

Mexico: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion

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 2006 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 19, 2006, 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 August 9, 2006. 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 September 6, 2006 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 6, 2006 discussion of the staff report that concluded the Article IV consultation.

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

Financial System Stability Assessment Update
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 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Mexico

Approved by Anoop Singh and Carlo Cottarelli

August 9, 2006

Discussions. Following the FSAP Update mission earlier this year, a staff team visited Mexico City May 8–19 for the Article IV Consultation. The team met with the Minister of Finance; the Governor and Board of the Bank of Mexico; officials from the Ministry of Finance, Bank of Mexico, the Ministry of Economy, the Office of the Presidency, the Ministry of Social Development, and other public agencies and enterprises, and with supervisors of financial institutions, and representatives of the private sector and academic community.

Team. The Article IV team comprised Caroline Atkinson (Head), Steve Phillips, Gil Mehrez, Vincent Moissinac (all WHD); Shekhar Aiyar (PDR); Marco Espinosa (MFD); and Luisa Zanforlin (ICM). Mr. Schwartz (Executive Director) and Mr. Calderon (Senior Advisor) also participated. Mr. Leone (STA) led the FSAP missions.

Previous consultation. The 2005 Article IV consultation was concluded on November 9, 2005, and the Staff Report was issued as IMF Country Report No. 05/381.

Relations with the Fund. Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4, and does not have restrictions on payments for current international transactions (App. 1).

Data. 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.

Selected Issues Papers. Two papers examine: (i) growth, diagnosing obstacles to faster productivity growth; and (ii) rising remittances inflows and their macroeconomic implications.

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I. CONTEXT AND KEY ISSUES

1. **Amid a favorable external environment, the economic recovery that began in 2003 has continued, Mexico has extended its record of macroeconomic and financial stability, and inflation has fallen to historic lows.** At the same time, important structural challenges remain—to accelerate growth and poverty reduction, and to address medium-term fiscal issues centered on oil revenue reliance.

2. **Recent Article IV consultations with Mexico have emphasized consolidation of the public finances in a favorable external environment, the development and implementation of the inflation targeting framework, and the structural reform agenda.** In broad terms, staff agreed with the authorities on the direction of their policies and objectives. On fiscal policy, the staff supported the authorities on the need for tax reform, and highlighted the need for an efficient and cautious approach to managing oil income and wealth. The authorities have used part of their oil windfall for deficit reduction, and recently a fiscal responsibility law was passed. Monetary policy has brought inflation to the low single digits, and the authorities have significantly enhanced monetary policy transparency and communication. On the structural policy front, the staff supported the authorities' agenda, but implementation was often frustrated by lack of political consensus.

3. **Good short-term prospects and a still-favorable external environment allowed the discussions to focus on structural issues and medium-term challenges.** The discussions also built on the findings of this year's FSAP Update, and focused especially in three areas:

- **Financial markets:** progress since the 2001 FSAP, in terms of both stability and efficiency; and the remaining financial reform agenda.
- **Fiscal policy:** the need to address underlying vulnerabilities and to counter pressures that will mount over the medium term, including in light of uncertainty concerning future levels of government oil income.
- **Growth, reforms, and competitiveness:** the challenges in raising productivity, competitiveness and growth (Selected Issues Chapter I).

4. **The Article IV discussions took place ahead of the July 2 elections, the results of which are under legal challenge.** After the electoral institute announced that Mr. Calderon (PAN) narrowly edged Mr. Lopez Obrador (PRD) in the presidential race, the PRD began a legal challenge, on which the electoral court will rule by early September at the latest. The elections yielded a congress divided among the three main parties, with the PAN having the greatest representation, followed by the PRD.

2006 Congressional Election Results 1/
(in number of seats)

		PAN	PRD	PRI	Other
Chamber of Deputies	500 seats	206 (+58)	127 (+30)	103 (-120)	64 (+32)
Senate	128 seats	52 (+5)	29 (+14)	33 (-25)	14 (+6)

1/ Party seat allocation in new Congress (and gain or loss). Preliminary results, as of July 2006.

II. RECENT DEVELOPMENTS

5. **After a slowdown early last year, growth recovered in the second half of 2005 and early 2006** (Figure 1). Growth in 2005 slowed to 3.0 percent, but is estimated to have rebounded to almost 5 percent in January–May 2006. Domestic demand grew somewhat faster than output, as private consumption and private investment were both strong. Manufacturing has accelerated this year, related to stronger U.S. industrial production and a rebound of auto exports. Employment grew by more than 5 percent in 2005, and formal employment finally surpassed its 2000 level.

6. **Bank credit continues to grow strongly, from a very low base.** A favorable macroeconomic environment, stronger bank balance sheets, better credit information, and mortgage insurance provided by a specialized development bank boosted consumer and housing bank credit in 2005 and so far in 2006. Credit to enterprises also has grown, but at a slower pace.

7. **Inflation, after an extended period above target, converged to the 3 percent target¹ in late 2005** (Figure 2). Subsequently, when headline inflation moved up in early 2006—mainly reflecting volatile food prices—core inflation remained steady and the headline rate came quickly back down.

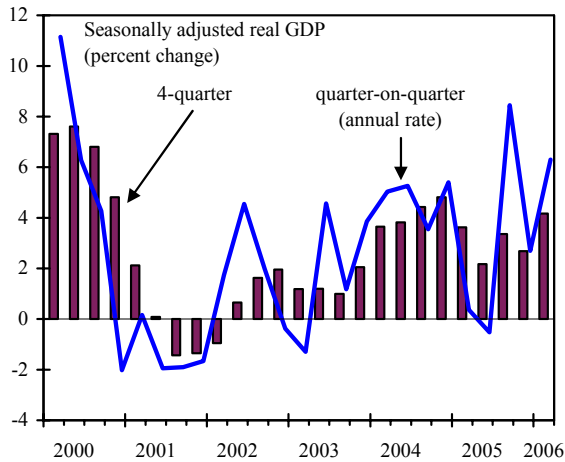
8. **Amid declining inflation and inflation expectations, the Bank of Mexico (BoM) in August 2005 began to unwind its earlier monetary tightening, before stopping in April 2006.** The overnight bank rate—for which the BoM targets a minimum level—was reduced from a peak of 9¾ percent to 7 percent in April, when the BoM ruled out additional easing “in the foreseeable future.”²

¹ While the BoM has established a 2–4 percent inflation *variability range*, the authorities have emphasized that the inflation target is 3.0 percent.

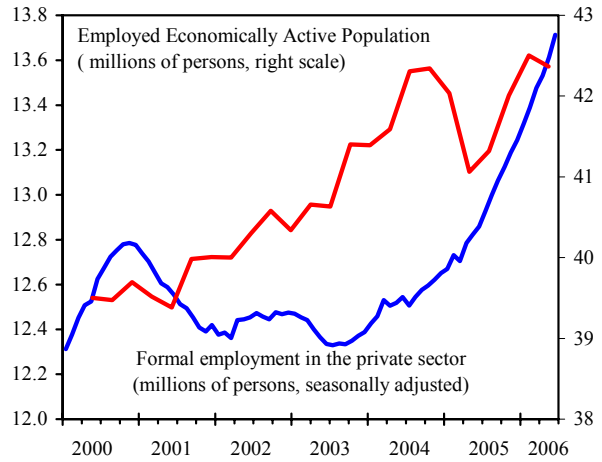
² The BoM has not changed the *corto*, its traditional policy instrument, since March 2005, but maintains it as an available tool.

Figure 1. Mexico: Real Sector Developments, 2000-2005

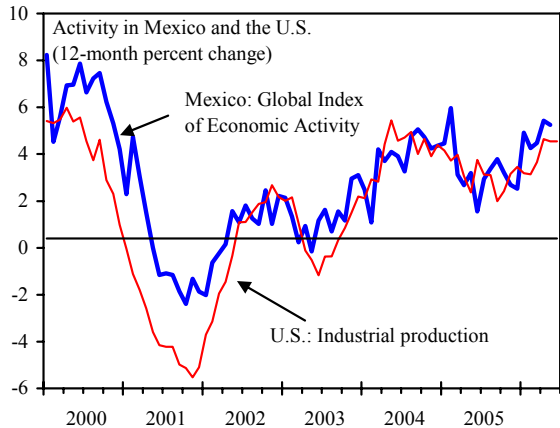
Growth has returned, after slowing sharply in early 2005...



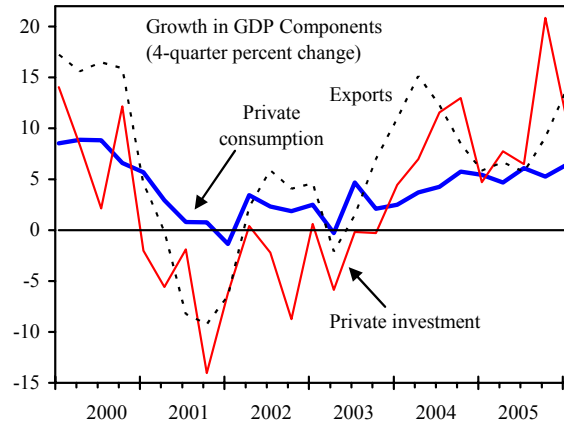
...and formal employment has picked up strongly.



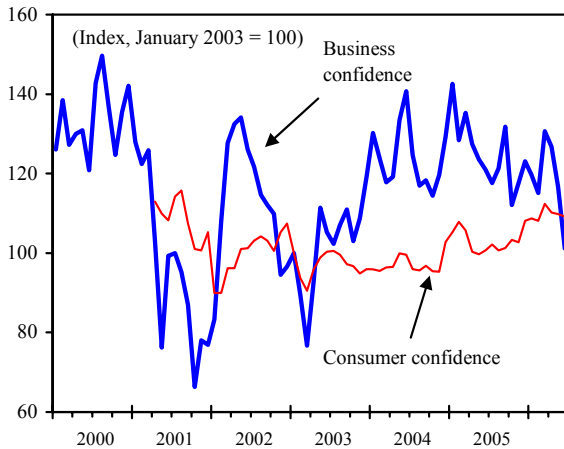
Mexican activity has moved closely with U.S. industrial production...



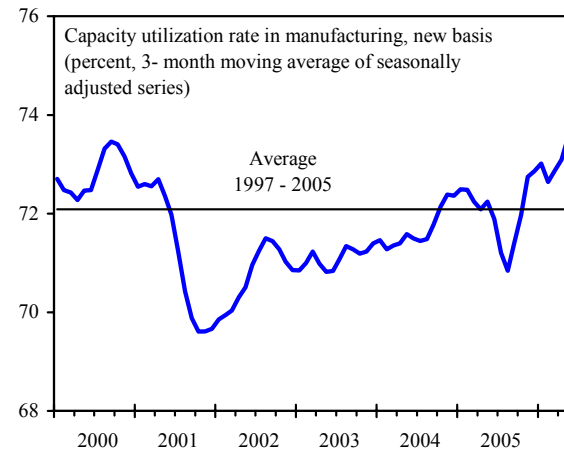
...with associated fluctuations in exports, while domestic demand has been more steady.



Consumer confidence has picked up since late-2005, but business confidence dropped in June.



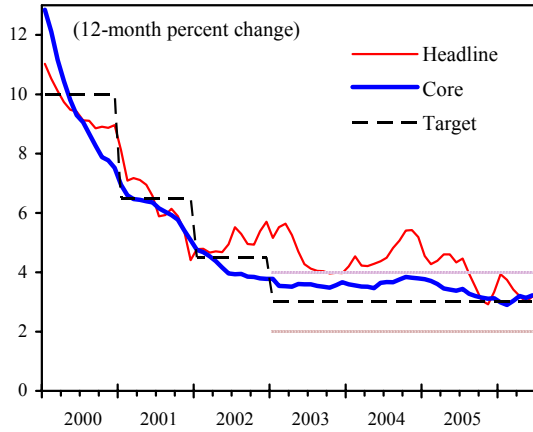
Capacity utilization in the manufacturing sector fell abruptly at mid-2005, but has rebounded.



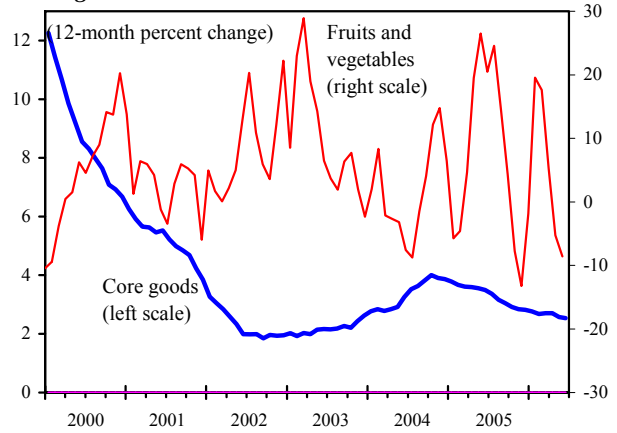
Sources: Mexican authorities; U.S. Federal Reserve; and Fund staff estimates.

Figure 2. Mexico: Inflation and Monetary Policy, 2000-2005

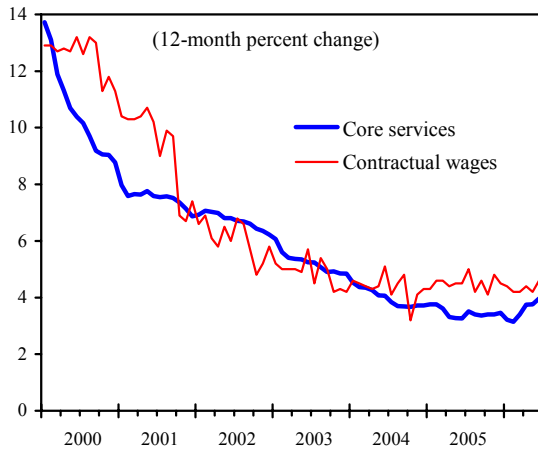
In late 2005, inflation converged to the 3 percent target for the first time.



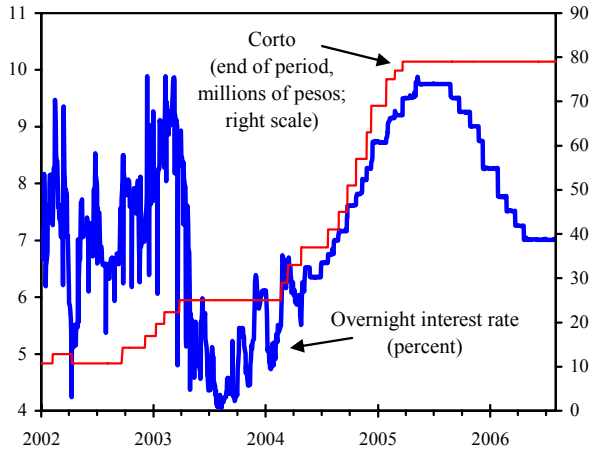
Food prices have been volatile, while core goods inflation has converged smoothly to the 3 percent target.



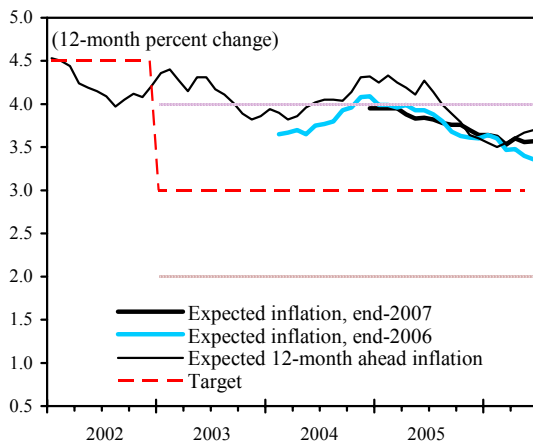
Wage increases have been fairly steady, at around 4.5 percent, since late 2003.



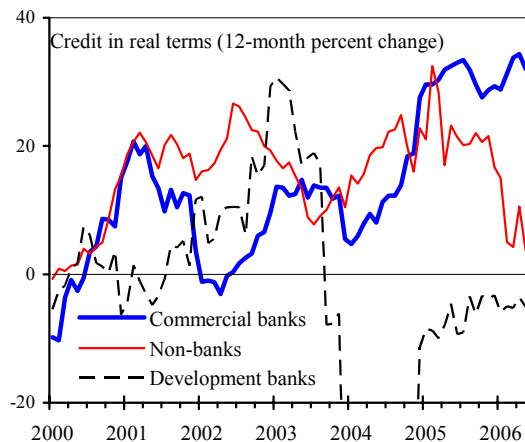
The BOM has unwound much of the earlier policy tightening.



Inflation expectations have come down, but still exceed the 3% inflation target.



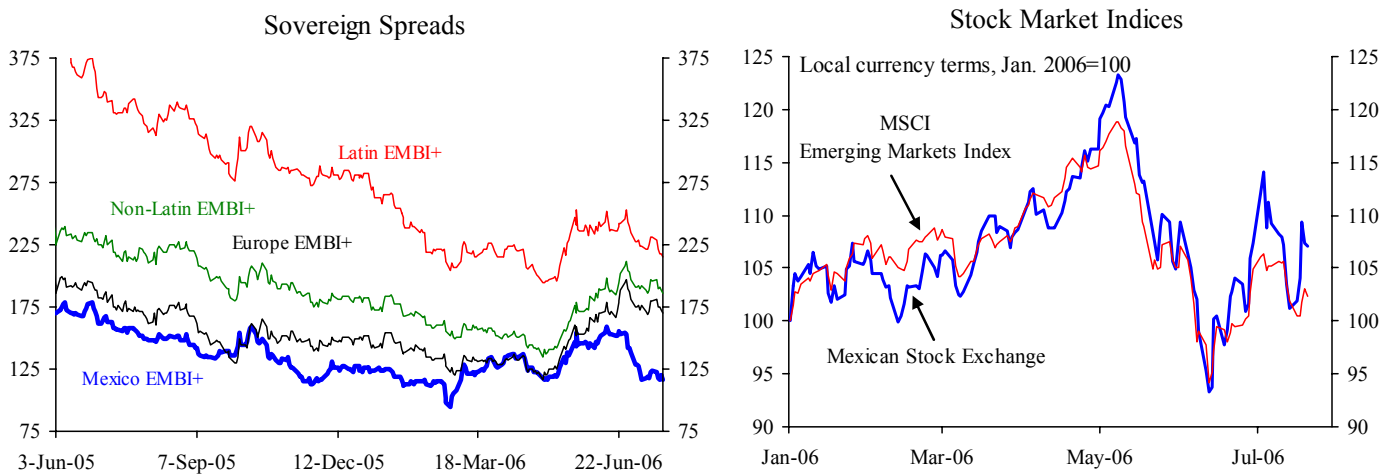
The credit recovery continues, with banks now outpacing non-bank intermediaries.



Sources: Mexican authorities; and Fund staff estimates.

9. **The BoM has adhered strictly to its policy of avoiding discretionary purchases or sales of foreign exchange** (Box 1). Still, NIR has trended upward, as the BoM receives the foreign exchange cash surplus generated by the public sector—including the state oil company, PEMEX. The pace of such accumulation has been moderated by the rule for selling a fixed share of this surplus. NIR reached US\$68.6 billion at end 2005, about 4½ months of imports and 1.6 times short-term external liabilities, and rose further to US\$76.7 billion in July 2006.

10. **With financial markets continuing to show confidence in Mexico, prices of Mexican assets have tended to move broadly in line with external markets** (Figure 3). Movements in the sovereign spread have tracked other emerging market spreads, with the level well below the EMBI index and at one point crossing briefly below 100 bp. The stock market, after doubling during 2004–05, hit a new peak in early May, but then followed other emerging markets downward, through mid-June. Mexico was not among the group of emerging markets hit hardest during the May-June global selloff, although this occurred amid pre-election uncertainty.



Sources: Bloomberg, Datastream.

11. **The peso, after generally appreciating since early 2004, reversed course in March 2006.** The initial depreciation was associated with a marked rise in U.S. long-term interest rates. In May, the peso weakened further, amid the global selloff of emerging market assets, and almost returned to its April 2004 low. Subsequently, announcement of the July 2 election results triggered a sharp appreciation (and stock market gain, as well as a drop in the sovereign spread).

Box 1. Operation of the Exchange Rate Regime

The value of the Mexican peso is continuously market-determined, in the absence of discretionary foreign exchange purchases or sales by the central bank. At the same time, BoM accumulates NIR from: (i) interest earned on its reserves; and (ii) its role as foreign exchange conversion agent for the government and PEMEX, which together generate a net foreign exchange cash surplus.

Rising oil export prices since 2002 have boosted this foreign exchange surplus and NIR accumulation. In March 2003, the authorities began to sell foreign exchange to the market, introducing a rule in which half of each quarter's NIR accumulation is subsequently sold, in equal-sized daily auctions.¹ This rule has been respected since its inception, irrespective of exchange rate developments.

Under this rule, NIR grew at an average annual rate of about US\$7 billion in 2003–2005, while BoM auctions of foreign exchange averaged about US\$5 billion. The ratios of NIR to imports, and to GDP, were broadly stable in 2004–05.

Under this policy regime, the variability of the peso has been similar to that of other flexible exchange rates. For example, from March 2003 to June 2006, the variation of the peso/dollar exchange rate (measured by the standard deviation of daily, weekly, or monthly changes) was broadly comparable to that of the exchange rates of the Canadian dollar and Euro. During this period, short-run fluctuations in the Mexican exchange rate were significantly correlated with movements in emerging market bond spreads (declines in the EMBI+ index were associated with appreciation of the peso). Shifts in world oil prices may also have influenced the peso in this period, but the statistical evidence for this relationship is much weaker. Statistically, it is not possible to discern any link from the BoM's daily foreign exchange sales to movements in the peso (as would be expected, given the very smooth rate of foreign exchange sales).²

¹ The BoM sells by auction half of the NIR accumulation that *would have been registered* over the quarter were it not for the foreign exchange sold under the rule. When the rule was adopted in March 2003, half of each quarter's accumulation was sold into the market over the next quarter. In March 2004, the rule was modified to sell the same amount over the next *four* quarters, reducing quarterly fluctuations in foreign exchange sales.

² BoM foreign exchange sales are small in relation to the turnover in the peso-dollar market. End-2004 figures indicate a daily turnover (spot and forward) of US\$15 billion, more than a thousand times the BoM's daily foreign exchange sales.

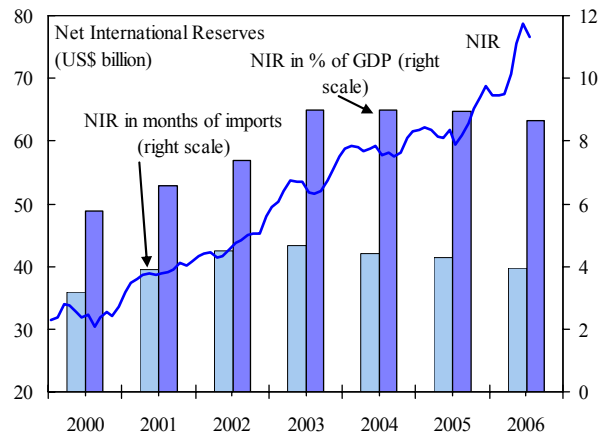
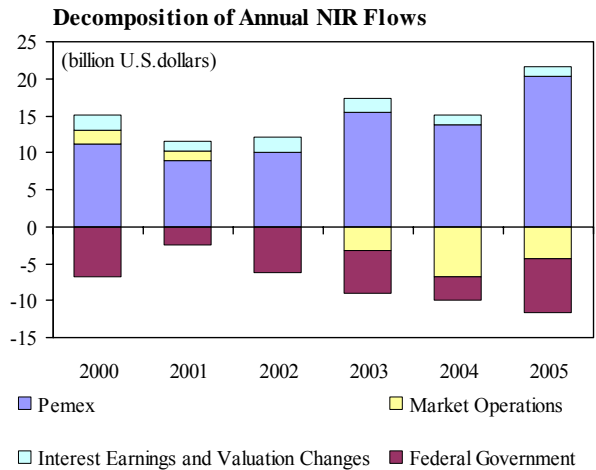
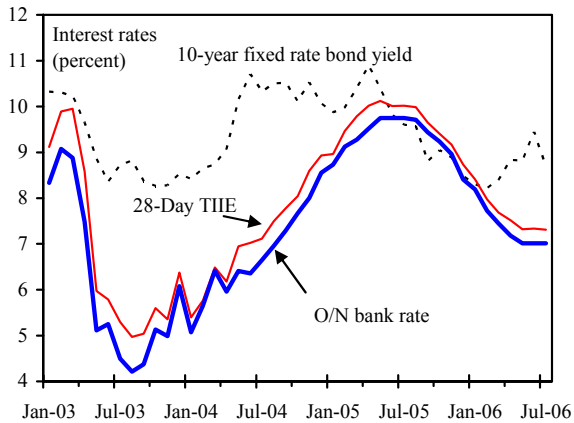
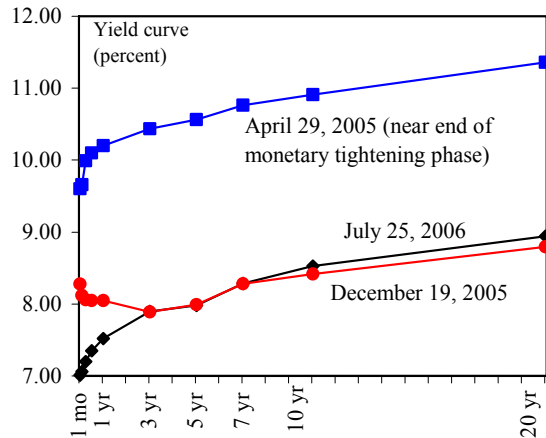


Figure 3. Mexico: Financial Market Developments

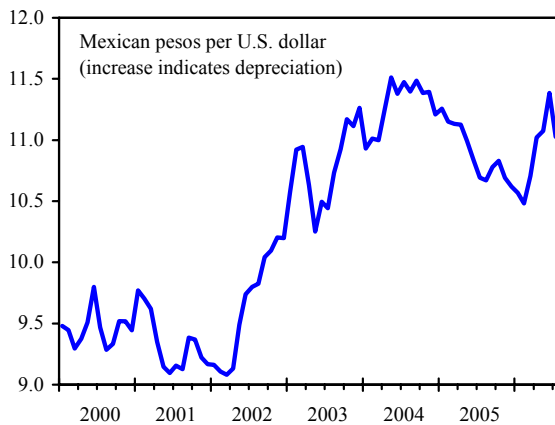
Short term interest rates have fallen since monetary easing began in August 2005...



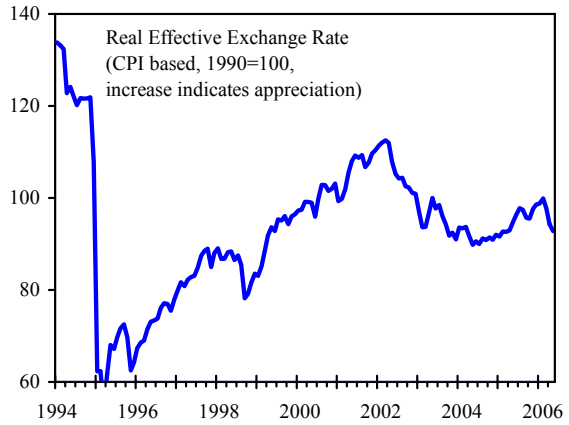
...while the yield curve has steepened since end-2005.



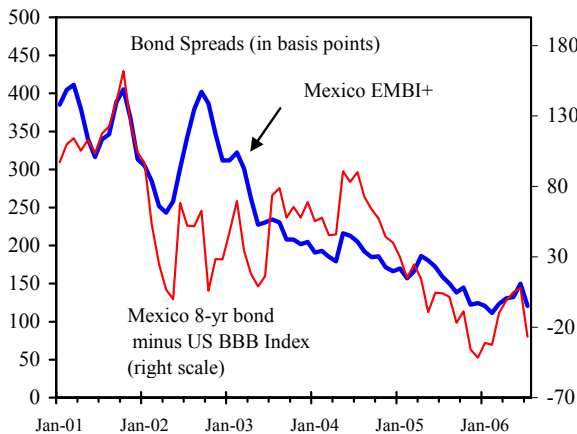
The peso's recent depreciation reversed much of the appreciation seen since early 2004...



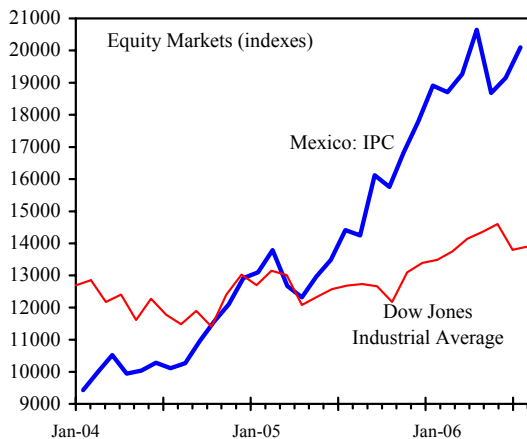
...and the real exchange rate is also nearly back to its early 2004 level.



Mexico's EMBI+ spread remains below 150 bp, even after recent global market corrections.



The stock market has continued to outperform the U.S. market.



Sources: Bloomberg LP; Mexican authorities; and Fund staff estimates.

12. **The fiscal accounts showed a further consolidation in 2005, helped by a modest rise in oil revenues and a better-than-expected balance of the development banks** (Figure 4). Although oil export prices were up sharply, net oil revenues rose by just 0.4 percent of GDP, reflecting a weak production outturn,³ as well as structural factors (see below). This modest gain helped narrow the augmented deficit, to 1.4 percent of GDP. The non-oil deficit narrowed slightly, to 7.2 percent of GDP. Although current expenditure turned up in 2005, this was offset by better non-oil revenue performance and negative net lending by the development banks, reflecting their sale of loans.⁴ In terms of the traditional budget measure, the government again met its target, as the traditional deficit fell to 0.1 percent of GDP.

Mexico: Financial Operations of the Public Sector, 2001-2006
(in percent of GDP)

	2001	2002	2003	2004	2005	Budget 2006	Staff Proj. 2006
Traditional balance	-0.7	-1.2	-0.7	-0.3	-0.1	0.0	0.2
Traditional balance excl.non-recurring revenue	-1.4	-1.9	-1.4	-1.8	-0.3	0.0	0.1
Augmented balance (PSBR excl. non-recurring revenue)	-3.7	-3.4	-3.2	-2.0	-1.4	-1.7	-1.6
Augmented revenue 1/	21.1	21.4	22.5	22.3	23.0	22.2	23.7
Augmented expenditure 1/	24.8	24.8	25.7	24.2	24.5	23.9	25.3
Non-oil augmented balance 2/	-7.8	-7.4	-7.8	-7.4	-7.2	-7.7	-7.9
Non-oil revenue (excl. non-recurring revenue) 1/	14.4	14.8	14.8	14.0	14.4	13.6	14.1
Non-oil expenditure 1/	22.2	22.2	22.6	21.4	21.5	21.3	22.1
Oil balance	4.1	4.0	4.7	5.4	5.7	6.0	6.4
Oil revenue 3/	6.7	6.5	7.7	8.3	8.7	8.5	9.6
Oil-related expenditure (incl. investment)	2.5	2.5	3.1	2.9	2.9	2.6	3.3
Gross augmented debt	47.9	49.7	50.0	46.0	44.0	...	42.8
Average crude oil export price (US\$/barrel)	18.8	21.6	24.8	31.0	42.7	36.5	54.4

Sources: Mexican authorities; and IMF staff estimates.

1/ IMF staff definitions. Augmented revenue is based on budgetary revenue minus adjustments for non-recurring revenue, capital gains on debt buy-backs and premium on par-bonds. Augmented expenditure includes budgetary expenditure plus adjustments for financial requirements of development banks, Pidiregas, IPAB, FARAC, Oil Stabilization and PEMEX Investment funds, debtor support program, and other adjustments.

2/ Based on oil revenue, net of PEMEX operational expenditure and interest and of oil sector investment.

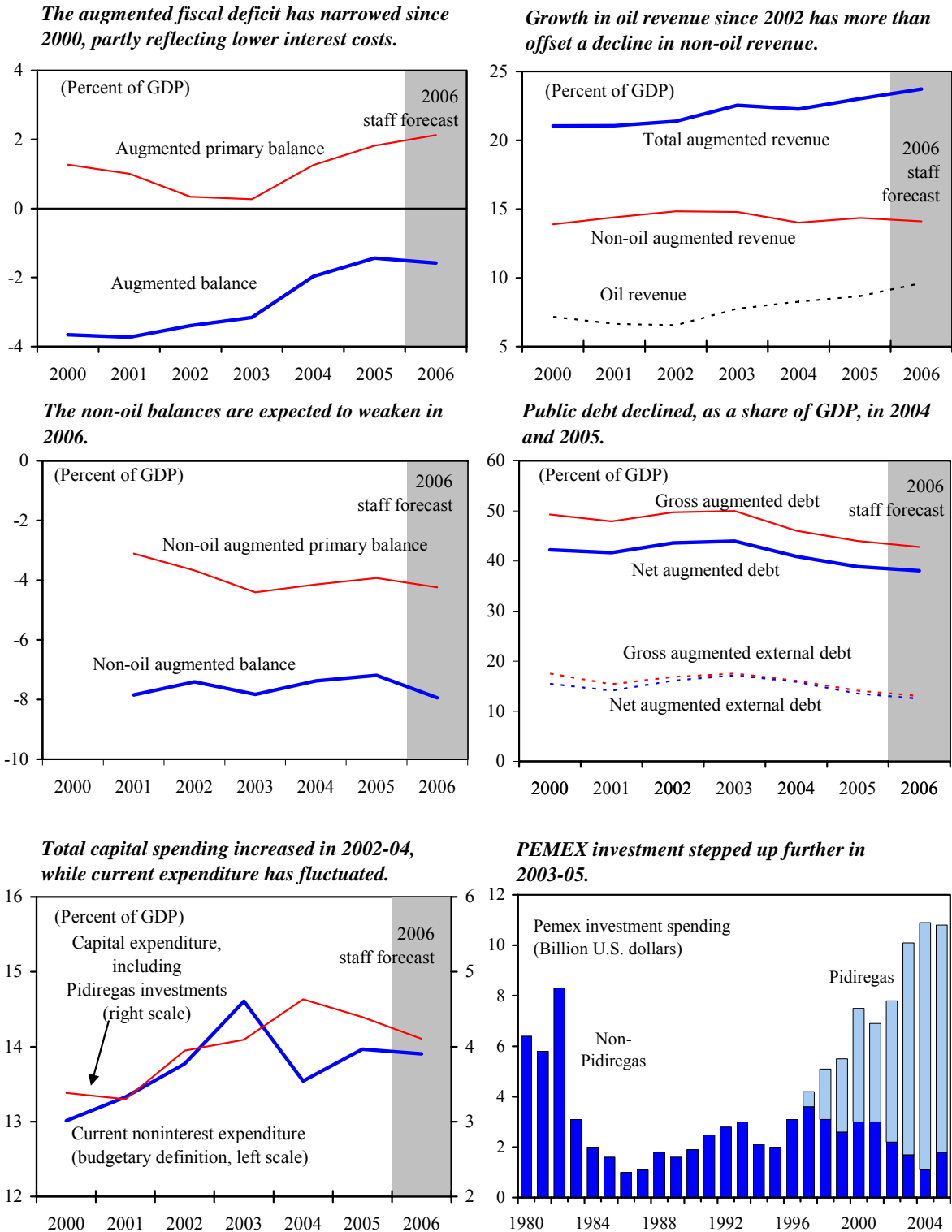
3/ Including fuel excise tax and net of PEMEX imports.

13. **The fiscal windfall from rising world energy prices has remained relatively modest.** Hydrocarbon production in Mexico is much smaller in relation to the size of the economy than in other oil exporting countries. Another factor is that Mexico's hydrocarbon import bill—roughly half as large as its hydrocarbon export receipts—has also been pushed

³ In 2005, oil production stagnated and oil export volume actually declined.

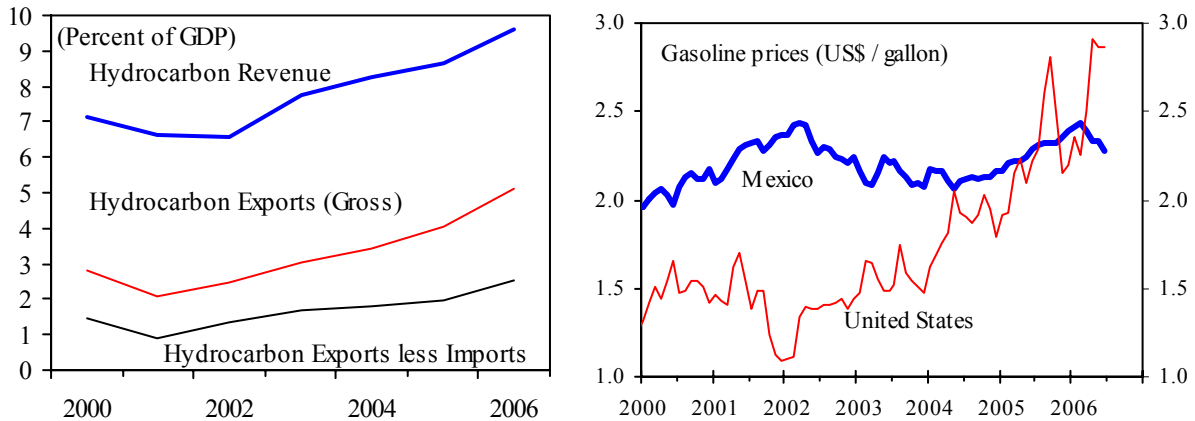
⁴ In the staff's presentation of the augmented fiscal accounts, *net* lending by the development banks counts as expenditure and adds to the augmented deficit; loan recovery, and the sale of loans, counts as negative expenditure and reduces the augmented deficit.

Figure 4. Mexico: Fiscal Sector, 2000-2006



Sources: Mexican authorities; and Fund staff estimates.

up by rising prices. Further, the fiscal gain from PEMEX' domestic sales has been significantly limited by the longstanding practice of holding domestic gasoline prices constant in real terms.⁵ Staff estimates that if such fuel prices had tracked world prices since 2002, revenue in 2006 would be some 2 percent of GDP higher than now projected.⁶



14. **Proven reserves of oil declined again in 2005.** As in recent years, oil was pumped out much faster than “new” oil was added to proven reserves, which are now down to about 11 years’ production (Box 2).

15. **The external position has continued to improve, helped by favorable external conditions that stayed ahead of the effect of rising domestic demand on imports** (Figure 5). Although imports grew strongly, rising remittances (Selected Issues Chapter II) and oil exports reduced the current account deficit to less than 1 percent of GDP in 2005, and in the first quarter of 2006 the current account moved into surplus. Non-oil exports performed well overall, with a rebound in the maquila sector. Mexico’s share in its main export market, the U.S., stabilized in 2005, after three years of decline. Foreign direct investment more than matched the current account deficit in 2005. Within the capital account, the public sector significantly reduced its external borrowing, while net borrowing of the corporate sector turned positive for the first time in several years.

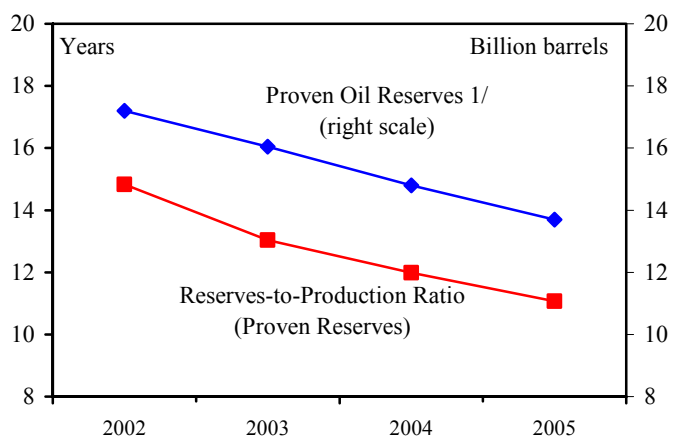
16. **The public debt ratio declined further in 2005, with gross public debt just under 45 percent of GDP.** External debt fell to about 13 percent of GDP. If the central bank’s international reserves were taken into account, net external public debt would be less than 5 percent of GDP. Of the domestically-issued debt, foreigners held about US\$12 billion at mid-2006 (about 1½ percent of GDP).

⁵ Other than gasoline and diesel prices, most energy prices in Mexico are adjusted in response to movements in world prices.

⁶ Considered in relation to U.S. gasoline prices, Mexican gasoline pump prices have moved from a situation of significant taxation in 2002 to a modest subsidy this year.

Box 2. Sustainability Issues in the Oil Sector

Oil revenues are key to the medium-term outlook for the public finances. Although oil plays a much smaller role in the economy of Mexico than in some other oil-exporters, the fiscal significance of oil is magnified by the lack of private participation in the sector. Thus all the oil sector's revenues, as well as its operating costs, import bill, and investment needs, directly influence the public finances. With oil-based revenues comprising around 40 percent of total public sector revenues, the performance of the sector—as represented entirely by PEMEX—is critical to the dynamics of the public finances.



Source: PEMEX.
1/ Crude and condensates.

The sustainability of PEMEX production is a potential concern. In recent years, oil production has grown little. Moreover, *proven* oil reserves have declined steadily from about 17 billion barrels in 2002 to 14 billion barrels in 2005. The ratio of proven reserves to annual production fell from about 15 years in 2002 to 11 years in 2005 (the measure of *proven plus probable* reserves declined similarly, from the equivalent of about 26½ years of production to about 21½ years.)

Future oil output will depend largely on PEMEX's success in developing and exploiting new oil fields. Oil production from the “supergiant” Cantarell field—which currently accounts for about 60 percent of total output—is projected by PEMEX to fall by almost 50 percent by 2010. Finding adequate replacements for this relatively accessible field will be a challenge. PEMEX expects that declining Cantarell output can be more than compensated over the next few years by developing existing fields (particularly the KMZ field) and exploring new oil sources. However, oil production forecasts, particularly for new fields, are subject to great uncertainty, and analysts do not rule out the possibility that total production could begin to decline in the next few years.

Significant investment expenditure and new technology will be required to exploit geologically challenging terrain and deep-sea sources.

Already, PEMEX investment has recently climbed to over US\$10 billion annually, from less than US\$1 billion in the 1990s. Although foreign technology is often acquired through equity participation by other oil majors in new projects, this is prohibited by Mexico's constitution.

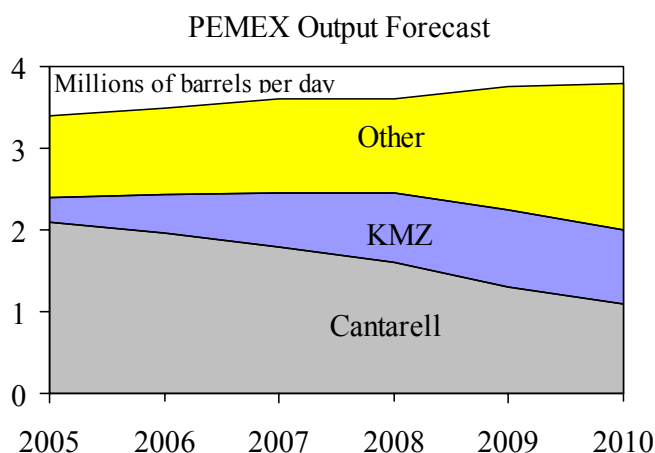
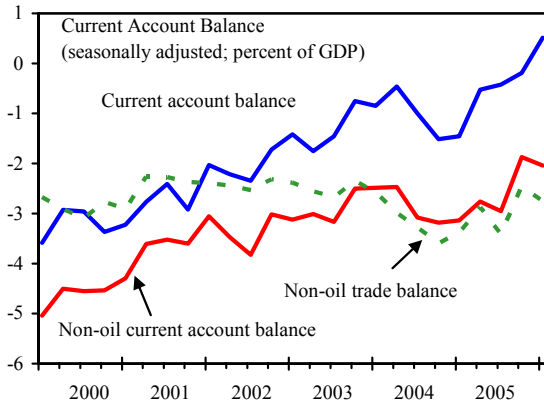
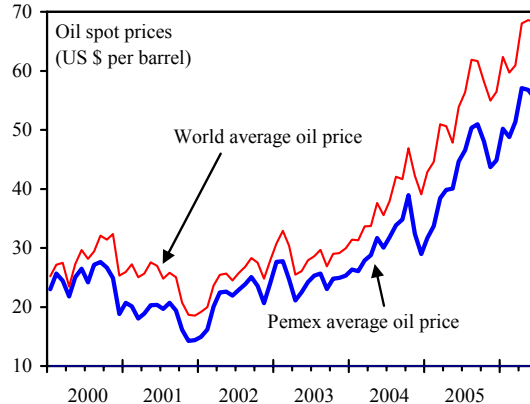


Figure 5. Mexico: External Sector, 2000 - 2005

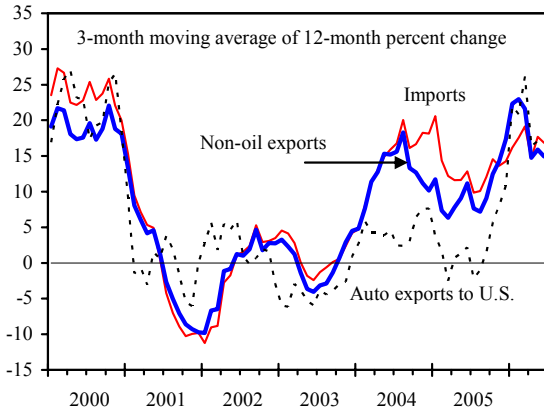
The annual current account deficit moved under 1 percent of GDP in 2005...



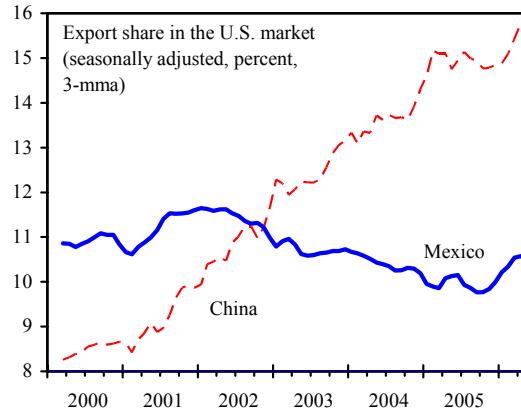
... helped by increasing oil export prices.



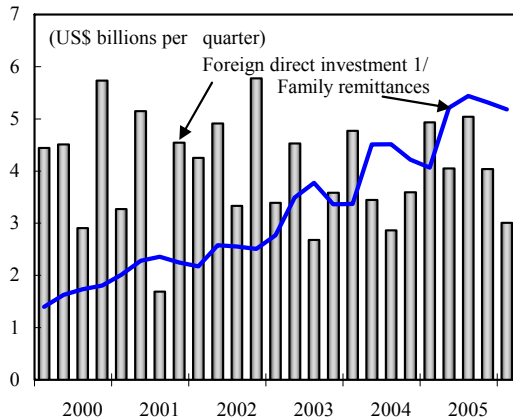
Import growth is strong; on the export side, auto sector fluctuations have been the key.



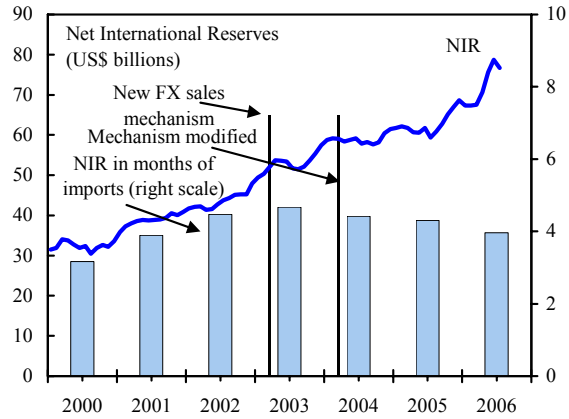
Mexico's export share in the U.S. market seemed to stabilize after 2004.



Recorded inbound family remittances continue to grow rapidly, quadrupling over the last 6 years.



NIR has continued to rise, roughly in line with import growth in recent years.



Sources: Mexican authorities; Haver Analytics; 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 Bancomer in 2004Q1.

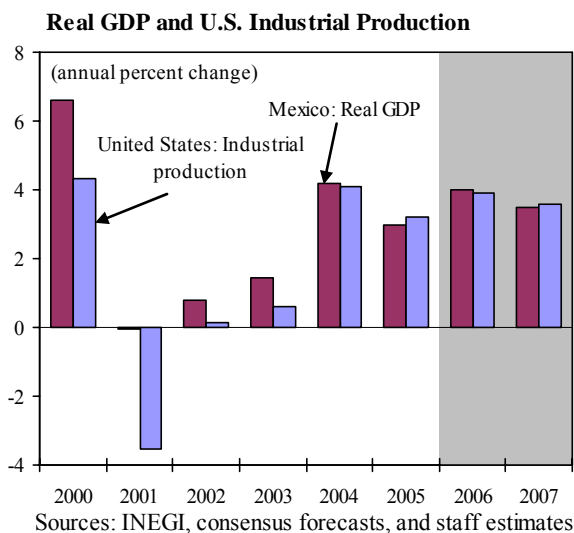
17. **Debt management emphasized improvement in maturity as well as a shift away from external debt.** The government conducted a number of liability management operations aimed at reducing the share of external debt, creating liquid benchmark bonds in the international market, and diversifying the investor base. The authorities have announced that the federal government has no foreign financing need for the rest of 2006; in June, the government announced that it will pre-pay about US\$7 billion of external debt to the World Bank and Inter-American Development Bank (see later). In the domestic debt market, the authorities continued to increase the share of fixed rate instruments and increased the average maturity of central government debt, which rose to almost 40 months in 2005, from 38 months in 2004. In the broader augmented public debt, however, substantial short-term debt remains, including on the books of IPAB, the deposit protection agency.

18. **Since the 2005 Article IV consultation, a number of significant reforms were approved by congress and became law.** These reforms (discussed later) include: (i) a budget and fiscal responsibility law; (ii) a strengthened competition law; (iii) a modified securities market law; and (iv) a bank resolution law.

III. REPORT ON THE DISCUSSIONS

A. Outlook

19. **The mission and authorities agreed that the overall economic outlook for 2006–07 was positive, in the context of a continued favorable external environment.** Staff expects growth this year to reach at least 4 percent, then to come closer to trend at around 3½ percent in 2007. This view takes account of the strong performance in the first half of 2006 and assumes continued steady growth in the U.S.. Growth would be fairly balanced, with consumption growing only slightly faster than GDP, and continued strong investment, while healthy export volume growth would roughly offset import volume growth. With the benefit of higher oil export prices, the already small external current account deficit would nearly disappear in 2006, before widening slightly in 2007. The authorities' view was broadly similar, but they noted that growth could be somewhat higher in both years (subsequently, the BoM raised its 2006 growth projection to a range of 4 to 4½ percent).



20. **Inflation in 2006–07 is expected to remain close to the 3 percent target.** The BoM projects 3 to 3½ percent inflation this year. Staff projections, based on a constant policy interest rate of 7 percent for the remainder of this year, put inflation at 3.3 percent at end-2006 and 3 percent in 2007. Surveys of private expectations are similar for 2006, and around 3.4 percent for 2007.

21. **Staff projects a slight widening of the augmented fiscal deficit in 2006, with a larger increase in the non-oil deficit.** The 2006 budget targets a zero balance on the traditional measure, but was based on an oil price significantly below current forecasts (and below the actual 2005 price), and a cut in expenditure (in real terms, relative to the 2005 outcome). This year's average price will likely exceed the budget's assumption by almost 50 percent (and the 2005 price by more than 25 percent), while the budget's adjustors will require the spending of much of the unbudgeted oil revenue. Relative to the 2005 outcome, oil revenue this year would rise by almost 1 percent of GDP; with some increase in oil-related capital expenditure, the *oil balance* would improve by 0.7 points. On the *non-oil balance*, current expenditure would hold about steady on the staff's projections, but with the expected resumption of net lending by the development banks and a projected fall back in non-oil revenue, staff projects that the non-oil augmented deficit would widen somewhat, to near 8 percent of GDP.

22. **For the near-term outlook, uncertainties include the U.S. economy and a further tightening of global liquidity conditions.** As the U.S. economy moves closer to full employment, the balance of risks from Mexico's tight link to the U.S. tilts less to the upside. Further tightening of global liquidity conditions could act to slow demand and activity, although Mexico would be less affected than some other emerging markets. Of course any sign of a major shift in macroeconomic policy discipline would represent a risk, particularly in light of the still-significant public financing needs. (More specific risk scenarios are discussed in Section E and Annex V.)

23. **Medium-term prospects depend importantly on Mexico's ability to implement structural reforms to address constraints to growth (Section IV, and Selected Issues Chapter I).** In the absence of major new reforms, staff projects that potential output would grow at about 3½ percent through the medium-term, a bit faster than recent historical experience. The authorities' view is similar, in a range of 3½ to 4 percent. Staff and the authorities agree that a transition to a much faster growth trend would require significant reforms. Regarding the medium-term fiscal outlook, the main factors will be implementation of the newly-established budget target (see below) and the continued containment of off-budget flows.

B. Fiscal Policy

24. **The mission welcomed the fiscal consolidation achieved in recent years that had been key to Mexico's improved economic position.** Declining annual targets for the fiscal deficit had been consistently met, and the broader augmented fiscal deficit had also been reduced, inducing a gradually declining trend in the debt ratio. Looking forward, implementation of the new Budget and Fiscal Responsibility Law would help maintain broad fiscal discipline (Box 3).

25. **However, several underlying fiscal problems will need to be resolved:**

- *Fiscal dependence on oil revenue.* Amid low tax revenue, the public finances are heavily reliant on an oil revenue stream that is uncertain, subject both to oil price risk and to risk of resource depletion. In the context of relatively low and declining oil reserves, the non-oil augmented deficit—more than 7 percent of GDP—remains uncomfortably large.

- *Public debt is still higher than desirable.* While the public debt ratio is not unusually high by international standards, it would be prudent to bring debt down more rapidly, particularly in light of the above-mentioned oil risks.
- *Spending pressures will rise over the medium term.* These include costs of public employee pensions, access to public health insurance, and infrastructure and education needs.
- *Limited accountability and control over state government expenditures.* State-level expenditures—supported by federal government transfers—are more important than in the past, highlighting the need for progress on this front.

26. **The authorities explained the approaches to these issues taken so far, including the passage of a fiscal responsibility law.** Although their tax reform proposals had not found support in congress, the proposed reform of pensions for public employees is under discussion in congress. To contain exposure to a decline in oil prices, budgets had been designed to avoid letting rising oil income translate into inertial expenditure, instead channeling it into contingent spending, including investment in the oil sector, as well as deficit reduction. The mechanism for handling oil income in the new Budget and Fiscal Responsibility Law continues in this direction, although there was some concern that it could allow a too-rapid increase in expenditure if oil prices rose abruptly. And the authorities noted that transfers to states would go up further with rising oil prices, making it more important to improve accountability and control of such expenditure.

27. **On the sustainability of oil income, the authorities explained the need to balance risks, inside a given legal framework.** To counter the prospect of declining production, PEMEX investment spending had been raised significantly, from a low base. Although the decline in proven reserves had not yet been arrested, these investments were expected to pay off with some lag, enough to avoid a decline in production. On the other hand, oil investments have inherent risks, and concerns about PEMEX governance could add to these. Unfortunately, a proposal to reform PEMEX governance and allow some risk-sharing with the private sector had not cleared congress.

28. **The mission agreed that PEMEX governance reform would be a critical step in ensuring that the oil industry operates most efficiently.** Mexico could follow other countries that have put national oil companies on a more commercial footing. It would also be important to reconsider the existing constraints on PEMEX financing—in which raising oil sector investment essentially requires either fiscal policy tightening or the issuance of public debt—since this may put too much strain on the public sector balance sheet, while denying PEMEX access to technologies and advantages that other oil companies obtain through joint ventures.⁷

⁷ Brazil's Petrobras illustrates the use of private equity finance in a national oil company.

Box 3. The New Budget and Fiscal Responsibility Law

This law enacted in March 2006 establishes: (i) an ongoing fiscal balance target; (ii) mechanisms for budgeting amid oil price uncertainty; and (iii) a medium-term expenditure framework.

Fiscal target. Future budgets are to aim at a zero balance on the traditional fiscal measure. Under exceptional circumstances, a weaker budget may be proposed, but this requires explicit justification and plans for returning to zero balance. (A stronger than required budget also may be proposed.) The law does not limit the augmented deficit, but does require projection and monitoring of this broader fiscal measure.

Medium-term implications and debt sustainability. Provided that off-budget flows do not rise above recent levels, consistent achievement of the targeted zero traditional balance would imply that the augmented deficit would remain near its recent level of 1½ percent of GDP. Such a stance would be consistent with a continued gradual reduction of the augmented public debt ratio.

Response to oil price fluctuations and saving of oil revenue. The law calls for a limited amount of financial saving and dissaving in response to fluctuations in oil prices. Federal oil revenues for each annual budget will be projected using a reference oil price. This price will be set by a formula based mainly on oil futures prices (a mix of short-term and medium-term futures), with a one-quarter weight on the average price of the last 10 years. Any excess income, that results from actual oil prices above the reference price, may first be used to compensate for certain budgetary overruns (e.g., higher interest costs, and the higher fuel bill of the state electricity company). The remainder is to be split between several stabilization funds (90 percent) and state-level investment projects (10 percent). Once these funds reach ceilings, totaling about 1½ percent of GDP, any subsequent excess is to be used for investment projects (75 percent) and eventual pension reform costs (25 percent). If the oil price turns out below its reference level, the stabilization funds can be drawn down, over time, but once exhausted, fiscal tightening is required.

Expenditure smoothing. As described, the new law does not aim to isolate expenditure completely from oil revenue fluctuations, even those that might appear to be temporary. While temporary and permanent price changes are difficult to gauge, the new reference price formula includes elements that may be related to long-run price tendencies. The new rule is built to play a smoothing role, and it will induce a degree of caution in times of rising oil prices. Still, there is the possibility that the new law could allow a rapid rise in public expenditure, including because the oil reference price formula puts much weight on *short-term* oil futures prices, which often move closely with the spot oil price. (An earlier proposal for the formula, analyzed in the previous Article IV consultation, put more weight on medium-term futures prices, and would have implied more smoothing, but was not supported by congress.) Against this, the practice of holding the domestic price of gasoline steady in real terms, if maintained, will reduce fluctuations in government revenue, and therefore limit the increase in expenditure that might otherwise be triggered by the new fiscal rule when oil prices rise.

Medium-term expenditure framework. Annual budgets now will be presented in the context of a long-term quantitative framework, with projections for the next five years, and the costs of new fiscal measures will have to be explicitly shown. Previously, each administration was required to publish only one medium-term fiscal plan, in its first year. Other provisions to strengthen expenditure management include greater transparency and controls over the use of trust funds, greater accountability in the selection of investment projects and the granting of subsidies, and stricter monitoring of within-year budget execution. Finally, the law includes steps toward performance-based budgeting, requiring the establishment of indicators to measure program outcomes.

29. **In the meantime, absent such reforms, the mission recommended that fiscal policy be more cautious than required by the budget law, given the risk of an eventual decline in oil income.** The mission suggested taking advantage of the currently very favorable external environment—high oil prices, as well as still-low international interest rates—to adopt a fiscal stance that would be more ambitious than the minimum required by the Budget and Fiscal Responsibility Law. In particular, the mission recommended avoiding an increase in the non-oil augmented deficit from its 2005 level, which would translate into targeting a surplus on the traditional budget measure in 2007.

30. **The authorities agreed that the 2007 budget should aim to save more oil income than will be possible this year.** They planned to prepare a draft of the 2007 budget which the incoming administration could consider before submitting its own budget to congress. They noted that the approved 2006 budget will require spending a considerable share of this year's unbudgeted oil income, and that there was not much room to overperform on the 2006 budget.

31. **The mission noted that a more ambitious fiscal stance could be based on a combination of revenue measures and selective expenditure cuts.** Tax reform, along the lines proposed earlier by the authorities, was essential. The recently-published “tax expenditure” estimates—quite high at 6.7 percent of GDP in 2005—give an indication of the room available for broadening the tax base.⁸ Improved tax administration could also play a role. Another possibility could be to adjust the administered price of gasoline—not only to remove the implicit subsidy that recently emerged when world prices surged, but also to move to restore the once-important excise tax on gasoline, which would also address negative externalities of gasoline consumption.⁹ On the expenditure side, savings could come for example from reducing and better targeting subsidies, such as that on electricity use.

C. Monetary and Exchange Rate Policy

32. **The mission commended the adept implementation of the inflation targeting framework, noting the enhanced credibility that had resulted from recent convergence.** Following the earlier tightening of monetary policy, the August 2005 decision to begin reversing that tightening seems well-timed—inflation was brought down, without inducing an undershooting of the target. Subsequently, when food price shocks took headline inflation to the top of the variability band, inflation expectations did not rise (in contrast to similar episodes in the past), suggesting increased credibility. Moreover, the authorities had been able to reduce interest rates during a time of peso weakness in March and April, without sacrificing credibility, as it was understood that the inflation outlook justified the moves.

⁸ For comparison, actual tax revenue was 9.5 percent of GDP in 2005, and oil earnings (net of operating costs and investment expenditure) were 5.7 percent of GDP.

⁹ For many years, gasoline pump prices (inclusive of excise taxes) were significantly above U.S. levels. Under the longstanding policy of holding the domestic price constant in real terms, international prices of gasoline began to exceed Mexican levels in late 2005. The mission also recommended letting the gasoline price move with world prices—after first restoring an appropriate after-tax gasoline price level, to avoid locking in a too-low price. Flexible pricing would then prevent a subsidy from re-emerging if world price rises further. However, because such price flexibility would significantly increase the volatility of oil-related income, it would make it even more important to save such income during times of high world prices.

33. **The authorities explained the factors that had led them in April to rule out further easing in the foreseeable future.** They did not see any sign of a threat to inflation from demand pressures or labor market tightness and estimated that some output gap remains; they also noted the price-disciplining effect of competition from China. On the other hand, there were some potential upside risks to inflation from external sources, and the uncertainty surrounding an election period argued for extra caution. Inflation expectations still about a half point above target also argued for holding a stance that could be characterized as still somewhat restrictive. The mission shared this assessment of the stance and risks, noting that continued focus on achieving the inflation target will further entrench credibility.

34. **The authorities considered that inflation expectations would align fully over time with the 3 percent inflation target, as policy continued to aim at keeping inflation outcomes centered on that target.** They were broadly satisfied with the results of their stepped-up efforts to communicate policy to the public. The mission agreed that private expectations would continue gradually to adjust after having been too pessimistic and suggested that additional traction could perhaps be gained by further steps in communicating with the public. The inflation reports published quarterly are an essential communication device as well as the regular statements after meetings, and the BoM has been increasingly forthcoming about its inflation projections. The BoM could go further by regularly publishing formal forecasts at multiple horizons, or by publishing a model of how it views the inflation process. The authorities indicated that such ideas were kept under consideration, and their potential advantages and disadvantages were being weighed. On monetary instruments, it was agreed that the interest rate signals given in the monthly policy announcements were clear and effective in governing monetary conditions.

35. **The floating exchange rate policy continues to work well.** The mission noted the advantages of the authorities' hands-off policy regarding the exchange rate, in terms of transparency, promoting hedging by the private sector, and keeping expectations focused on the inflation target. The rule for selling a fixed share of the public sector's foreign exchange surplus fits well inside this policy of symmetric exchange rate flexibility.

36. **The mission and authorities agreed that NIR had reached a healthy level, according to standard indicators of reserve adequacy.** If the authorities were to decide that NIR was growing faster than necessary, the mission recommended that any modified rule preserve the best features of the current one, in which NIR does not respond to exchange rate developments. Subsequently, the authorities in June announced a debt management operation that will have the effect of slowing NIR growth this year, while leaving the existing exchange rate policy mechanisms intact. In this operation, central bank NIR will be used to pre-pay about US\$7 billion of the government's external debt to the World Bank and IDB.¹⁰

¹⁰ In compensation, the government will transfer new government paper to the BoM, which the BoM will exchange in the market for equivalent outstanding liabilities of the central bank. From a consolidated viewpoint, the operation will leave unchanged the net external debt and the net domestic debt of the consolidated public sector, while generating net interest savings (essentially because the interest cost of the prepaid external debt exceeded the interest earnings on NIR).

As a consequence, staff projects that while NIR will continue to grow this year, the increase will be considerably less than in 2005, notwithstanding higher oil export prices.

D. Financial Issues and Policies

37. **The FSAP Update found considerable progress since the 2001 FSAP, and confirmed the overall strength and resilience of the financial system.** Although financial intermediation overall is still relatively limited, conditions for its further development are improving.

38. **Since the 2001 FSAP, a major reform effort has aimed at enhancing the stability of the financial sector and strengthening its role in providing credit to the private sector.** The supervision of banks and securities has improved significantly. The audit and debt exchange of disputed bank restructuring bonds removed an important source of legal uncertainty in the banking system. Market infrastructure has improved, with new legal and regulatory frameworks for various intermediaries and the modernization of large value payments systems. Derivatives markets have grown significantly, allowing better management of risks.

39. **New legislation continues these efforts by strengthening corporate governance, authorizing private mortgage insurance, deregulating credit that is not funded by deposits, and creating a new bank resolution framework.** The new stock market law considerably strengthens investors' rights and enables stock-market listings for smaller firms. Non-bank credit institutions (Sofoles, which are not permitted to take deposits) will be deregulated: licensing requirements and restrictions on the market segment they can enter are being withdrawn gradually. The new bank resolution framework, once complementary regulations are implemented, will provide clear mechanisms to deal with insolvent commercial banks.

40. **Helped by good macroeconomic policies, sound oversight, and a favorable external environment, the financial system has increased its resilience to adverse shocks.** Overall, private banks are profitable and liquid, and their capital is high (currently over 15 percent of risk-weighted assets).¹¹ Commercial banks appear capable of withstanding significant market and credit risk shocks, according to tests conducted for the FSAP Update.

41. **Commercial banks' asset quality continues to improve, although strong growth of consumer credit could eventually bring some deterioration of credit portfolios.** In that context, the authorities are moving to strengthen further the monitoring of consumer credit risk. For now, the level of household debt is significantly lower than in other countries, and overall non-performing loans remain low for both banks and non-bank credit institutions. Loan loss provisions, in excess of required levels, provide a reassuring cushion.

¹¹ The relatively high CARs are partly explained by banks' large holdings of government securities, which effectively carry a zero risk weighting. Government liabilities still account for an important part of commercial banks' assets, although this share has declined in the last few years.

42. **Even with the recent growth of credit and securities markets, financial intermediation overall remains relatively limited, while the INFONAVIT housing fund plays a significant role.**¹² Commercial bank credit to non-financial enterprises is no more than 10 percent of GDP. (In comparison, funds channeled through INFONAVIT reached 5 percent of GDP in 2005.) Local corporate debt issuance increased in 2005, but remains low at 2 percent of GDP. Domestic equity issuance remains small, somewhat less than US\$2 billion in 2005, although this did represent a ten-fold increase with respect to 2004. The market for asset-backed securities has been the fastest growing segment of Mexico's private debt market, since their legal framework was strengthened in 2003.

43. **Among the recommendations from the FSAP Update, the mission highlighted priorities for future policies in three areas:**

- *Enhancing the supervisory regime and contingency planning, to entrench resilience.* Next steps should include full-fledged consolidated supervision of financial conglomerates, further enhancing the monitoring of consumer credit risk, creating clearer rules for inter-agency contingency planning, and adopting a legal framework to guarantee the political and budgetary autonomy of supervisory bodies.
- *Further rationalization and reform of development banks.* Some development banks have been reformed and have developed market-friendly instruments to promote access to finance, but some have not reformed (see FSSA report). The challenges include redefining the mandates of those banks, further consolidating and rationalizing the system, continuing with current plans to establish a "subsidiaries bureau" to rationalize the various financial subsidy and guarantee programs, and implementing performance indicators. In the growing housing finance market, the SHF, a specialized development bank for housing, has played a key role in developing the market; it will be appropriate to stick to the timetable for the SHF to withdraw from financing mortgages.
- *Promoting access to financing and competition.* Along with continuing efforts to strengthen creditors' and investors' rights, steps to promote greater competition would help improve access to financing. For *banks*, the mission endorsed the authorities' work to foster competition by improving disclosure of information on availability and costs of credit and retail payment services, and by fostering greater cooperation among institutions in the use of financial infrastructure. For *pension funds*, the mission welcomed plans to require transparent disclosure of each fund's investment performance, including with reference to investment benchmarks.

44. **The authorities generally concurred with the findings and recommendations of the FSAP Update.** They noted that their most recent reform efforts aimed to address many

¹² Infonavit is an autonomous housing fund for private sector employees that receives mandatory payroll contributions and is required by law to provide housing finance to its affiliates. Infonavit has increased its dominance of the primary mortgage market, from 49 percent of outstanding balances in 2000 to 60 percent at the end of 2005. Mortgage lending by FOVISSSTE (the equivalent of Infonavit for public sector employees) adds to the public sector's large presence in this market.

of the issues. Regarding financial market development, they and the staff expected the effects of reforms implemented in recent years to accumulate over time.

E. Vulnerabilities and Measures to Boost Resilience

45. **The mission noted Mexico's success in reducing vulnerabilities and building resilience.** In addition to the strengthened financial system, Mexico benefits from: (i) an improved public sector balance sheet, especially strong in terms of low exposure to exchange rate risk;¹³ (ii) the flexible exchange rate in the context of a credible inflation anchor; and (iii) levels of external debt and external financing needs, of both the public and private sector, that are relatively low in international comparisons.

Selected Vulnerability Indicators, 2005
(In percent of GDP, unless otherwise indicated)

	Mexico	Median, sample of 48 emerging market countries
External sector		
Gross reserves in percent of short-term debt at remaining maturity	155.4	149.2
Total gross external debt	22.5	47.9
<i>Of which:</i> External debt of domestic private sector	8.4	19.9
Current account balance	-0.6	-1.8
Gross external financing requirement 1/	5.8	12.4
Public sector 2/		
Overall balance	-1.4	-2.1
Gross public sector financing requirement 3/	11.3	8.1
Public sector gross debt	44.0	46.2
<i>Of which:</i> Exposed to exchange rate risk 4/	14.1	20.3
Exposed to rollover risk (ST debt, residual maturity) 5/	10.6	6.1
MLT debt at variable interest rate 6/	14.5	12.3
Memo items:		
EMBI + secondary market spread (bps, average)	155.9	

Source: Staff estimates.

1/ Current account deficit plus amortization of external debt.

2/ For Mexico, public sector includes public enterprises.

3/ Overall fiscal deficit plus debt amortization and rollover; 2005 estimate for Mexico.

4/ Debt in foreign currency or linked to the exchange rate, domestic and external.

5/ Short-term debt and maturing medium- and long-term debt, domestic and external, excluding external debt to official creditors.

6/ As of end 2005 for Mexico and as of end 2004 for the sample of emerging market countries.

¹³ In terms of stocks, net external debt of the consolidated public sector (i.e., net of central bank NIR) is around 3 percent of GDP. This debt stock is approximately matched by PEMEX's 2006 net foreign exchange earnings (to say nothing of the present value of PEMEX's future income stream). In terms of current income flows, PEMEX's net foreign exchange flow exceeds interest on all public external debt, which was about 1 percent of GDP in 2005. Amortization of all public external debt was about 2½ percent of GDP 2005.

46. **To further reduce vulnerabilities, the mission emphasized continuing efforts to reduce the public debt ratio and strengthen the debt structure.**¹⁴ Short-term external financing needs are low, but the average maturity of the domestic component of the total public debt, while increasing, is still relatively short. This generates significant gross financing needs, estimated by staff to be 1½ percent of GDP this year. It would be important also to bring down further the share of domestic debt indexed to the interest rate. The authorities confirmed that they would continue in these directions, taking into account also the costs of extending maturity in the context of an upward-sloping yield curve.

47. **The mission commended the transparent, non-opportunistic approach to public debt issuance, which has helped build confidence.** In an adverse scenario, including a hypothetical loss of confidence in Mexican assets, it would be advisable to stick to this debt strategy, and in particular to avoid a large shift in issuance toward debt that is either very short-term or indexed to interest rates. The authorities commented that fiscal policy would be the most effective response to such a shock. Finally, the mission recommended consolidating the analysis and management of public debt to the extent possible, including shifting the sizable debt of the deposit protection agency (IPAB) to the books of the federal government. The authorities noted that the latter would require legislation.

48. **Staff's sensitivity analysis of potential shocks highlights the importance of continuing to extend debt maturity and of reducing oil risks.** A hypothetical "confidence shock" episode with a hike in interest rates and a sharp depreciation, along with weaker growth, could put the public debt on an upward path, though not an extreme one. However, gross public sector financing needs could rise significantly if a shock were sustained and short-term debt began to be used intensively to finance amortization. Oil risk was also examined. In the near-term, this is centered on a possible sharp drop in oil prices, but over longer horizons there is the risk of declining production, and the mission also discussed a scenario in which oil production would fall in the medium term (Annex V).

49. **The mission suggested that oil-related risks could be contained in two ways:**

- Strengthening the non-oil fiscal balance. Especially if proven oil reserves were to continue to decline, it would be prudent to aim at a significant reduction over time of the non-oil deficit.
- Diversifying risk. From a financial perspective, risks to the public sector could be reduced by allowing some sharing of risk with the private investors in PEMEX investment. This would allow the public sector balance sheet to have a safer structure: a lower level of debt, and a lower share of its assets invested in the oil sector.

50. **Also discussed was a scenario involving lower U.S. and world growth, prompted for example by a possible loss of confidence in U.S. assets and rising global interest rates.** Activity in Mexico would be particularly affected, through the country's tight links to the U.S., while a drop in world oil prices (which is assumed to be triggered by weaker

¹⁴ Outside the public sector, the mission noted the absence of signs of financial distress in the corporate sector, while external debt of the private sector is relatively low, about 10 percent of GDP.

U.S. and global activity) would reduce fiscal revenues. In such a scenario, the fiscal deficit could widen by 1 to 2 percentage points of GDP, mainly from effects of lower oil prices and higher interest rates. Again, it was agreed that a fiscal policy response—as indeed would be required by the new fiscal responsibility law— would be important, while monetary policy should remain focused on the inflation target.

F. Growth, Competitiveness, and the Reform Agenda

51. **During the past decade, a number of accomplishments have helped set the stage for faster growth.** These include macroeconomic and financial system stability, reforms to promote a deeper capital market and financial intermediation, and a range of specific reforms to improve the business environment, and the functioning of particular sectors. Just recently, laws were passed to improve corporate governance and help fight anti-competitive practices. Attention also has been given to human capital, with the development of incentive-based social assistance programs and broader access for health insurance.

52. **Still, Mexico faces significant structural problems that together have prevented the gains in productivity needed for fast growth (Selected Issues Chapter I).** The problem has several dimensions: the need for better infrastructure to integrate Mexico further with the rest of North America; the challenge of improving the education system and building human capital; and the need to address deficiencies in governance, the rule of law and security, judicial systems, and the regulatory environment. In such dimensions, Mexico generally lags not only other OECD member countries but also other investment grade emerging market countries—especially in East Asia. While Mexico has made some progress, reforms in such areas take time, and it is clear that much room for improvement remains.

53. **Growth is also held back by barriers to flexible resource reallocation and in some areas by lack of sufficient competitive forces to spur productivity growth.** In the energy sector, legal constraints support a state oil monopoly, and ban nearly all competition in the electricity sector. Moreover, the governance of PEMEX constrains the company's ability to pursue efficiency.¹⁵ In the private sector, a number of key sectors are highly concentrated, and this may translate into pricing power on important inputs¹⁶ and limit incentives to adapt. Regulation makes formal labor markets too rigid (the large informal sector is more flexible, but participation in the informal sector can be inefficient from a broader point of view, with negative externalities that slow growth).

54. **Barriers to the dynamic functioning of markets could be addressed on multiple fronts.** The authorities were hopeful that the recent reform of the competition law, strengthening the federal competition commission, would work as a powerful tool. As discussed earlier, steps are being taken to promote competition in the financial sector, from licensing new entrants, to information and transparency requirements that will help consumer choice. The mission also recommended removing those barriers to external competition that

¹⁵ For example, it is difficult to transfer PEMEX oil field workers to a new installation, even after a well runs dry.

¹⁶ Telecommunications is one example, where regulatory oversight so far has been unable to stop prices that are high in international comparison, as documented by the OECD.

still exist in the form of import licensing requirements and limitations on FDI. While the bulk of Mexico's trade is with other NAFTA members—on a very liberal basis—tariffs on goods from other countries could still be streamlined and reduced.¹⁷ More competition could be allowed in the energy sector. Cutting across sectors, reform of labor regulation would allow a more flexible allocation of resources, and promote active competition by firms for labor.

55. In facing challenges in terms of international competition, the authorities and the mission agreed that these would best be addressed by the structural reforms needed to boost productivity and growth. Greater microeconomic flexibility—spurred by competition—was essential, along with a more highly-skilled work force. Attempts to hold on to existing low-wage activities would be counterproductive to the goal of raising economic well-being, as well as unlikely to be successful over the medium term. The mission noted that one symptom of Mexico's international competitiveness may be the rate of inward FDI, which is rather low by international comparison (Figure 6). Again, this highlights the need for structural reforms.

56. Regarding the real exchange rate, the authorities emphasized that this was a market-determined relative price that could be expected to respond flexibly to productivity developments. They considered that there were now no distortions that should cause the real exchange rate to deviate from a notional equilibrium level.¹⁸ The mission shared this view, and noted that with the external current account near balance, export volume growing faster than overall GDP, and Mexico's export market share recently stabilizing, there were no clear symptoms of exchange rate overvaluation.¹⁹ The mission also agreed that the exchange rate is not an available policy tool for influencing competitiveness. Any attempts to use nominal policies to manipulate the real exchange rate would run the risk of boosting inflation, while failing to address underlying competitiveness issues.

57. In the evolution of Mexico's real exchange rate, factors seem to be at work in both directions. The productivity growth differential and supply push from China especially is a continuing force for real depreciation of the peso. In the other direction, rising receipts from remittances and oil exports—to the extent that these trigger greater domestic demand²⁰—are forces for real appreciation.

¹⁷ In particular, the tariffs applied on imports from non-preferential partners could be made uniform and low (the simple average MFN tariff was reported by UNCTAD to be 14.5 percent in 2005, more than double that of Mexico's NAFTA partners).

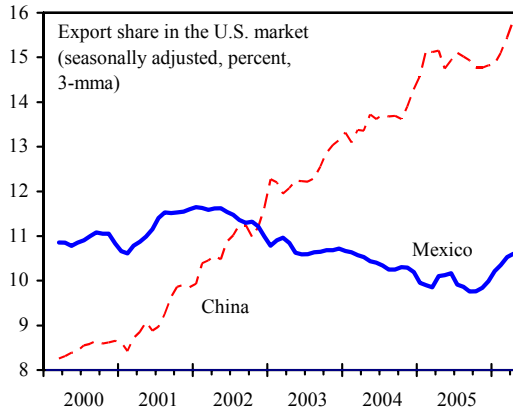
¹⁸ Thus Mexico does not have capital controls, nor discretionary exchange market intervention that responds to the level of the exchange rate.

¹⁹ The mission also observed that the real exchange rate, having peaked in 2002, was within about 10 percent of its 1985–2005 average (although structural changes meant that the historical average was not necessarily an indication of a long-run equilibrium).

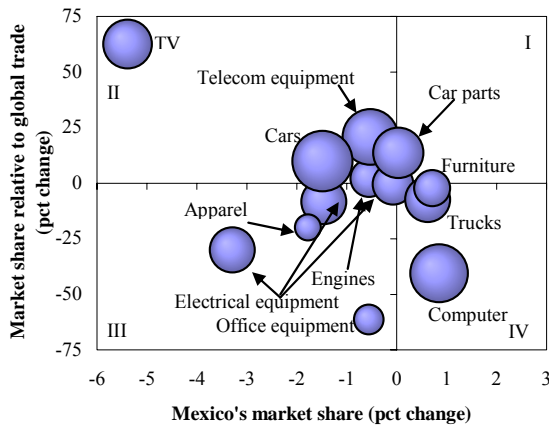
²⁰ Both effects may be limited. On remittances, part of the recorded increase reflects only improved measurement (Selected Issues Chapter II). Regarding oil, the increase in income from *net* energy exports has been modest, and it has not translated fully into government spending.

Figure 6. Mexico: Competitiveness Indicators

Mexico's export share in the U.S. market is stabilizing after a long decline....

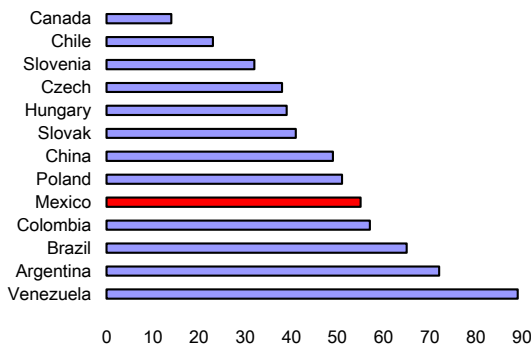


But there are potential competitiveness concerns in the long-run...



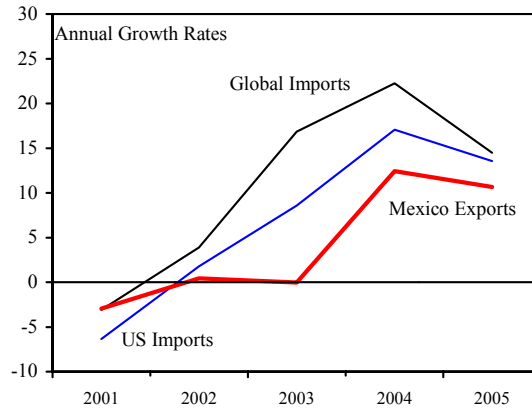
Mexico continues to lag behind comparators in aggregate rankings of competitiveness...

World Economic Forum Competitiveness Ranking 1/

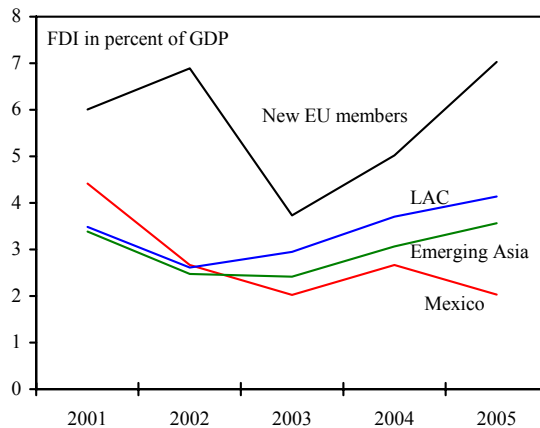


1/ Rank in 2006 survey out of 117 countries.
2/ Rank in 2006 survey out of 60 countries.

...and non-oil export growth has picked up with favorable external conditions

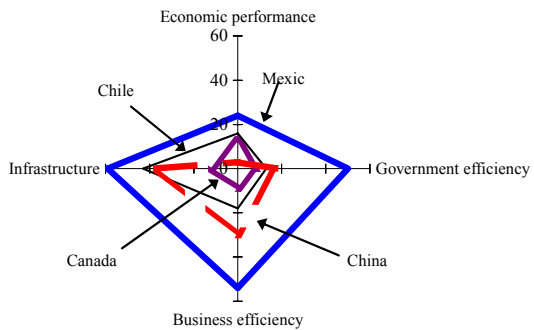


...illustrated by low FDI in comparison to other emerging markets.



...and in important sub-categories of competitiveness.

IMD Elements of Competitiveness 2/



Sources: Haver Analytics; IFS; UN COMTRADE; Mexican authorities; and Fund staff estimates.

IV. STAFF APPRAISAL

58. **Mexico has come a long way toward establishing the macroeconomic, financial and social stability needed to foster rapid economic growth.** Fiscal discipline has put public debt on a downward trend and supported confidence. Monetary policy has achieved low inflation, in the context of a floating exchange rate regime that has promoted smooth external adjustment. Indeed, the independent central bank has been an important component of institutional strength and continuity, including at times of political transition. The financial system—once a source of instability—has been put on a sound footing. Progress also has been made in reducing poverty through targeted programs. A transition to a multi-party democracy and a more transparent government is also laying the basis for better governance and faster growth.

59. **Mexico's two main economic policy challenges are to fully entrench stability and to remove remaining obstacles to the economic growth necessary to end poverty.**

60. **Monetary policy is well developed, and its job of disinflation nearly complete.** The recent monetary tightening and easing phases were implemented deftly, and the convergence of inflation to the targeted 3 percent was critical to credibility. Inflation expectations are now within a half-point of that target; the final disinflation step will be to close that gap through the maintenance of the central bank's steady focus on its inflation target. In the meantime, the authorities could extend their advances in monetary policy communication by regularly publishing a fuller quantitative forecast of inflation.

61. **The floating exchange rate policy, implemented steadfastly and symmetrically, continues to serve Mexico well.** As the central bank for years has abstained from discretionary intervention, it is now well understood in Mexico that the exchange rate is market-determined, and that monetary policy is focused on the inflation target. In addition to facilitating continuous external adjustment, this policy has given the private sector appropriate incentives to manage currency exposures.

62. **An essential part of Mexico's stability is the resilience of the financial system.** This year's FSAP Update documented this resilience, and the important steps that continue to be taken to secure it. Looking ahead, the FSAP Update provides a possible roadmap for further progress. Among the recommendations, several stand out as most fundamental to entrenching stability, including securing the institutional and budgetary independence of financial supervisory bodies, improving consolidated supervision of financial groups, creating clearer rules for interagency contingency planning, and enhancing the monitoring and analysis of fast-growing household credit. It will also be important to improve further the mandates, functions, and instruments of the development banks, and rationalize their operations.

63. **To serve Mexico fully, the financial system will need to be not only stable but also deeper, providing credit on a larger scale.** Today, there are hopeful signs of an emerging dynamism in the financial sector, and it is likely that further benefits of recent reforms are in the pipeline. Still, it will be important to continue with reforms and policy steps to deepen financial intermediation and promote competition.

64. **Sustained fiscal policy discipline has fostered economic stability, as the fiscal stance has been strong enough to gradually reduce the public debt ratio.** However, chronically weak tax revenue has added to the challenge of providing for adequate social and investment expenditures while maintaining fiscal discipline. Tax reform proposals deserve fresh consideration.

65. **Indeed, new policy efforts will be needed to maintain an appropriate fiscal stance over the medium term.** Expenditure pressures can be expected to mount steadily. Some, such as pressure to expand energy subsidies, should be resisted. Instead, expenditure on such subsidies should be reduced, by eliminating them or targeting them to those with low income. Other pressures, such as for enhanced infrastructure and appropriate social expenditures, are important for long-term growth and poverty reduction, but will be difficult to meet without raising tax revenue.

66. **So far, oil income has compensated for the fundamental weakness of low tax revenue—but oil can be an uncertain source of income.** Wary of the risks of allowing public expenditure to track oil prices upward, the authorities have sought to steer the rising oil receipts of recent years into a mix of deficit reduction and discretionary (non-inertial) spending, including on investment; so far, they have been able to avoid a major increase in the non-oil fiscal deficit. Still, the level of the non-oil deficit appears uncomfortably high, taking into account the relatively low level of proven oil reserves, as well as the size of public debt. If oil reserves were to continue their decline, fiscal policy will need increasingly to take into account uncertainties about future oil production and the sustainability of the non-oil fiscal position.

67. **The oil sector poses a policy dilemma, exacerbated by institutional constraints and governance issues.** On one hand, a low rate of investment in oil could mean a decline in production, fiscal receipts and exports. On the other hand, committing to additional investment may be difficult, given concerns about the efficiency of PEMEX, and legal constraints that mean that oil sector investment can be financed only by public debt, which may not be desirable. In this context, proposals to reform PEMEX governance, and to allow risk-sharing with the private sector, deserve new consideration.

68. **To address other potential sources of vulnerability, the staff recommends that debt management strategy continue along recent lines.** Great progress has been made in reducing the public sector's exposure to peso depreciation. The relevant challenge now is to improve still further the structure of domestically-issued debt, especially to reduce the still-substantial gross financing needs of the public sector. Debt management would be facilitated by consolidating the management of all forms of public debt.

69. **While the near-term growth outlook for Mexico remains closely linked to that of the U.S. economy, medium-term growth will depend on structural reforms.** Having achieved stability, Mexico still has a distance to go in creating conditions for fast growth. The challenges include improving the education system and building human capital; enhancing infrastructure; and further improvement in judicial systems, security, and other aspects of the business and regulatory environment. Moreover, to spur productivity growth, labor market flexibility and competitive forces in general need to be given more room. The authorities are right to emphasize reforms such as the new competition law, steps to promote

competition in the financial sector and to remove barriers to labor market flexibility, and the opening of industries now occupied by state monopolies. Implementation of such pro-growth reforms is the best way to assure Mexico's international competitiveness and ability to take full advantage of globalization.

70. It is recommended that the next Article IV consultation with Mexico be held on the standard 12-month cycle.

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

I. Social and Demographic Indicators										
GDP per capita (U.S. dollars, 2005)	7,143									33.0
Population (millions, 2004)	103.8									19.3
Life expectancy at birth (years, 2002)	73.5									9.5
Under 5 mortality rate (per thousand, 2003)	28.0									110.3
II. Economic Indicators										
	1998	1999	2000	2001	2002	2003	2004	2005	Proj.	
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
(Annual percentage change, unless otherwise indicated)										
National accounts in constant prices										
Real GDP	5.0	3.8	6.6	0.0	0.8	1.4	4.2	3.0	4.0	3.5
Net exports (contribution)	-1.1	-0.5	-1.8	-0.7	0.0	0.7	-0.3	-0.9	-0.2	-0.8
Total domestic demand	6.2	4.3	8.3	0.7	0.8	0.8	4.4	3.8	4.1	4.2
Private consumption	5.4	4.3	8.2	2.5	1.6	2.3	4.1	5.4	4.2	4.2
Public consumption	2.3	4.7	2.4	-2.0	-0.3	0.8	-0.4	0.5	0.3	0.3
Gross fixed private investment	13.8	7.2	9.0	-5.9	-4.1	-1.5	8.8	9.6	7.0	7.0
Gross fixed public investment	-7.5	10.7	25.2	-4.2	17.0	8.5	2.5	-0.5	1.9	2.5
Change in business inventories (contribution)	0.4	-0.6	0.3	0.4	-0.2	-1.0	0.2	-1.5	-0.1	-0.1
External sector										
Exports, f.o.b. 1/	1.2	14.6	21.5	-3.1	0.6	3.9	13.8	15.2	18.9	8.6
Export volume 1/	12.6	6.6	10.2	0.1	-2.0	-2.3	5.0	9.3	9.4	7.1
Imports, f.o.b. 1/	12.7	10.6	23.1	-1.7	-1.3	1.9	15.8	13.2	15.4	11.3
Import volume 1/	13.5	11.6	19.6	-2.5	-0.6	-0.4	9.9	7.9	10.2	10.0
Petroleum exports (percent of total exports)	9.7	11.6	15.5	13.0	14.6	17.6	19.7	23.0	25.8	24.7
Terms of trade (deterioration -)	-9.5	8.5	7.1	-3.9	3.3	3.9	2.9	0.5	3.9	0.2
Exchange rates										
Nominal exchange rate (US\$/Mex\$)										
(average, depreciation -)	-15.4	-4.7	1.1	1.2	-3.4	-11.7	-4.6	3.4	...	...
Real effective exchange rate (CPI based)										
(average, depreciation -)	0.8	8.5	8.3	6.4	0.0	-10.5	-3.8	4.1	...	...
Employment and inflation										
Consumer prices (end of year)	18.6	12.3	9.0	4.4	5.7	4.0	5.2	3.3	3.3	3.0
Formal sector employment (annual average)	3.7	5.7	5.9	-0.5	-0.8	-0.5	1.3	3.1	...	...
Formal sector unemployment rate (annual average)	3.2	2.5	2.2	2.4	2.7	3.2	3.7	3.6	3.5	3.3
Real manufacturing wages (annual average)	2.8	1.5	6.0	6.7	1.9	1.4	0.3	-0.1	...	...
Money and credit										
Broad money (M4a)	25.1	19.7	12.8	16.0	10.8	13.5	12.6	15.2	12.4	11.1
Treasury bill rate (28-day cetes, in percent, annual average)	24.6	21.4	15.3	11.2	7.1	6.2	6.8	9.2	7.1	6.9
(In percent of GDP)										
Nonfinancial public sector										
Augmented balance	-6.3	-6.3	-3.7	-3.7	-3.4	-3.2	-2.0	-1.4	-1.6	-1.6
Non-oil augmented balance	...	...	...	-7.8	-7.4	-7.8	-7.4	-7.2	-7.9	-8.3
Augmented primary balance	0.6	1.3	1.3	1.0	0.3	0.3	1.3	1.8	2.1	2.1
Traditional balance	-1.2	-1.2	-1.1	-0.7	-1.2	-0.7	-0.3	-0.1	0.2	0.0
Gross public sector debt	52.6	55.8	49.3	47.9	49.7	50.0	46.0	44.0	42.8	41.6
Net public sector debt	45.0	46.8	42.2	41.7	43.6	44.0	40.9	38.9	38.1	37.2
o/w percent in foreign currency	52.1	46.9	37.9	34.2	37.0	39.1	38.8	34.8	32.3	30.9
Savings and investment										
Gross domestic investment	24.3	23.5	23.7	20.9	20.6	20.6	22.1	21.8	22.0	22.4
Public investment	2.8	3.0	3.6	3.6	4.2	4.5	4.6	4.3	4.2	4.2
Private investment	18.1	18.2	17.8	16.4	15.0	14.4	15.0	15.0	15.5	16.0
Change in inventories	3.4	2.3	2.3	0.9	1.4	1.6	2.5	2.5	2.4	2.2
Gross national saving	20.5	20.6	20.5	18.0	18.6	19.2	21.1	21.2	21.9	21.9
Public saving 2/	-3.5	-3.3	-0.1	-0.1	0.8	1.4	2.7	2.9	2.6	2.6
Private saving	24.1	23.9	20.6	18.2	17.7	17.8	18.4	18.3	19.3	19.3
External current account balance	-3.8	-2.9	-3.2	-2.8	-2.1	-1.4	-1.0	-0.6	-0.1	-0.4
Non-oil external current account balance	-4.5	-4.0	-4.7	-3.8	-3.3	-3.0	-2.8	-2.7	-2.7	-2.9
Net foreign direct investment	2.9	2.8	3.0	3.7	2.7	2.0	2.1	1.5	1.6	2.1
(In percent of exports of goods, nonfactor services, and transfers)										
Public external debt service 3/	28.1	28.6	32.2	25.1	20.6	20.4	16.6	13.6	14.5	12.3
(In billions of U.S. dollars, unless otherwise indicated)										
Net international reserves	30.1	30.7	33.6	40.9	48.0	57.4	61.5	68.7	70.2	79.0
Gross official reserves in percent of short-term debt 4/	65.2	49.9	65.8	91.6	110.1	138.0	161.5	155.4	160.2	165.6
Gross external debt (in percent of GDP, end of period)	39.6	37.4	28.7	26.4	25.0	25.4	24.3	22.5	20.3	20.5
Crude oil export price, Mexican mix (US\$/bbl)	10.2	15.7	24.6	18.6	21.5	24.7	31.0	42.7	54.4	56.9

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

1/ Total exports are defined net of imports by the maquila sector. Correspondingly, total imports do not include maquila sector imports.

2/ Estimated as the difference between the augmented fiscal balance, as reported by SHCP, and public investment, as reported in the national accounts.

3/ Includes the IMF and public development banks and trust funds net of the collateral of Brady bonds.

4/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

Table 2. Mexico: Financial Operations of the Public Sector, 2001–2006
(In percent of GDP)

	2001	2002	2003	2004	2005	Budget /1 2006	Staff Projection 2006
Budgetary revenue, by entity	21.9	22.1	23.2	23.0	23.3	22.2	23.8
Federal government revenue	16.2	15.8	16.4	16.5	16.9	15.2	16.6
Tax revenue	11.3	11.6	11.1	10.0	9.7	9.5	9.5
Excise tax (including fuel)	1.9	2.2	1.7	1.1	0.6	0.6	0.2
Nontax revenue	4.9	4.2	5.3	6.5	7.2	5.8	7.1
Public enterprises	5.7	6.4	6.8	6.5	6.4	7.0	7.2
PEMEX	1.8	2.4	2.6	2.5	2.2	3.0	3.1
Other	3.9	4.0	4.2	4.0	4.2	4.0	4.1
Budgetary revenue, by type							
Oil revenue	6.7	6.5	7.7	8.3	8.7	8.5	9.6
Non-oil tax revenue 2/	9.8	9.8	9.9	9.3	9.5	9.2	9.7
Non-oil non-tax revenue	5.5	5.8	5.6	5.4	5.1	4.4	4.5
Budgetary expenditure	22.6	23.3	23.9	23.2	23.3	22.2	23.6
Primary	19.3	20.5	21.1	20.6	20.8	19.2	20.7
Programmable	15.9	16.9	17.6	17.1	17.3	15.7	17.1
Current	13.3	13.8	14.6	13.5	14.0	13.4	13.9
Wages	7.1	7.3	7.3	6.7	6.7	6.7	6.7
Pensions	1.9	2.0	2.1	1.9	2.1	2.1	2.1
Subsidies and transfers	2.1	2.2	2.3	2.3	2.4	2.5	2.7
Other	2.2	2.2	2.9	2.6	2.8	2.1	2.4
Capital	2.6	3.2	3.0	3.5	3.4	2.4	3.2
Physical capital	2.4	2.3	2.7	3.0	2.8	2.4	2.7
Financial capital	0.2	0.8	0.3	0.6	0.6	0.0	0.6
Nonprogrammable	3.4	3.5	3.5	3.5	3.5	3.5	3.6
Of which: revenue sharing	3.4	3.4	3.3	3.1	3.3	3.3	3.5
Interest payments 3/	3.2	2.8	2.8	2.7	2.5	3.0	2.9
Traditional balance	-0.7	-1.2	-0.7	-0.3	-0.1	0.0	0.2
Adjustments to the traditional balance	3.0	2.1	2.4	1.7	1.4	1.7	1.8
PIDIREGAS	0.8	0.8	1.1	1.1	0.9	0.9	0.9
IPAB	1.0	0.5	0.3	-0.7	0.3	0.2	0.2
Budgetary adjustments	0.3	0.2	0.1	0.1	0.1	0.1	0.1
PEMEX and oil stabilization fund (-: net inflows)	0.0	0.0	-0.1	-0.5	-0.2	0.0	0.0
FARAC	0.1	0.4	0.0	0.2	0.0	0.0	0.0
Debtor support	0.0	-0.1	0.0	-0.2	0.0	0.1	0.1
Development banks	0.1	-0.4	0.4	0.2	-0.1	0.4	0.3
Nonrecurring revenue	0.7	0.7	0.7	1.5	0.2	0.0	0.1
Augmented balance (PSBR excl. nonrecurrent revenue)	-3.7	-3.4	-3.2	-2.0	-1.4	-1.7	-1.6
Augmented interest expenditure	4.7	3.7	3.4	3.2	3.3	3.8	3.7
Augmented primary balance 4/	1.0	0.3	0.3	1.3	1.8	2.1	2.1
Memorandum items							
Non-oil augmented balance 5/	-7.8	-7.4	-7.8	-7.4	-7.2	-7.7	-7.9
Crude oil export price, Mexican mix (US\$/bbl)	18.6	21.5	24.7	31.0	42.7	36.5	54.4
Gross public sector debt	47.9	49.7	50.0	46.0	44.0	...	42.8
Net public sector debt	41.7	43.6	44.0	40.9	38.9	...	38.1
Nominal GDP (billions of Mexican pesos)	5809.7	6263.1	6891.4	7713.8	8374.3	8803.6	9053.1

Sources: Mexican authorities; and Fund staff estimates. Data refer to non-financial public sector, including PEMEX and other public enterprises but excluding state and local governments (except as noted).

1/ Based on version approved by Congress.

2/ Total tax revenue excluding excise tax on gasoline.

3/ Also includes transfers to IPAB and the debtor support programs (amounting to about 20 percent of total interest payments)

4/ Treats transfers to IPAB as interest payments.

5/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, excise tax on gasoline) and PEMEX operational expenditure, interest payments, and capital expenditure.

Table 3. Mexico: Summary Balance of Payments, 2002–2011

	2002	2003	2004	2005	Staff Projections					
					2006	2007	2008	2009	2010	2011
	(In billions of U.S. dollars)									
Current account	-13.5	-8.6	-6.6	-4.8	-0.7	-3.6	-7.0	-9.8	-12.9	-15.7
Merchandise trade balance, f.o.b.	-7.6	-5.8	-8.8	-7.6	-3.8	-8.8	-13.5	-16.9	-19.9	-22.2
Exports 1/	101.8	105.7	120.3	138.6	164.8	178.9	190.5	204.6	220.9	239.6
<i>Of which:</i>										
Petroleum and derivatives	14.8	18.6	23.7	31.9	42.5	44.1	43.3	42.7	42.2	41.8
Manufactures	82.3	81.6	90.0	99.5	112.5	124.2	136.6	151.3	168.1	186.9
Imports 1/	-109.4	-111.5	-129.1	-146.1	-168.6	-187.7	-204.0	-221.5	-240.8	-261.8
Factor income	-12.1	-12.1	-10.2	-12.9	-14.5	-14.2	-14.6	-15.2	-15.9	-17.0
Other services and transfers	6.2	9.3	12.4	15.7	17.6	19.4	21.1	22.3	22.9	23.4
Financial account	25.9	21.1	10.8	12.7	2.2	12.5	15.7	18.3	21.3	24.1
Public sector	-3.0	-3.3	2.5	-6.7	-10.4	-4.0	-3.9	-3.8	-3.7	-3.6
Medium- and long-term borrowing	-2.4	0.0	-2.1	-5.5	-10.4	-4.0	-3.9	-3.8	-3.7	-3.6
Disbursements	10.9	15.6	13.4	6.8	8.8	13.4	12.8	12.2	11.6	11.0
Amortization 2/	13.2	15.6	15.4	12.3	19.2	17.4	16.7	16.0	15.3	14.6
Other, including short-term borrowing	-0.6	-3.3	4.5	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	28.9	24.4	8.3	19.5	12.7	16.5	19.6	22.1	25.0	27.7
Direct investment	17.4	12.9	14.2	11.9	13.1	13.5	14.2	15.1	16.0	16.9
Bonds and loans 3/	0.2	3.0	3.0	10.6	3.1	10.5	11.2	13.1	16.3	17.7
Banking system	-3.0	-0.5	-0.9	-2.3	-1.5	-1.0	-0.3	-0.1	0.0	0.0
Corporate sector (incl. Pidiregas)	3.1	3.5	3.9	12.9	4.7	11.5	11.5	13.2	16.4	17.7
Equity investments and change in assets abroad	11.3	8.5	-8.9	-3.0	-3.5	-7.5	-5.8	-6.0	-7.3	-7.0
Equity investments	-0.1	-0.1	-2.5	3.4	2.2	0.4	1.3	0.6	0.8	0.9
Change in assets abroad	11.4	8.6	-6.4	-6.4	-5.8	-7.9	-7.1	-6.7	-8.0	-7.9
Errors and omissions and valuation adjustments	-5.2	-3.0	-0.1	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-7.1	-9.5	-4.1	-7.2	-1.5	-8.8	-8.7	-8.5	-8.4	-8.4
	(In percent of GDP, unless otherwise indicated)									
Memorandum items:										
Current account balance	-2.1	-1.4	-1.0	-0.6	-0.1	-0.4	-0.8	-1.0	-1.3	-1.5
Nonoil current account balance 8/	-3.3	-3.0	-2.8	-2.7	-2.7	-2.9	-3.0	-3.0	-3.1	-3.1
Nonoil trade balance 8/	-3.5	-3.8	-4.8	-5.1	-5.7	-6.3	-6.4	-6.4	-6.3	-6.1
Merchandise exports	15.7	16.5	17.6	18.0	20.3	21.3	21.6	21.8	22.2	22.8
Petroleum and derivatives exports	2.3	2.9	3.5	4.2	5.2	5.3	4.9	4.6	4.3	4.0
Merchandise imports	16.9	17.5	18.9	19.0	20.7	22.4	23.1	23.6	24.2	24.9
Gross financing needs (billions of US\$) 4/	69.5	64.1	53.4	51.7	49.9	59.7	66.7	73.4	81.4	90.5
Gross international reserves 5/										
End-year (billions of US\$)	50.7	59.0	64.2	74.1	75.6	84.4	93.1	101.6	110.1	118.4
Months of imports of goods and services	4.7	4.8	4.6	4.6	4.3	4.4	4.5	4.5	4.5	4.5
Months of imports plus interest payments	4.2	4.3	4.2	4.2	3.9	4.0	4.1	4.1	4.1	4.1
Percent of short-term debt (by residual maturity) 6/	110.1	138.0	161.5	155.4	160.2	165.6	169.0	169.3	169.3	169.3
Percent of gross financing requirement 7/	92.7	119.5	144.2	153.0	148.7	145.5	143.5	139.4	139.4	139.4
Crude oil export volume (millions of bbl/day)	1.69	1.82	1.88	1.83	1.91	1.90	1.90	1.90	1.90	1.90
Crude oil export price, Mexican mix (US\$/bbl)	21.5	24.7	31.0	42.7	54.4	56.9	55.9	55.1	54.5	53.8
Gross total external debt	25.0	25.4	24.3	22.5	20.3	20.5	20.3	20.1	20.2	20.5
<i>Of which:</i> Public external debt	16.8	17.5	16.1	14.1	13.0	12.2	11.5	10.8	10.1	9.5
Gross total external debt (billions of US\$)	162.0	162.4	166.2	172.7	165.4	171.9	179.2	188.5	201.1	215.2
<i>Of which:</i> Public external debt	104.7	109.9	108.5	103.9	99.9	96.6	95.5	95.0	94.5	94.0
Public external debt service (in percent of exports of goods, services, and transfers)	20.6	20.4	16.6	13.6	14.5	12.3	11.0	9.9	8.8	7.8
	(Annual percentage change)									
Export volume	-2.0	-2.3	5.0	9.3	9.4	7.1	7.6	7.8	8.0	8.1
Non-oil exports	-2.0	-3.5	5.2	11.1	10.0	8.0	8.5	8.6	8.8	8.8
Import volume	-0.6	-0.4	9.9	7.9	10.2	10.0	8.9	9.0	9.0	8.0
Consumer goods	8.0	-0.8	12.1	18.2	15.5	13.2	9.8	10.3	9.7	8.2
Intermediate goods	-1.2	1.4	10.3	4.0	8.7	9.0	8.5	8.5	8.6	7.9
Capital goods	-6.0	-6.0	6.2	10.6	9.0	9.0	8.8	9.3	9.4	8.0

Sources: Bank of Mexico; Secretariat of Finance and Public Credit; and Fund staff projections. Staff presentation, aggregated from more detailed Bank of Mexico data.

1/ Total exports are defined net of imports by the maquila sector. Correspondingly, total imports do not include maquila sector imports.

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/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

7/ The financing requirement excludes pre-payments of public sector debt and reserve accumulation.

8/ Excluding oil exports and petroleum products imports.

Table 4. Mexico: Summary Operations of the Financial System, 1999–2006 1/

	1999	2000	2001	2002	2003	2004	2005	Mar. 2006
(In billions of Mexican pesos)								
Bank of Mexico								
Net international reserves 2/	291.9	322.5	374.8	500.9	645.4	685.7	730.3	735.2
In U.S. dollars (billions)	30.7	33.6	40.9	48.0	57.4	61.5	68.7	67.5
Net domestic assets	-103.2	-113.5	-149.3	-237.0	-341.8	-345.5	-350.2	-382.1
Net credit to nonfinancial public sector	-193.2	-287.5	-185.1	-116.8	-129.2	-141.4	-182.4	-169.6
Net credit to financial institutions	34.4	69.6	10.5	-15.3	-68.9	-105.1	-135.6	-194.8
Other	55.6	104.4	25.3	-104.9	-143.7	-99.0	-32.3	-17.7
Monetary base	188.7	208.9	225.6	263.9	303.6	340.2	380.0	353.0
Financial system 1/								
Net foreign assets	366.7	484.2	612.1	709.9	711.1	648.7	728.6	777.0
Net domestic assets	1,777.8	1,533.1	1,438.7	1,764.8	1,891.4	2,178.8	2,207.4	2,329.4
Net credit to nonfinancial public sector	676.1	772.3	869.0	983.5	1,125.0	1,191.2	1,201.5	1,188.5
Net holdings of government securities	-93.8	-140.9	-46.4	-35.3	0.0	0.0	0.0	0.0
Net holdings of Bank of Mexico securities	0.0	20.3	43.4	48.8	37.0	36.9	39.5	51.8
Credit to private sector 3/	937.7	1,006.7	933.1	1,178.7	1,170.6	1,272.8	1,496.0	1,686.8
Medium and long term foreign obligations	290.1	278.5	246.4	264.0	274.6	248.7	184.9	173.2
Other net liabilities	-272.1	-733.0	-1,006.2	-954.6	-1,207.8	-1,435.0	-1,866.4	-2,095.8
Liabilities to the private sector	2,126.5	2,471.8	2,810.6	3,165.3	3,535.7	4,013.8	4,617.5	5,029.0
Memorandum items:								
(In annual percentage change)								
Growth of monetary base	43.5	10.7	8.0	17.0	15.0	12.0	11.7	-7.1
Growth of liabilities to the private sector	22.8	16.2	13.7	12.6	11.7	13.5	15.0	3.5
Growth of credit to the private sector 3/ <i>of which</i>	2.7	7.4	-7.3	26.3	-0.7	8.7	17.5	12.8
Banking Sector 3/	0.7	5.9	-14.1	25.2	-8.7	2.0	18.2	13.6
Nonbank financial institutions 3/	18.0	15.8	31.2	44.0	23.3	18.9	15.0	28.0
Consumer loans from banks 4/	17.4	35.5	43.2	42.2	51.9	48.7	52.4	51.7
Business loans from banks 4/	-12.6	16.2	-4.2	8.3	1.9	23.1	11.2	13.6
(In percent of GDP)								
Monetary base	4.1	3.8	3.9	4.2	4.4	4.4	4.5	4.0
Liabilities to the private sector	46.3	45.0	48.4	50.5	51.3	52.0	55.1	60.4
Credit to the private sector 3/ <i>of which</i>	20.4	18.3	16.1	18.8	17.0	16.5	17.9	18.2
Banking Sector 3/	17.1	15.2	12.3	14.3	11.9	10.8	11.8	12.0
Nonbank financial institutions 3/	1.2	1.1	1.4	1.9	2.1	2.2	2.4	2.4
Consumer loans from banks 4/	0.6	0.7	0.9	1.2	1.6	2.1	3.0	3.1
Business loans from banks 4/	5.3	5.2	4.7	4.7	4.4	4.8	4.9	4.8

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

1/ Financial system includes Central Bank, commercial and development banks, and nonbank financial institutions (e.g. Sofoles, pension funds). The presentation, different from that of the BoM, is based on International Financial Statistics methodology.

2/ NIR figures are as published by Banco de Mexico, which are defined net of foreign currency denominated liabilities to Mexico's government.

3/ Includes loans, securities, non-performing loans, and other credit.

4/ Commercial banks, performing loans only.

Table 5. Mexico: Financial Soundness Indicators for Commercial Banks, 2000-2006

	2001	2002	2003	2004	2005	1Q06
	(In percent)					
Regulatory capital to risk-weighted assets	13.9	15.5	14.2	14.1	14.3	16.0
Nonperforming loans to total gross loans	5.1	4.6	3.2	2.5	1.8	1.7
Return on assets (after tax)	0.8	-1.1	1.7	1.5	2.4	2.4
Return on equity (after tax)	8.6	-10.4	14.2	13.0	19.5	19.0
Interest margin to gross income *	59.5	58.5	52.6	60.5	60.8	59.9
Noninterest expenses to gross income *	71.4	73.2	64.8	65.6	58.0	56.9
Liquid assets to total assets	30.2	26.4	31.6	35.1	33.5	30.6
Liquid assets to short-term liabilities	97.9	76.2	88.2	101.9	89.9	85.7

Source: CNBV

*compiled based on annual flow data and annual average of end-of-month stock data.

Table 6. Mexico: Indicators of External Vulnerability, 2001–2006

	2001	2002	2003	2004	2005	2006			
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Apr.	May.	Jun.
Financial Market indicators									
Exchange rate (per U.S. dollar, end-period)	9.16	10.44	11.24	11.15	10.63	10.89	11.09	11.30	11.27
(year-to-date percent change)	-4.7	14.0	7.6	-0.8	-4.6	2.4	4.3	6.2	6.0
28-day treasury auction rate (percent; period average)	6.5	7.0	6.1	8.5	8.2	7.4	7.2	7.0	7.0
EMBI+ Mexico (basis points; period average)	313	312	205	166	125	123	130	132	150
Stock exchange index in U.S. dollar terms (year-to-date percent change)	18.3	-15.7	33.4	48.0	44.5	5.7	11.2	-1.2	1.5
Financial system									
Bank of Mexico net international reserves (US\$ billion)	40.9	48.0	57.4	61.5	68.7	67.5	70.6	75.6	78.7
Real credit to the private sector (12-month percent change) 1/	-11.2	19.5	-4.5	3.4	13.7	17.7	17.9	19.8	...
Commercial banks' nonperforming loans (percent of total loans)	5.1	4.6	3.2	2.5	1.8	1.7	...	...	...
Commercial banks' loan loss provision (percent of nonperforming loans)	123.8	138.1	167.1	201.8	241.3	252.0	...	...	...
Exports and Imports									
Trade balance (US\$ billion; year-to-date)	-9.6	-7.6	-5.8	-8.8	-7.6	0.8	1.1	1.0	0.6
Exports (year to date, annual percentage change) 2/	-3.1	0.6	3.9	13.8	15.2	30.2	26.2	25.8	24.8
<i>Of which</i>									
Non-oil	-3.0	0.4	0.0	12.4	11.0	21.2	17.9	18.7	17.9
Imports (year to date, annual percentage change) 2/	-1.7	-1.3	1.9	15.8	13.2	20.2	16.5	18.4	19.2
<i>Of which</i>									
Consumer goods	18.3	7.2	1.6	18.1	24.0	25.7	19.7	23.2	23.0
Capital goods	-6.8	-6.7	-3.7	11.8	16.0	19.5	17.0	19.1	18.7
Terms of trade (12-month percent change)	-3.9	3.3	3.9	2.9	0.5	0.5	2.1	-0.2	...
Real effective exchange rate (CPI based; 12-month percent change) 3/	7.0	-8.6	-9.9	1.1	7.2	5.5	1.4	-1.9	1.5
External Debt									
Nonfinancial public sector external debt (percent of GDP)	14.3	16.1	17.2	15.9	13.5	...	...	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 4/	0.9	0.7	0.5	0.6	0.2	...	...	...	...
Private sector external debt (percent of GDP)	10.3	8.9	8.4	7.8	7.2	...	...	...	...
Private sector short-term external debt (percent of GDP)	2.0	1.5	1.5	1.2	1.2	...	...	...	...
Memorandum items:									
Gross international reserves to short-term debt (by residual maturity, percent) 4/	91.6	110.1	138.0	161.5	155.4	...	...	...	...
Monetary base to gross international reserves (percent)	55.0	49.9	45.8	47.5	48.2	42.6	41.1	38.9	38.5

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

1/ Does not include loans associated with FOBAPROA/IPAB debt-restructuring programs.

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

3/ Increase = appreciation.

4/ The short-term debt by residual maturity includes pre-payment of debt.

Table 7. Mexico: Baseline Medium-Term Projections

	2001	2002	2003	2004	2005	Staff Projections					
						2006	2007	2008	2009	2010	2011
(Annual percentage change, unless otherwise indicated)											
National income and prices											
Real GDP	0.0	0.8	1.4	4.2	3.0	4.0	3.5	3.5	3.5	3.5	3.5
Consumer prices (end of year)	4.4	5.7	4.0	5.2	3.3	3.3	3.0	3.0	3.0	3.0	3.0
Consumer prices (average)	6.4	5.0	4.5	4.7	4.0	3.5	3.3	3.0	3.0	3.0	3.0
External sector											
Nonoil current account balance 1/	-3.8	-3.3	-3.0	-2.8	-2.7	-2.7	-2.9	-3.0	-3.0	-3.1	-3.1
Exports, f.o.b.	-3.1	0.6	3.9	13.8	15.2	18.9	8.6	6.5	7.4	7.9	8.5
Imports, f.o.b.	-1.7	-1.3	1.9	15.8	13.2	15.4	11.3	8.7	8.6	8.7	8.8
Terms of trade (deterioration -)	-3.9	3.3	3.9	2.9	0.5	3.9	0.2	-0.9	0.0	0.2	-0.3
Oil export price (US\$ / bbl)	18.6	21.5	24.7	31.0	42.7	54.4	56.9	55.9	55.1	54.5	53.8
Interest rates											
Treasury bill rate (average 28-day cetes)	11.2	7.1	6.2	6.8	9.2	7.1	6.9	6.6	6.6	6.6	6.6
Real interest rate (28-day cetes)	4.5	2.0	1.6	2.0	5.0	3.6	3.5	3.5	3.5	3.5	3.5
(In percent of GDP)											
Nonfinancial public sector											
Augmented balance 2/	-3.7	-3.4	-3.2	-2.0	-1.4	-1.6	-1.6	-1.5	-1.5	-1.4	-1.4
Augmented primary balance	1.0	0.3	0.3	1.3	1.8	2.1	2.1	2.0	1.9	1.9	1.9
Augmented non-oil balance 3/	-7.8	-7.4	-7.8	-7.4	-7.2	-7.9	-8.3	-7.2	-7.1	-6.7	-6.3
Saving and investment											
Gross domestic investment	20.9	20.6	20.6	22.1	21.8	22.0	22.4	22.6	23.2	23.8	24.3
Fixed investment	20.0	19.3	18.9	19.6	19.3	19.7	20.2	20.8	21.3	21.8	22.3
Public	3.6	4.2	4.5	4.6	4.3	4.2	4.2	4.2	4.2	4.2	4.2
Private	16.4	15.0	14.4	15.0	15.0	15.5	16.0	16.7	17.1	17.6	18.1
Inventories	0.9	1.4	1.6	2.5	2.5	2.4	2.2	1.7	1.9	2.1	2.0
Gross national saving	18.0	18.6	19.2	21.1	21.2	21.9	21.9	21.7	22.1	22.5	22.8
Public sector	-0.1	0.8	1.4	2.7	2.9	2.6	2.6	2.7	2.7	2.7	2.8
Private sector	18.2	17.7	17.8	18.4	18.3	19.3	19.3	19.0	19.4	19.7	20.0
Current account balance	-2.8	-2.1	-1.4	-1.0	-0.6	-0.1	-0.4	-0.8	-1.0	-1.3	-1.5

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

1/ Excluding oil exports and petroleum products imports.

2/ Projection assumes fiscal policy will target and achieve an augmented deficit of about 1 1/2 percent of GDP, from 2006.

3/ Excluding oil revenues, Pemex expenditures, and oil investments.

Table 8. Mexico: Millenium Development Goals

	1990	1995	1998	2001	2004
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 \$1 a day poverty and malnutrition rates				
Income share held by lowest 20%	..	..	..	4	..
Malnutrition prevalence, weight for age (% of children under 5)	17	17	8	..	..
Poverty gap at \$1 a day (PPP) (%)	..	..	..	1	..
Poverty headcount ratio at \$1 a day (PPP) (% of population)	..	..	..	4	..
Poverty headcount ratio at national poverty line (% of population)	..	37	..	20	..
Prevalence of undernourishment (% of population)	..	..	5	..	5
2. Achieve universal primary education	2015 target = net enrollment to 100				
Literacy rate, youth total (% of people ages 15-24)	95	..	..	..	98
Persistence to grade 5, total (% of cohort)	80	..	89	90	..
Primary completion rate, total (% of relevant age group)	85.9	95	96.9	97.1	98.9
School enrollment, primary (% net)	98	..	98	99	100
3. Promote gender equality	2005 target = education ratio to 100				
Proportion of seats held by women in national parliament (%)	12	..	14	16	23
Ratio of girls to boys in primary and secondary education (%)	97.9	..	98.9	100.2	101.9
Ratio of young literate females to males (% ages 15-24)	98.4	..	..	..	100.1
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	35	36	36	37	37
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds				
Immunization, measles (% of children ages 12-23 months)	75	90	96	95	96
Mortality rate, infant (per 1,000 live births)	37	30	..	25	23
Mortality rate, under-5 (per 1,000)	46	36	..	30	28
5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths				
Births attended by skilled health staff (% of total)	..	..	85.7	..	95
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	83	..
6. Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.				
Children orphaned by HIV/AIDS	..	..	..	..	..
Contraceptive prevalence (% of women ages 15-49)	..	..	65	70	73
Incidence of tuberculosis (per 100,000 people)	50.2	..	..	..	31.7
Prevalence of HIV, female (% ages 15-24)	..	..	..	0	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	0	0
Tuberculosis cases detected under DOTS (%)	..	..	29.3	91.1	71.4
7. Ensure environmental sustainability	2015 target = various (see notes)				
CO2 emissions (metric tons per capita)	4.5	4	3.8	3.9	..
Forest area (% of land area)	36	..	..	34	34
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	5	5	5	6	6
Improved sanitation facilities (% of population with access)	66	..	..	77	..
Improved water source (% of population with access)	80	..	..	91	..
Nationally protected areas (% of total land area)	..	..	..	..	10.2
8. Develop a Global Partnership for Development	2015 target = various (see notes)				
Aid per capita (current US\$)	1.9	4.2	0.5	0.8	1.2
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	18	18	14	14	12
Fixed line and mobile phone subscribers (per 1,000 people)	65.1	104.1	139.4	357.5	544.6
Internet users (per 1,000 people)	0	1	12.8	74.6	135.2
Personal computers (per 1,000 people)	8.2	26.3	36.7	69.4	108
Total debt service (% of exports of goods, services and income)	21	27	21	25	23
Unemployment, youth female (% of female labor force ages 15-24)	5.8	11	6.4	5	7.8
Unemployment, youth male (% of male labor force ages 15-24)	5.2	8.9	4.8	3.6	5.6
Unemployment, youth total (% of total labor force ages 15-24)	5.4	9.6	5.4	4.1	6.4

Sources: Mexican authorities; and World Development Indicators database.

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 dwellers.

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 June 30, 2006

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	2,285.04	88.37
Reserve Position	300.81	11.63
Holdings Exchange Rate		

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	290.02	100.00
Holdings	316.54	109.14

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	Jul 07, 1999	Nov 30, 2000	3,103.00	1,939.50
Stand-by	Feb 01, 1995	Feb 15, 1997	12,070.20	8,758.02
EFF	May 26, 1989	May 25, 1993	3,729.60	3,263.40

VI. Projected Payments to the Fund:

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges / Interest		0.02	0.02	0.02	0.02
Total		<u>0.02</u>	<u>0.02</u>	<u>0.02</u>	<u>0.02</u>

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 November 9, 2005. The relevant staff report was IMF Country Report No. 05/427.

IX. Technical Assistance

National Accounts Mission	STA	May , Nov. 2005
Payments Systems	MFD	December 2004

X. Resident Representative: None.

MEXICO: STATISTICAL ISSUES

Core data are adequate for surveillance. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). A data ROSC for Mexico was completed on May 23, 2003 (IMF Country Report No. 03/150). The overall quality of statistics is good. In a number of cases, the periodicity and timeliness of disseminated data exceeded SDDS requirements. However, there are various areas where further improvements could be made. The authorities are aware of this situation and are continuing work in this regard. Implementation of a constitutional amendment granting administrative and legal independence to the National Institute of Statistics, Geography and Informatics (INEGI) is pending further legislative action.

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 implemented, 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.

A follow-up **national accounts** (NA) mission conducted in May 2006 found that most of the recommendations made by the November 2005 mission on NA methodology have been implemented. This relates to the compilation of the input-output table and preliminary estimates for the new base year (2003). The National Institute of Statistics, Geography and Informatics (INEGI) compiled earlier this year an employment matrix to estimate the non-observed activities (informal, illegal, and underground), as recommended. The results of the employment matrix point to some 44 million employees, 12 million more than the figure included in the NA estimates for 2003. The authorities are planning to include non-observed activities in a satellite account instead of in the core NA accounts.

The mission also suggested additional data sources and methods to improve the coverage of non-observed activities; the appropriate dimensions of the input-output table; and the methodology to compile production accounts for several industries and sectors.

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. 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. However, the authorities have not reported government finance statistics (GFS) for publication in the *GFS Yearbook* since data for 2000 were reported in 2001.

Monetary data are reported on a regular monthly basis to STA. The authorities have also completed the migration to the new standardized report forms for the central bank, other depository corporations, and other financial corporations.

MEXICO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF JULY 12, 2006

	Date of latest observation	Date received	Frequency of data ⁶	Frequency of reporting ⁶	Frequency of publication ⁶	Memo Items:	
						Data Quality – Methodological soundness ⁷	Data Quality Accuracy and reliability ⁸
Exchange Rates	June 2006	July 2006	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	March. 2006	April. 2006	M	M	M		
Reserve/Base Money	May 2006	July 2006	M	D, M	W	LO, LO, O, O	LO, O, O, O, O
Broad Money	May 2006	July 2006	M	M	M		
Central Bank Balance Sheet	May 2006	July 2006	W	W	W		
Consolidated Balance Sheet of the Banking System	May 2006	July 2006					
Interest Rates ²	June 2006	July 2006	D	D	D		
Consumer Price Index	May 2006	Jun. 2006	Bi-W	Bi-W	Bi-W	O, O, LNO, O	LO, LNO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴						LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt ⁵							
External Current Account Balance	March 2006	June 2006	Q	Q	Q	LO, LO, LO, LO	LO, O, O, O, LO
Exports and Imports of Goods and Services	Feb. 2006	Mar. 2006	M	M	Bi-W		
GDP/GNP	Q4 2005	Mar. 2006	Q	Q	Q	O, O, LO, O	LO, LNO, O, LO, LO
Gross External Debt	Jan. 2006	Mar. 2006	M	M	M		

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

³Foreign, domestic bank, and domestic nonbank financing.

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

⁵Including currency and maturity composition.

⁶Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

⁷Reflects the assessment provided in the data ROSC published on May 23, 2003 and based on the findings of the mission that took place during February 20 to March 7, 2002. For the dataset corresponding to the variable in each row, the assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁸Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

MEXICO—RELATIONS WITH THE WORLD BANK

The World Bank Group maintains a substantial program of lending operations, analytical work and policy dialogue with Mexico. The Bank's Country Partnership Strategy (CPS) with Mexico, as discussed by its Board in April 2004, proposes a selective program of IBRD and IFC operations and a strategic program of analytical and learning services built upon four strategic pillars: (a) reduce poverty and inequality; (b) increase competitiveness; (c) strengthen institutions; and (d) promote environmental sustainability. The CPS envisages a greater focus on the role that the Bank can play as a knowledge institution, while continuing to deliver a program of lending operations consistent with Mexico's development needs.

As of March 31, 2006, the Bank's portfolio consists of 19 active projects with a total undisbursed balance of US\$2.4 billion. The IBRD exposure in Mexico was US\$8.99 billion, representing 8.84% of the IBRD's total portfolio.

During FY06, the Bank has extended several loans to deliver support to the four strategic pillars of the CPS, increasing the lending operations to US\$1.79 billion in commitments. In education, the Bank is supporting the second phase of a plan to improve the quality of basic education services through a US\$240 million loan, which aims to transform the ways schools are managed. In addition, the Bank provides US\$180 million for the first phase of a tertiary education student assistance program designed to increase the possibilities for young individuals from lower-income families to continue from secondary education to tertiary levels of education, increasing their earning power and social mobility. In support of the national country strategy outlined in the *Acuerdo Nacional para el Campo*, the access to land for young farmers project will provide rural development through the improvement of land markets and access to land as one of the key pillars for reducing rural poverty and inequality.

The Bank also continues to support the strengthening of Mexico's financial sector, through a US\$501.26 million that focuses on diversifying the financial sector and capital markets to enhance Mexican competitiveness. The Bank also backs a substantial agenda in the area of competitiveness through a first programmatic competitiveness development loan of nearly US\$300 million, aiming to promote a cross-governmental approach to improving productivity in order to accelerate growth and increase exports and employment levels. In addition, it would support policy and institutional reforms in the following areas: 1) innovation, technology development and training; 2) the investment climate; 3) logistics and trade facilitation; and 4) energy. Other loans that seek to enhance the provision of environmental services and secure their long-term sustainability; support the modernization of Mexico's water supply and sanitation sector; and support housing and urban development projects have also been approved by the board.

MEXICO: DEBT SUSTAINABILITY ANALYSIS, 2006–2011

1. Standardized bound tests

Standardized stress tests, based on the historical volatility of key macroeconomic variables for the past 10 years, indicate that the level of public debt would not increase substantially over the medium-term if macro conditions turned out significantly worse than projected.

Public finances. Assuming effective real interest rates close to 7 percent (instead of the 4½ percent staff baseline forecast) or real GDP growth of 1.1 percent (instead of 3½ percent), the public debt ratio would either increase slightly or decline more slowly than in the baseline projections. Similarly, public sector financing requirements would increase but in all cases would stay in the 12-14 percent of GDP range. This resilience largely reflects staff's baseline assumption that the primary augmented fiscal balance stays at a surplus of 1-1¼ percent over the medium-term, supported by adherence to the new fiscal responsibility law (which would require on average a zero overall balance on the traditional budget measure). In the context of such discipline on the primary balance, even the assumption of 10 percent of GDP in contingent debt is not enough to destabilize debt dynamics. (However, in the event of a negative shock to oil revenue, maintaining such a balance could require an important fiscal adjustment effort, as discussed further below.)

External finances. The same standardized tests confirm the strong external position of the overall Mexican economy. Because of Mexico's low level of external debt, the deterioration of the growth outlook, or of the current account primary balance, would have only limited effects on the future trajectory of external debt and external financing requirements. Of the shocks considered, the most significant would come from a large exchange rate depreciation vis-à-vis the US dollar, but even in this case the overall external debt would remain below 35 percent of GDP by 2011.²¹

2. Oil shock scenarios

A prominent risk scenario would be an inability to significantly strengthen the non-oil fiscal balance in the context of a sudden and sustained drop in oil prices; e.g., US\$ 40 per barrel for the world average petroleum price from mid-2006 onwards, implying about US\$32.5 per barrel for the Mexican oil mix. Assuming only limited spending cuts, the primary augmented balance is estimated to shift from a 1¼ percent of GDP surplus to a deficit of the same magnitude, resulting in an annual increase in public debt of more than 1 percentage point of GDP and high financing requirements throughout the medium-term.²² On the external side, the main effects would be a reduction in the pace of reserve accumulation and the ratcheting

²¹ This applies to the country's gross external debt. The impact on a net basis is less, due to the revaluation of the central bank's international reserves.

²² The actual fiscal impact would depend importantly on the administered pricing of the domestic energy provided by state enterprises, including gasoline and electricity: if lower international fuel prices were transmitted to domestic consumers, their effect on the fiscal accounts would be accordingly greater.

up of the level of external debt (by 3 percentage points of GDP in 5 years) and external financing requirements (by a bit more than 3 percentage points of GDP in 5 years).

Another risk is that oil reserves may not be fully replaced and oil production starts declining. With the goal to approximate what would happen if ongoing exploration efforts do not suffice to offset declining production at Mexico's biggest oil field, staff simulated a scenario in which total oil production declines by 17 percent between 2006 and 2011. In this scenario, oil exports are projected to decline by almost half by 2011 (faster than oil production because of growing domestic needs); the annual loss in export receipts, and the annual loss in fiscal revenues, would both reach close to 2 percent of GDP by 2011. Assuming no offsetting decline in import volumes or fiscal spending, this shock would end the decline of the external debt and public debt ratios and in fact put each on upward trajectories. The external debt ratio in 2011 is then projected five percentage points above its current level, whereas the public debt ratio in 2011 is projected close to today's level.

A combination of negative shocks to oil quantities and prices—again assuming passive fiscal policy—would of course accelerate the deterioration of the external and public debt outlook. Combining the same oil production decline as earlier with an oil export price of \$28 barrel (its 2001-2004 average), the public debt ratio would reach 52 percent of GDP and the external debt ratio 31¼ percent by 2011 (respectively 7 percentage points and 9 percentage points higher than 2005 levels).

3. Other stress scenarios

Considering two other potential sources of stress—a loss of market confidence, or a sharp slowdown of the US economy—staff estimates indicate that the main challenge would be to provide for a higher liquidity financing need.

One would risk scenario simply assumes an arbitrary shock to market confidence in Mexican assets, implying a financial liquidity test, with a rapid deterioration of the exchange rate, a hike in interest rates, and a return to short-term or interest rate indexed debt as the principal means to finance the fiscal deficit and public debt falling due. Using magnitudes observed in recent crisis episodes (outside Mexico), staff finds that the fiscal deficit would not show a marked deterioration. However, there would be a substantial rise in short-term financing requirements, which could be a cause for a further deterioration of confidence and further financial pressures on the public sector. The external position would deteriorate—mostly because of the lesser value of GDP—but again without creating sustainability or refinancing risks, given the strength of Mexico's initial net external asset position.

Finally, basic calculations of the possible effects of a so-called “hard-landing” scenario in the United States, which would entail sudden economic stagnation, higher domestic interest rates but also some peso appreciation against the dollar, and declining remittances and oil export prices, confirm the same sources of potential vulnerability, but with a smaller growth of the public financing requirement than the previous scenario. Still, in this case, the oil and interest rate shocks would cause a widening of the fiscal deficit (which in turn could undermine confidence in public debt, if it were not met with clear signs of a fiscal policy response).

Table 1. Mexico: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	
1 Baseline: Public sector debt 1/	47.9	49.7	50.0	46.0	44.0	42.8	41.6	40.7	39.7	38.6	37.6	0.8
o/w foreign-currency denominated	14.3	16.1	17.2	15.9	13.5	12.3	11.5	10.8	10.1	9.5	8.9	
2 Change in public sector debt	-1.4	1.8	0.3	-3.9	-2.0	-1.2	-1.2	-0.9	-1.1	-1.1	-1.0	
3 Identified debt-creating flows (4+7+12)	-0.5	1.2	-0.9	-5.0	-3.2	-1.8	-1.3	-0.9	-1.1	-1.1	-1.0	
4 Primary deficit	-1.0	-0.3	-0.3	-1.3	-1.8	-2.1	-2.1	-2.0	-1.9	-1.9	-1.9	
5 Revenue and grants	21.1	21.4	22.5	22.3	23.0	23.7	23.4	22.7	22.6	22.5	22.5	
6 Primary (noninterest) expenditure	20.1	21.1	22.2	21.0	21.2	21.6	21.4	20.7	20.7	20.6	20.6	
7 Automatic debt dynamics 2/	1.1	2.4	-0.2	-3.4	-1.1	0.4	0.9	1.1	0.9	0.9	0.9	
8 Contribution from interest rate/growth differential 3/	1.9	0.4	-1.4	-3.2	-0.3	0.4	0.9	1.1	0.9	0.9	0.9	
9 Of which contribution from real interest rate	1.9	0.8	-0.8	-1.4	0.9	2.0	2.3	2.5	2.2	2.2	2.2	
10 Of which contribution from real GDP growth	0.0	-0.3	-0.6	-1.9	-1.3	-1.6	-1.4	-1.4	-1.3	-1.3	-1.3	
11 Contribution from exchange rate depreciation 4/	-0.8	2.0	1.2	-0.1	-0.7	...	...	...	...	...	...
12 Other identified debt-creating flows	-0.7	-0.7	-0.7	-1.5	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
13 Privatization receipts (negative)	-0.7	-0.7	-0.7	-1.5	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-0.9	0.5	1.1	1.0	1.1	0.7	0.1	0.1	0.1	0.1	0.0	
Public sector debt-to-revenue ratio 1/	227.5	232.4	221.7	206.7	191.1	180.4	177.7	179.6	175.6	171.7	167.2	
Gross financing need 6/	16.7	15.9	15.6	13.1	11.3	11.7	11.0	11.0	10.4	9.8	9.3	
in billions of U.S. dollars	103.6	103.2	99.4	89.5	86.9	95.2	92.5	96.8	97.3	97.3	97.4	
Scenario with key variables at their historical averages 7/						42.8	40.9	39.1	37.3	35.5	33.8	-1.0
Scenario with no policy change (constant primary balance) in 2006-2011						42.8	41.1	40.0	38.7	37.4	36.1	0.8
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.0	0.8	1.4	4.2	3.0	4.0	3.5	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	9.9	8.7	6.9	4.7	7.7	9.1	9.1	8.7	8.8	8.9	9.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	1.8	-1.6	-2.7	2.3	5.2	5.9	6.5	5.9	6.0	6.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	4.9	-12.3	-7.1	0.8	4.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.8	7.0	8.5	7.4	5.4	3.9	3.2	2.2	2.9	3.0	2.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	2.1	4.3	9.7	2.1	-1.5	6.1	2.3	0.4	2.3	1.8	1.5	
Primary deficit	-0.9	-0.5	0.0	-0.1	-1.8	-2.1	-2.1	-2.0	-1.9	-1.9	-1.9	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\epsilon(1+r)] / (1+g+\pi+g\pi)$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ϵ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\epsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Table 2. Mexico: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2001-2011
(In percent of GDP, unless otherwise indicated)

	2001	2002	Actual			Projections					
			2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Baseline Projections											
Gross financing need 1/ in billions of U.S. dollars	16.7	15.9	15.6	13.1	11.3	11.7	11.0	11.0	10.4	9.8	9.3
	103.6	103.2	99.4	89.5	86.9	95.2	92.5	96.8	97.3	97.3	97.4
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						11.7	10.3	9.7	9.1	8.4	7.7
A2. No policy change (constant primary balance) in 2006-10						11.6	10.8	10.6	9.9	9.2	8.6
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						11.7	11.5	11.6	11.2	10.7	10.3
B2. Real GDP growth is at baseline minus one-half standard deviations						11.7	11.5	11.9	11.9	11.9	12.1
B3. Primary balance is at baseline minus one-half standard deviations						11.7	11.7	11.9	11.5	11.1	10.7
B4. Combination of B1-B3 using 1/4 standard deviation shocks						11.7	11.7	11.9	11.6	11.2	10.9
B5. One time 30 percent real depreciation in 2006 5/						11.7	12.0	12.9	12.3	11.8	11.2
B6. 10 percent of GDP increase in other debt-creating flows in 2006						11.7	12.5	14.1	13.6	13.0	12.4
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						95.2	86.4	85.9	85.8	83.9	81.3
A2. No policy change (constant primary balance) in 2006-10						94.1	90.3	93.6	92.7	91.7	90.7
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						95.2	96.9	102.7	104.7	106.4	108.3
B2. Real GDP growth is at baseline minus one-half standard deviations						95.2	95.1	102.8	107.7	113.2	119.8
B3. Primary balance is at baseline minus one-half standard deviations						95.2	98.5	104.8	107.6	110.0	112.7
B4. Combination of B1-B3 using 1/4 standard deviation shocks						95.2	97.8	104.0	106.6	108.8	111.4
B5. One time 30 percent real depreciation in 2006 5/						95.2	69.3	78.9	79.9	80.6	81.8
B6. 10 percent of GDP increase in other debt-creating flows in 2006						95.2	105.3	124.9	127.1	128.8	130.9

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

4/ The implied change in other key variables under this scenario is discussed in the text.

5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 3. Mexico: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -0.6
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	
1 Baseline: External debt	26.4	25.0	25.4	24.3	22.5	20.3	20.5	20.3	20.1	20.2	20.5	
2 Change in external debt	-2.3	-1.4	0.4	-1.1	-1.9	-2.1	0.1	-0.2	-0.2	0.1	0.2	
3 Identified external debt-creating flows (4+8+9)	-3.0	-1.1	0.5	-2.1	-3.6	-2.2	-1.5	-1.2	-0.9	-0.6	-0.4	
4 Current account deficit, excluding interest payments	0.8	0.2	-0.5	-0.7	-1.0	-1.8	-1.3	-1.0	-0.7	-0.4	-0.3	
5 Deficit in balance of goods and services	2.1	1.8	1.6	2.0	1.6	1.1	1.7	2.2	2.5	2.8	3.0	
6 Exports	18.3	17.6	18.5	19.6	20.1	22.4	23.6	23.9	24.3	24.7	25.3	
7 Imports	20.4	19.4	20.1	21.6	21.7	23.6	25.3	26.1	26.8	27.5	28.3	
8 Net non-debt creating capital inflows (negative)	-3.9	-2.1	-1.2	-1.4	-1.5	-1.5	-1.2	-1.3	-1.3	-1.3	-1.3	
9 Automatic debt dynamics 1/	0.1	0.8	2.2	0.0	-1.1	1.0	1.1	1.1	1.1	1.1	1.1	
10 Contribution from nominal interest rate	2.0	1.8	1.8	1.6	1.6	1.9	1.8	1.8	1.7	1.7	1.8	
11 Contribution from real GDP growth	0.0	-0.2	-0.4	-1.0	-0.6	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	
12 Contribution from price and exchange rate changes 2/	-1.9	-0.9	0.8	-0.7	-2.0	...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	0.7	-0.3	-0.1	1.0	1.8	0.1	1.6	1.0	0.7	0.8	0.7	
External debt-to-exports ratio (in percent)	144.1	141.6	137.4	123.9	111.7	90.7	86.7	84.7	82.9	82.0	80.9	
Gross external financing need (in billions of US dollars) 4/ in percent of GDP	71.8	62.4	54.6	49.4	44.5	48.4	50.8	58.0	64.9	72.9	82.1	
	11.5	9.6	8.6	7.2	5.8	6.0	6.1	6.6	6.9	7.3	7.8	
Scenario with key variables at their historical averages 5/						20.3	18.5	16.5	14.4	12.3	10.1	-2.6
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.0	0.8	1.4	4.2	3.0	4.0	3.5	3.5	3.5	3.5	3.5	
GDP deflator in US dollars (change in percent)	7.1	3.5	-2.9	2.7	9.2	1.7	-0.2	1.7	2.4	2.5	2.3	
Nominal external interest rate (in percent)	7.6	7.3	7.2	6.9	7.4	8.7	9.0	9.1	9.1	9.2	9.3	
Growth of exports (US dollar terms, in percent)	-3.6	0.5	3.3	13.5	15.2	18.0	8.7	6.7	7.5	8.0	8.4	
Growth of imports (US dollar terms, in percent)	-1.4	-0.7	2.0	14.8	13.1	14.7	11.0	8.6	8.6	8.9	8.9	
Current account balance, excluding interest payments	-0.8	-0.2	0.5	0.7	1.0	1.8	1.3	1.0	0.7	0.4	0.3	
Net non-debt creating capital inflows	3.9	2.1	1.2	1.4	1.5	1.5	1.2	1.3	1.3	1.3	1.3	

1/ Derived as $[r - g - \rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ 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, ϵ = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) 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.

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

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

Table 4. Mexico: External Sustainability Framework--Gross External Financing Need, 2001-2011

	Actual					Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/ in percent of GDP	71.8	62.4	54.6	49.4	44.5	48.4	50.8	58.0	64.9	72.9	82.1
	11.5	9.6	8.6	7.2	5.8	6.0	6.1	6.6	6.9	7.3	7.8
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						48.4	55.3	56.4	55.7	53.5	50.1
A2. Scenario with falling international oil prices						46.1	55.6	64.4	73.3	83.9	96.2
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						48.4	51.2	58.6	65.6	73.8	83.3
B2. Real GDP growth is at baseline minus one-half standard deviations						48.4	51.0	58.3	65.3	73.4	82.7
B3. Non-interest current account is at baseline minus one-half standard deviations						48.4	57.3	67.0	76.8	88.3	101.6
B4. Combination of B1-B3 using 1/4 standard deviation shocks						48.4	54.3	62.9	71.3	81.2	92.6
B5. One time 30 percent nominal depreciation in 2006						48.4	55.1	62.6	70.0	78.4	88.0
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						6.0	6.2	5.7	5.1	4.4	3.7
A2. Scenario with falling international oil prices						5.6	6.4	7.1	7.6	8.2	8.9
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						6.0	6.1	6.6	7.0	7.4	7.9
B2. Real GDP growth is at baseline minus one-half standard deviations						6.0	6.1	6.8	7.2	7.7	8.3
B3. Non-interest current account is at baseline minus one-half standard deviations						6.0	6.8	7.6	8.2	8.9	9.7
B4. Combination of B1-B4 using 1/4 standard deviation shocks						6.0	6.5	7.2	7.7	8.4	9.1
B5. One time 30 percent nominal depreciation in 2006						6.0	9.5	10.3	10.8	11.4	12.1

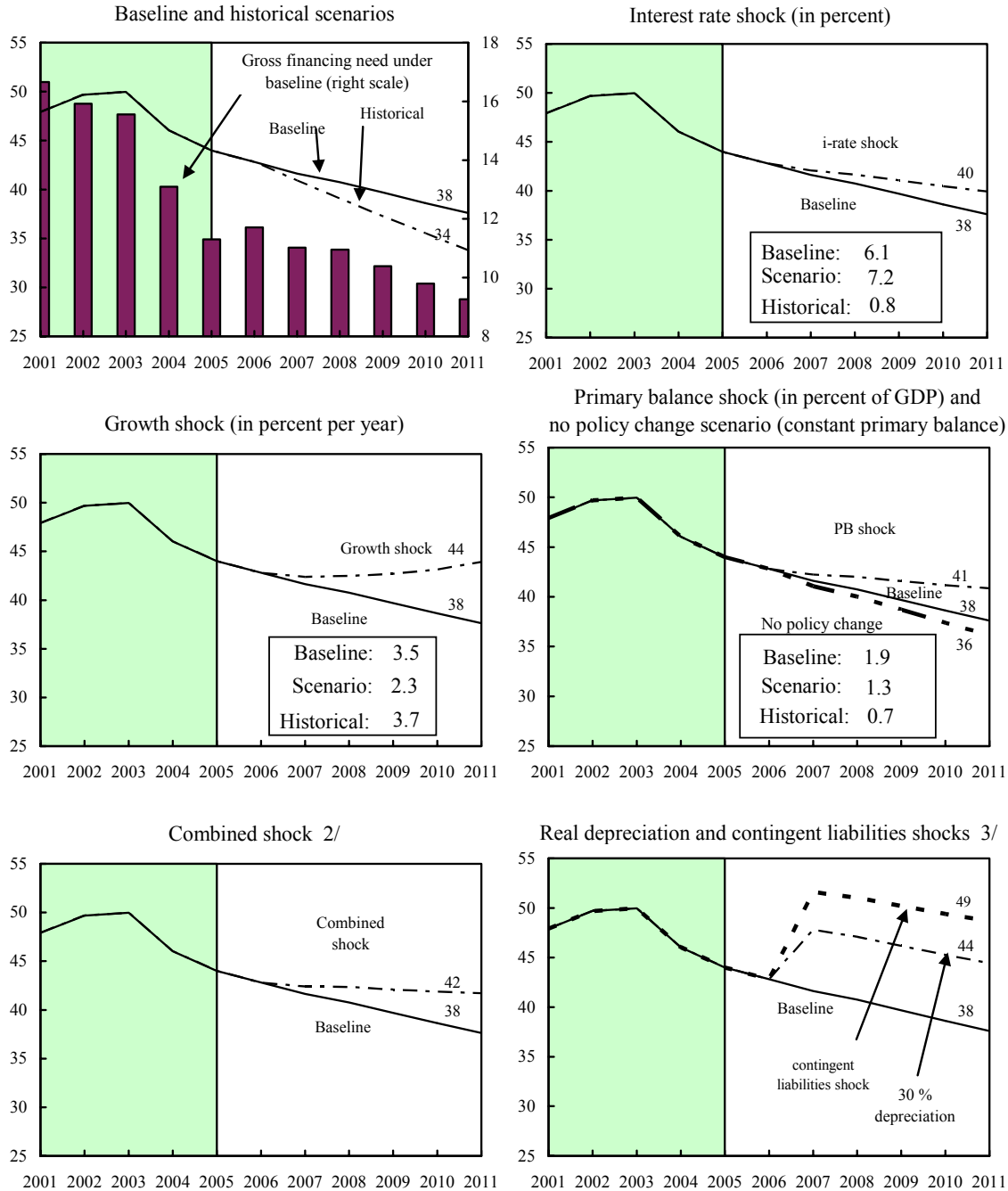
1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ 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.

4/ The implied change in other key variables under this scenario is discussed in the text.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.

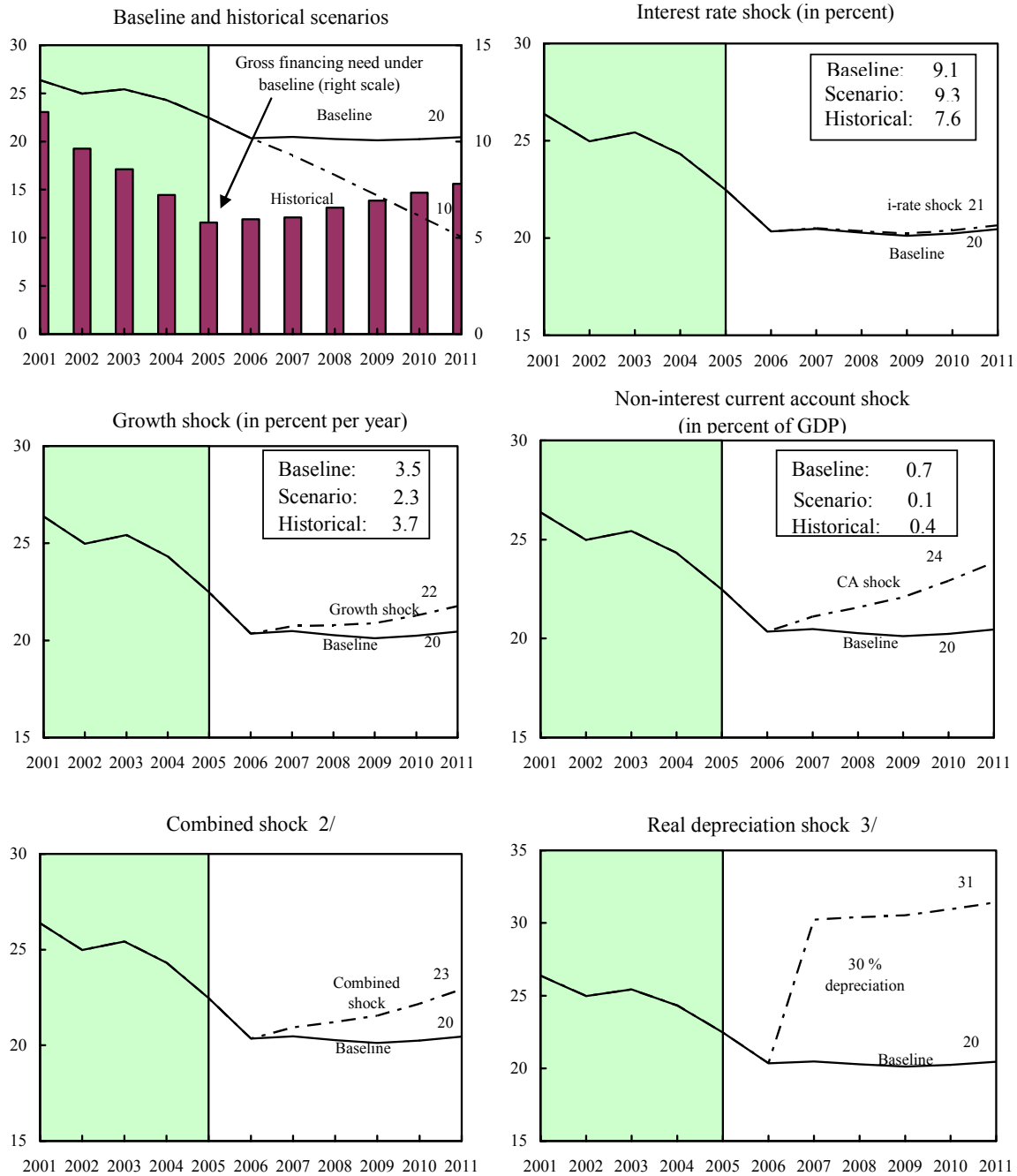
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2007.

**Statement by the IMF Staff Representative
September 6, 2006**

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

1. **Latest data on economic activity confirm a continued strong rebound from the soft spot in the first part of 2005.** GDP growth in the first half of 2006 reached 5.1 percent on a yearly basis, somewhat above expectations. Employment in the formal sector increased at an annual rate of more than 6½ percent in June. This momentum, which has been driven by strong manufacturing exports and domestic demand, appears to have continued into the third quarter, as manufacturing exports and consumption goods imports both grew by about 20 percent in dollar terms in July.
2. **The inflation outlook has remained broadly stable, with annual rates of both headline and core inflation at 3.3 percent as of mid-August.** In the July survey, expectations for headline inflation at end-2007 edged down, from 3.5 percent to 3.4 percent, while expectations for core inflation stayed close to 3.2 percent. In its monetary policy meeting in late August, the central bank again decided to hold the policy interest rate floor at 7 percent.
3. **In August, the authorities implemented the debt management operations they had announced in June, but expanded their scale.** The government purchased about US\$12.5 billion of international reserves from the central bank, by transferring new government paper to the central bank, which the bank in turn exchanged in the market for outstanding central bank bills. The government will soon use these funds to buy back about US\$9 billion of external debt owed to the IDB and the World Bank; US\$3.5 billion already was used to retire outstanding external sovereign bonds. As a result, net international reserves declined to about US\$65.5 billion by August 18, compared to about US\$77.5 billion in late July.
4. **In the financial markets, the sharp gains seen in early July have been maintained.** During August, the stock market, sovereign bonds, long-term domestic bonds, and the Mexico peso all strengthened.
5. **On August 28, Mexico's electoral court announced that a partial recount of the July 2 presidential vote had not altered the result that Mr. Calderon (PAN) had narrowly edged Mr. Lopez Obrador (PRD).**



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IMF Executive Board Concludes 2006 Article IV Consultation with Mexico

On September 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico¹.

Background²

The economic recovery that began in 2003 has continued. After slowing in the first half of 2005, growth has since rebounded, to exceed 5 percent in the first half of 2006, amid strong growth in both domestic and external demand. Manufacturing has accelerated this year, related to stronger U.S. industrial production and a rebound in auto exports. Employment in the formal sector increased at an annual rate of more than 6½ percent in June, its fastest pace for the past six years. Bank credit continues to grow strongly, from a low base.

The 12-month headline inflation rate converged to the official target of 3 percent for the first time toward the end of 2005. While headline inflation picked up again in early 2006 as a result of volatile food prices, core inflation remained steady and the headline rate came quickly back down. At mid-August 2006, the annual rates of both headline and core inflation were 3.3 percent. Inflation expectations as reported by central bank surveys have gradually come down, although they remain slightly above the inflation target.

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.

² Methodological differences mean that the figures cited in this PIN may differ in some cases from those published by the Mexican authorities.

Amid an improving inflation outlook, the Bank of Mexico (BoM) began in August 2005 to unwind its earlier monetary tightening, before stopping in April 2006. In the process, the overnight interbank rate declined from 9¾ percent to 7 percent. Since April, the BoM has held monetary conditions steady. The BoM has continued to abstain from discretionary intervention in the foreign exchange market, following the rule for its foreign exchange sales announced in early 2003. Still, net international reserves tended to accumulate over time, driven mainly by the foreign exchange surplus of PEMEX, the state-owned oil company.

With financial markets continuing to show confidence in Mexico, prices of Mexican assets have moved broadly in line with external markets. After posting strong gains in recent years, the stockmarket followed other emerging markets downward from May through mid-June 2006, and the peso and sovereign bond also lost some value during this period. Subsequently, announcement of the July 2 election results appeared to trigger a broad-based rally of Mexican assets.

The fiscal deficit, and public debt ratio, has continued to decline. The 2005 augmented deficit, at about 1½ percent of GDP, was half a percentage point of GDP lower than in 2004, helped by higher oil revenues, a better performance of non-oil revenue collections, and negative net lending by the development banks. Deficit reduction, combined with the effects of faster growth and a stronger peso, brought gross augmented debt down to 44 percent of GDP in 2005, from about 50 percent of GDP in 2003. For 2006, staff projects the augmented deficit to stay close to last year's level. While oil-related revenues will rise this year, spurred by higher prices, adherence to the budget's fiscal adjustors will require the spending of much of the unbudgeted oil revenue. Assuming a rebound of development banks' net lending, the non-oil augmented deficit is projected to rise, to near 8 percent of GDP.

The external position has continued to improve, helped by favorable external conditions. Although imports grew strongly, rising remittances and oil exports reduced the current account deficit to less than 1 percent of GDP in 2005, and the external current account was near balance in the first semester of 2006. Non-oil exports have performed well recently, and Mexico's share in its main market, the U.S., stabilized in 2005 after three years of decline. Foreign direct investment in 2005 was more than double the size of the current account deficit.

Public debt management has continued to focus on lengthening debt maturity and shifting away from external debt. The average maturity of the federal government domestic debt rose from 38 to almost 40 months in 2005. The public sector significantly reduced its rate of external borrowing in 2005. In August 2006, the authorities began to implement a sequence of debt management operations that will effectively reduce external debt, and net international reserves, by about US\$12.5 billion. This operation left international reserves at about US\$66 billion at end-August, approximately 1½ times Mexico's total short-term external debt (measured on a remaining maturity basis).

Executive Board Assessment

Directors commended the Mexican authorities for establishing the macroeconomic and financial stability needed to foster growth and resilience to shocks. Fiscal policy has earned broad credibility and put public debt on a gradual downward trend. A prudent monetary policy has achieved low inflation, and the floating exchange rate regime has allowed smooth external adjustment. Directors noted the important progress made in strengthening the financial sector and creating conditions for its further development. The challenge ahead will be for the new government to put in place structural reforms that will remove remaining obstacles to growth while fully entrenching macroeconomic stability.

Directors commended the authorities for reducing the fiscal deficit and the public debt ratio, and improving the public debt structure. At the same time, they noted that continued reliance on oil revenues renders the achievement of fiscal policy objectives potentially vulnerable to a decline in oil prices or production, and therefore suggested containing the non-oil fiscal deficit.

Directors welcomed the adoption of a fiscal responsibility law and medium-term budget framework. They noted that the chronic weakness of tax revenues will have to be addressed to achieve the new fiscal target over the medium term, and encouraged the authorities to give fresh consideration to tax reform proposals. Directors also noted the scope for better targeting expenditures to make room for more productive social and investment spending. Directors welcomed renewed investment in the oil sector, but pointed to the need to improve governance at the state-owned oil company and allow risk-sharing with the private sector in the financing of its investment program.

On debt management, Directors commended the authorities for the substantial progress in reducing the public sector's external exposure. Looking forward, they welcomed the authorities' intention to continue extending the maturity of the domestically-issued debt, thereby reducing public sector gross financing needs. They also suggested consolidating the management of all forms of public debt.

Directors commended the success of monetary policy in achieving convergence with the authorities' inflation target. Directors noted that inflation expectations are declining and are likely to also converge to the inflation target as the Bank of Mexico continues to focus policy on that target.

Directors considered that Mexico has been well served by its exchange rate policy, which is characterized by transparency, symmetric flexibility, and a rules-based approach to reserve accumulation. This has facilitated external adjustment and given the private sector appropriate incentives to manage currency exposures. Concerning Mexico's external competitiveness, Directors considered that it would depend mainly on the implementation of structural reforms. Directors welcomed the considerable progress made in strengthening the financial sector and capital markets and reducing potential vulnerabilities. They encouraged the authorities to continue with their agenda of financial sector reforms, and highlighted the need to secure the institutional and budgetary independence of supervisory bodies, improve consolidated

supervision of financial groups, create clearer rules for interagency contingency planning, and enhance the monitoring of fast-growing household credit.

Directors noted that the financial sector was becoming more dynamic, and that bank credit was expanding after a long period of stagnation. They encouraged continued efforts to deepen financial intermediation and promote competition.

Noting that achievement of macroeconomic and financial stability had brought a more favorable environment for growth, Directors encouraged the authorities to move ahead with ambitious structural reforms to create the conditions for fast economic growth in the medium term. They highlighted the major challenges faced by Mexico, including improving the education system and building human capital, enhancing infrastructure, and improving further judicial systems, security, and other aspects of the business and regulatory environment. They underscored that market flexibility and competitive forces should be given more room to spur productivity growth. Directors welcomed recent reforms such as the new competition law and the modified securities market law, and encouraged the authorities to remove barriers to labor market flexibility and to the opening of industries that are now occupied by state monopolies. They considered that implementation of such pro-growth reforms is the best way to assure Mexico's international competitiveness and ability to take full advantage of globalization.

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. The [Staff Report](#) for the 2006 Article IV Consultation with Mexico is also available.

Mexico: Selected Economic Indicators ^{1/}

	2001	2002	2003	2004	2005
(Annual percentage changes, unless otherwise indicated)					
National accounts and prices					
Real GDP	0.0	0.8	1.4	4.2	3.0
Real GDP per capita ^{2/}	-1.5	-0.7	0.0	2.7	1.5
Gross domestic investment (in percent of GDP)	20.9	20.6	20.6	22.1	21.8
Gross national savings (in percent of GDP)	18.0	18.6	19.2	21.1	21.2
Consumer price index (end period)	4.4	5.7	4.0	5.2	3.3
External sector					
Exports, f.o.b. ^{3/}	-3.1	0.6	3.9	13.8	15.2
Imports, f.o.b. ^{4/}	-1.7	-1.3	1.9	15.8	13.2
External current account balance (in percent of GDP)	-2.8	-2.1	-1.4	-1.0	-0.6
Change in net international reserves (end of period, billions of U.S. dollars)	7.3	7.1	9.5	4.1	7.2
Outstanding external debt (in percent of GDP)	26.4	25.0	25.4	24.3	22.5
Total debt service ratio ^{5/} (in percent of exports of goods, services, and transfers)	41.3	37.0	36.6	30.8	25.6
Nonfinancial public sector					
Augmented overall balance	-3.7	-3.4	-3.2	-2.0	-1.4
Traditional overall balance	-0.7	-1.2	-0.7	-0.3	-0.1
Gross augmented public sector debt	47.9	49.7	50.0	46.0	44.0
Net augmented public sector debt	41.7	43.6	44.0	40.9	38.9
Money and credit					
Monetary base	8.0	17.0	15.0	12.0	11.7
Broad money (M4a)	16.0	10.8	13.5	12.6	15.2
Treasury bill rate (28-day cetes, in percent, annual average)	11.2	7.1	6.2	6.8	9.2

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

1/ Methodological differences mean that the figures in this table may differ from those published by the Mexican authorities

2/ Fund staff estimates.

3/ Exports net of maquila sector imports.

4/ Excludes maquila sector imports.

5/ Public and private sectors.