	2.1	2.1	2.2	2.0
Nominal external interest rate (in percent)	7.9	7.7	7.7	5.7	5.9	7.8	1.2	6.7	7.7	7.8	8.0	8.0	9.0	7.9
Growth of exports (US dollar terms, in percent)	13.0	21.3	-4.2	0.6	3.8	10.6	9.8	18.3	7.3	5.4	6.3	5.1	5.1	7.9
Growth of imports (US dollar terms, in percent)	10.3	22.6	-1.4	-0.7	2.0	8.8	14.8	17.5	6.7	6.0	6.2	6.3	4.7	7.9
Current account balance, excluding interest payments	-0.2	-0.8	-0.9	-0.7	0.1	0.1	2.4	0.6	0.5	0.3	0.3	0.0	0.1	0.3
Net non-debt creating capital inflows	2.2	1.8	3.2	2.0	1.3	2.5	0.8	1.6	1.6	1.6	1.6	1.5	1.5	1.6
										II. Stress Tests for External Debt Ratio				**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**24.5**	**23.6**	**22.5**	**21.3**	**19.8**	**18.1**	**-2.1**
A2. Country-specific shock of a fall in oil prices 6/								**24.5**	**26.3**	**26.4**	**26.1**	**25.8**	**25.5**	**0.0**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**24.5**	**24.8**	**25.1**	**24.9**	**24.6**	**24.3**	**-0.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**24.5**	**26.4**	**28.4**	**28.1**	**27.8**	**27.4**	**-0.9**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**24.5**	**31.6**	**41.0**	**40.7**	**40.2**	**39.7**	**-1.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**24.5**	**29.3**	**34.1**	**34.0**	**34.0**	**34.0**	**-0.3**
B5. Combination of 2-5 using one standard deviation shocks								**24.5**	**31.7**	**40.1**	**39.9**	**39.7**	**39.5**	**-0.7**
B6. One time 30 percent nominal depreciation in 2005								**24.5**	**34.1**	**33.8**	**33.5**	**33.1**	**32.7**	**-1.0**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. This definition differs from that used in Table 3 of the Staff Report, as it does not reflect the financing requirement resulting from gross reserve accumulation.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ The implied change in other key variables under this scenario is discussed in the text.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 2. Mexico: Debt Ratio and Gross External Financing Need, 2003-09 1/



Source: IMF staff calculations.

1/ Shocks are calibrated using the data for the past 10 years.

Statement by the IMF Staff Representative
October 18, 2004

The following information has become available since the staff report was issued to Executive Directors. The thrust of the staff appraisal remains unchanged.

1. **Recent indicators are consistent with continuing economic recovery.** The index of overall economic activity rose by 3.5 percent in July over the previous year, while gross fixed investment increased by 8.6 percent over the same period, and retail sales grew by 4.8 percent. Industrial production rose by 4.7 percent in August over the previous year.

2. **Headline CPI inflation increased to 5.1 percent in September (12-month basis), while core inflation edged up to 3.8 percent.** Contractual wage settlements rose to 4.8 percent in September after averaging 4½ percent in the first eight months of the year. In mid-October, Mexico's social security institute (IMSS) and its unions agreed on a 3 percent wage increase plus 1 percent in benefits for the next twelve months. Inflation expectations for end-2004 climbed further to 4.6 percent in the September survey.

3. **The Bank of Mexico (BOM) increased the *corto* for the sixth time this year on September 24.** This tightening action came soon after an increase in domestic short-term interest rates associated with the tightening in U.S. monetary policy on September 21. As a result, short-term rates have risen by close to 50 basis points since the beginning of September. The peso has strengthened as interest rates have risen, appreciating by about 2½ percent against the U.S. dollar since early September.

4. **Trade data for August showed a smaller-than-expected deficit.** Imports increased by 20.7 percent from the year-ago level, while exports increased by 27.3 percent reflecting higher oil exports and non-oil export volumes. Net international reserves stood at US$57.6 billion end-September, compared with US$57.2 billion at end-August.

5. **The price of Mexican crude oil could exceed the staff's estimate for 2004.** The price of the Mexican mix has averaged US$30.1 per barrel for the year through mid-October, compared with staff assumption of U$31.4 per barrel for the year as a whole. The current spot price stands near US$40 per barrel, suggesting that the average price for the year could modestly exceed the staff's assumption.

6. **On September 22, the government issued US$1 billion of 30-year bonds to pre-fund 2005 financing requirements.** The bond was issued with a yield of 6.9 percent, implying a spread of 210 basis points over U.S. treasuries. High demand for the bond allowed the amount issued to increase from US$1 to US$1.5 billion. Pemex also recently issued a US$1.75 billion perpetual bond with a coupon of 7.75 percent in Asian markets. Mexico continues to include collective action clauses (CACs) in bond issues.

Statement by Moises Schwartz, Executive Director for Mexico
October 18, 2004

During the last few years the Mexican economy has been characterized by macroeconomic stability, efficient debt management, financial sector soundness and compliance with international standards and codes in a number of areas. The recovery of the economy is well underway. GDP is expected to post a growth of 4.0 percent in 2004 and 3.8 percent in 2005. The upturn of the economy is linked to the strength of the global economy, particularly to that of the US. Recent manufacturing and maquila exports reflect the strengthening of world recovery and imports of intermediate goods anticipate growth of industrial activity. Consumption and investment have also shown increased dynamism. The recovery has been widespread among the different sectors and has resulted in improved employment indicators. The current account deficit, which accounted for more than 7 percent of GDP in the run-up to the 1994-95 crisis, is down to a sustainable 1.5 -2.0 percent of GDP. International reserves have increased ten-fold over the past ten years to close to US$60 billion and a decade of a successful floating-exchange-rate regime has almost been completed. The current floating scheme and prudent macroeconomic policies have placed the country in a much better position to deal with capital market disturbances and prevented the build up of external disequilibria.

Inflation and Monetary Policy

During the last eight years inflation has declined significantly, reaching levels that had not been experienced for over three decades. Single digit inflation has become the norm and inflation reached a figure under 4 percent at the end of 2003. Notwithstanding, recent inflation has been boosted by supply shocks, including a temporary suspension of some meat imports from the US, climate effects on agricultural prices and the impact of higher international prices for oil and other commodities. In particular, it should be noted that the increases in administered prices have resulted from the non-discretionary use of formulas that link domestic prices to international references. Moreover, one should bear in mind that the cyclical recovery currently experienced by the economy feeds up the pass-through of supply shocks to consumer prices and thus has an effect on inflationary expectations.

Within the framework of an inflation-targeting scheme, the Bank of Mexico carries out a cautious analysis of the origins of inflationary pressures and their impact on inflation expectations. Monetary authorities have focused policy implementation on limiting the effects on inflation expectations that result from higher commodities' prices, remaining vigilant to address cyclical pressures on inflation that could emerge from the strength of aggregate demand and promoting an orderly transition to an environment of higher interest rates. Reiterating its commitment to achieve the inflation target, the central bank has tightened monetary policy on six occasions this year.

Staff suggests that monetary policy implementation should consider the publication of an official inflation forecast in order to solve *"problems in communicating policies"* when inflation is above target. However, the fact that headline inflation has surpassed the target does not entail "communications problems". Inflation has recently peaked up as a result of imported inflation, specifically, increases in commodity prices related to an upturn in world economic activity as well as a result of geopolitical uncertainty. Inflation expectations produced by market participants for the medium and long term place inflation within the variability interval announced by the central bank, and communication problems are not present. The Bank of Mexico has repeatedly tightened policy in order to bring inflation back to its variability range.

Moreover, the fact that the central bank has not incorporated inflation forecasts in its inflation-targeting scheme does not mean that its design has not been improved. During recent years, the Mexican inflation-targeting framework has incorporated additional elements that facilitate communication. For example, monetary policy announcements now take place according to a predetermined calendar, policy statements place more emphasis on underlying inflation and on explaining the nature of price shocks, and monetary policy implementation is fully understandable by market participants. Furthermore, a thorough analysis of a wide range of indicators, data and models has given the central bank a good grasp of the transmission process of monetary policy. The publication of an official inflation forecast as well as other refinements to Mexico's inflation-targeting scheme are constantly evaluated by the central bank board.

However, it is believed that at a stage when the inflation forecast might be different from the target, an official forecast would not add much to the analysis, could even create confusion and needlessly affect the credibility of the central bank. Let us assume, for example, that an official inflation forecast is above the inflation target or variability interval announced by the central bank. Once the forecast is released, and assuming that the central bank enjoys some credibility, market participants would expect the monetary authority to implement policy in such a way as to achieve its original target. If the central bank is able to attain the original inflation target, the forecast looses relevance and next time a forecast is announced, market participants will not find it useful. However, if the original target is not met, the central bank would be regarded as a "good predictor" but as incompetent in reaching its target. In this case, the official forecast would simply serve to "validate" higher inflation expectation and thus affect inflation dynamics. In this case, the inflation forecast would unnecessarily delay the disinflationary process and make the fight against inflation more difficult.

Staff should note that for those successful inflation-target countries that do provide an inflation forecast, their forecast is almost always within their confidence or variability interval around the point target. In this case, the inflation forecast helps guiding expectations within the interval and, as such, it does not contradict the target. But in a situation where current inflation is running above the target, we do not see how an official forecast could help. On the contrary, as it has been the case, if the central bank clearly specifies that its original target is maintained, even though current inflation exceeds such a target, and monetary policy is clearly identified as committed to bring inflation down from the current level to its medium term objective, then the central bank is in a stronger position to affect inflation expectations and thus speeds up the disinflationary process. This is the alternative that the Bank of Mexico has opted for and it has given good results. Furthermore, inflation forecasts produced by market participants are constantly updated and contrasted with the central bank's target, so no communication problems or lack of transparency have been present.

Fiscal Policy and Debt Management

On the fiscal front, a deficit of 0.3 percent of GDP is expected for 2004, with the aim to reduce it to 0.1 percent in 2005. Public Sector Borrowing Requirements are expected to amount to 2.6 percent of GDP at the end of this year and 2.1 percent in 2005. Public finances have benefited from the oil windfall and the recovery, hence the authorities expect to accomplish the fiscal targets without problems. Fiscal spending has become more efficient and more transparent and the debt structure has also been strengthened.

We agree with staff that the process of fiscal consolidation that has taken place in Mexico should have relied less on oil related revenues. Nevertheless, the following must be emphasized. During the current Administration fiscal targets have been met (both the traditional definition of deficit and Public Sector Borrowing Requirements) every year even during the low growth episode that the Mexican and the world economy went through. In this context, several countries used fiscal policy to foster the recovery, a temptation that was avoided in Mexico. In addition, the political economy process has prioritized fiscal consolidation over undertaking counter-cyclical policies. My authorities believe that, given the current conditions facing the Mexican economy, this is the correct approach. Furthermore, in the last two years and for 2005 the Income Law incorporated conservative assumptions for the oil price, therefore permanent expenditure pressures are not being generated by the high prices observed in the oil market. This strategy has led to excess revenues that have been allocated to savings and investment. Certainly, it would be desirable to increase savings as staff recommends, but it would be imprecise to consider that the extraordinary revenue has been used to boost public-sector consumption. In sum, the consistent achievement of the fiscal goals in recent years should not be belittle as a minor achievement.

Notwithstanding that in recent years the achievement of fiscal goals has been favored by high oil revenues, it must be highlighted that the composition of public spending has improved, favoring productive investment. Therefore, once the fiscal accounts are adjusted to consider productive investment in order to assess the sustainability of the fiscal position, we find that public finances are better and that fiscal consolidation efforts have been greater than what an ordinary analysis reveals.

Throughout the report one finds several instances where staff suggests that *"the spending of windfall oil revenues has made the fiscal position more vulnerable to a decline in oil prices"*, and *"on the need to save a significant portion of future windfalls to avoid increasing dependence of the budget on oil revenues"*. We find these comments misleading since they do not clearly depict what has taken place in Mexico and consider that this kind of comments seem to confuse the economic concept of savings with that of financial savings.

We all agree that long-run fiscal sustainability would generally imply saving a portion of the current non-renewable resource revenue. Such an approach would both stabilize usable revenue and provide for the accumulation of financial resources that compensate for the depletion of the natural resource, thus allowing to implement fiscal policies that are set within a longer-term framework. That is, financial savings are designed to smooth expenditure.

As opposed to the above definition of financial savings, the economic concept of saving refers to the excess of current revenue over current expenditure with the objective of preserving net government wealth. Savings in this case can be allocated both to public investment or held as financial assets. Moreover, economic theory does not favor any of the two possible destinies. However, it is common sense that if a government allocates all of its economic savings to public investment during "good" times and fails to build up financial assets, it might find it difficult to finance expenditures during "rainy days".

As a result of the above considerations, Mexican authorities have tried to strike the right balance between the allocation of excess revenues and it must be stressed that its largest share has been devoted to investment and savings rather than current expenditures (a fact that staff fails to recognize). According to the current Budget Decree, after deducting the expected increase on non-programmable expenditures and the decrease in other revenue sources, excess revenues are allocated according to a formula that distributes 74.2 percent to savings vehicles (PEMEX trust fund, Oil Stabilization Fund and improvement of the public balance) and 25.8 percent to infrastructure investment in the states. The fact that it is expected that PEMEX will eventually allocate its share to investment in the development of the Mexican oil sector (exploration, production, etc.) should not be seen as "current expenditures" but as a measure that preserves wealth and allows the oil company to become more efficient. We have to keep in mind that the rate of return from investing in the development of the Mexican oil sector is substantially larger than the yield that can be obtained from financial assets as T-bills, thus Mexico finds it more profitable to invest in the oil sector than in financial assets.

Therefore, the assumption that in 2004 savings have been small is incorrect. Moreover, it should also be recognized that no permanent expenditure pressures are being generated as a result of the spending expansion associated with excess revenues. These revenues are allocated mostly to investment and savings and are non-recurrent in nature and consequently can not become a pressure for public finances.

As a result of the external public debt management strategy, the government faces a comfortable debt-service payments schedule as debt has been rolled over on more favorable terms. An example is the recent placement of US$1.5 billion at a fixed rate with a 30 year maturity. This issuance allows the Mexican government to pre-finance most of its 2005 obligations and is in accordance with the external net debt-reduction target of US$500 million approved by Congress for this year.

Risks associated with a reduction of flows to emerging markets have considerably been reduced by changing the composition of public debt and relying more heavily on domestic financing. Moreover, the reduction in the cost of financing in the domestic market has contributed to an improvement of the private sector's balance-sheet position and in the development of domestic markets. The maturity of the yield curve has been extended up to 20 years. Institutional investors are now interested in domestic issuances with long-term fixed rates due to further progress in the development of the financial system and reforms to the pension system. In order to further reduce interest rate risk, the government will continue to substitute debt with floating rates for new instruments with fixed rates. Currently, almost 50 percent of domestic debt instruments with a maturity of one year or more are linked to fixed rates, compared to nearly 15 percent at the end of 2000. It is expected that domestic debt will represent 65 percent of public debt in 2005, compared to 53 percent in 2000.

In the staff's treatment of the evolution of the debt to GDP ratio one should realize that, in recent years, the path of this ratio has been more influenced by the behavior of the exchange rate of the Mexican peso with respect to the dollar as well as by the exchange rate of the dollar with respect to other currencies in which public debt is subscribed. This is an important clarification since usually an increase of the debt to GDP ratio can erroneously be interpreted as lack of fiscal discipline. Exchange rate movements are temporary in nature and therefore the authorities expect debt as a share of GDP to return to a decreasing path.

The international comparison sections of the Selected Issues paper on the *"Structure and Cost of Public Debt in Mexico"* show that the current broad public debt level in Mexico is lower than the median value of emerging market economies as a percentage of GDP, support the conception that Mexico's public debt level is not high and claim that the size of the Mexican public debt does not itself prevent future rating upgrades. As such, the referred analysis refutes the Staff Report's characterization of Mexican debt in paragraph 25 as *"uncomfortably high"*.

Output Gap, Productivity and Structural Reform

Staff's growth assumptions for 2005-2009 deserve further analysis. The rate of growth of potential output at the baseline scenario (2.9 percent) seems low, as it is based on a total-factor-productivity (TFP) growth rate assumption heavily influenced by the large negative swings observed in the periods of crisis of the 80s and 90s. Therefore, it is not consistent with estimates of potential growth for the periods 1996-2001/2002, carried out by previous studies and by the background paper itself. Along with the TFP growth estimation problems, the output gap (below 2 percent) to infer the behavior of GDP growth is small since it overlooks the macroeconomic conditions and is affected by end-of-sample problems. These factors may be leading to a substantial underestimation of growth for the next years. Taking into account that: (a) trend TFP growth should be higher, (b) the output gap is larger than estimated in the paper, (c) the process of getting back to the potential output should take 3-4 years at most, and (d) the fact that the Mexican economy is still to benefit from the recent financial sector reforms and from a sounder banking system, the average growth rate for 2005-2009 should be revised upwards by at least 0.5 percent. This is important since growth forecasts have an effect on all the medium-term fiscal projections produced by staff.

We agree with staff that medium-term growth prospects are contingent on making progress in the reform agenda. Analytical work has emphasized that lack of further economic reforms accounts for the failure to deliver growth and development. Significant challenges remain in

Mexico's structural reform process. The absence of progress in implementing structural reforms has affected competitiveness. Authorities have been engaged in a constructive dialogue with all sectors in order to reach consensus on a whole set of reforms that would boost productivity. Approval by the Legislative branch is in the best interest of the country as it would contribute to raise potential growth.

Statistical Coverage of Fiscal Accounts

Mexico is a strong believer in the usefulness of Fund's surveillance. In the last ten years, the availability and transparency of Mexican economic and financial indicators have increased considerably and, as noted on the staff report and on the ROSC on data dissemination, the overall quality of statistics is good and timely. Mexico observes the SDSS and its metadata are posted on the DSBB. We understand the importance of fiscal indicators, including those of the non-financial public sector, and publish our fiscal targets. Since 2001 Mexico publishes a comprehensive measure of the fiscal balance--the Public Sector Borrowing Requirement--which includes the financing needs of public entities and of private and social entities that act on the government's behalf.

However, we are concerned by the fact that the coverage of fiscal statistics in Fund documents and programs varies across regions. The evenhandness of surveillance is questioned when we note that, according to a FAD internal report, more than 80 percent of Latin American countries provide information on the non-financial public enterprise sector. In contrast, the operations of public enterprises in Middle-Eastern countries are not covered in the fiscal accounts, and only 12 percent of the OECD countries provide this information. Similarly, the coverage of fiscal targets in Fund programs in Latin America includes, in over 70 percent of the cases, non-financial public sector figures. This contrasts markedly with an average of nearly 20 percent in the universe of country programs, and with the absence of non-financial public sector coverage in Middle Eastern countries. If we are all to be measured by the same yardstick, it would be required to develop indicators for all members including all type of fiscal contingencies. We call on management and staff to design a plan that would guarantee that all membership is subject to the same scrutiny.

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

IMF Executive Board Concludes 2004 Article IV Consultation with Mexico

On October 18, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

After three years of weak activity, the broad-based recovery underway this year provides encouraging evidence that the factors holding back Mexico's growth were temporary. Business confidence and investment have risen, foreign direct investment (FDI) inflows are strengthening, exports have picked up sharply, and market perceptions of Mexico remain favorable. While inflation has risen moderately above the authorities' objective, it remains far below levels historically experienced by Mexico. Higher oil prices and a recovery in non-oil exports have led to a narrowing in the current account deficit. The current account deficit has been more than matched by FDI inflows.

Economic activity accelerated to 3.8 percent in the first half of 2004 over the previous year. This recovery is partly attributable to strengthening U.S. industrial production, as reflected in growth in Mexican manufactured exports of 10½ percent (seasonally adjusted) in the first seven months of 2004 over the same period in 2003. Inflation accelerated from 4 percent at end-2003 to 5.1 percent in September, boosted by supply shocks, including a temporary suspension of some meat imports from the United States, higher oil and commodity prices, and their impact on administered prices. Core inflation was lower, standing at 3.8 percent, but has shown no signs of decelerating since early 2003.

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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.

Net international reserves increased to US$58 billion in August 2004, compared with US$48 billion at end-2002, reflecting strong PEMEX receipts. A change was made to the mechanism for auctioning international reserves in March 2004. The Banco de Mexico continues to pre-announce the amount of dollars to be sold in the market, equal to 50 percent of net reserve accumulation in the previous three-month period. The sale of dollars will now, however, be spread over the following 12 months, as opposed to three months, to reduce volatility in the amount sold throughout the year.

Targets for the traditional deficit have been met in recent years. But the pace of fiscal consolidation, viewed in terms of the augmented public sector deficit, has been slower than envisaged in the authorities' 2002 medium-term plan. While this deficit was reduced from 3.7 percent of GDP in 2000 to 3.1 percent in 2003, gross public debt rose by about 1.75 percentage points to 51 percent of GDP during those years, reflecting both currency depreciation and slow growth. For 2004, the augmented deficit is expected to remain broadly unchanged, while the traditional deficit would fall slightly to 0.4 percent of GDP, in line with budget targets. The draft budget for 2005 calls for a decline in the augmented deficit to 2.2 percent of GDP, while the traditional deficit would fall to 0.1 percent of GDP.[2]

The Banco de Mexico has tightened policy seven times since the beginning of 2004 via increases in the *corto* (the borrowed reserves objective). In addition, domestic market conditions have been affected by the two increases in the U.S. federal funds target rate. The overnight inter-bank (*fondeo*) rose from about 5 percent in January to slightly over 8 percent in mid-September. Long-term interest rates rose by slightly less over this period, with the 10-year government bond yield increasing from about 8½ percent in January to 10½ percent in September. The peso depreciated by 2 percent through end-September after falling by 6½ percent against the U.S. dollar in 2003.

Market sentiment toward Mexico remains positive, as reflected in its investment-grade status. After a short-lived spike to 250 basis points in mid-May as U.S. interest rates rose, Mexico's EMBI+ spread has fallen back to about 180 basis points.

The government has made significant progress in strengthening the structure of public debt. Several liability management operations, including an exchange of global bonds in early 2004, have helped to improve the efficiency of the yield curve. Domestic public debt management has concentrated on extending maturities, improving the liquidity of benchmark issues, and deepening domestic financial markets. Nevertheless, some public debt vulnerabilities remain, with a large portion of domestic debt either short term or linked to short-term interest rates. The public sector also has a significant gross financing need.

[2] Methodological differences mean that the figures in this document may differ from those published by the Ministry of Finance.

Executive Board Assessment

Executive Directors commended the Mexican authorities for their continued pursuit of sound macroeconomic policies, and welcomed signs that recently the economic recovery has strengthened and become more broadly based, while business confidence and investment have risen. Meanwhile, FDI inflows have been strong, exports have picked up, and market perceptions of Mexico remain favorable. Progress in modernizing the financial sector has continued, and balance sheets appear healthy. The key challenges going forward will be to enhance Mexico's economic performance on a lasting basis by bringing inflation down to the long-term objective, reducing debt vulnerabilities, and reinvigorating the program of structural reforms.

On fiscal policy, Directors welcomed the authorities' continuing commitment to medium–term fiscal consolidation, and commended the authorities' track record in meeting fiscal targets. They noted that the budget is dependent on volatile oil revenues. In this context, most Directors encouraged the authorities to aim at saving significantly more of the excess oil revenues for the medium term, while some considered the use of part of these revenues for productive investments to be a prudent strategy. Looking ahead, Directors urged the authorities to establish stronger mechanisms to ensure that a substantial portion of the windfall is saved. This will require redoubled efforts to ensure that medium-term expenditure reduction is combined with measures to achieve significant increases in non-oil revenues.

Directors considered that fiscal reforms will have a crucial role to play in achieving further consolidation. In particular, formal fiscal responsibility principles based on the augmented fiscal measures should be helpful in avoiding slippages in meeting medium-term targets. Directors regretted the setback to efforts aimed at enhancing the efficiency of the tax system and promoting fiscal stability. They believed that tax reform to raise non-oil revenues will be needed to avoid budget cuts that could jeopardize spending in social areas and on public infrastructure. Pension reform will also be required to ensure that the fiscal accounts remain on a sound path. Directors encouraged the authorities to take actions to enhance the accountability and efficiency of several public enterprises, including PEMEX, in order to strengthen the fiscal position and raise the quality of Mexico's infrastructure.

Directors identified several other key elements of the reform agenda that should be pursued. These include stepped up efforts to improve governance and enhance flexibility in the labor market. Directors considered that building a consensus around these efforts, as well as on actions to enhance competition in the telecommunications sector, will be vital for promoting private investment.

Regarding monetary policy, Directors recognized the success of Mexico's inflation targeting framework in bringing inflation down to low single-digit levels. They noted that, although the long-term inflation target is close to being met, sustained achievement of the target is proving to be problematic in an environment of repeated price shocks. Directors accordingly viewed the recent tightening of the monetary stance as appropriate to ensure the credibility of the authorities' commitment to lowering inflation. Looking ahead, Directors agreed that a tightening bias in policy will remain appropriate until there are clear signs that inflation expectations are declining toward the long-term objective.

Directors supported the authorities' efforts to refine monetary policy announcements to signal the policymakers' views more directly to markets. Steps in this direction have led to more stable short-term interest rates in recent months, as well as to more predictable market responses to policy actions. Directors generally agreed that there is scope to further increase transparency and predictability in policy implementation over time, including by moving to an interest rate instrument when conditions warrant. Directors were encouraged by the refinements to the inflation-targeting framework. Many Directors acknowledged the drawbacks to moving toward publication of an official inflation forecast in the immediate circumstances, given the evolving nature of monetary instruments and the risks of adding to uncertainty about policy intentions at a critical time. However, this issue should be kept under review.

Directors observed that Mexico's flexible exchange rate regime has been effective in cushioning the economy from external shocks. They viewed external competitiveness to be broadly consistent with a sustainable balance of payments position. They agreed that the rules-based mechanism for accumulating foreign reserves appropriately reflects the authorities' transparent approach to reserves management and their commitment to a market-determined exchange rate.

Directors welcomed the continued improvement in broad indicators of banking sector soundness. They noted that the banking system as a whole has a sound level of profitability and capital adequacy. A significant challenge in the period ahead will be to deepen financial activity without excessive risk-taking, and to streamline financial regulation to encourage innovation and competition. In this regard, Directors encouraged the authorities to review the operations of the nonbank financial sector and the development banks to ensure that they do not pose a source of hidden financial risks.

Directors endorsed the authorities' continued commitment to reduce vulnerabilities relating to public debt**.** In addition to sustained progress with fiscal consolidation, they welcomed plans to improve the debt structure further by continuing to increase fixed–rate domestic–currency instruments, extending the domestic yield curve, and diversifying the investor base.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Mexico: Selected Economic and Financial Indicators [1/]

	1999	2000	2001	2002	2003
(Annual percentage changes, unless otherwise indicated)					
National accounts and prices					
Real GDP	3.6	6.6	0.0	0.6	1.3
Real GDP per capita 2/	2.6	4.8	-1.5	-0.9	-0.2
Gross domestic investment (in percent of GDP)	23.5	23.7	21.1	20.8	19.8
Gross national savings (in percent of GDP)	20.5	20.6	18.2	18.6	18.4
Consumer price index (end period)	12.3	9.0	4.4	5.7	4.0
External sector					
Exports, f.o.b. 3/	14.8	21.8	-3.7	0.6	4.3
Imports, f.o.b. 4/	10.6	23.1	-1.7	-1.3	1.9
External current account balance (in percent of GDP)	-2.9	-3.1	-2.9	-2.1	-1.4
Change in net international reserves (end of period, billions of U.S. dollars)	0.6	2.8	7.3	7.1	9.5
Outstanding external debt (in percent of GDP)	37.0	28.3	26.1	25.2	26.1
Total debt service ratio 5/ (in percent of exports of goods, services, and transfers)	43.2	44.6	38.4	31.1	31.0
Nonfinancial public sector (in percent of GDP)					
Augmented overall balance 6/	-6.3	-3.7	-3.7	-3.3	-3.1
Traditional overall balance	-1.1	-1.1	-0.7	-1.2	-0.6
Net augmented public sector debt	46.5	42.2	41.5	43.8	45.4
Money and credit					
Monetary base	43.5	10.7	8.0	17.0	15.0
Broad money (M4) (including public sector)	19.6	12.9	16.0	10.7	13.3
Treasury bill rate (28-day cetes, in percent, annual average)	21.4	15.2	11.3	7.1	6.2

Sources: National Institute of Statistics and Geography; Bank of Mexico; and Ministry of Finance and Public Credit.

1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.
2/ Fund staff estimates.
3/ Includes exports less imports from in-bond industries.
4/ Excludes imports of in-bond industries.
5/ Private and public sectors.
6/ The augmented balance is the public sector borrowing requirement less nonrecurring revenues.