October 2002
IMF Country Report No. 02/237

Mexico: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Mexico

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 13, 2002,** 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 13, 2002.** 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 23, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 23, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Mexico.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representative for the 2002 Consultation with Mexico

Approved by Miguel E. Bonangelino and G. Russell Kincaid

August 13, 2002

- Discussions for the 2002 Article IV consultation were conducted in Mexico City during June 3–13. The mission consisted of Mr. Kalter (Head), Ms. Krieger (WHD) and Messrs. Cordoba (WHD), Bauer (FAD), Hviding (PDR), and Ms. Papi (ICM). Messrs. Loser and Bonangelino participated in some of the discussions. Mr. Muñiz, the Fund's senior resident representative, assisted the mission. Mr. Beauregard, Advisor to the Executive Director representing Mexico and Mr. Gonzales, Assistant to the Executive Director, attended the meetings.

- In August 2000, Mexico prepaid its outstanding obligations to the Fund. Comprehensive economic data are available for Mexico on a timely basis, and are sufficient to conduct surveillance adequately. Mexico is in observance of the Fund's Special Dissemination Standard and has submitted metadata, which have been posted on the Fund's Data Standard's Bulletin Board. Mexico accepted the obligations of Article VIII in 1946. Mexico's exchange system is free of restrictions.

- At the conclusion of the 2001 Article IV consultation on August 3, 2001 Executive Directors commended the authorities for their prudent economic management, and noted Mexico's improved resilience to external shocks and the progress made in strengthening the banking system. Particularly noteworthy has been Mexico's solid reputation in recent years for addressing adverse circumstances. Several Directors expressed concerns about the level of external competitiveness and supported a rebalancing of the policy mix, which would be reinforced by efforts to reform the tax system.

- Summaries of Fund and World Bank relations with Mexico are provided in Attachments I and II, respectively. Attachment III presents Statistical Issues.

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Recent developments: The economic slowdown in the United States triggered a sharp weakening in Mexican economic activity in 2001 from the rapid pace in the preceding year. Signs of a rebound in economic activity emerged in the second quarter of 2002. The 12-month inflation rate slowed to 4.4 percent at end-2001 (well under the target of 6.5 percent), while the external current account deficit narrowed to 2.8 percent of GDP (from 3.1 percent of GDP in 2000). The authorities made considerable progress in rebalancing the policy mix in 2001, as fiscal policy was tightened on a cyclically adjusted basis and monetary policy was relaxed. Mexican financial markets have weakened since early-April 2002 in response to the rise in global risk aversion and developments in Brazil. Nevertheless, market sentiment toward Mexico remains favorable, supported by the country's investment-grade rating.

Policy discussions: Discussions focused on the outlook for the economy and the appropriate policy stance needed to achieve the authorities' objectives for 2002 and the medium term. Although the prospects for the Mexican economy are generally favorable, important challenges and risks remain. In this context, the mission:

- Supported the authorities' **current policy mix** but warned that the easing of the fiscal policy stance this year (cyclically adjusted) places emphasis on the need for significant fiscal adjustment in 2003 and the medium term.

- Supported the authorities' **medium-term program,** which is geared toward maintaining investor confidence and market access, while taking into account the still weak economic activity.

- Stressed that without **additional permanent sources of fiscal revenue,** the fiscal targets for 2003 and the medium term are at risk.

- Supported the **current monetary stance** under the prevailing circumstances, which is geared toward achieving a decline in inflation to 3 percent by 2003, but would caution against tightening monetary policy prematurely in light of the low core inflation rate, sizable output gap, and uncertainties concerning the timing and magnitude of the economic recovery.

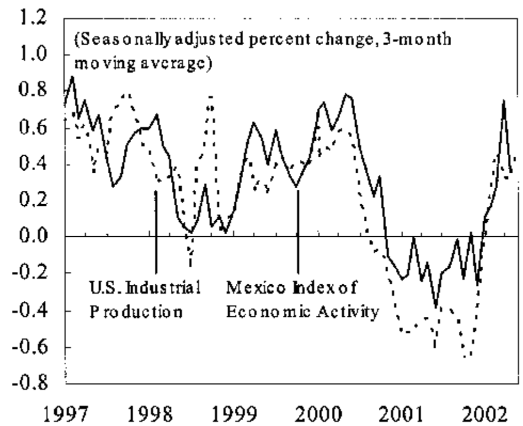
- Concluded that Mexico would **be able to weather a replay of past capital account crises arising from contagion,** and that there exists the institutional capacity to maintain prudent economic management and react in an appropriate manner to adverse shocks.

- Emphasized, nevertheless, that while significant progress has been made in debt management, slippages in implementing planned fiscal and structural policies could still leave the economy vulnerable to adverse shocks.

I. Economic Background

1. **Economic activity weakened in 2001 from the rapid pace in the preceding year** (Figure 1 and Table 1). Last year's recession, which was characterized by a 0.3 percent decline in real GDP, was the first in Mexico's recent history not associated with a domestic economic crisis. The slowdown in the U.S. economy triggered the recession and was reflected in a significant weakening in exports and employment.[1] In addition, there was a marked deceleration in domestic demand growth (7½ percentage points). Higher unit labor costs as well as a worsening in business confidence associated with the deterioration in global economic prospects, resulted in a contraction in private investment (following five consecutive years of rapid growth) and a decline of inventories. Notwithstanding continued real wage growth and incentives offered by retailers, private consumption growth fell sharply from the unsustainably rapid pace seen in 2000, as employment cutbacks adversely affected disposable income growth and consumer

Figure 1. Mexico and the United States Economic Activity



Mexico: Contribution to Real GDP Growth
(In percent)

	1998	1999	2000	2001	Staff Proj. 2002	Staff Proj. 2003
GDP	4.3	3.3	6.2	-0.3	1.5	4.1
Net exports	**-1.0**	**-0.5**	**-1.7**	**-0.7**	**-0.5**	**-0.5**
Exports of goods, nonfactor services	2.9	3.3	4.9	-1.8	1.9	3.5
Imports of goods, nonfactor services	3.9	3.8	6.7	-1.1	2.4	4.0
Domestic demand	**5.3**	**3.8**	**7.9**	**0.5**	**2.0**	**4.6**
Consumption	3.3	3.1	5.5	2.2	1.0	2.7
General government	0.2	0.4	0.2	-0.1	0.2	-0.7
Private sector	3.1	2.6	5.3	2.3	0.8	3.5
Gross domestic investment	2.0	0.7	2.5	-1.7	1.0	1.8
Public sector	-0.4	0.4	0.7	-0.3	0.1	0.4
Private sector	2.0	0.9	1.5	-0.9	0.3	1.4
Inventory change	0.3	-0.7	0.3	-0.5	0.6	0.0

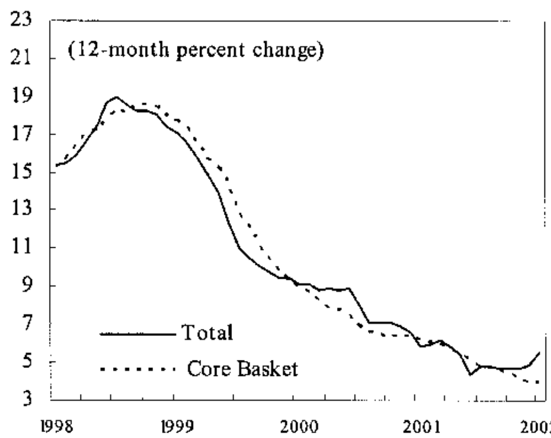
Sources: National Institute of Statistics and Geography; and Fund staff estimates.

[1] The links between the Mexican and U.S. economies have strengthened considerably since the entry-into-force of NAFTA in 1994. In 2001, the United States was the destination of almost 90 percent of Mexico's exports and the source of some three-fourths of Mexican imports.

confidence. The 12-month inflation rate slowed to 4.4 percent at end-2001, well under the target of 6.5 percent; core inflation declined from 7.5 percent in 2000 to 5.1 percent in 2001 (Figure 2).

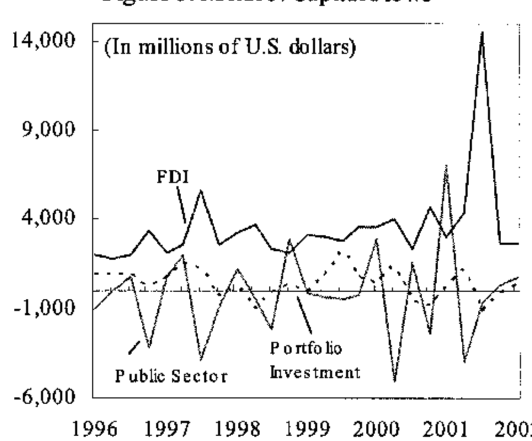
2. **Signs of a rebound in economic activity emerged in the second quarter of 2002 (Table 2).** The global index of economic activity (a proxy for monthly GDP) grew at an average pace of 0.8 percent in April–May (seasonally adjusted; monthly rate), led by higher non-oil exports, investment, and private consumption; employment rose by 1½ percent in the first half of 2002 (seasonally adjusted; annual rate), more than reversing the decline in the second half of 2001. Retail sales registered brisk gains, buoyed by higher employment and a continued recovery in bank credit to the consumer sector. The 12-month inflation rate rose to 4.9 percent in June 2002, owing largely to increased transport and electricity tariffs, and a weather-related hike in food prices; the core inflation rate continued to decline to 4.0 percent. The weakness in domestic demand last year contributed to a **narrowing of the external current account deficit** to 2.8 percent of GDP from 3.1 percent of GDP in 2000, as both lower oil- and non-oil exports were more than offset by a sharp contraction in intermediate and capital goods imports (Table 3). The external deficit continued to moderate in the first half of 2002 to an estimated 2.5 percent of GDP, with some acceleration in non-oil export growth.

Figure 2. Mexico: Inflation



3. **The external current account deficit in 2001 was more than financed by foreign direct investment (FDI)**, reflecting the US$12.5 billion purchase of Banamex by Citibank (more than half of this inflow was offset on a net basis by an associated increase of assets abroad) (Figure 3). Other capital inflows were also strong, helped by investors' perception of Mexico as a "safe haven" among emerging markets. **In the first half of 2002, FDI is estimated to have moderated to more normal levels,[2] while portfolio capital inflows were markedly lower** (compared with the same period in 2001). Reduced public sector inflows were due to smaller external borrowing, a fall in foreign investors' holdings of local government bonds, and the significant release of Brady collateral that took

Figure 3. Mexico: Capital Flows



[2] FDI has financed about two-thirds of the current account deficit in recent years.

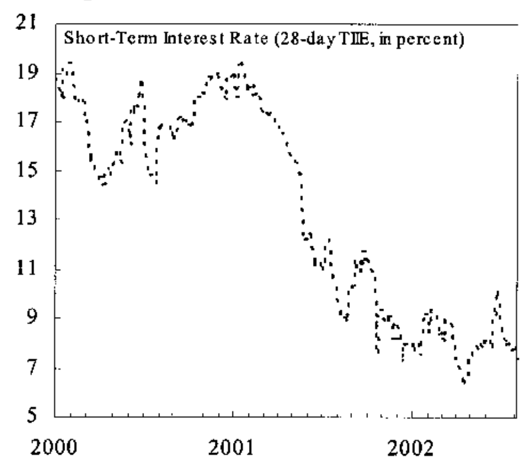
place in 2001. At the same time, corporate sector borrowing abroad fell, as firms switched from external to domestic borrowing due to the opportunity to issue with favorable terms in the local corporate bond market and the unsettled conditions in international capital markets.

4. **Net international reserves increased** by US$0.8 billion during the first half of 2002, following a gain of over US$9 billion in 2001.[3] Gross international reserves amounted to more than US$45½ billion at the end of June 2002, equivalent to 125 percent of short-term debt by residual maturity and 82 percent of annual gross external financing requirements (Table 4).

5. **The authorities made progress in rebalancing the policy mix in 2001** as fiscal policy was tightened on a cyclically adjusted basis (Tables 5 and 6).[4] In the face of lower-than-budgeted revenues, the authorities implemented expenditure cuts and improved the enforcement of existing tax regulations to broadly achieve their targeted 2001 fiscal deficit of 0.7 percent of GDP. Using a comprehensive definition of the fiscal balance—net public sector borrowing requirement (PSBR)—the 2001 deficit was about unchanged at 3.8 percent of GDP.

6. As inflationary pressures declined, **the Bank of Mexico (BOM) eased its monetary stance during 2001**, which reinforced a sharp decline in short-term domestic interest rates (to 6¼ percent in December 2001 from over 17 percent a year earlier) (Table 7).[5] A tightening of monetary policy in February 2002 was reversed in April as the BOM concerns that inflation might rise in response to an unanticipated increase in transportation and electricity tariffs diminished. Interest rates continued to fall through end-April 2002 (to a real rate in *ex ante* terms of under 1 percent), but that fall subsequently has been reversed (Figure 4).

Figure 4. Mexico: Interest Rates

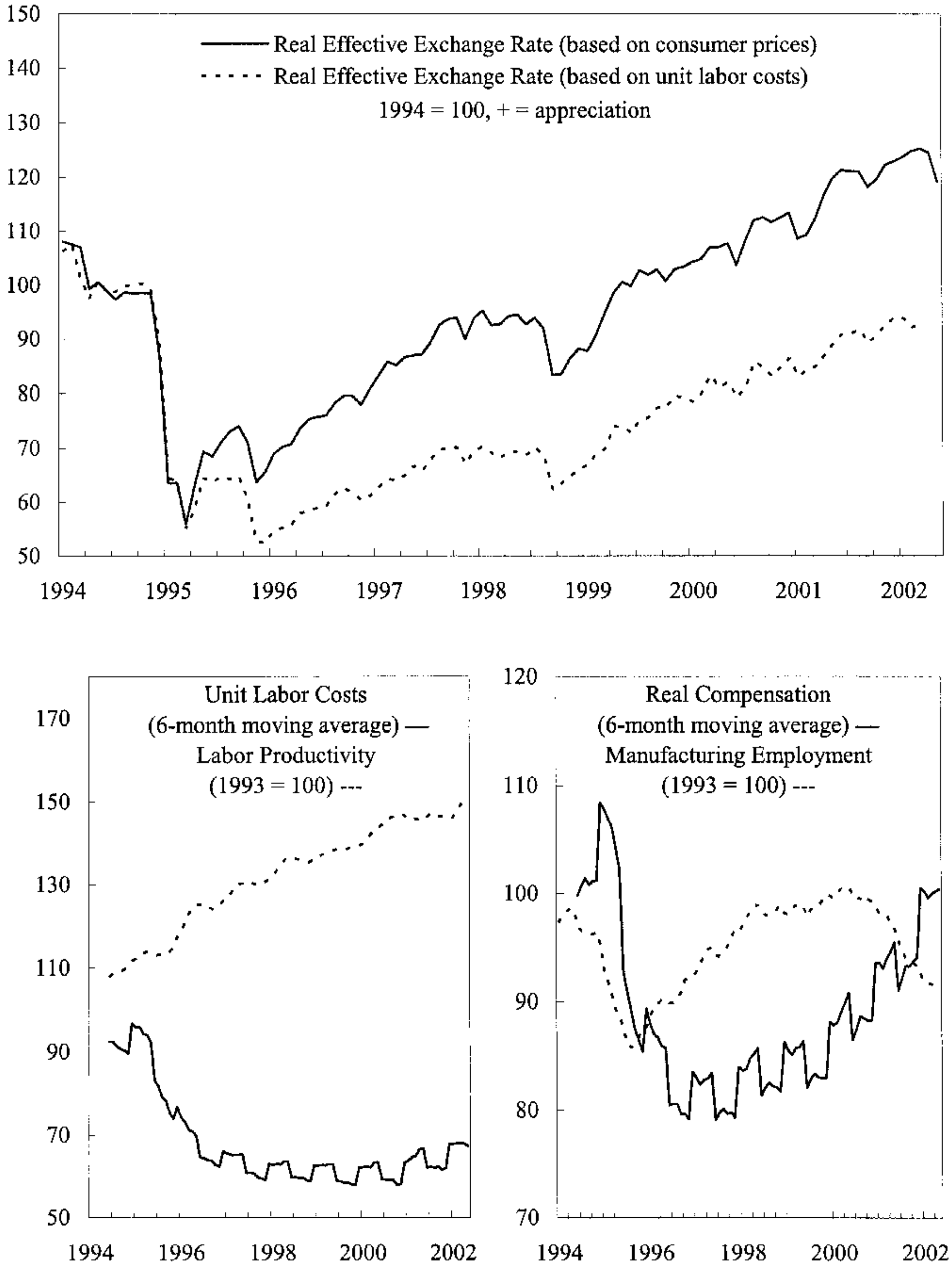


[3] The sizable reserve build-up in 2001 mainly reflected sales of foreign exchange to the central bank by PEMEX and the federal government (and not intervention).

[4] The non-oil primary impulse indicates a fiscal withdrawal of 0.9 percent of GDP. This outcome represented a considerably tighter fiscal stance than initially envisaged, given that the original budget was based on a real GDP growth of 4½ percent.

[5] The monetary policy easing was accomplished through reductions in the *corto* (settlement balance).

Figure 5. Mexico: Competitiveness and Wage Indicators

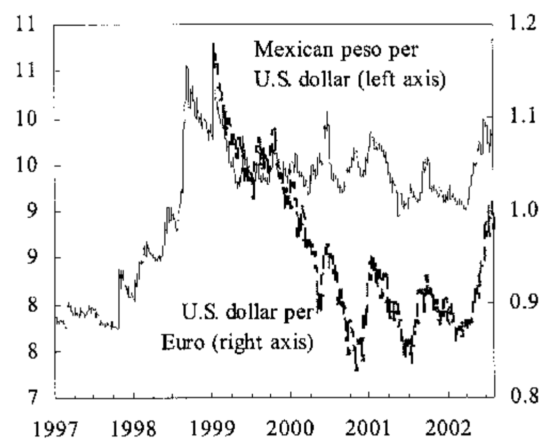


Sources: Bank of Mexico; IMF; and INEGI.

7. **Market sentiment toward Mexico remains favorable** supported by upgrades of foreign-currency denominated bonds to investment-grade status by both Standard and Poor's and Fitch IBCA in early 2002.[6] This upgrade has contributed to a widening of the investor base, which has helped to mitigate the contagion effects from turmoil in emerging markets (Box 1). Nevertheless, Mexican financial markets have weakened since early-April 2002, reflecting developments in Brazil and the deterioration in U.S. equity markets. International bond spreads (as represented by the EMBI+ for Mexico) increased to around 380 basis points at end-July (from a low of 230 basis points in mid-March), with some indications of an increased correlation of spreads with those of Brazil and the overall EMBI+ index.

8. **After trading in a narrow range, the peso depreciated from end-March 2002,**[7] the depreciation was partly influenced by some market participant's perception that the (above noted) relaxation of monetary policy was an expression of the BOM's concern about the sizeable real appreciation of the peso in recent years (Figure 5); it also reflected the weakness of the U.S. dollar against major currencies[8] and the general turbulence in emerging markets (Figure 6). The depreciation together with a recent moderation in unit labor costs have contributed to some gain in competitiveness.[9] In any case, the peso still has appreciated

Figure 6. Mexico: Exchange Rate



[6] In addition, Moody's upgraded Mexico's sovereign debt within the investment grade class in February 2002 and re-affirmed the stable outlook in June.

[7] The peso traded in a narrow range of Mex$9.0–Mex$9.2 per U.S. dollar from October 2001 through end-March 2002; subsequently, it depreciated to Mex$10 per U.S. dollar at end-June before strengthening to Mex$9.85 per U.S. dollar at end-July.

[8] This relationship reflects the market perception that the Mexican economy is closely tied to the U.S. economy, and the greater sensitivity of Mexico's foreign exchange market to shifts in capital inflows.

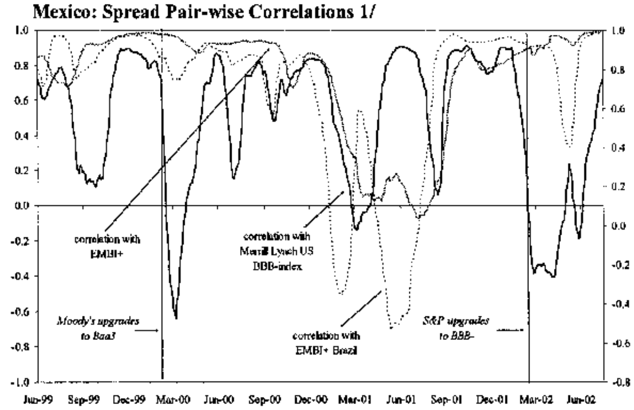
[9] Contractual annual wage increases decelerated from 10½ percent in early 2001 to 6½ percent during the first half of 2002 (in line with the decline in inflationary expectations and the sizable output gap), while labor productivity growth rebounded from a cyclically related decline in 2001 (labor productivity growth slowed to 0.9 percent in 2001 from an average annual pace of 4¾ percent during 1995–2000).

Box 1. Mexico's Sovereign Bonds and Integration with U. S. Fixed Income Markets

The upgrades to investment grade since 2000 by the major credit rating agencies have led to the inclusion of Mexico in the key U.S. fixed income benchmark (the Lehman Aggregate) and to a broadening of the investor base to include U.S.-based investment grade only (high grade) institutional investors.

Following the broadening of the investor base for Mexico's external debt after the upgrade by Moody's in March 2000, the correlation of Mexican sovereign spreads with that of other emerging markets (as represented by the overall EMBI+ index) fell considerably, especially during the period of emerging market turmoil during January through October 2001 (see upper chart). By contrast, the correlation of Mexican spreads with similarly-rated U.S. corporate bonds (as represented by the Merrill Lynch U.S. BBB index) rose. Moreover, Mexico decoupled much earlier from the adverse developments in Argentina (August 2000) than the rest of the major emerging market sovereigns. Since November 2001, however, the correlation between Mexican sovereign spreads and the EMBI+ has increased, as Mexican spreads moved together with the entire emerging markets asset class, whose prices first climbed (in the case of Mexico also helped by S&P's upgrade in February 2002) and then entered a period of weakness and high volatility (in addition, Mexico's weight in the EMBI+ increased substantially at end-2001). Further, the correlation with U.S. corporate bonds started declining, as U.S. markets started weakening before Mexican sovereign debt. Nevertheless, Mexico has recently shown incipient renewed signs of decoupling from Brazilian markets, as well as from the jitters in U.S. corporate, equity, and foreign exchange markets.

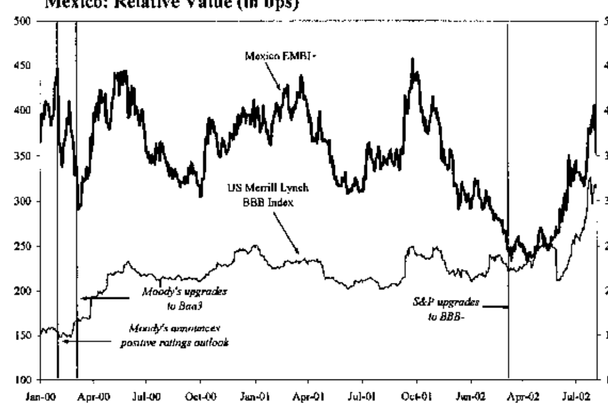
Mexico: Spread Pair-wise Correlations 1/



1/ Using a six-month window, note EMBI+ includes Mexico, hence pair-wise correlations are biased upwards.

Mexico: Relative Value (in bps)

0.2

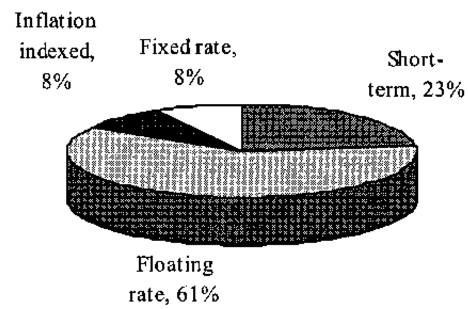


In the wake of the upgrades by the credit rating agencies in early 2002, Mexico's spreads reached a historical low of 233 basis points and for a brief period the differential with the Merrill Lynch U.S. BBB- index disappeared (see lower chart). However, in recent weeks, as both the emerging markets sell off, especially in the rest of Latin America, and renewed weakness of U.S. markets negatively affected Mexico, Mexico's spreads have risen above U.S. corporates', even though the differential remains small by historical standards.

significantly in real effective terms in recent years both in relation to relative consumer prices and (by less) in relation to unit labor costs.[10]

9. **The government has made substantial progress in improving public sector debt management,** resulting in a lower cost of funding, longer maturities and reduced external vulnerability. Public sector external debt declined from 42 percent of GDP in 1995 to 16 percent of GDP in 2001 and the sovereign has repurchased or swapped 80 percent of its outstanding stock of Brady bonds through liability management operations (Appendix Box 1). The authorities also have made considerable progress in the development of a domestic debt market and have shifted increasingly toward issuing fixed-rate instruments with longer maturities, enabling an important increase in the average maturity and duration of its domestic debt.[11] The stock of domestic government debt in the hands of non-residents also declined dramatically during this period, falling to less than US$2 billion from over US$30 billion in 1995.[12] Nonetheless, exposure to short-term and floating interest rates (over 80 percent of domestic debt) and the large gross public sector borrowing requirement (12 percent of GDP) still constitute significant vulnerabilities for the public sector (Figure 7).

Figure 7. Mexico: Public Sector Domestic Debt, 2001



II. Policy Discussions

10. **The authorities announced their medium-term economic program for 2002–06 ("PRONAFIDE"),** while the mission was conducting the Article IV consultation. This program, which establishes the government's strategy to increase potential output within a stable economic

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[10] As a result, some private market participants consider a sizable depreciation of the peso as an important risk. The July 2002 Foreign Exchange Consensus Forecast Reports the Mexican peso as overvalued by 20 percent compared with its recently-estimated PPP calculation, while the July J. P. Morgan Exchange Rate Model suggests that the recent depreciation has brought the peso closer to its long-run equilibrium (5 percent overvaluation).

[11] Market makers were introduced in the domestic debt market and long-term fixed-rate securities (3-, 5-, 7- and 10-year bonds) are being issued since 2000. While the average maturity of government securities increased from 450 days in January 1999 to almost 800 days in May 2002, most of this debt is still linked to short-term interest rates.

[12] The authorities and private market participants both believe that these figures underestimate somewhat the true exposure of nonresidents, as nonresidents' derivative operations with government securities as the underlying asset would not be recorded as a nonresident holding, although the ultimate risk is borne by a nonresident.

environment, includes two distinct growth scenarios that are differentiated by the degree of the achievement of the structural reforms envisaged in the National Development Plan (NDP). The authorities stressed their determination to carry out successfully the envisaged structural reform program to its fullest. The administration is facing difficulties in gaining approval of its legislative agenda in congress, which is dominated by opposition parties, and politicians already are focusing on the July 2003 congressional and gubernatorial elections.

11. **Central to the effort in both of the authorities' growth scenarios would be further fiscal consolidation**, with a reduction in the PSBR to around 1¾ percent of GDP by 2006 (from almost 4 percent in 2002) (Table 8). Critically, with no adjustment budgeted for 2002, a substantial part of the deficit reduction over the period would take place in 2003. It is expected that this planned front-loaded fiscal consolidation would enhance the program's credibility and affect favorably the public sector debt dynamics, helping to contain the growth of aggregate demand and ease pressure on real interest rates.

12. Within this context, discussions with the authorities centered on the outlook for the economy and the appropriate policy stance needed to achieve the authorities' objectives for 2002 and the medium term. **Although the prospects for the Mexican economy are generally favorable, important challenges and risks remain.** In this context, the mission:

- Supported the authorities' **current policy mix** but warned that the easing of the fiscal policy stance in 2002 (cyclically adjusted) placed an additional burden on monetary policy and increased the need for significant fiscal adjustment in 2003.

- Supported the authorities' **medium-term program,** which is geared toward maintaining investor confidence and market access, while taking into account the still weak economic activity.

- Stressed that without **additional permanent sources of fiscal revenue**, the fiscal targets for 2003 and the medium term are at risk.

- Supported the **monetary policy stance which is geared toward achieving a decline in inflation to 3 percent by 2003** and actions that the BOM is considering to take to further strengthen the inflation targeting framework.

- Concluded that Mexico would be **able to weather a replay of past capital account crises arising from contagion**, and that there exists the institutional capacity to maintain prudent economic management and react in an appropriate manner to adverse shocks.

- Emphasized, nevertheless, that while significant progress has been made in debt management, slippages in implementing planned fiscal and structural policies could still leave the economy vulnerable to adverse shocks.

A. Economic Outlook and Structural Reforms

13. The sound implementation of macroeconomic and structural policies and the increased integration with the U.S. economy following the 1994–95 economic crisis have

provided a favorable context for Mexico's economic development. Potential economic growth in Mexico is estimated to have been 3.9 percent a year during 1997–2001 (compared with 2 percent during 1982–94), while both real manufacturing wages and formal sector employment have expanded.[13] There has also been impressive progress in reducing poverty levels, which declined from 62 percent in 1996 to 46 percent in 2000 and more than reversed the sharp increase that occurred in the aftermath of the 1994–95 crisis.[14] The improvement in potential output growth since the mid-1990s can be attributed to a recovery in total factor productivity, associated with inter alia, greater macroeconomic stability, technology transfer associated with a sharp increase in foreign direct investment, and the significant structural improvements that have taken place.[15]

14. **Notwithstanding these gains, poverty remains an endemic problem in Mexico; the gains in formal sector employment have reportedly not been reflected in a notable reduction in the size of the informal sector, and there exist sizable regional disparities in growth.** Against this background, the authorities confirmed the priority being attached to increasing per capita economic growth. They recognized that this will require further fiscal consolidation as well as structural reforms aimed at strengthening external competitiveness, increasing productivity, and further strengthening the financial sector.

15. **The authorities' high-growth scenario (with an average potential growth rate of 5¼ percent) assumes full implementation of the structural reform program,** while the second scenario (with an average growth rate of 3½ percent) considers only a limited implementation of the reform package. The government's reform agenda includes: (i) energy sector reform designed to increase capacity to match the growing demand in recent years; (ii) reduction of labor market rigidities; (iii) liberalization of the telecommunications sector; (iv) reform of the judicial system, including improving governance; and (v) tax reform to increase non-oil revenues (Box 2).[16]

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[13] See Chapter I in CR/01/191 for an analysis of potential real GDP growth in Mexico.

[14] According to World Bank estimates as reported in the 2002 Country Assistance Strategy (CAS) Paper for Mexico. The CAS emphasizes that in Mexico, real growth is the most important determinant of poverty reduction.

[15] Total factor productivity (TFP) is estimated to have grown at an average annual rate of 3 percent during 1996–2000 after falling by 0.8–2.5 percent a year during 1981–95 (see World Bank Country Economic Memorandum, *Mexico: Enhancing Factor Productivity Growth,* 1998 and "*The Productivity Recovery in Mexico,*" mimeo, IMF, 2000). The wide range of TFP growth rates during 1981–95 reflects differences in assumptions on the rate of capital depreciation and the definition of labor. The decline in TFP is estimated to have more than accounted for the decline in output per worker that occurred during the earlier period.

[16] The authorities also expect that the impulse effects of the structural reforms that have already been introduced, in particular those in the banking sector and the further phasing-in of the NAFTA agreement, will provide an additional boost to output.

Box 2. Medium-Term Economic Strategy of the Fox Administration

The government's National Development Plan (NDP) for 2002–06 includes the implementation of structural reforms in the following areas:

1. **Labor market reform** aimed at increasing productivity and employment in the formal sector by reducing rigidities. The government is currently working on fostering consensus between business and labor groups for a reform to be submitted to congress by end-2002 that would contain the following broad elements:
    - a reduction in the sizable non-wage costs that currently characterizes Mexican labor markets by introducing new forms of hiring (such as apprenticeship contracts, seasonal hiring, and hiring for probationary periods);
    - the possibility of adapting working hours to fit individual circumstances (while maintaining the 48-hour weekly limit), which should help hiring in small and medium-sized firms;
    - greater opportunities for increased training by reducing certain bureaucratic requirements and expanding the scope of training programs;
    - he rationalization of certain legal requirements, for example, linking safety requirements to the risks of the job rather than to the number of employees; and
    - improved union governance (including accountability to members) and litigation by shortening the litigation process, and abolishing the right of unions to call a strike before a firm starts business.

2. **Energy sector reform** designed to increase capacity to match the growing demand in recent years, through fostering greater private sector participation and improving the regulatory framework in line with international standards.
    - In June 2002, PEMEX introduced the use of Multiple Service Contracts (MSC), which will allow private contractors broader operation responsibilities in gas fields within the existing constitutional limitations.[1]
    - The government is promoting a reform that would allow broader private sector participation in the electricity sector, especially in the generation and commercialization of electricity to large industrial consumers.

3. **Telecommunications reform** aimed at increasing coverage, quality and costs of services; guaranteeing a competitive environment; and promoting new technologies and services. The government and a congressional commission is currently working on fostering consensus for a bill that would consider strengthening government regulatory authority; spectrum planning and administration; concessions and permits; satellite services; dominant carrier regulation; consumer protection and fines.

4. **Fighting corruption and improving the quality of public administration** through:
    - an improved legal and regulatory framework aimed at reducing corruption, increasing the accountability of civil servants, and providing a better framework for sanctioning corruption. A number of initiatives have already been sent to congress and a law enabling public access to government information was approved by congress in April 2002;
    - a strengthening of internal controls, auditing procedures and monitoring of public expenditure, and coordination mechanisms with local governments;
    - improved supervision and control of suppliers and contractors; and
    - financial disclosure by civil servants and sanctions for non-compliance.

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[1] The constitution reserves the right of oil and gas production to the state. Through the MSC, a single contractor (or consortia) will be able to operate the fields as well as provide specialized services to PEMEX. It is expected that this will improve efficiency in the administration of private contractors which are currently coordinated by PEMEX.

16. **In the staff's view, it would be possible to achieve potential output growth of around 4 percent during 2003–06**, based on the continued implementation of strong macroeconomic policies, ongoing reforms in the financial sector, and a partial implementation of the structural reforms contained in the NDP. Real GDP is expected to grow by around 1½ percent in 2002, led by the pickup in U.S. economic activity and an end to the negative drag of inventory decline (Figure 8). Also, the inflation target of 4½ percent for 2002 is within reach. This is broadly in line with official projections and those in surveys of private forecasts. Subsequently, real GDP growth is projected to average 4.5 percent a year during 2003–06, supported by higher rates of capital accumulation and productivity gain, as the current output gap (estimated at 3 percent of GDP in 2002) is closed (Table 9 and Figure 9). Inflation is projected to decline to 3 percent in 2003, and remain in line with industrial country inflation thereafter. Private savings are projected to decline somewhat in 2003 (reflecting the large increase in public savings), and thereafter to remain broadly stable (Figure 10).

Figure 8. Real GDP Growth—Mexico and the United States

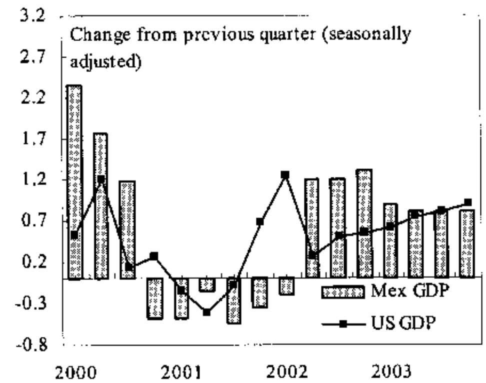
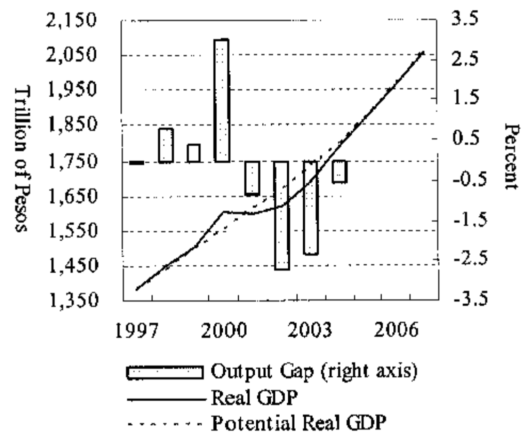


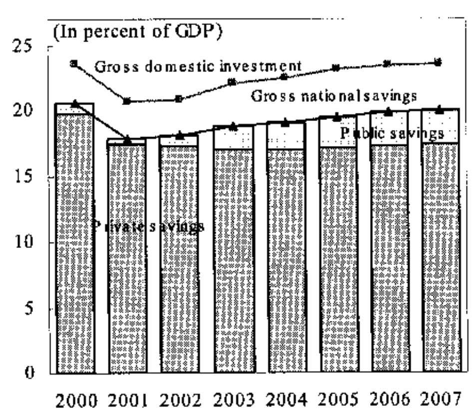
Figure 9. Mexico: Potential and Real GDP



B. Fiscal Policy

17. **The 2002 budget,** which includes a tax package approved by congress at the end of 2001, established a deficit ceiling of around 0.7 percent of GDP (equivalent to a PSBR of 3.9 percent of GDP). While the tax package fell short of the authorities' original proposal, the authorities still expected it to yield 1 percentage point of GDP in additional revenues (Appendix Box 2). In combination with further improvements in tax administration, tax revenues were budgeted to increase from 11.3 percent of GDP in 2001 to a historical high of 13 percent of GDP (though still low relative to other emerging economies). The increased revenue was fully allocated to finance additional social expenditure and investment.

Figure 10. Mexico: Investment and Savings



18. **During the first half of 2002, public sector revenue was below budget (by 0.3 percent of GDP) due to lower tax collections (revenue from oil was broadly as budgeted).**[17] The government announced spending cuts covering about one-half of the revenue shortfall.[18] Overall, the staff projects that the 2002 fiscal target is well within reach taking into account the higher-than-budgeted oil revenues projected in the remainder of the year as well as steps taken by the authorities to curtail expenditures.[19] The authorities broadly agreed with the staff's estimates and emphasized that they stand ready to implement additional expenditure cuts, as needed, to meet the budget deficit target.

19. **The mission strongly supported the authorities' aim to reduce significantly the PSBR and public debt over the medium term.** Implementing the fiscal adjustment path laid out in PRONAFIDE would reduce total gross public sector debt by about 6 percentage points of GDP over the next five years to 43 percent of GDP. On a net basis (i.e., after subtracting liquid assets) public sector debt would fall below 40 percent of GDP over the period. The authorities agreed that adhering to the 2003 fiscal target is critical to ensure that the medium-term objectives are met and that investor confidence is maintained, while allowing for a recovery in credit to the private sector and a reduction of the pressures on the external current account deficit.

20. **The mission emphasized the risks associated with a smaller deficit reduction effort (than called for under PRONAFIDE) as it would not only moderate the decline in public sector debt (relative to GDP), but also increase the vulnerability to adverse shocks.** To illustrate this point, the mission discussed the possible impact that a smaller-than-expected fiscal adjustment could have on market confidence, with a resulting increase in real interest rates and fall in the economic growth rate.[20] The staff pointed out that a relatively moderate deterioration

[17] Income tax and VAT collections suffered from the lagged impact of weak economic activity as well as the initial impact of the switch from an accrual to cash basis for the VAT. In addition, revenues from the excise taxes introduced under the tax package were lower-than-projected.

[18] The 2002 budget includes adjustors which establish that if revenues are below budget then: (i) if due to lower oil revenue, the shortfall can be compensated with resources from the oil stabilization fund (OSF); and (ii) if the oil revenue shortfall exceeds the possible use of OSF resources, or if the shortfall originates in other revenue, expenditure should be cut by an amount equivalent to the revenue shortfall. If revenues exceed budget estimates, two-thirds of revenues should be saved and one-third could be spent on infrastructure investment, and for oil production.

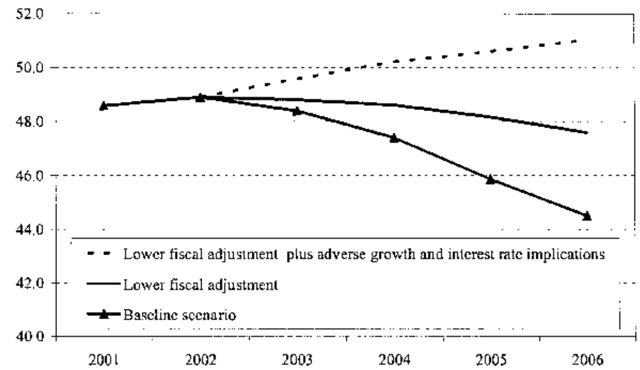
[19] The latest WEO projection for the average world oil price in 2002 is US$19.2 per barrel for the Mexican mix compared with US$15.5 per barrel in the budget. In addition to the announced spending cuts, the authorities issued a decree that instructs line ministries to reduce most current expenditures by 5 percent, which could provide savings of up to 0.2 percent of GDP. In June, the authorities privatized the state insurance company Aseguradora Hidalgo and its' remaining stake in Bancomer, which yielded proceeds amounting to 0.3 percent of GDP.

[20] The staff illustration assumes that the PSBR declines (before including adverse interest rate and growth movements) to only 3 percent of GDP by 2006. After taking into account a 100 basis

(continued)

in the underlying assumptions would be sufficient to reverse the favorable debt dynamics, leading to a rise in the public sector debt (Figure 11).

Figure 11. Mexico: Sensitivity of Gross Public Debt to Fiscal Adjustment
(In percent of GDP)



21. **The staff pointed to the importance of additional revenue measures to reduce dependence on oil revenue and to ensure the achievement of the medium-term fiscal targets.** The authorities concurred and indicated that they would continue to press for further tax reform, including the harmonization of VAT rates, although congressional support for such measures would be difficult to obtain for 2003.[21] They would also continue their efforts to increase revenue from an improvement in tax administration, although this could not substitute for a more fundamental strengthening of non-oil revenue.[22]

22. **The authorities emphasized their continued commitment to limit expenditure growth as needed to achieve the fiscal targets.** The staff estimated that in the absence of additional revenue measures, primary expenditure would need to be constrained to a real annual rate of increase of about 1 percent during 2003–06. This issue would be particularly relevant in 2003, when real primary expenditure would need to decline by 3 percent to meet the target. While the staff expressed concern that a number of rigidities were reducing the scope for expenditure restraint, the authorities pointed to initiatives that were underway to increase the

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points increase in the average real interest rate and a 1 percentage point drop in average annual real GDP growth during 2003–06, the stock of public debt (in percent of GDP) rises during the period.

[21] Given the uncertain political support for additional revenue measures, the staff's baseline scenario does not include revenue from further tax reform.

[22] Legislation to reform the fiscal code, which would help improve tax administration and combat tax evasion is presently before congress. In addition, the authorities have embarked on a project to modernize the tax administration service (SAT) with the assistance from the World Bank. The project seeks to expand the taxpayer base, increase the control of fiscal obligations, and improve taxpayer access to better tax administration services. A recent Fund TA mission identified a number of areas of tax administration where further progress could be achieved, including through the introduction of a unique taxpayer identification number, as well as streamlined payment and reporting procedures.

control and efficiency of expenditure.[23, 24] The mission welcomed these efforts but cautioned that the timing and size of the resulting savings were difficult to predict.

23. **The recent fiscal ROSC (CR/02/200) noted the considerable progress made in improving transparency and in complying with international standards**. Major initiatives that have been introduced include reforms to the budget process, timely disclosure of fiscal information, strengthening of internal control and audit; and the reduction of discretionality in intergovernmental relations. However, a number of areas were identified where further action would help to achieve full compliance with international standards. These include: further improvements in the presentation of fiscal information; a redefinition of the institutional coverage of government; presentation of the budget in a medium-term context; and publication of the estimated costs of quasi-fiscal operation, contingent liabilities, and tax expenditures (reduced revenue from tax concessions).

C. Monetary Policy

24. During the discussions, the authorities indicated that there appears to be **little room for easing monetary policy further under current conditions,** in light of the recent uptick in inflation expectations and the international market turbulence. Staff agreed that the current monetary stance appears appropriate under the prevailing circumstances. Subsequently, the BOM stated publicly that current market conditions suggest an increased likelihood for the remainder of the year of adverse external and domestic events (including the possibility of: lower U.S. growth; a further contraction of capital flows to emerging markets; a pass-through from the recent depreciation of the peso to prices; and worsening expectations regarding progress on the structural reform agenda). Nevertheless, the staff would caution the authorities against tightening monetary policy prematurely in light of the low core inflation rate, sizable output gap, and uncertainties concerning the timing and magnitude of the economic recovery.

25. **The authorities noted their intention to strengthen further the inflation targeting framework adopted in 2001 (Appendix Box 4)**. They indicated that they are considering the

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[23] Rigidities on the expenditure side include a rising wage bill, which is set to reach 7½ percent of GDP in 2002, and medium-term expenditure pressures in the area of social security (Appendix Box 3).

[24] The constitutional reform of the budgetary process that is being considered by congress includes provisions requiring congress to provide a nondebt creating financing source to cover the cost of new legal initiatives, while the recently approved information law (*Ley de información*) would improve the governance of public expenditure. In the area of public expenditure management, the authorities are aiming to change the methodology of budget formulation for the 2003 budget, to allow for improved prioritization of expenditure. A recent Fund TA mission found little progress in the implementation of the treasury information system (SIAFF) and recommended a number of reforms to improve budget preparation and execution, including the establishment of a Treasury Single Account for more effective cash management and expenditure policy implementation.

adoption of a long-term inflation objective, in order to enhance the transparency of monetary policy and to improve communications with the markets. Also, while weight is being given to core inflation in setting monetary policy, formal inflation targeting would continue to be based on the "headline" inflation rate. In the latest inflation report, the BOM announced an inflation objective of 3 percent for 2004 and beyond with a band of plus/minus 1 percent.

26. **The authorities stated that the BOM will continue to use the *corto* (settlement balances) as its principal policy instrument** as it has proven to be a useful tool that is well known and accepted by the market, allowing for large and rapid adjustments in interest rates. Staff noted that the direct targeting of interest rates would enhance transparency in the conduct of monetary policy and, importantly, help reduce volatility of interest rates. This could lower the vulnerability of the public sector from the still high proportion of short-term domestic debt linked to interest rates. The authorities indicated that they would consider a move toward the direct targeting of short-term (overnight) interest rates when additional evidence accumulates of the BOM's success in reducing and maintaining inflation at industrial country levels.

27. **The authorities mentioned that the recent currency depreciation would correct the negative net worth of the BOM.** The BOM incurred losses in 2001 (0.3 percent of GDP) resulting from the cost of sterilization and the effect of the currency appreciation on the valuation of international reserves that fully absorbed the BOM's capital and remaining reserves. With the currency depreciation observed so far this year, the BOM has replenished its reserve. The authorities indicated that, while it would be desirable to modify the BOM's law to introduce automatic transfers from the federal government to replenish the BOM's capital as recommended in the 2001 FSSA, they did not consider this a legislative priority.[25] Rather, by law the authorities will replenish the BOM's capital and reserves before transfers of BOM profits to the federal government resume in the future.

D. Financial System

28. **The health of the financial sector has continued to improve**. Financial indicators generally strengthened in 2001 and the first quarter of 2002, and nearly all banks already meet the requirements of regulatory capital that will be in effect at the beginning of 2003. Notwithstanding the improved financial conditions, real bank credit to the private sector declined during the first five months of 2002, continuing the overall trend since the 1994–95 economic crisis (Figure 12). By contrast, nonbank domestic credit to the private sector, especially by institutional investors, has been growing steadily in recent years and has become an important source of financing (Box 3).

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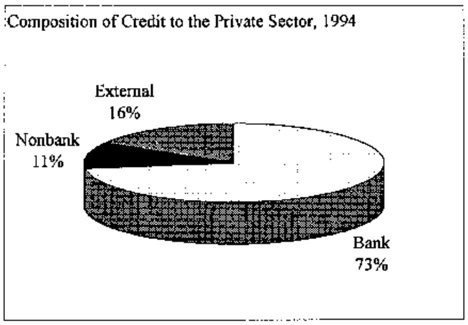
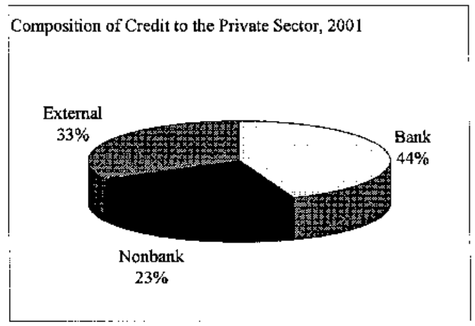
[25] The FSSA recommended the introduction of a symmetric treatment of profits and losses of the BOM vis-à-vis the government or the establishment of a general reserve fund which could serve to smoothen inter-temporal operating surpluses and shortfalls. The BOM operates a general reserve fund which is being replenished in 2002, but the rules for its operation are not explicit nor publicly disclosed.

Box 3. Financing of the Private Sector in Mexico

Credit to the non-bank private sector declined from 62 percent of GDP in 1994 to 31 percent at end 2001. Until the 1994–95 economic crisis, banks had been the main source of credit to the private sector in Mexico. Since then, bank credit has declined considerably in real terms, while non-bank and foreign financing have kept apace with real GDP growth and have increased significantly their share in private credit (see chart). Domestic institutional investors (mainly pension and mutual funds) have grown strongly since 1997, and are becoming important providers of credit to the private sector, and at the same time are fostering the development of domestic capital markets.





According to a quarterly BOM survey, the most important source of corporate financing is inter-firm credit (suppliers' loans).

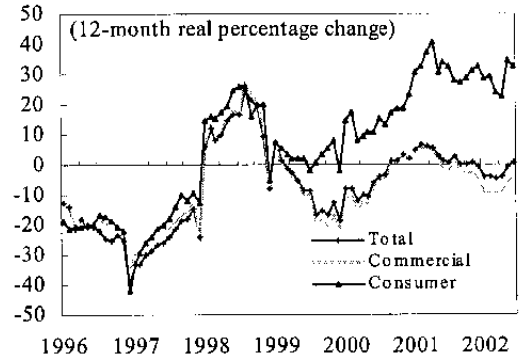
- For over 50 percent of the firms, suppliers credit is the main source of financing and this share has been steadily increasing over time.
- Credit from commercial domestic banks is only mentioned by 20 percent of the firms as an important source of financing. The main reasons provided in the survey for not using bank financing are high interest rates, reluctance of banks to provide credit, and an uncertain economic environment.
- The third source of financing mentioned in the survey is credit from enterprises of the same group at about 12 percent, followed by foreign credits, and other sources, which include mainly bond financing.

There are strong indications that domestic institutional investors are rapidly acquiring a prominent role in financing the corporate sector. While still relatively small, pension and mutual funds, investment houses, and insurance companies accounted for 12 percent of total credit to the private sector at end-2001, up from 3 percent in 1998. Funds under management of local institutional investors have grown very briskly in the last few years: pension funds grew 52 percent in 2001 alone, and mutual funds rose even more. This trend is continuing in 2002. The growing importance of domestic institutional investors increases the investor base for long maturity paper, providing a potential source of long-term funds for enterprises, which has thus far been limited in Mexico. Changes to pension funds' investment requirements are also contributing to this development.

The authorities' efforts since 2000 to improve the legal framework of the financial system are likely to pay off in the near future by facilitating a resumption of credit growth. The improved financial health of the banking system, reflected in the relatively high levels of capital and loan provisioning, plus a satisfactory level of liquidity, would likely permit a recovery in credit growth as the economy recovers. In addition, the recent decline in interest spreads as well as the competition from the bond market would begin to affect banks' profitability and thus would force them to look for alternative sources of income, making them more willing to take on more credit risk in order to improve the bottom line. However, the extension of credit to small- and medium-sized corporations would likely resume more gradually, as banks enhance their risk assessment capabilities and firms develop a credit culture.

29. The 2001 FSSA concluded that the financial system has improved its resilience to shocks in recent years and is not likely to pose systemic problems. Additional measures are being introduced aimed at increasing the system's resilience to shocks and achieving full observance of international standards, many of which are in line with the FSSA's recommendations. In particular:

Figure 12. Mexico: Adjusted Bank Credit to the Private Sector 1/



1/ Excludes restructured FOBAPROA/IPAB and non-performing loans.

- A sequence of measures has been announced aimed at reducing the BOM's credit risk associated with the payments system and achieving compliance with international standards in this area within the next five years.[26]

- Legislation passed by congress in April 2002 aims at modernizing the state-owned development banks through the imposition of tighter regulatory standards, improved accountability and corporate governance, and a clearer definition of their mandates.

- Legislation was sent to congress in May 2002 that would complement the framework for secured lending that was introduced in 2000. The new law, which would allow creditors to rapidly collect on loan collateral, is aimed at further enhancing the prospects for credit growth by strengthening the judicial process of loan recovery.

- Steps are being taken to reduce the bias toward an open-bank resolution approach, which will become increasingly inconsistent with a "least cost resolution" strategy under the gradual elimination of the universal deposit guarantee beginning in 2003.

- In the area of housing finance, a new state bank (*Sociedad Hipotecaria Federal (SHF)*) was created in October 2001 with the objective of promoting the primary and secondary mortgage markets.

30. The staff noted the authorities' rapid action to create the "Committee for the Modernization of the Financial System" in 2001 as a follow up to the FSAP, which aims at identifying and following up on issues related to the structure, operation, and regulation of the financial sector. It agreed on the importance of these ongoing reforms, and also noted the importance of an action plan to strengthen banking supervision further in areas such as reducing the fragmentation of supervisory powers, and fostering the credibility of the National Banking and Securities Commission (CNBV) by strengthening its' autonomy.

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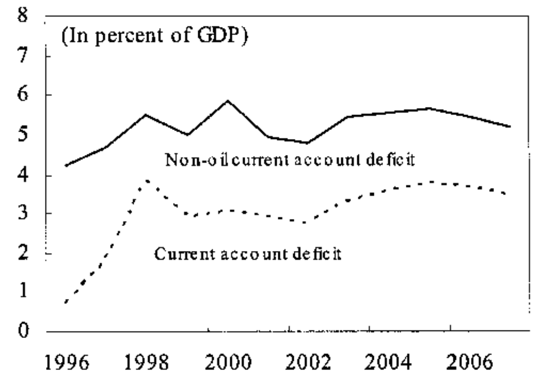
[26] The first of these measures, which was introduced in February 2002, requires the same-day settlement of intra-day credit granted by the BOM.

31. The authorities recognized that a key challenge for the banking sector is the **resumption of broad-based and sound lending to the private sector.** They stressed that credit growth was being held down by a lack of demand and that the improved financial situation of banks, ample liquidity, and the sizable reduction in real interest rates will likely result in a pick up in private sector credit growth as the economy recovers and the envisaged improvements to creditor's rights are introduced.

E. External Sector Policies

32. Staff projects that the **external current account deficit would widen moderately in the medium term before stabilizing at around 3.5 percent of GDP** (Table 10 and Figure 13). In 2002, the current account deficit is projected to remain broadly unchanged at 2.8 percent of GDP and then widen modestly during 2003–06 reflecting an acceleration in domestic demand and a decline in the international price of oil.[27] The projections reflect the expectation that Mexican goods will make modest gains in market share, as the increased capital stock and structural reforms translate into higher relative productivity growth, and economic integration is deepened.

Figure 13. Mexico: External and Non-oil Current Account Deficit



33. **About two-thirds of the current account deficit in 2002 and the medium term is expected to be financed by foreign direct investment** and the remainder by increased public and private sectors external borrowing (including PIDIREGAS) and only moderate portfolio inflows (Table 11).[28] Reflecting the fact that most of the public sector foreign exchange earnings are deposited in the BOM, the planned external borrowing to finance PIDIREGAS projects would contribute to an accumulation of net international reserves of close to US$6 billion in 2002 and an annual US$4–5 billion in the medium term.

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[27] The non-oil current account deficit is expected to stabilize at 5.3 percent of GDP.

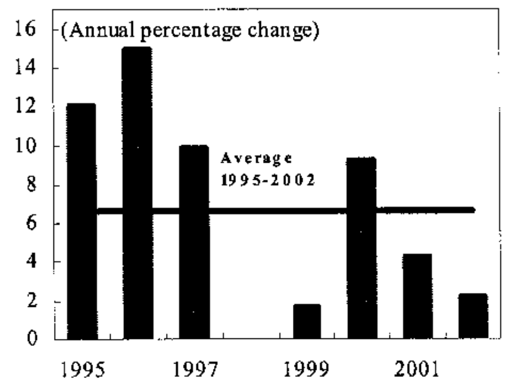
[28] PIDIREGAS are public investment projects financed and executed by the private sector with a deferred budgetary impact. Since most of the financing for these projects comes from abroad and the Treasury and PEMEX have to sell all their excess foreign exchange to the BOM, a large portion of PIDIREGAS financing results in a net accumulation of international reserves.

34. **Total external debt is projected to remain broadly unchanged at around 27 percent of GDP**, notwithstanding the projected rise in external borrowing by the public sector noted above (Table 12). As a share of exports of goods and services and transfers, external debt would decline by nearly 30 percentage points to 108 percent by 2007 while total external debt service would fall slightly to reach 22 percent during the same period.

35. **Staff and the authorities agreed that the level of international reserves is adequate (Appendix Box 5)**. The authorities stressed that the quality of reserves is protected by the Law of the Bank of Mexico, which mandates that reserves must be invested in assets that are unencumbered and freely usable.[29]

36. Despite the recent depreciation of the peso, **the real effective exchange rate has appreciated significantly in recent years (see Figure 5)**. The authorities stressed that the sustained increase in export market shares and the recent narrowing in the non-oil current account deficit (cyclically adjusted) indicated that Mexican exports remained competitive (Figure 14).[30] More fundamentally, staff agreed with the BOM that additional structural measures would be an appropriate means to further increase productivity and that targeting the level of the exchange rate would be inappropriate in the context of their inflation-targeting framework.

Figure 14. Mexico: Non-oil Export Market Share 1/



1/ Growth in Mexican non-oil exports less growth in export-weighted non-oil imports of the rest of the world.

37. **While nonpreferential external tariffs remain high, the authorities continue to make progress in trade liberalization.**[31] During 2001 and so far in 2002, bilateral agreements have been signed with the European Union (covering mainly automobiles, pharmaceutical products, and mechanical equipment), the European Free Trade Association countries (Iceland, Norway, Liechtenstein, Switzerland), and Brazil (covering textiles, electronics, and agricultural products). The

[29] International reserves cover more than 180 percent of base money and nearly 100 percent of narrow money.

[30] Diminishing gains in market share in recent years could reflect the reduced structural impact over time of entry into NAFTA as well as the impact of the real currency appreciation.

[31] Mexico has a trade restrictiveness index (TRI) level of 6 (in a scale from 0 to 10, with 10 as maximum trade restrictedness), reflecting mainly a relatively high most favored nation tariff (applying to all World Trade Organization members that have no special agreement with Mexico) of 16.5 percent (up by 3 percentage points from 1997).

authorities remain committed to multilateral agreements and participated actively in the Doha Round of the World Trade Organization (WTO), but also plan to expand further their web of bilateral agreements to include Japan later this year. The authorities stressed that their active use of bilateral and regional agreements in their pursuit for trade liberalization had been beneficial, resulting in a generalized increase of Mexico's trade with all of its trading partners.

38. A first evaluation report of the Financial Action Task Force's (FATF) 40 recommendations on **combating money laundering** was completed in June 2000; Mexico was found to be in full or partial compliance with all the recommendations. Moreover, the FATF considered that Mexico had the essential measures in place to effectively counter money laundering, and that it met the requirement for membership of the FATF. Mexico signed the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism, and the senate is expected to ratify the convention in the next ordinary session. The Mexican authorities responded comprehensively to the Fund's questionnaire on efforts to combat money laundering and terrorism financing. As of end-April 2002, both chambers of the Mexican congress approved the implementing legislation for the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Mexico does not allow the tax deductibility of bribes as a business activity.

F. Remaining Vulnerabilities and Capacity for Policy Reaction

39. **Notwithstanding Mexico's generally favorable economic prospects, a number of downside risks remain.** In particular, the recent deterioration in U.S. equity markets, and weakening of market sentiment toward Brazil underscore several key vulnerabilities to the outlook:

- **Mexico's sizable external financing requirements** (see Table 11) make the country vulnerable to adverse shifts in market sentiment toward emerging market countries.[32] Total gross external financing requirements for 2002 and 2003 are estimated at US$61 billion and US$65 billion, respectively, equivalent to around 10 percent of GDP and 140 percent of the current level of gross international reserves, and constituting roughly 15 percent of projected gross inflows to developing countries.[33] The gross external financing needs of the public and nonfinancial corporate sectors and the current account deficit contribute about equally to the external financing

[32] The gross financing requirement includes the current account deficit, short-term debt by residual maturity, and reserve accumulation.

[33] Based on staff projections of gross inflows of FDI, bond and equity issues, and loan contracts for 2002 as a share of Mexican gross financing requirement excluding trade credit and interbank loans.

requirement; the financial sector's gross financing requirement is less than 10 percent of the total.[34]

- **The gross financing needs of the public sector** for 2002 and 2003 is estimated at US$76 billion and US$71 billion, respectively (12 percent of GDP). While the external rollover risk is low (the average maturity of foreign currency sovereign bonds is close to eight years), the domestic rollover risk is still relatively large (about 20 percent of domestic debt falls due in each year), even though it has been declining due to the continued deepening of the domestic bond market. Domestic funding sources appear stable and nonresident holdings of domestic public sector debt are negligible.[35]

Gross Financing Needs of the Public Sector 2002–03

	2002	2003	2002	2003
	(in US$ billion)		(in percent of GDP)	
Gross financing needs of the public sector	**76.2**	**71.0**	**11.8**	**9.9**
Net PSBR (deficit)	23.2	19.9	3.6	3.0
Rollover of debt amortizations	52.9	51.1	8.2	7.7
External debt	11.9	8.4	1.9	1.3
Domestic debt	41.0	42.7	6.4	6.4
Federal government	31.5	26.2	4.9	3.9
Short-term	19.2	18.3	3.0	2.8
Long-term	12.4	7.9	1.9	1.2
IPAB	7.9	15.0	1.2	2.3
Other	1.6	1.5	0.2	0.2

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

- The **public sector is particularly vulnerable to increased interest rates** and to a lesser extent decreased economic growth (Figure 15). A significant stalling in the structural reforms process (including fiscal consolidation) could adversely affect investors' confidence and external competitiveness, lower the country's potential growth rate, and have an adverse effect on public sector debt.

- The **corporate sector** is vulnerable to a potential sharp retrenchment of international bank lending (it's reliance on bank financing is significantly higher than that of the

[34] Nonprime private borrowers are particularly exposed to refinancing risks, as their access to capital markets is most linked to sentiment toward emerging markets. Indeed, a few sub-investment grade companies have recently experienced difficulties in accessing international capital markets.

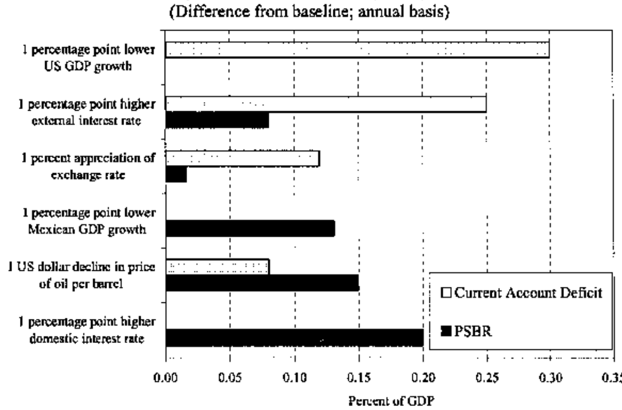
[35] Foreign holdings of domestic public debt instruments are less than 2 percent of the total stock, compared with around 70 percent at end-1994.

sovereign). Mexico, Taiwan Province of China, Korea, and Chile all have strong similarities in their borrowing patterns from international banks with that of Brazil, (their common creditor indices all are around 0.8).[36] However, Mexican entities on the whole are financially strong and have significant claims on international banks, which are mitigating factors of this vulnerability.

40. **Stress simulations on Mexico's gross external financing requirement** suggest that the external sector would be able to weather a potential "replay" of past capital account crises (Mexico 1995, Russia 1998, and Brazil 1999 crises). Based on the same debt-rollover rates, reduced access to external capital, and a change in nonresidents' portfolio investment as observed during these crises, the potential **external financing gap** was estimated to reach from US$3 billion to US$16 billion in 2002; these gaps could be closed through a combination of policy adjustments, exchange rate depreciation, and/or the partial drawdown of international reserves.

41. **Stress simulations on Mexico's public sector borrowing requirement** indicate that it is not significantly exposed to a sharp depreciation of the exchange rate, but it would suffer from a sustained increase in domestic interest rates.[37] An increase of domestic interest rates as experienced in past crises (Mexico1995, Russia 1998, or Brazil 1999) would **raise the PSBR** significantly (by about 3.4 percentage points of GDP, 0.6 percentage point of GDP, and 0.1 percentage point of GDP, respectively, on an annual basis).[38]

Figure 15. Mexico: Sensitivity Analysis
(Difference from baseline; annual basis)



[36] The common creditor index is calculated from the BIS bank claim data and measures the similarity between countries' borrowing patterns: the index varies between 0 and 1, with a higher value indicating a higher degree of similarity. See Box 3.1 "The scope for Emerging Markets Contagion" in Chapter III (Emerging Market Developments and Financing), in the Global Financial Stability Report of Q2 2002.

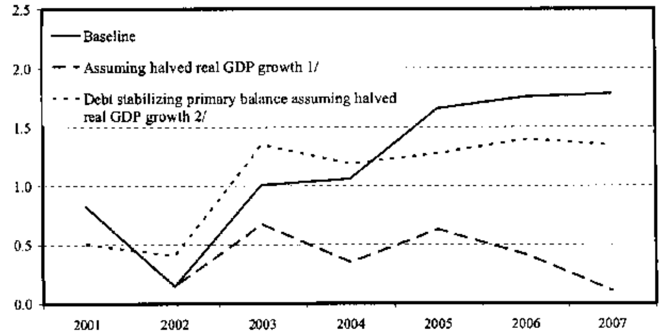
[37] The public sector's foreign currency cash-flow is slightly positive, as revenues from net exports of oil exceed the projected interest payments on Mexico's public external debt. By contrast, each one percentage point increase in average annual domestic short-term interest rates would increase the PSBR by 0.2 percent of GDP.

[38] Rising EMBI+ spreads would have little immediate impact on the fiscal position as over 80 percent of Mexico's external debt carry fixed interest rates and the average maturity of foreign currency sovereign bonds is close to eight years. However, this would have a negative impact on Mexico's ability to place new debt.

With approximately 40 percent of revenue coming from oil, the public sector's vulnerability would also rise in response to a decline in crude oil prices. Specifically, a decline of one dollar per barrel in the price for the Mexican oil mix would result in a decline in government revenue of somewhat less than 0.2 percent of GDP (see Figure 15). Furthermore, the low level of non-oil revenues constitutes a vulnerability of the public sector, due to the constraints it puts on expenditure and the low base for increasing revenues.

42. **Sensitivity analysis** suggests that the paths of external and public debt are not affected significantly by a temporary moderate decline in economic growth, higher interest rates, or a depreciation of the real exchange rate. In addition, as reported in Appendix Box 6, a substitution of the baseline assumptions by five year historical average for these variables would leave the debt dynamics largely unaffected. However, **more significant negative shocks** would put pressure on both the external and the public debt-to-GDP ratios. **A halving of the staff's medium-term real GDP forecast** (with unchanged fiscal policy) would increase gross public sector debt from 49 percent of GDP in 2002 to over 53 percent of GDP in 2007; the stabilization of public debt at its current levels in such a scenario would require an additional adjustment in the augmented primary balance of about 0.9 percent of GDP each year on average (Figure 16).

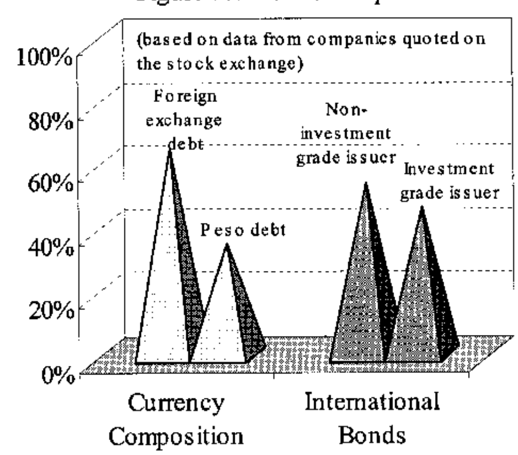
Figure 16. Mexico: Actual and Debt-Stabilizing Augmented Primary Budget Balances Assuming Halved Real GDP Growth (in percent of GDP)



1/ Assumes unchanged nominal expenditure and revenue-to-GDP ratio.
2/ Primary balance needed to stabilize the debt-to-GDP ratio.

43. An analysis of **the private corporate sector** showed that the financial difficulties experienced recently by some companies are either sector- or company-specific and do not appear to indicate wide-spread financial weaknesses in the corporate sector (Box 4, and Chapter 1 of the Selected Issues Paper). Nevertheless, some second-tier companies have significantly higher leverage, and have relatively greater exposure to exchange rate and refinancing risk; a **series of stress tests** prepared by staff suggest that a moderate shock to the exchange rate, interest rates, and growth combined with only 60 percent rollover of one year's amortizations could result in severe financing difficulties for some companies (Figure 17). The staff recommended that the authorities intensify the monitoring of the corporate sector to include privately-owned companies in order to obtain a more representative picture of the entire corporate sector. The authorities' plan to undertake a World Bank-led ROSC on corporate governance was also welcomed.

Figure 17. Mexico: Corporate Debt



Box 4. The Mexican Corporate Sector

The Mexican corporate sector is highly segmented, with access to bond and bank financing available almost exclusively to top-tier companies, most of which enjoy significant market power in highly concentrated markets. The analysis below is based on data for publicly-traded firms on the Mexican stock market (BMV). Although the sample is far from representative of the corporate sector in terms of value-added and employment, it is believed to reflect well the companies that have access to debt financing, especially external financing.

Vulnerability analysis

Leverage is modest. On average, the debt-to-equity ratio is near unity for the firms represented in the sample, although some medium and small-sized exporting companies have significantly higher leverage (over 2).

The maturity structure of debt is manageable. The share of short-term debt in total debt is only slightly over 50 percent, which is fairly low compared with other emerging markets.

The share of foreign exchange (FX) debt in total debt is quite high (66 percent at end-2001). However, the recent increase in domestic bond issuance is replacing some of the external borrowing with domestic borrowing and should reduce the percentage of foreign currency denominated debt (see below).

The net open foreign exchange position of BMV firms at end-2001 was negative (US$14.2 billion, equivalent to 18 percent of capital, with liabilities amounting to US$44.9 billion and assets US$30.6 billion). Although no breakdown of FX assets exists, anecdotal evidence suggests that a significant share consists of equity holdings/participations abroad, and hence likely to be fairly illiquid. According to the authorities and private market participants, the Mexican corporate sector does not conduct significant FX hedging operations through derivatives .

Refinancing risk is projected to increase in the coming years. BMV firms have US$15.7 billion in FX debt to be repaid in 2002, of which 35 percent is owed by medium and small exporters and 5 percent by non-exporters (with relatively greater exposed to FX risk). However, in 2004, there are US$1.8 billion in bond redemptions, which is a large amount by historical standards and hence may constitute a vulnerability.

Exposure to other Latin American countries appears to be limited. However, several companies have limited exposure to Brazil, mainly in terms of subsidiary operations.

Companies in default and with financial difficulties are mostly in specific sectors (e.g., mining, steel, and telecom) suffering from the global downturn, weak commodity prices, a strong currency, and high leverage. They appear not to be characteristic of widespread financial difficulties in the corporate sector.

Summary of stress test results

A quantitative stress test suggests that the liquidity and solvency effects of a combined adverse 1 standard deviation shock to the exchange rate, interest rates, and growth would be negligible. If, however, such a shock were to be accompanied by a significant reduction in (external and domestic) market access, the defaults could be much more widespread; if only 60 percent of one year's amortizations were to be successfully rolled over, payments in default could amount to US$2 billion, affecting companies with a combined accounting capital of US$10 billion.

Corporate governance

Regulatory changes aimed at improving minority shareholders' rights have been recently introduced: these include greater disclosure requirements, a minimum of 25 percent of directors have to be independent, fairer rules for buyouts (same conditions have to be offered to minority shareholders). Although these are very positive steps, more needs to be done to bring corporate governance in line with best practices (for e.g., OECD guidelines suggest 51 percent of independent directors).

44. In order to reduce existing vulnerability relating to the public debt, the authorities intend to further improve public debt management by increasing the issuance of fixed-rate instruments and establishing benchmark issues (government paper with sufficient liquidity at a particular maturity to provide a reference price for the private sector) in the domestic debt market, although they recognized that the market was still in a developmental stage. Further, the continued deepening of the domestic bond market stemming from the rapid growth of domestic institutional investors provides an alternative source of financing, mitigating contagion risk as the domestic market is likely to be much less sensitive to international factors and less exposed to episodes of market closure.

45. The government's **sound economic policies in recent years have been accompanied by considerable progress in strengthening the institutional framework** which provide a firm basis for the maintenance of economic and financial stability, enabling needed actions in the face of external shocks:[39]

- Despite some weaknesses, Mexico's budget institutions and practices have provided a solid framework in recent years for the execution of fiscal policy, enabling an effective response to external shocks. Subnational government finances are not a major vulnerability in Mexico.

- According to the 2001 FSSA, important progress has been made in recent years toward the implementation of international standards and codes in the financial sector. Mexico's independent central bank has gained considerable credibility in recent years in the conduct of monetary policy, but further progress (especially in coordination among supervisory agencies) is needed to achieve full compliance in the area of transparency of monetary and financial policies and Basel Core Principles for effective banking supervision. Mexico is in broad compliance with the standards and codes in the insurance and securities markets. As noted earlier, an action plan is in place to achieve compliance in the area of payments systems.

- As noted above, the Mexican financial system has improved its resilience to shocks; as a result, it is not likely to pose systemic problems. In addition, many FSSA recommendations are being followed-up and implemented by the government.

- The fiscal ROSC noted the considerable progress made in recent years improving transparency and in complying with international standards.

- Market participants generally view Mexico's efforts to maintain constructive relations with the private sector as first class. There are no external arrears and Mexico's Investor Relations Office is viewed as a model for other emerging market countries.

46. Moreover, the authorities have gained a **solid reputation for addressing adverse circumstances through prudent economic policy management.** In the event of exceptional

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[39] See Chapter V of the Selected Issues Paper for additional information on Mexico's institutional framework.

balance of payments pressures on the capital account resulting from international contagion, the authorities indicated that they would let interest rates and the peso absorb the shock, supported by an appropriate fiscal policy response (similar to the response to the 1998–99 Russia and Brazil crises, which was very well received by financial markets).

III. Staff Appraisal

47. Economic activity weakened in 2001 from the rapid pace in the preceding year, but is projected to recover this year led by the pickup in U.S. economic activity. The inflation rate slowed to well under the target in 2001; reflecting the authorities' tight policy stance and weak economic demand conditions, the inflation target of 4½ percent for 2002 is within reach. The weakness in domestic demand contributed to a narrowing of the external current account deficit in 2001, which moderated further in the first half of 2002. The deficit has largely been financed by foreign direct investment, which continues to be strongly attracted by a restructured economy that is increasingly integrating with its NAFTA partners. Net international reserves more than fully cover short-term debt by residual maturity.

48. The authorities are to be commended for maintaining prudent fiscal and monetary policies in the face of weak economic activity. It is particularly noteworthy that last year's recession was the first in Mexico's recent history not associated with a domestic economic crisis. This favorable performance continues to distinguish the country as a relatively "safe haven" among emerging markets, which should help shield it from international market turbulence.

49. At the center of the authorities' medium-term economic program is the achievement of the structural reforms envisaged in the NDP, which aim at strengthening external competitiveness and increasing productivity. Full implementation of the structural reform program should enable high rates of growth that would facilitate reducing poverty and increasing employment and real wages. In this context, the staff strongly supports the government's reform agenda, with particular emphasis on continued tax reform to reduce reliance on oil revenues; energy sector reform designed to increase capacity to match the growing demand; improved labor market flexibility; liberalization of the telecommunications sector; and, reform of the judicial system, including improving governance.

50. It is also critical that the authorities achieve their objective of strengthening significantly the fiscal position with an important reduction in the fiscal deficit and public debt by 2006. Staff stresses the importance of the authorities' implementing successfully their intention of frontloaded fiscal adjustment in 2003. Following the easing (cyclically adjusted) of the fiscal stance this year, this would greatly enhance market credibility. Overall, while its achievement will be challenging, carrying out successfully the NDP should have a highly favorable impact on the public sector debt dynamics, helping to ease pressures on real interest rates and allowing room for increased private sector activity; importantly, it would also reduce vulnerability to external shocks.

51. Additional tax revenue measures will be critical in ensuring the achievement of the medium-term fiscal targets without placing an excessive burden on expenditure control. The

authorities' intention to continue to build support for tax reform, especially the harmonization of VAT rates, is welcome. However, there is a risk that congressional support for these measures may not be forthcoming. The authorities' continued efforts to increase revenue from improved tax administration are important, but they cannot substitute for a more fundamental strengthening of non-oil revenue.

52. Achieving the medium-term fiscal targets in the absence of additional revenue measures would require particularly strict expenditure restraint, especially in 2003. The authorities are fully committed to curtail expenditure as needed in order to achieve the fiscal targets and they have a strong track record to show in this regard. The commitment to restrain expenditure should nonetheless be complemented with continued efforts to increase the efficiency of public expenditure.

53. The Bank of Mexico's monetary policy stance is appropriately geared to achieve a decline in inflation to 3 percent in 2003 and there appears to be little room for easing monetary policy under current conditions, in light of the recent uptick in inflation expectations and the international market turbulence. At the same time, however, staff cautions against tightening monetary policy prematurely in light of the low core inflation rate, sizable output gap, and uncertainties concerning the timing and magnitude of the economic recovery. Moreover, an easing of monetary conditions could be warranted should prospects for economic recovery falter, provided it is associated with a reduction in inflation expectations.

54. The authorities' intention to strengthen further the inflation targeting framework is commendable, including the announced adoption of a long-term inflation objective for 2004 and beyond, in order to enhance the transparency of monetary policy and to improve communication with the markets. Use of the *corto* continues to be a flexible and efficient monetary policy instrument that allows for appropriate adjustments in interest rates in response to economic shocks. However, moving to the direct targeting of short-term interest rates should be an element of a more formalized inflation targeting framework. This would enhance transparency in the conduct of monetary policy and, by reducing the volatility of interest rates, help decrease the vulnerability of domestic debt (given the high proportion that is still linked to short-term and floating interest rates).

55. The health of the Mexican financial system has continued to strengthen as evidenced by the improvement in financial indicators in the past year. Further, additional measures are being introduced to increase the system's resilience and move toward international standards. Of particular note are a sequence of measures aimed at reducing the Bank of Mexico's credit risk associated with the payments system and legislation passed by congress in April 2002 to modernize the state-owned development banks. However, the new resilience of the financial system has yet to be fully tested as a broad-based resumption of bank lending to the private sector has not still occurred. In this regard, the proposed legislation aimed at complementing the framework for secured lending is particularly important to further enhance the prospects for credit growth. The authorities are also encouraged to strengthen further banking supervision toward achieving full compliance with international standards, and further increase the resilience of the banking system to shocks including through the adoption of

resolution procedures for nonviable banks.

56. The present level of international reserves is reasonably adequate in the context of a flexible exchange system; they more than fully cover short-term liabilities on a residual maturity basis. Importantly, reserves are invested in assets that are unencumbered and freely usable. Nevertheless, the strength of the peso continues to pose a few concerns regarding the competitiveness of the traded good sector. These concerns are tempered by the sustained increase in export market shares and the improvement in the (cyclically adjusted) non-oil current account deficit. Further, the timely implementation of the additional structural measures proposed by the authorities would increase productivity and competitiveness.

57. Notwithstanding the generally favorable economic prospects, a number of risks remain that require careful consideration by the authorities. The recent deterioration in U.S. equity markets and weakening of market sentiment toward Brazil combined with a rise in global risk aversion underscore several key vulnerabilities. Mexico's gross external financing requirements are still large and the public sector debt dynamics remain vulnerable to interest rate increases. In addition, a lackluster recovery of the U.S. economy or failure to implement the government's planned medium-term fiscal adjustment or structural reform agenda would lower economic growth prospects and increase the economy's vulnerability. The authorities' intent to improve further public sector debt management through continued emphasis on the issuance of fixed-rate instruments, and establishing benchmark issues in the domestic debt market, is welcome. To further reduce existing vulnerabilities, the authorities' intention to undertake a World Bank-led ROSC on corporate governance is welcome. Importantly, the authorities also should intensify the monitoring of the corporate sector to include privately-owned companies in order to obtain a more representative picture of the entire corporate sector.

58. The government has gained recently a well-deserved reputation for addressing adverse circumstances through prudent economic policy management and for strengthening the institutional basis for maintaining economic and financial stability. In particular, despite some weaknesses, the budget institutions and practices have provided a solid framework in recent years for the execution of fiscal policy, enabling an effective response to external shocks; also, sub-national government finances are not a source of major vulnerability in Mexico. Further, Mexico's independent central bank has gained considerable credibility in recent years in the conduct of monetary policy and the financial system is not likely to pose systemic problems.

59. Mexico's data are generally of good quality, timely, and adequate to conduct surveillance effectively. The recently completed fiscal ROSC concludes that considerable progress has been made in improving transparency in public finances. The authorities' request for publication of the final report is a strong indication of their intention to enhance further the transparency and efficiency of its fiscal accounts.

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

Box 1. Public Sector Debt Management in Mexico

Mexico has made substantial progress in reducing the risks associated with its public debt. On external debt, these achievements include the development of a yield curve for sovereign bonds in the U.S. dollar market; and improved liability management operations such as the Brady-bond buybacks and hedging strategies to reduce currency and interest rate risks. These steps have resulted in a reduction in the stock of external debt and improvement in the amortization profile, and have contributed to Mexico's investment grade rating from all three major credit rating agencies. On the domestic front, the authorities have promoted the development of a market for public sector debt instruments, which has allowed the government to extend the average maturity of its domestic debt by issuing long-term bonds indexed to inflation or short-term interest rates and, more recently, through the issuance of long-term fixed-rate bonds.

Notwithstanding this substantial progress, the relatively large share of short-term and indexed domestic debt is a source of vulnerability. Short-term debt by residual maturity represents 20 percent of the total stock of domestic debt and long-term instruments indexed to short-term interest rates represent 60 percent of the total. While the share of short-term debt has declined owing to the growing issuance of long term fixed rate instruments—which increased the average maturity of federal government securities from 420 days in end-1999 to 744 days in end-2001—the debt amortization profile still shows large concentrations over the next three years.

The authorities' debt management strategy could be enhanced by:

- **developing a benchmark for public sector debt** which would provide a reference point for the desired composition of public debt. The benchmark would establish objectives such as the desired share of fixed and floating rate bonds, the currency composition, the amortization profile, the type of instrument and market diversification. Once the benchmark is approved, this would provide a valuable instrument to assess all debt management decisions.

- **streamlining the number of public debt instruments (BREMs, Cetes, Bondes, Udibonos, *Bonos Tasa fija*, BPAs, PICs) and issuers (central bank, federal government, IPAB, and FARAC)** in order to improve efficiency in debt management.

- **making further progress in the disclosure of information on public debt** and quality of debt statistics. Although the government publishes a vast array of public debt data, this information is dispersed in different publications and does not lend itself to easy analysis.

Box 2. Mexico's Tax Reform

On December 31, 2001 Mexico's congress approved a package of revenue enhancing tax measures. The new legislation falls short of the original tax reform proposal that the government had sent to congress. While congress supported most of the proposed reform and simplification of the income tax, it did not eliminate VAT exemptions and zero-ratings, including on foodstuff and medicine, which was one of the main cornerstones of the original reform. In order to compensate—in part—the resulting revenue shortfall, the congress enacted an excise tax package, which included the creation of a new tax on luxury goods and services. Overall, the main elements of the approved package are as follows:

- unification of the corporate and the top marginal personal income tax at a rate of 35 percent and gradual reduction to 32 percent by 2005;
- elimination of the 5 percent withholding tax on dividends and profits distributed to individuals and nonresidents and reestablishment of a system of upfront investment deductions;
- streamlining and rationalization of the special income tax regimes for the primary and ground transportation sectors;
- creation of a new 3 percent payroll tax borne by the employer to finance an existing labor subsidy ("salary credit");
- modification of the VAT accounting basis from accrual to cash-flow;
- modifications and increases to the excise tax (Impuesto Especial sobre Producción y Servicios) on tobacco, cellular phone calls and cable TV, alcoholic beverages and soft drinks sweetened with fructose;
- creation of a new 5 percent excise tax on luxury goods and services; and
- authorization for the states to establish limited taxes on personal income from business activities and professional services and on final sales of goods and services.

The government expects the tax package to generate additional revenue of 1 percent of GDP, about half of the amount projected for the government's original reform proposal. Most of the additional revenue would be generated through the modifications to the income tax (0.8 percent of GDP).

The enacted reforms to the income tax have received broad support and been mostly considered as a valuable step forward in the modernization and simplification of the income tax, while the failure to broaden the VAT base has been seen as a missed opportunity to strengthen sustainably the non-oil revenue base. Considerable public debate emerged over several elements of the excise tax package. While part of the uneasiness about these taxes might be explained by a lack of clarity in the drafting of the actual law, the criticism also pointed to the distortionary effects of some of these taxes such as the excise on soft drinks.

Box 3. Medium-Term Expenditure Pressures Deriving from Mexico's Social Security System

Mexico's demographic structure is aging rapidly, with the country's elderly population expected to grow five-fold over the next 50 years and the old age dependency ratio projected to rise from 7 to 25.[1] The increase of the elderly population together with the associated changes in health patterns will result in sizable expenditure pressures on Mexico's public pension and health systems, some if which are already surfacing.

- Total budgetary health expenditure has increased rapidly at a real rate of 7.5 percent per annum over the past 5 years, to an expected 2.5 percent of GDP in 2002, as the government has sought to raise the coverage and improve the quality of public health care. Health care costs will likely rise in the future owing to population aging and associated changes in the epidemiological profile of the population. If recent growth rates in expenditure were to continue, total health outlays in the budget could reach 2.7 percent of GDP by 2007.

- Mexico reformed its ailing public pension scheme for private sector workers in 1997. While the reform returned the pension scheme to financial viability, it also created transition costs, which amounted to 0.7 percent of GDP in 2001. It is expected that these transition costs will gradually rise during the next several decades to over 2 percent of GDP.

- A number of pension schemes exist for public sector workers, most of which operate as defined-benefit systems that are financed on a pay-as-you-go-basis. These pension schemes have not been reformed to-date and most of them have accumulated significant unfunded liabilities because their contribution levels are insufficient to finance benefits, which are generous by international standards (see Chapter 4 of the Selected Issues Paper). In the absence of significant reforms, these unfunded liabilities will gradually become explicit as workers in the public sector retire.

Estimated Unfunded Pension Liabilities
(In percent of GDP)

	Actuarial Deficit	Implicit Debt
IMSS RJP	n.a.	5.0
ISSSTE	58.0	50.0
PEMEX	n.a.	3.0
CFE	n.a.	1.0
Subnational Governments	30.0	n.a

- Total budgetary outlays on pensions have already been rising at an annual rate of 7 percent in real terms during 1997–2002 due to the costs associated with the 1997 pension reform and rising cash-flow deficits in a number of pension schemes that cover public sector workers. If this trend is maintained, pension expenditure in the budget could rise further from 2.0 percent of GDP in 2002 to 2.3 percent of GDP by 2007. Pension outlays could rise even faster in the longer term since most public sector pension schemes will confront their most dramatic demographic pressures in 10–20 years and since reforms to the pension schemes for public sector workers could likely create additional resource needs.

The authorities are conscious of the fiscal risks that are contained in Mexico's current social security system. In consequence, fundamental pension and health reform figure prominently in the government's structural reform agenda. While specific blueprints for reform have yet to be revealed, the authorities have recently begun to raise public awareness on the need for social security reform through the elaboration and dissemination of diagnostics studies on the financial health of Mexico's most important social security institutions.

1/ The old age dependency ratio measures the number of people aged 65+ per 100 people in the active age group (14–64 years old).

Box 4. Inflation Targeting in Mexico

Mexico formally adopted an inflation-targeting framework in January 2001. End-year inflation was targeted to decline to no more than 6½ percent in 2001, 4½ percent in 2002 and around 3 percent in 2003. In July 2002, the BOM formally established the 2003 inflation target at 3 percent and announced that from 2004 onwards it would be maintained at 3 percent with a band of +/- 1 percent around the midpoint.

The BOM has a legal mandate to achieve price stability as well as the instrument independence to pursue it. Monetary policy is conducted in a flexible manner with settlement balances (the *corto)* as the operational target. Although Mexico is unique among inflation targeters in its use of the *corto* as the operational target (all other inflation-targeting countries currently use short-term interest rates), a well-documented positive correlation exists between changes in the settlement balances objective and subsequent changes in market-determined interest rates. In addition, under a system such as Mexico's in which interest rates and the exchange rate are market determined, external shocks affecting country risk are absorbed by both variables, and short-term interest rates could move without a change in the settlement balances objective. As a result, there is no unique relationship between the level of the objective and short-term interest rates; therefore, **it is the change in the settlement balances objective rather than its level that signal the direction of monetary policy.**

The **BOM communicates its views** to the market primarily through quarterly inflation reports published one month after the end of each quarter. The governor and members of the governing board of the BOM communicate more frequently with the market via public speeches. Also, whenever the settlement balances objective is changed, a press release explaining the rationale for the action is issued.

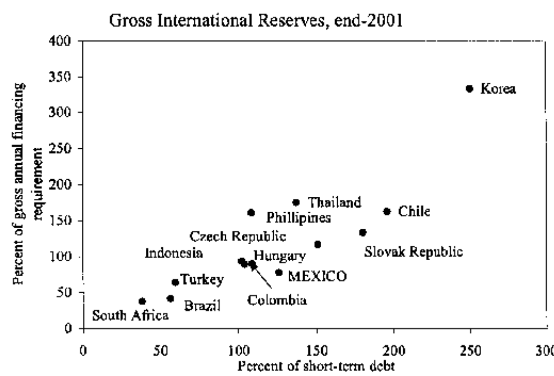
To gauge the appropriateness of the monetary policy stance the BOM compares, *inter alia*, the inflation expectations of private analysts with the official target, and monitors domestic demand, contractual wage settlements, exchange rate developments, and administered prices. In its communication with the markets, the BOM has increasingly focused attention on core inflation as a better indicator of the underlying inflation developments. Nonetheless, the inflation target is based and will continue to be based on headline inflation as this is the rate that is most widely understood by the general public and the one that influences contracts.

Currently, the BOM does not publish inflation projections from its inflation model. However, the **BOM is studying the use of formal inflation models** in other inflation-targeting countries. This has been difficult to implement in light of the **changing nature of the inflation process** in Mexico, which has evolved from being closely related to supply shocks, to being increasingly associated with aggregate demand developments.

Box 5. The Adequacy of the Bank of Mexico's International Reserves

International reserves serve an important function in maintaining liquidity and allowing time to absorb shocks in situations where access to borrowing is curtailed or very costly, such as during the Asia crisis and in the mid-1990s in Mexico. Empirical research suggests that higher levels of reserves in countries serve to reduce: (i) the likelihood that a crisis will take place; and (ii) the severity of a crisis if it does take place.[1/]

Key **indicators of reserve adequacy suggest that Mexico's level of reserves is adequate** (see figures below).[2/] As of end-2001, international reserves covered about 125 percent of all debt with a remaining maturity of less than one year and about three quarters of the gross annual external financing requirement (which includes the external current account deficit). Stress tests of capital account crises conducted by the staff support this view. Although Mexico's reserves as a share of imports are lower than in a number of other emerging market countries, this partly reflects the relatively high import intensity of the country's exports. It should also be considered that comparability of reserve levels across countries are hampered, in some instances, by definitional differences.



According to the Law of the Bank of Mexico reserve's have to be invested in assets that are unencumbered and freely usable. It is the current practice of the Bank of Mexico not to invest in branches of banks that have their headquarters in Mexico and to refrain from undertaking derivative operations in foreign exchange. Domestic banks and the rest of the domestic private sector have only negligible foreign exchange deposits in the central bank and public sector foreign exchange deposits (mainly PEMEX and federal government) amounted to about 9 percent of net international reserves at end-April 2002.

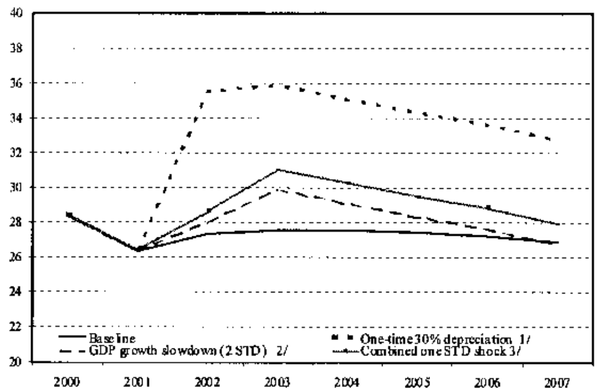
1/ See, for example, Bussière, Matthieu, and Christian Mulder (1999), "External Vulnerability in Emerging Market Economies: How High Liquidity Can Offset Weak Fundamentals and The Effects of Contagion," *IMF Working Paper* WP/99/88.

2/ The two figures show the level of gross reserves in emerging market countries (i.e. countries included in the IFC Global Index as of February 1999) classified as managed floaters or free floaters in Reinhart and Rogoff (2002), "The Modern History of Exchange Rate Arrangements: A Reinterpretation." NBER. The reserve figures in the first figure refer to end-November 2001 and include total reserves (including gold) as reported in International Finance Statistics. The second figure is based on data presented in 2001and 2002 Article IV staff reports, except for the Philippines where the report from the December 2001 Post-Program Monitoring was used.

Box 6. Fiscal and External Sustainability

The staff prepared a set of alternative medium-term projections in order to assess the sensitivity of its baseline projection to standardized changes in the key assumptions (see Appendix Tables 1 and 2). The methodology used is broadly in line with that recently endorsed by the Executive Board.[1/] The staff also complemented its medium-term analysis with a balance of payment's stress test to assess the vulnerability to a sudden reduction in external capital market access. Overall, the baseline projections of external and public sector debt are quite robust to alternative assumptions about the underlying macroeconomic variables. The use of five-year historical averages of the key assumptions does not significantly alter the medium-term projections. Indeed, in some cases the debt-to-GDP ratio would fall by more than in the baseline scenario. Additional temporary negative shocks to key assumptions such as interest rates, the real exchange rate, GDP deflator, and real GDP growth would lead to some increase in the level of public and external debt. However, in all cases the debt ratios would return to a declining trend once conditions normalize:

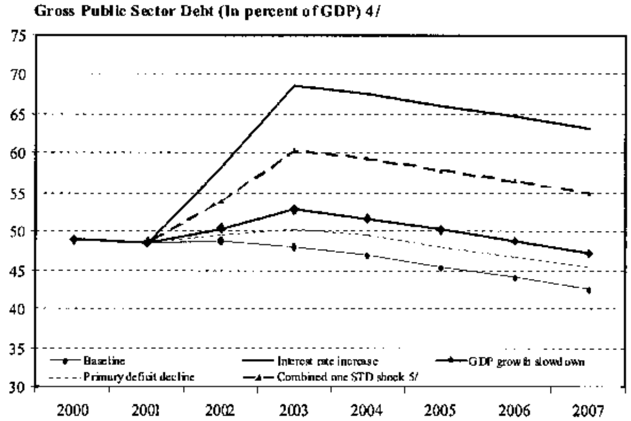
External Debt (In percent of GDP)



- **External debt appears most vulnerable to a large and sustained decline in the real exchange rate** (a sustained 30 percent real depreciation would lead to a debt-to-GDP ratio of about 36 percent); the other simulated shocks would push the external debt-to-GDP ratio just slightly above 30 percent of GDP.

Chart notes:
1/ Effect of one-time 30 percent depreciation of the peso.
2. Effect of a two standard deviation shock of real GDP growth lasting two years.
3/ Combined effect of a one standard deviation shock of interest rates, the real exchange rate and the non-interest external current account.

Gross Public Sector Debt (In percent of GDP) 4/



- **The simulations confirm the vulnerability of public sector debt to a sustained increase in interest rates and to lower GDP growth.** A two-standard deviation increase in the effective nominal interest rate would, if sustained for two years, increase the public sector debt-to-GDP ratio by about 20 percentage points to close to 69 percent of GDP, prior to resuming its downward trend.[2/] Although a combined one-standard deviation shock to real GDP growth, effective nominal interest rates, GDP deflator growth, and the augmented primary balance would result in a rise in the debt-to-GDP ratio to about 60 percent, the debt ratio would decline gradually once the shock subsides.

Chart notes:
4/ Effect of two-year two-standard deviation shock of each variable. In absolute terms, the shocks imply the following deviations from the baseline assumptions in 2002 (2003): Interest rate +20.6% (+20.1%); augmented primary deficit +0.7% of GDP (+1.5% of GDP); and real GDP growth -2.9% of GDP (-5.5% of GDP).
5/ Effect of a combined two-year shock equal to one standard deviation on interest rate, real GDP growth, GDP deflator growth and the augmented primary deficit.

1/ The staff's work follows the methodology proposed in "Assessing Sustainability".
2/ In this simulation, a two standard deviation shock would increase the average effective interest rate about 20 percentage points above the baseline assumption. Such a sharp increase would push interest rates close to default levels. The large absolute magnitude of the historical two standard deviation shock reflects the steady decline in nominal interest rates that has occurred during the past five years. In the current circumstances, a shock of the presented magnitude would be very unlikely to occur.

Table 1. Mexico: Selected Economic and Financial Indicators

	1998	1999	2000	Prel. 2001	Staff Proj. 2002
(Annual percentage change, unless otherwise indicated)					
National income and prices					
Real GDP	5.0	3.6	6.6	-0.3	1.4
Real GDP per capita	3.2	1.8	4.8	-2.1	-0.4
GDP deflator	15.3	15.5	12.0	5.4	4.8
Consumer prices (end of year)	18.6	12.3	9.0	4.4	4.5
Consumer prices (average)	15.9	16.6	9.5	6.4	4.8
External sector					
Exports, f.o.b.	1.1	14.8	21.8	-3.7	6.6
Export volume	9.3	11.4	20.8	1.8	4.4
Imports, f.o.b.	12.7	10.6	23.1	-1.7	3.4
Import volume	13.5	11.6	19.8	1.5	1.5
Terms of trade (deterioration -)	-5.5	4.8	4.5	-3.9	0.1
Exchange rates					
Nominal exchange rate (US$/Mex$) (average, depreciation -)	-13.3	-4.4	1.1	1.2	...
Real effective exchange rate (CPI based) (average, depreciation -)	1.9	9.0	10.0	8.3	...
Real effective exchange rate (ULC based) (average, depreciation -)	0.9	9.9	11.2	7.9	...
Labor markets					
IMSS employment 1/	8.0	6.8	5.9	1.0	...
Real manufacturing wages	2.8	1.5	5.8	6.4	...
Money and credit					
Broad money (M2)	24.0	13.4	-7.6	9.9	7.9
Monetary base	20.5	43.5	10.7	8.0	10.0
Monetary base end-period velocity	0.4	-16.9	7.0	-0.3	-3.1
Treasury bill rate (28-day cetes, in percent, annual average)	24.8	21.4	15.2	11.3	7.9
Real interest rate (in percent, annual average)	7.7	9.6	6.8	7.2	3.5
(In percent of GDP)					
Nonfinancial public sector					
Augmented overall balance	-6.3	-6.3	-3.7	-3.8	-3.6
Budgetary revenue	20.0	20.4	21.1	21.1	21.8
Total expenditure 2/	26.3	26.7	24.7	24.9	26.5
Non-oil augmented balance	-10.2	-10.5	-8.9	-8.6	-8.0
Traditional primary balance 3/	1.7	2.5	2.6	2.6	2.5
Traditional overall balance 4/	-1.2	-1.1	-1.1	-0.7	-0.7
Savings and investment					
Gross domestic investment	24.3	23.5	23.6	20.7	20.3
Public investment	2.6	3.0	4.4	4.3	4.4
Private investment	18.3	18.2	16.8	15.3	15.0
Change in inventories	3.3	2.4	2.3	1.1	0.9
Gross national savings	20.4	20.6	20.5	17.8	17.6
Public savings	-3.7	-3.3	0.8	0.5	0.8
Private savings	24.2	23.9	19.7	17.3	16.8
External current account balance	-3.8	-2.9	-3.1	-2.9	-2.8
Non-oil external current account balance	-5.5	-5.0	-5.9	-5.0	-4.8
Net public external debt (including IMF) 5/	20.1	19.7	15.9	15.3	16.0
Net domestic nonfinancial public sector debt (end of period) 6/	9.5	10.5	8.7	8.7	8.9
Net domestic financial public sector debt (end of period) 7/	17.7	16.4	17.6	18.0	17.6
(In percent of exports of goods, nonfactor services, and transfers)					
Public external debt service 8/	21.6	22.5	26.0	22.6	12.5
(In billions of U.S. dollars, unless otherwise indicated)					
Change in net international reserves (increase -)	-3.7	-3.9	-8.2	-9.2	-4.8
Gross official reserves in percent of short-term debt 9/	70.9	76.6	86.8	122.4	123.8
Gross external debt (in percent of GDP, end of period)	39.4	36.9	28.4	26.6	27.6
Oil export price (US$/bbl)	10.2	15.7	24.8	18.6	19.2

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

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

Table 2. Mexico: Key Economic Indicators

(Annual percent change, unless otherwise indicated) 1/

	2001						2002					
	QI	QII	QIII	QIV	Nov.	Dec.	QI	Jan.	Feb.	Mar.	Apr.	May
Aggregate supply indicators												
Real GDP	2.0	0.1	-1.5	-1.6	...	...	-2.0	...	...	...	...	...
Real GDP (seasonally adjusted)	-0.3	-0.4	-0.2	-0.6	...	...	-0.2	...	...	...	...	...
Leading indicator of economic activity (seasonally adjusted)	-1.9	-0.4	0.5	-1.1	0.6	0.0	1.5	0.9	0.1	0.9	2.6	-3.3
Global index of economic activity (seasonally adjusted)	-0.4	-0.8	-0.4	-0.5	0.5	-0.7	0.6	0.5	0.7	-0.4	2.0	-0.4
Industrial production (seasonally adjusted)	-1.3	-1.8	-0.4	-1.0	0.6	-0.2	0.9	0.4	0.8	-0.2	1.7	-0.4
Imports (BOP data; seasonally adjusted)	-2.9	-3.8	-2.7	-1.3	-1.7	0.6	1.0	-0.7	2.2	1.2	2.9	-0.5
Aggregate demand indicators												
Private consumption	6.6	4.1	1.6	1.5	...	...	-1.5	...	...	...	...	...
Retail sales (seasonally adjusted)	1.8	-0.9	-0.8	0.6	0.4	0.3	0.8	1.1	-1.5	1.2	0.5	1.3
Fixed capital investment (seasonally adjusted)	-3.9	-3.5	-2.0	-1.0	0.2	-0.4	1.8	1.5	0.4	0.8	1.6	1.7
Non-oil exports (BOP data; seasonally adjusted)	-4.0	-3.6	-3.5	-2.3	-3.1	2.6	2.2	0.2	1.1	1.8	3.8	-0.9
Inflation and labor markets												
Consumer price inflation	7.5	6.9	6.0	5.2	5.4	4.4	4.7	4.8	4.8	4.7	4.7	4.7
Core inflation	6.7	6.4	6.0	5.4	5.4	5.1	4.7	4.8	4.7	4.5	4.4	4.2
Open unemployment rate (percent, seasonally adjusted)	2.2	2.3	2.4	2.6	2.6	2.8	2.7	2.8	2.5	2.7	2.7	2.7
IMSS employment 2/	-0.1	-0.2	-0.5	-0.2	0.1	0.3	0.5	0.0	0.3	0.3	0.3	0.4
Nominal contractual wage increases	10.3	10.4	9.5	7.0	6.7	7.4	6.5	6.6	6.9	6.1	5.8	6.5
In relation to 12-month ahead expected inflation	3.9	3.5	-1.0	1.7	1.5	2.4	1.8	1.7	2.1	1.5	1.1	1.8
Real manufacturing wages	5.5	5.0	5.8	8.8	8.1	10.3	3.7	5.4	3.5	2.2	4.5	3.7
Manufacturing labor productivity	1.6	0.8	-0.4	-0.1	0.2	1.4	4.3	3.5	4.6	4.9	4.8	4.9
Manufacturing unit labor costs	5.1	4.5	6.8	7.6	6.5	8.3	1.5	1.1	-1.6	5.2	-8.7	-1.6
External sector												
Non-oil trade balance (seasonally adjusted, US$ billions)	-0.8	-0.7	-0.8	-0.9	-1.1	-0.8	-0.8	-0.7	-0.9	-0.8	-0.7	-0.7
(in percent of GDP)	-0.9	-0.8	-0.8	-1.0	...	...	-0.5	...	...	...	...	...
Real effective exchange rate												
Relative consumer prices	4.4	12.3	8.2	8.0	8.6	8.4	...	13.8	14.1	11.6	6.7	-0.5
Relative unit labor costs	4.3	10.2	8.1	9.1	9.5	8.8	...	13.1	9.4	9.3	...	...

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

1/ For seasonally adjusted series, percent changes are from preceding period.
2/ Mexican Social Security Institute. A measure of formal sector employment.

Table 3. Mexico: Summary Balance of Payments

	1998	1999	2000	Prel. 2001	Proj. 2002
(In billions of U.S. dollars)					
Current account	**-16.1**	**-14.0**	**-17.7**	**-17.8**	**-17.7**
Merchandise trade balance, f.o.b.	-7.9	-5.6	-8.0	-10.0	-9.3
Exports	74.9	86.0	104.7	100.8	107.8
Of which					
Petroleum and derivatives	7.1	9.9	16.4	12.8	13.1
Manufactures 1/	63.5	71.7	83.6	83.6	90.1
Imports	-82.8	-91.6	-112.7	-110.8	-117.1
Factor income	-13.3	-12.9	-14.4	-13.7	-14.0
Other services and transfers	5.1	4.5	4.7	5.8	5.6
Financial account	**18.4**	**18.6**	**23.2**	**23.3**	**23.7**
Public sector	1.6	-1.2	-3.1	2.6	7.5
Medium- and long-term borrowing	1.5	0.0	-5.5	-2.7	7.0
Disbursements	13.2	11.1	14.3	17.7	15.7
Amortization 2/	11.7	11.1	19.8	20.3	8.7
Other, including short term borrowing	0.1	-1.2	2.4	5.3	0.5
Private sector	16.9	19.8	26.4	20.6	16.2
Direct investment 3/	11.3	12.5	14.7	24.7	12.2
Bonds and loans 4/	5.4	6.3	6.6	-0.7	1.9
Banking system	-1.0	-1.7	-2.8	-3.1	0.6
Corporate sector	6.4	8.0	9.4	2.4	1.3
Equity investments and change in assets abroad	0.2	1.0	5.0	-5.7	2.1
Equity investments	-0.7	3.8	0.4	0.2	1.4
Change in assets abroad 3/	0.9	-2.8	4.6	-5.8	0.7
Errors and omissions and valuation adjustments	1.3	-0.7	2.8	3.8	0.0
Net international reserves (increase -)	-3.7	-3.9	-8.2	-9.2	-6.0
(In percent of GDP, unless otherwise indicated)					
Memorandum items:					
Current account balance	-3.8	-2.9	-3.1	-2.9	-2.8
Non-oil current account balance	-5.5	-5.0	-5.9	-5.0	-4.8
Non-oil trade balance	-3.6	-3.2	-4.2	-3.7	-3.5
Merchandise exports	17.8	17.9	18.0	16.3	16.7
Merchandise imports	19.7	19.0	19.4	17.9	18.2
Gross financing needs (billions of US$) 5/	63.8	60.1	74.3	78.0	60.9
Gross international reserves 6/					
End-year (billions of US$)	31.9	31.9	35.6	44.9	50.8
Months of imports of goods and services	3.6	3.0	3.4	4.1	4.1
Months of imports plus interest payments	3.1	2.6	2.9	3.5	3.5
Percent of short-term debt (by residual maturity) 7/	70.9	76.6	86.8	120.8	130.6
Percent of financing requirement 8/	54.1	52.7	55.2	81.8	83.6
IMF (net purchases, billions of US$)	-1.1	-3.7	-4.3	0.0	0.0
Crude oil export volume (millions of bbl/day)	1.7	1.6	1.68	1.71	1.69
Crude oil price (US$/bbl)	10.2	15.7	24.8	18.6	19.2
Gross total external debt	39.4	36.9	28.4	26.4	27.3
Of which: public external debt 9/	24.9	22.5	17.3	15.9	17.0
Gross total external debt (billions of US$)	165.8	177.7	165.0	162.8	176.0
Of which: public external debt 9/	105.0	108.1	100.4	98.4	109.7
Public external debt service (in percent of exports of goods, services, and transfers) 9/	21.6	22.5	26.0	22.6	12.3
(Annual percentage change)					
Export volume	9.3	11.4	20.8	1.8	4.8
Non-oil exports	10.6	14.9	23.0	1.6	5.4
Import volume	13.5	11.6	19.8	1.5	3.7
Consumer goods	19.9	10.6	33.4	22.2	6.2
Intermediate goods	11.7	9.2	18.7	-1.4	2.5
Capital goods	15.4	19.5	14.9	-4.2	5.5

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

1/ Includes net proceeds from in-bond industries.

2/ Includes pre-payment of external debt.

3/ In 2001, FDI includes the US$12.5billion Citibank acquisition of Banamex. This is reflected in an equal increase in private sector assets in the same year, followed by partial drawdown in the following years.

4/ Includes financing of PIDIREGAS up to 2001 (in line with the authorities presentation). For 2002 financing of PIDIREGAS is considered as a public sector financing item.

5/ Defined here as the sum of the current account deficit, debt amortization (including pre-payments, short-term debt and IMF repurchases), and gross reserves accumulation.

6/ Excludes balances under bilateral payments accounts.

7/ From 1999, short-term debt excludes pre-payments of public sector debt.

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

9/ Includes the IMF and public development banks and trust funds. Includes debt associated with PIDIREGAS.

Table 4. Mexico: Indicators of External Vulnerability

(12-month percentage change, unless otherwise indicated)

	Dec. 2000	Sep. 2001	Dec. 2001	Mar. 2002	Apr. 2002	May 2002	Jun. 2002	Jul. 2002
Market indicators								
Exchange rate (per U.S. dollar, end-period)	9.61	9.51	9.17	9.02	9.37	9.66	9.96	9.79
(year-to-date average, Mex$/US$)	9.5	9.3	9.2	9.1	9.1	9.2	9.3	9.4
(year-to-date percent change)	1.0	-0.7	-4.2	-1.4	2.5	5.6	8.9	7.0
Money market interest rate (TIIE 28 days in percent)	18.8	11.5	8.0	8.1	6.8	8.1	9.8	7.9
Real 28-day treasury auction rate (percent; end-period)	6.6	0.9	0.3	1.9	1.2	1.8	1.8	2.1
28-day treasury auction rate (percent; end-period)	17.6	9.7	6.8	7.5	5.3	6.9	8.1	6.8
EMBI+ Mexico (basis points; end of period)	392	431	308	251	255	265	323	390
Stock exchange index in U.S. dollar terms (year-to-date percent change)	-21.2	-3.9	18.0	17.0	15.2	4.9	-7.3	-10.9
Financial system								
Bank of Mexico net international reserves (US$ billion)	35.6	42.9	44.9	46.3	45.2	45.0	45.6	45.9
(year-to-date change, US$ billion)	8.2	7.3	9.2	1.5	0.3	0.2	0.8	1.1
Monetary base	10.7	12.8	8.0	22.8	15.3	17.2	17.0	17.6
Real M2a 1/	3.8	7.7	12.0	10.9	9.9	10.0	9.5	...
Real private sector credit 1/ 2/	-12.4	-13.9	-11.3	-13.3	-14.2	-12.7	...	...
Real adjusted credit to the private sector 2/ 3/	-24.7	-22.0	-11.7	-12.6	-13.1	-12.6	...	...
Commercial banks' nonperforming loans (percent of total loans) 4/	5.0	4.4	4.3	4.2	4.3	4.4	...	...
Commercial banks' loan loss provision (percent of nonperforming loans) 4/	119.3	125.3	129.8	135.1	130.4	127.2	...	...
External sector								
Terms of trade (percent change)	-5.3	-5.9	0.0	3.2	2.6	3.3	...	...
Pemex crude export price (year-to-date average; US$/barrel)	24.6	19.8	21.6	17.0	18.4	19.2	19.7	...
Real effective exchange rate (CPI based; year-to-date average) 5/	10.0	8.4	8.3	3.9	3.2	2.0	...	...
Real effective exchange rate (ULC based; year-to-date average) 5/	11.2	7.6	8.0	2.7	...	...	...	...
Exports (year to date, annual percentage change) 6/	21.8	-0.8	-3.7	-8.2	-4.4	-3.7	-3.9	...
Of which								
Non-oil	16.2	2.5	-0.4	-6.0	-3.0	-2.8	-3.5	...
Imports (year to date, annual percentage change) 6/	23.1	0.9	-1.7	-9.2	-6.0	-5.0	-5.0	...
Of which								
Consumer goods	37.1	22.7	18.3	-3.6	3.6	4.2	4.1	...
Capital goods	17.5	-3.4	-6.8	-14.0	-9.8	-7.3	-8.0	...
Trade balance (US$ billion; year-to-date)	-8.0	-5.8	-10.0	-1.8	-2.3	-2.9	-3.2	...
Nonfinancial public sector external debt (percent of GDP) 7/	15.3	13.8	13.2	13.7	13.4	13.3	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 7/ 8/	0.7	0.6	0.6	0.8	0.7	0.7	...	...
Private sector external debt (percent of GDP)	11.2	10.3	10.0	10.1	10.1	10.2	...	...
Private sector short-term external debt (percent of GDP)	3.9	3.5	3.3	3.3	3.3	3.3	...	...
Commercial banks' foreign credit lines (roll-over rates in percent)	119.9	42.0	17.3	48.8	52.4	56.8	42.3	...
Of which								
Banks domiciled in the United States and Canada	178.8	109.0	22.4	7.7	38.2	28.2	45.5	...
Banks domiciled in the European Union	122.2	13.3	12.4	49.7	47.3	80.0	21.0	...
Memorandum items:								
Gross international reserves to short-term debt (by residual maturity, percent) 8/	86.8	104.2	122.4	125.7	125.3	124.8	126.5	...
Monetary base to gross international reserves (percent)	62.0	45.8	54.9	51.2	48.8	50.6	50.0	48.8

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

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

2/ Includes non-performing loans.

3/ Includes assets sold to FOBAPROA/IPAB.

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

5/ Increase = appreciation.

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

7/ Includes development banks. Excludes PIDIREGAS which at end-2001were equivalent to $18 billion (2.9 percent of GDP).

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

Table 5. Mexico: Financial Operations of the Public Sector

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	Prel. 2001	Budget 2002	Proj. 2002
Budgetary revenue	**20.4**	**20.8**	**21.6**	**22.0**	**22.7**	**22.6**
Oil revenue 1/	6.1	6.2	7.2	6.7	6.4	6.9
Federal government	3.9	4.0	5.2	4.9	4.1	4.4
PEMEX	2.1	2.2	2.0	1.8	2.3	2.5
Non-oil revenue	14.3	14.6	14.5	15.3	16.3	15.6
Federal government	10.3	10.6	10.6	11.4	12.5	11.8
Tax revenue	8.9	9.4	9.4	9.8	11.0	10.3
Income taxes	4.4	4.7	4.7	5.0	5.9	5.6
VAT	3.1	3.3	3.5	3.6	3.6	3.5
Other	1.4	1.5	1.2	1.3	1.4	1.2
Non-tax revenue	1.3	1.2	1.2	1.5	1.5	1.5
Privatization receipts	0.3	0.1	0.4	0.3	0.6	0.6
Central bank profits	0.0	0.3	0.0	0.0	0.0	0.0
Other	1.0	1.1	0.8	1.3	0.9	0.9
Parastatal entities	4.1	3.9	3.8	3.9	3.8	3.8
Budgetary expenditure	**21.6**	**21.9**	**22.7**	**22.7**	**23.4**	**23.2**
Current expenditure	18.7	19.4	20.2	20.2	21.1	20.9
Wages	6.9	7.3	7.1	7.3	7.5	7.5
Pensions	1.5	1.9	1.9	1.9	2.0	2.1
Revenue sharing	3.0	3.1	3.2	3.4	3.5	3.5
Interest expenditure	2.6	3.1	3.0	2.6	2.5	2.4
Cash cost of bank and debtor support	0.3	0.5	0.6	0.7	0.8	0.8
Other	4.4	3.5	4.3	4.3	4.7	4.8
Capital expenditure	2.9	2.6	2.5	2.4	2.3	2.3
Extrabudgetary balance	0.0	0.1	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.0	0.0	-0.1	0.0	0.0
Traditional overall balance	**-1.2**	**-1.1**	**-1.1**	**-0.7**	**-0.6**	**-0.7**
plus adjustments to the traditional balance	-4.7	-4.8	-2.2	-2.4	-2.5	-2.2
less non-recurrent revenue	0.4	0.4	0.4	0.7	0.8	0.8
Net public sector borrowing requirement (PSBR) 2/	**-6.3**	**-6.3**	**-3.7**	**-3.8**	**-3.9**	**-3.6**
Financing	**6.3**	**6.3**	**3.7**	**3.8**	**3.9**	**3.6**
Nonrecurrent revenue (incl. privatizations)	0.4	0.4	0.4	0.7	0.8	0.8
External 3/	1.5	1.2	0.8	0.8	1.5	1.2
Domestic	4.5	4.7	2.5	2.3	1.6	1.6
Memorandum items:						
Traditional primary balance 4/	1.7	2.5	2.6	2.6	2.7	2.5
Augmented primary balance 4/	0.5	1.3	1.2	0.8	0.1	0.3
Non-oil balance 5/	-10.2	-10.5	-8.9	-8.6	-8.0	-8.2
Non-oil primary balance 4/	-3.7	-3.2	-4.4	-4.3	-4.3	-4.7
Gross public sector debt	54.9	50.8	49.0	48.6	49.0	48.9
External 6/	21.9	19.2	17.3	15.9	16.5	16.5
Of which: PIDIREGAS	1.1	2.3	2.7	2.9	4.3	4.0
Domestic	33.0	31.6	31.7	32.7	32.1	32.4
Of which: bank restructuring and debtor-support liabilities	21.4	17.7	19.1	19.2	18.8	18.9
Net public sector debt	50.0	46.6	42.3	42.0	42.3	42.5

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

1/ Oil revenue includes extraction rights, PEMEX net revenue, PEMEX excess return levy, and IEPS on gasoline.
2/ Excludes nonrecurrent revenue. The authorities also publish the net public sector borrowing requirement including nonrecurrent revenue.
3/ Includes PIDIREGAS financing.
4/ Treats bank restructuring transfers and debtor-support as interest expenditure.
5/ PSBR less oil revenue plus PEMEX operating expenditure.
6/ Includes the external debt of the federal government, public entities, and external debt of development banks.

Table 6. Mexico: Cyclically Adjusted Public Sector Balances

(In percent of GDP)

	Prel.	Budget	Staff Projections					
	2001	2002	2002	2003	2004	2005	2006	2007
Budgetary revenue	22.0	22.7	22.6	21.7	21.4	21.2	20.9	20.8
Of which: oil revenue	6.7	6.4	6.4	6.7	6.4	6.3	6.1	6.0
Budgetary expenditure	22.7	23.4	23.2	22.0	21.5	20.9	20.5	20.3
Of which: interest payments	3.3	3.4	3.2	3.3	3.1	3.1	3.1	2.9
Traditional budget balance	**-0.7**	**-0.6**	**-0.7**	**-0.3**	**-0.1**	**0.3**	**0.4**	**0.5**
Adjustments to the traditional balance	-3.1	-3.3	-3.0	-2.7	-2.4	-2.2	-2.2	-2.1
PSBR (excluding nonrecurrent revenue)	**-3.8**	**-3.9**	**-3.6**	**-3.0**	**-2.5**	**-2.0**	**-1.8**	**-1.6**
Cyclically adjusted PSBR 1/	**-3.7**	**-3.6**	**-3.3**	**-2.8**	**-2.4**	**-1.9**	**-1.7**	**-1.6**
Cyclically adjusted non-oil primary balance 2/	**-0.7**	**-1.1**	**-1.4**	**-0.5**	**-0.5**	**0.1**	**0.3**	**0.4**
Non-oil primary fiscal impulse	**-0.9**	**0.4**	**0.7**	**-0.9**	**0.0**	**-0.6**	**-0.2**	**-0.1**
Memorandum items:								
Gross public sector debt	48.6	49.0	49.0	48.8	47.7	46.2	44.7	43.2
GDP (millions of pesos)	5772	6184	6138	6632	7163	7736	8324	8957

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

1/ Estimated as the PSBR plus the additional tax revenue if GDP was at potential (with unitary elasticity). The cyclically adjusted deficit deficit will be lower (higher) than the actual deficit if the economy operates below (above) potential.

2/ Revenue is adjusted to exclude oil export revenue and non-recurrent income. Expenditures exclude the nonrecurrent costs of bank restructuring and debtor-support programs, financial requirements of development banks, and PEMEX operational expenditures.

Table 7. Mexico: Summary Operations of the Financial System

	1998 Dec.	1999 Dec.	2000 Dec.	Prel. 2001 Dec.	Proj. 2002 Dec.
(In billions of Mexican pesos)					
Bank of Mexico					
Net international reserves 1/	235.2	264.2	347.4	416.2	498.7
In U.S. dollars	23.5	27.4	35.6	44.9	50.9
Net domestic assets 1/	-103.7	-75.4	-138.4	-190.4	-250.3
Net credit to nonfinancial public sector	-98.7	-193.2	-287.5	-185.1	...
Net credit to financial public sector	64.9	82.3	95.9	109.8	...
Net credit to commercial banks	-58.8	10.5	43.4	-26.0	...
Other	-11.1	24.9	9.8	-89.2	-250.3
Monetary base	131.5	188.8	208.9	225.7	248.4
Banking system					
Net foreign assets	67.3	69.5	68.8	124.3	129.8
Net domestic assets 2/	1318.7	1474.7	1301.4	1143.8	1227.2
Net credit to nonfinancial public sector	220.2	229.0	381.5	302.4	324.5
Credit to private sector	744.5	747.5	715.4	662.0	710.2
Credit to FOBAPROA/IPAB and *cetes especiales*	607.8	632.9	419.1	383.3	389.6
Other net	-253.8	-134.7	-214.6	-204.0	-197.1
Medium- and long-term foreign obligations 2/	329.0	288.6	278.5	246.4	255.2
Other net liabilities 2/	-65.7	-13.5	28.6	-166.1	-175.0
Liabilities to private sector 2/	1122.7	1269.1	1063.1	1187.7	1276.8
(In annual percentage change, unless otherwise indicated)					
Memorandum items:					
Real monetary base	1.6	27.8	1.6	3.5	5.3
Real M1a 2/ 3/	1.0	12.5	6.2	16.3	3.6
Of which					
Currency in circulation	3.8	26.1	1.8	4.8	5.3
Checking accounts	-1.8	7.0	5.6	22.7	2.9
Real M2	1.5	3.0	-20.3	6.7	3.2
Real M2a 2/ 4/	6.2	8.5	3.7	12.1	...
Of which					
Bank time deposits	-1.6	-14.4	-37.8	-25.8	...
Securities issued by federal government	4.8	32.8	3.3	-20.8	...
Securities issued by private sector entities	24.2	-17.3	6.4	-6.5	...
Real M3a 2/ 5/	5.6	7.7	4.1	11.8	...
Real M4a 2/ 6/	4.8	6.3	3.0	11.2	...
Monetary base velocity (GDP to monetary base) 2/	0.4	-16.9	7.0	-0.3	-3.1
M2a velocity (GDP to M2a) 2/	-3.9	-2.1	4.8	-8.0	...
Real credit to the private sector 2/	-1.7	-10.6	-12.2	-11.4	2.7
Real adjusted credit to the private sector 2/ 7/	0.5	-9.1	-24.6	-11.8	1.7
(In percent)					
Commercial banks financial ratios 8/					
Liquid assets to assets	26.2	28.2	25.7	34.8	...
Finance margin to assets	5.1	6.1	5.7	5.4	...
Cash finance margin to assets 9/	-1.4	-0.4	1.0	1.9	...
Return on equity before taxes	-2.5	-2.0	14.2	15.7	...
Operating expenses to loan portfolio 10/	32.3	34.3	30.1	25.5	...
Nonperforming loans to total loans 11/	15.5	8.5	5.0	4.3	...
Loan-loss provisions to nonperforming loans 11/	73.4	102.3	119.3	129.8	...

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

1/ Difference with annual projections as annual projections are based on fixed nominal exchange rates.

2/ From January 1997 onwards, monetary aggregates are based on resident financial institutions only including deposits of the public sector. There is a break in the series in 2000 due to a reclassification of interbank repo operations.

3/ Currency in circulation, checking accounts, and debits card accounts.

4/ M1a plus time deposits, securities issued by the public sector, securities issued by the private sector, and saving accounts outside SIEFORES.

5/ M2a plus deposits held by non-residents.

6/ M3a plus deposits held in non-resident affiliates and branches of Mexican banks.

7/ Including assets sold to FOBAPROA and assets converted in UDI.

8/ Through December 1998: Banamex, Banorte, BBV, Bancomer, Bital, Citibank, Confia, Inverlat, Santander, Mexicano. From January 1999: Banamex, Banorte, BBV-Bancomer, Bital, Santander Mexicano, Serfin.

9/ Excluding interest income from IPAB/FOBAPROA notes and before loan-loss provisions.

10/ Interest expenditure plus administrative costs to loan portfolio (excluding assets sold to FOBAPROA).

11/ From January 1997 stricter accounting rules were introduced.

Table 8. Mexico: Medium-Term Financial Operations of the Public Sector

(In percent of GDP)

	Prel.	Budget	Staff Projections					
	2001	2002	2002	2003	2004	2005	2006	2007
Budgetary revenue	**22.0**	**22.7**	**22.6**	**21.7**	**21.4**	**21.2**	**20.9**	**20.8**
Federal government revenue	**16.3**	**16.6**	**16.2**	**15.6**	**15.3**	**15.2**	**15.0**	**14.9**
Tax revenue	11.3	13.0	12.5	12.5	12.4	12.4	12.3	12.4
Income tax	5.0	5.9	5.6	5.6	5.6	5.6	5.6	5.6
VAT	3.6	3.6	3.5	3.5	3.5	3.5	3.4	3.4
Other	2.8	3.5	3.4	3.3	3.1	3.0	2.9	2.8
Administrative measures	0.0	0.0	0.0	0.1	0.2	0.3	0.4	0.5
Nontax revenue	4.9	3.6	3.7	3.2	2.9	2.8	2.6	2.5
Rights of nonrenewable resources	3.7	2.3	2.4	2.4	2.3	2.3	2.2	2.2
Capital income (Aprovechamientos)	1.2	1.2	1.2	0.6	0.5	0.4	0.3	0.2
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Public enterprises	5.7	6.1	6.4	6.1	6.0	6.0	6.0	5.9
PEMEX	1.8	2.3	2.5	2.3	2.2	2.2	2.1	2.1
Other	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Budgetary expenditure	22.7	23.4	23.2	22.0	21.5	20.9	20.5	20.3
Primary	19.4	20.0	20.1	18.7	18.4	17.8	17.5	17.4
Programmable	15.9	16.3	16.4	15.1	14.8	14.2	13.9	13.8
Current	13.3	14.0	14.1	12.7	12.5	11.9	11.6	11.5
Of which : wages	7.3	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Of which : pensions	1.9	2.0	2.1	2.1	2.2	2.2	2.3	2.3
Capital	2.6	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Nonprogrammable	3.5	3.7	3.6	3.6	3.6	3.6	3.6	3.6
Of which : revenue sharing	3.4	3.5	3.5	3.4	3.4	3.4	3.4	3.4
Interest payments and other	3.3	3.3	3.2	3.3	3.1	3.1	3.1	2.9
Transfers to IPAB	0.7	0.8	0.8	0.9	0.7	0.7	0.7	0.5
Interest	2.6	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Extrabudgetary balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Traditional overall balance	**-0.7**	**-0.6**	**-0.7**	**-0.3**	**-0.1**	**0.3**	**0.4**	**0.5**
Traditional primary balance 1/	2.6	2.7	2.5	3.0	2.9	3.4	3.5	3.5
Adjustments to traditional balance	**-3.1**	**-3.3**	**-3.0**	**-2.7**	**-2.4**	**-2.2**	**-2.2**	**-2.1**
- PIDIREGAS financing requirement	0.8	1.5	1.2	1.5	1.3	1.2	1.1	1.0
- IPAB financing requirement	1.0	0.5	0.5	0.5	0.4	0.4	0.3	0.3
- FARAC financing requirement	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
- Budgetary adjustments	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
- Debtor support programs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Financing requirement of development banks	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3
- Non-recurrent revenue	0.7	0.8	0.8	0.2	0.2	0.2	0.2	0.2
Net Public Sector Borrowing Requirement (PSBR)	**-3.8**	**-3.9**	**-3.6**	**-3.0**	**-2.5**	**-2.0**	**-1.8**	**-1.6**
Augmented primary balance 1/	**0.8**	**0.1**	**0.3**	**1.1**	**1.2**	**1.7**	**1.8**	**1.9**
Memorandum items:								
Cyclically adjusted PSBR	-3.7	-3.6	-3.3	-2.8	-2.4	-1.9	-1.7	-1.6
Real primary expenditure growth, incl. Pidiregas (in percent)	-2.3	9.6	3.5	-3.1	2.4	0.7	2.3	3.7
Total interest cost	4.6	4.0	3.9	4.0	3.6	3.7	3.6	3.5
Total oil revenue 2/	6.7	6.4	6.9	6.7	6.4	6.3	6.1	6.0
Non-oil tax revenue	9.8	11.0	10.3	10.3	10.3	10.3	10.4	10.4
Non-oil balance	-8.6	-8.0	-8.2	-7.3	-6.6	-5.9	-5.6	-5.3
Gross public sector debt	48.6	49.0	48.9	48.8	47.7	46.2	44.7	43.2
Net public sector debt	42.0	42.6	42.5	42.6	41.9	40.6	39.4	38.1

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

1/ Treats transfers to IPAB as interest payments.

2/ Oil revenue includes extraction rights, Pemex net revenue, excess return levy and IEPS on gasoline.

Table 9. Mexico: Medium-Term Macroeconomic Framework

	Prel.	Staff Projections					
	2001	2002	2003	2004	2005	2006	2007
	(Annual percentage change, unless otherwise indicated)						
National income and prices							
Real GDP	-0.3	1.4	4.0	4.8	4.7	4.3	4.3
Consumer prices (end of year)	4.4	4.5	3.0	3.0	3.0	3.0	3.0
Consumer prices (average)	6.4	4.8	3.8	3.0	3.0	3.0	3.0
External sector							
Exports, f.o.b.	-3.7	6.6	11.2	11.8	12.4	11.1	11.1
Imports, f.o.b.	-1.7	3.4	14.5	13.6	12.5	11.0	10.9
Terms of trade (deterioration -)	-3.9	0.1	-0.5	-1.2	-0.4	-0.6	-0.1
Interest rates							
Treasury bill rate (average 28-day cetes)	11.3	7.9	9.1	8.2	8.1	8.1	8.1
Real interest rate	7.2	3.5	5.1	5.0	5.0	5.0	5.0
	(In percent of GDP)						
Nonfinancial public sector							
Augmented balance 1/	-3.8	-3.6	-3.0	-2.5	-2.0	-1.8	-1.6
Overall balance 2/	-0.7	-0.7	-0.3	-0.1	0.3	0.4	0.5
Savings and investment							
Gross domestic investment	20.7	20.3	21.7	22.3	22.9	23.3	23.6
Fixed investment	19.6	19.4	20.7	21.2	21.8	22.2	22.5
Public	4.3	4.4	4.8	4.5	4.3	4.2	4.2
Private	15.3	15.0	15.9	16.7	17.5	18.0	18.3
Inventories	1.1	0.9	1.1	1.1	1.1	1.1	1.1
Gross national saving	17.8	17.6	18.2	18.4	19.0	19.4	19.7
Public sector	0.5	0.8	1.8	2.0	2.4	2.5	2.6
Private sector	17.3	16.8	16.4	16.4	16.6	16.9	17.1
External current account balance	**-2.9**	**-2.8**	**-3.6**	**-3.8**	**-3.9**	**-3.9**	**-3.9**

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

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

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

Table 10. Mexico: Summary Medium-Term Balance of Payments

	Prel.	Staff Projections					
	2001	2002	2003	2004	2005	2006	2007
	(In billions of U.S. dollars)						
Current account	**-17.8**	-17.7	**-21.9**	**-25.2**	**-27.8**	**-29.9**	**-30.3**
Merchandise trade balance, f.o.b.	-10.0	-9.3	-12.7	-16.1	-17.9	-19.0	-18.5
Exports	100.8	107.8	120.5	134.9	151.7	170.0	191.0
Of which:							
Petroleum and derivatives	12.8	13.1	14.5	14.1	14.6	14.6	15.1
Manufactures 1/	83.6	90.1	100.9	115.2	131.0	148.7	168.7
Imports	-110.8	-117.1	-133.2	-151.0	-169.6	-189.0	-209.5
Factor income	-13.7	-14.0	-14.3	-14.5	-15.4	-16.5	-17.6
Other services and transfers	5.8	5.6	5.1	5.3	5.4	5.6	5.8
Financial account	**23.3**	**23.7**	**26.5**	**29.9**	**32.8**	**34.1**	**34.7**
Public sector	2.6	7.5	10.4	9.6	8.3	8.0	7.5
Medium- and long-term borrowing	-2.7	7.0	9.8	9.1	7.7	7.4	7.0
Disbursements	17.7	15.7	21.5	21.0	18.5	17.7	16.9
Amortization 2/	20.3	8.7	11.7	11.9	10.8	10.3	10.0
Other, including short-term borrowing	5.3	0.5	0.6	0.6	0.6	0.5	0.5
Private sector	20.6	16.2	16.2	20.3	24.6	26.2	27.2
Direct investment 3/	24.7	12.2	15.9	17.1	18.4	19.7	21.2
Bonds and loans 4/	-0.7	1.9	2.6	2.7	3.7	3.5	3.9
Banking system	-3.1	0.6	0.6	-0.3	1.2	1.5	1.4
Corporate sector	2.4	1.3	2.0	3.0	2.5	2.0	2.5
Equity investments and change in assets abroad	-5.7	2.1	-2.3	0.5	2.5	3.0	2.0
Equity investments	0.2	1.4	1.5	1.6	1.7	2.0	2.0
Change in assets abroad 3/	-5.8	0.7	-3.8	-1.1	0.8	1.0	0.0
Errors and omissions and valuation adjustments	3.8	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-9.2	-6.0	-4.7	-4.7	-5.0	-4.3	-4.4
	(In percent of GDP, unless otherwise indicated)						
Memorandum items:							
Current account balance	-2.9	-2.8	-3.2	-3.5	-3.6	-3.6	-3.5
Non-oil current account balance	-5.0	-4.8	-5.3	-5.4	-5.5	-5.4	-5.2
Non-oil trade balance	-3.7	-3.5	-4.0	-4.1	-4.2	-4.1	-3.8
Merchandise exports	16.3	16.7	17.6	18.5	19.5	20.6	21.8
Merchandise imports	17.9	18.2	19.4	20.7	21.8	22.9	23.9
Gross financing needs (billions of US$) 5/	78.0	60.9	65.5	73.6	73.6	79.0	84.2
Gross international reserves 6/							
End-year (billions of US$)	44.9	50.8	55.5	60.1	65.2	69.4	73.8
Months of imports of goods and services	4.1	4.1	3.9	3.8	3.7	3.5	3.4
Months of imports plus interest payments	3.5	3.5	3.4	3.3	3.2	3.1	3.0
Percent of short-term debt (by residual maturity) 7/	120.8	130.6	127.1	147.8	145.3	151.8	145.9
Percent of financing requirement 8/	81.8	83.6	80.5	87.7	87.2	92.9	92.5
Crude oil export volume (millions of bbl/day)	1.71	1.69	1.90	2.00	2.10	2.20	2.28
Crude oil price (US$/bbl)	18.6	19.2	19.1	17.7	17.4	16.6	16.6
Gross total external debt	26.4	27.3	27.6	27.6	27.4	27.2	26.9
Of which: public external debt 9/	15.9	17.0	17.5	17.7	17.7	17.6	17.5
Gross total external debt (billions of US$)	162.8	176.0	188.8	201.2	213.1	224.4	235.8
Of which: public external debt 9/	98.4	109.7	120.0	129.5	137.7	145.6	153.1
Public external debt service (in percent of exports of goods, services, and transfers) 9/	22.6	12.3	13.5	12.9	11.4	10.3	9.3
	(Annual percentage change)						
Export volume	1.8	4.8	10.7	11.9	11.5	11.4	11.3
Non-oil exports	1.6	5.4	10.6	12.6	12.2	12.0	12.0
Import volume	1.5	3.7	12.1	12.0	11.0	10.2	9.7
Consumer goods	22.2	6.2	13.8	13.3	12.6	10.8	9.3
Intermediate goods	-1.4	2.5	11.0	11.4	10.1	9.8	9.7
Capital goods	-4.2	5.5	13.8	12.3	12.0	10.8	9.8

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

1/ Includes net proceeds from in-bond industries.

2/ Includes pre-payment of external debt.

3/ In 2001, FDI includes the US$12.5billion Citibank acquisition of Banamex. This is reflected in an equal increase in private sector assets in the same year, followed by partial drawdown in the following years.

4/ Includes financing of PIDIREGAS up to 2001 (in line with the authorities presentation). For the forecasting period (from 2002) financing of PIDIREGAS is considered as a public sector financing item.

5/ Defined here as the sum of the current account deficit, debt amortization (including pre-payments, short-term debt, and IMF repurchases), and gross reserves accumulation.

6/ Excludes balances under bilateral payments accounts.

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

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

9/ Includes the IMF and public development banks and trust funds. Includes debt associated with PIDIREGAS, in contrast to previous staff reports.

Table 11. Mexico: External Financing Requirements and Sources
(In billions of U.S. dollars)

	Prel.	Staff Projections					
	2001	2002	2003	2004	2005	2006	2007
1. Gross financing requirements 1/	**78.1**	**58.8**	**68.4**	**76.1**	**75.6**	**79.9**	**85.9**
External current account deficit	17.9	17.3	23.6	26.6	28.7	29.7	30.8
Debt amortization	51.0	36.7	40.1	44.8	41.8	46.0	50.7
Medium- and long- term debt	35.8	23.6	25.6	29.3	25.2	28.3	32.1
Public sector 2/	20.3	8.7	11.7	11.9	10.8	10.3	9.9
International financial institutions 3/	1.6	1.8	1.7	1.7	1.9	2.1	2.3
Other official creditors	0.7	0.7	0.6	0.6	0.5	0.6	0.7
Bonds	1.4	4.4	2.9	4.8	4.4	2.5	2.5
Other	16.7	1.8	6.5	4.9	4.1	5.1	4.4
Commercial banks	3.8	4.5	3.0	3.3	2.6	2.9	3.3
Corporate private sector	11.7	10.4	10.9	14.1	11.8	15.2	19.0
Short-term debt	15.2	13.1	14.5	15.6	16.7	17.7	18.6
Public sector	4.3	3.7	4.2	4.7	5.2	5.7	6.2
Commercial banks	2.4	1.4	1.5	1.6	1.8	1.9	2.1
Corporate private sector	8.5	8.0	8.8	9.2	9.7	10.0	10.3
IMF repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserve accumulation	9.2	4.8	4.7	4.7	5.0	4.3	4.4
2. Available financing	**78.1**	**58.8**	**68.4**	**76.1**	**75.6**	**79.9**	**85.9**
Foreign direct investment	24.8	12.1	15.6	16.7	18.0	19.2	20.6
Debt financing from private creditors	45.4	41.6	51.0	55.1	50.7	54.7	59.4
Medium- and long-term financing	32.2	27.1	35.4	38.4	34.0	37.1	40.8
Public sector 4/	16.1	10.7	19.5	18.9	16.4	15.6	14.7
Bonds	3.3	9.9	12.2	13.1	12.3	10.4	10.2
Other	12.8	0.8	7.3	5.8	4.1	5.2	4.5
Commercial banks	1.6	5.0	3.5	2.9	3.6	4.3	4.7
Corporate private sector	14.6	11.4	12.4	16.6	14.0	17.2	21.5
Short-term financing	13.1	14.5	15.6	16.7	16.7	17.7	18.6
Official creditors	1.6	2.1	2.0	2.0	2.1	2.1	2.2
International financial institutions 3/	1.3	1.8	1.7	1.7	1.7	1.7	1.7
Other official creditors	0.2	0.3	0.3	0.3	0.4	0.4	0.5
Other flows 5/	6.4	3.0	-0.2	2.3	4.9	3.9	3.7
IMF purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Gross international reserves (eop) 6/	44.9	49.7	54.3	59.0	64.0	68.3	72.7
Percent of short-term debt (by residual maturity) 7/	122.4	123.8	121.2	141.0	139.2	145.6	140.5
Percent of financing requirement 7/	83.2	78.0	76.0	83.6	84.6	90.2	89.2

Sources: Mexican authorities and Fund staff estimates and projections.

1/ The gross external financing requirement includes the current account deficit, short-term debt by residual maturity, and gross reserve accumulation.
2/ Historical data include prepayment of external debt.
3/ Excluding the IMF.
4/ Includes PIDIREGAS financing from 2002.
5/ Including net equity investments, net increase on assets abroad, and net errors and omissions.
6/ Excludes balances under bilateral payments accounts.
7/ Excludes prepayment of public sector debt.

Table 12. Mexico: Medium-Term External Debt and Debt-Service Indicators

	Prel.	Projections					
	2001	2002	2003	2004	2005	2006	2007
	(In billions of U.S. dollars)						
External debt outstanding 1/	**164.6**	**177.3**	**190.1**	**202.4**	**214.3**	**225.7**	**237.0**
Public debt	98.4	106.7	117.0	126.5	134.7	142.6	150.0
Direct debt	98.4	106.7	117.0	126.5	134.7	142.6	150.0
Medium and long term	94.8	102.6	112.3	121.4	129.0	136.4	143.3
Of which: PIDIREGAS 2/	18.1	26.0	35.2	43.5	51.5	59.4	67.1
Short term	3.7	4.2	4.7	5.2	5.7	6.2	6.7
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	9.0	9.6	10.2	10.0	11.2	12.6	14.1
Nonbank private sector 3/	57.1	60.9	62.9	65.9	68.4	70.4	72.9
Public financial assets 4/	3.7	3.5	4.1	4.7	5.3	6.0	6.8
Net external public sector debt 5/	94.7	103.2	113.0	121.9	129.4	136.6	143.2
Public sector external debt service	**27.7**	**15.8**	**19.1**	**20.3**	**19.9**	**20.0**	**20.2**
Amortization	20.3	8.7	11.7	11.9	10.8	10.3	9.9
Interest	7.4	7.2	7.4	8.4	9.1	9.7	10.3
Private sector external debt service	**20.7**	**18.3**	**19.5**	**23.3**	**20.4**	**24.0**	**28.5**
Amortization	15.5	14.9	13.9	17.4	14.4	18.0	22.2
Interest	5.2	3.4	5.6	5.9	6.1	6.0	6.2
Net resource transfer 6/	**-4.2**	**-3.7**	**-9.1**	**-11.9**	**-13.0**	**-13.2**	**-13.2**
	(In percent of GDP)						
Total external debt	**26.6**	**27.6**	**28.7**	**28.7**	**28.5**	**28.3**	**28.0**
Public sector	15.9	16.6	17.6	17.9	17.9	17.9	17.8
Medium and long term	15.3	15.9	16.9	17.2	17.2	17.1	17.0
Of which: PIDIREGAS	2.9	3.2	3.4	3.9	4.0	4.0	5.3
Short term (excluding IMF)	0.6	0.7	0.7	0.7	0.8	0.8	0.8
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	10.7	11.0	11.0	10.7	10.6	10.4	10.3
Medium and long term	9.2	9.4	9.4	9.1	9.0	8.9	8.8
Short term	1.5	1.6	1.6	1.6	1.6	1.6	1.5
Net external public sector debt	15.3	16.0	17.0	17.3	17.2	17.1	16.9
Interest obligations on external public sector debt	1.2	1.1	1.1	1.2	1.2	1.2	1.2
Net resource transfer	-0.7	-0.6	-1.4	-1.7	-1.7	-1.7	-1.6
	(In percent of exports of goods, services, and transfers)						
Total external debt	134.0	139.7	137.1	130.6	123.2	116.8	110.4
Of which							
Public sector	80.1	84.0	84.4	81.6	77.4	73.8	69.9
Of which							
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt service	39.4	26.9	27.9	28.1	23.2	22.8	22.7
Of which							
Public sector debt 7/	22.6	12.5	13.8	13.1	11.4	10.3	9.4

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

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

2/ Corresponds to external obligations of private contractors undertaken on behalf of the public sector. This debt is not considered as public sector debt by the authorities.

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

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

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

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

7/ Includes the Fund.

MEXICO: FUND RELATIONS

(As of June 30, 2002)

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

II. **General Resources Account**:	**SDR Million**	**Percent of Quota**
Quota	2,585.80	100.0
Fund holdings of currency	2,585.39	99.98
Reserve position in Fund	0.42	0.2
Financial transaction plan transfers (net)	200.00	

III. **SDR Department**:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	290.02	100.0
Holdings	283.37	97.7

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

V. **Financial Arrangements**:

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

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

		Forthcoming			
	2002	**2003**	**2004**	**2005**	**2006**
Charges/interest	0.10	0.20	0.20	0.20	0.20
Total	**0.10**	**0.20**	**0.20**	**0.20**	**0.20**

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 August 2, 2001. The relevant staff report was CR/01/190. In the context of the 2001 Article IV consultation, a joint Bank-Fund mission visited Mexico City in March 2001 under the Financial Sector Assessment Program.

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

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

MEXICO: RELATIONS WITH THE WORLD BANK

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

Using the program flexibility built into the 1999 CAS, the Bank was able to deliver, over the past four years, assistance both at the broad reform agenda and at the sectoral level. New lending committed during the FY1999–2002 period remained at a strong US$4.8 billion. The Bank's analytical work carried out over the past few years in support of its lending program and policy dialogue with the Mexican government was summarized in a collection of Policy Notes,[1] covering more than 30 different sectors and themes, that served as a highly appreciated, analytical bridge across administrations.

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

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

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

MEXICO: STATISTICAL ISSUES

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

Although some of the **balance of payments statistics** conforms to the fifth edition of the Balance of Payments Manual, a full transition has not yet been completed. Several measures to improve **external debt statistics** have been carried out, including the compilation of data on external liabilities of publicly traded companies registered with the Mexican stock exchange (external debt outstanding, annual amortization schedule for the next four years broken down by maturity, and type of instrument), but a projection of the total external debt service of commercial banks is still not available. **International reserves** data are compiled according to the Operational Guidelines for the Data Template on International Reserves and Foreign Currency Liquidity of the IMF (October 1999).

In the fiscal area, the authorities have started in 2001 to report 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.

The data ROSC mission that visited Mexico in February/March 2002 concluded that the country is in observance of the SDDS. In a number of cases, the periodicity and timeliness of disseminated data exceeded SDDS requirements. The quality of the macroeconomic statistics available to the public was generally good, although there was scope for improvement, particularly as regards the coverage and availability of information on methodologies, techniques, and source data, as well as in the presentation of certain data.

Mexico: Core Statistical Indicators

As of June 30, 2002

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	June 30	June 26	End-Dec.	June 26	May 31	June 30	June 30	May 31	First quarter 2002	First quarter 2002	First quarter 2002	First quarter 2002
Date Received	June 30	June 30	Apr. 24	June 30	June 30	June 30	July 15	July 9	June 1	May 15	May 15	May 15
Frequency of Data 1/	D	W	W	D	M	D	Bi-W	M	Q	Q	Q	M
Frequency of Reporting 1/	D	W	W	D	M	D	Bi-W	M	Q	Q	Q	Q
Source of Update 2/	A	A	N	A	N	N	N	N	N	N	N	N
Mode of Reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	B	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 1/	D	W	W	W	M	D	Bi-W	M	Q	Q	Q	Q

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

Mexico: Public Sector Debt Sustainability Framework

	2000	2001	2002p	2003p	2004p	2005p	2006p	2007p	Average 2002–07
A. Public debt dynamics decomposition: baseline									
Gross public sector debt (as percentage of total revenue)	232.6	230.1	224.8	226.8	225.4	220.1	215.8	209.4	220.4
Gross public sector debt (as percentage of GDP)	49.0	48.6	48.9	48.8	47.7	46.2	44.7	43.2	46.6
Of which: foreign currency denominated (as percentage of GDP)	17.3	15.9	16.5	17.5	17.8	17.9	18.0	18.0	17.6
Of which: local currency denominated (as percentage of GDP)	31.7	32.7	32.4	31.2	29.9	28.3	26.7	25.2	29.0
Gross public sector debt (change in debt to GDP ratio)	-1.8	-0.3	0.3	-0.1	-1.1	-1.5	-1.4	-1.5	-0.9
Net debt creating flows (in percent of GDP)	-5.0	0.7	-0.1	-0.9	-1.3	-1.8	-1.7	-1.8	-1.2
Augmented primary deficit (in percent of GDP)	-1.2	-0.8	-0.3	-1.1	-1.2	-1.7	-1.8	-1.9	-1.3
Total revenue (in percent of GDP) 1/	21.1	21.1	21.8	21.5	21.2	21.0	20.7	20.6	21.1
Total expenditure (in percent of GDP) 2/	24.7	24.9	25.4	24.5	23.6	22.9	22.5	22.2	23.5
Total primary expenditure 4/	19.8	20.3	21.5	20.5	20.0	19.3	18.9	18.8	19.8
Total Interest cost 3/	4.9	4.6	3.9	4.0	3.6	3.7	3.6	3.5	3.7
Net nondebt creating inflows (percent of GDP)	0.4	0.7	0.8	0.2	0.2	0.2	0.2	0.2	0.3
Nonrecurrent revenue (in percent of GDP)	0.4	0.7	0.8	0.2	0.2	0.2	0.2	0.2	0.3
(r-g-(p+pg))/(1+g+p+gp) * D	-3.3	2.2	1.0	0.4	0.0	0.2	0.4	0.3	0.4
(1+g+p+gp)	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
(r-g-(p+pg)) * D	-4.0	2.4	1.0	0.4	0.0	0.2	0.4	0.3	0.4
r * D	5.9	4.9	4.1	4.4	3.9	4.0	3.9	3.7	4.0
-g* D	-3.4	0.1	-0.7	-2.0	-2.3	-2.2	-2.0	-1.9	-1.9
-(p+pg) * D	-6.5	-2.6	-2.4	-2.0	-1.6	-1.6	-1.5	-1.5	-1.7
Residual (percent of GDP)	3.1	-1.0	0.3	0.7	0.2	0.2	0.2	0.2	0.3
B. Sensitvity analysis for public debt to GDP ratio 4/									
1.- If interest rate, real GDP growth, GDP deflator growth primary balance and non-debt flows are at five-year average	49.0	48.6	47.2	46.2	44.6	43.1	41.6	40.0	43.8
2.- If interest rate in year t and t+1 is on average plus 2 STD	49.0	48.6	58.3	69.2	68.1	66.6	65.3	64.0	65.2
3.- If real growth in year t and t+1 is on average minus 2 STD	49.0	48.6	50.4	53.1	52.0	50.5	49.1	47.6	50.4
4.- If GDP deflator in year t and t+1 is on average minus 2 STD	49.0	48.6	49.5	49.5	48.4	46.9	45.5	43.9	47.3
5.- If augmented primary balance in year t and t+1 is on average minus 2 STD	49.0	48.6	49.6	51.1	50.2	48.8	47.5	46.1	48.9
6.- Combination of 2–5, using one STD shock	49.0	48.6	53.9	60.7	59.7	58.2	56.9	55.5	57.5
7.- Previous using two STD shock	49.0	48.6	61.5	78.7	77.7	76.3	75.1	73.8	73.8
8.- One time 30 percent depreciation in t, everything else at baseline except primary deficit	49.0	48.6	53.4	53.3	52.2	50.7	49.3	47.8	51.1
9.- Increase of debt ratio in t by 10 percent of GDP	49.0	48.6	58.9	58.9	57.8	56.3	54.9	53.5	56.7

Sources: Bank of Mexico; and Fund staff estimates.

1/ Budgetary revenue excluding non-recurrent income, capital gains on debt buy-backs and premia on par bonds.

2/ Budgetary expenditure + PIDIREGAS financing requirement + IPAB financing requirement+ FARAC financing requirement + development banks financing requirement + inflation component of indexed bonds + reserves of IMSS and ISSSTE + debtor support programs.

3/ Budgetary financing cost + accrued interest IPAB + net interest PIDIREGAS + inflation component of indexed bonds + FARAC financing requirement + debtor support programs.

4/ Projection assumes a constant residual at the baseline level.

Mexico: External Debt Sustainability Analysis

	1999	2000	2001	Projections 2002	2003	2004	2005	2006	2007
1. Baseline scenario									
1. Gross external debt (percent of GDP)	36.9	28.4	26.4	27.3	28.4	28.4	28.3	28.1	27.8
2. Gross external (change in debt-to-GDP ratio)	-2.5	-8.5	-2.1	0.9	1.1	0.0	-0.1	-0.2	-0.3
3. Net debt creating flows (lines 4-5+6)	-5.7	-5.6	-3.1	-0.5	-0.3	-0.9	-0.8	-0.8	-0.8
4. Current account deficit, excluding interest payments (percent of GDP)	0.2	0.7	0.9	1.2	1.3	1.5	1.6	1.6	1.6
5. Net nondebt creating inflows (percent of GDP)	3.4	2.6	4.0	2.1	2.6	2.6	2.6	2.7	2.7
6. Debt dynamic: (r-g-ρ+gρ))/(1+g+ρ+gρ)) debt/GDP (lines (7-8-9)/10)	-2.5	-3.7	0.1	0.4	1.0	0.2	0.2	0.3	0.3
7. r (interest rate) times debt/GDP	2.9	3.0	2.2	1.6	1.9	2.0	1.9	1.8	1.8
8. g (real GDP growth rate) times debt/GDP	1.4	2.5	-0.1	0.4	1.1	1.3	1.2	1.1	1.1
9. (ρ + gρ) (ρ = U.S. dollar value of GDP deflator, growth rate) times debt/GDP	4.4	5.1	2.1	0.8	-0.2	0.4	0.4	0.4	0.4
10. Adjustment factor: 1+g+ρ+gρ	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1
11. Residual, including change in gross foreign assets/GDP	3.2	-2.9	1.0	1.5	1.4	0.9	0.7	0.6	0.6
Memorandum items: Key macro and external assumptions									
Nominal GDP (billion U.S. dollars) 1/	481.1	580.7	617.9	643.3	663.9	706.7	752.1	797.5	845.6
Real GDP growth (in percent per year)	3.7	6.6	-0.3	1.5	4.0	4.8	4.7	4.3	4.3
Real exchange rate (change, in percent per year)	9.0	10.0	8.3	1.5	-2.4	0.0	0.0	0.0	0.0
Nominal GDP deflator (in U.S. dollars, change in percent per year)	10.3	12.6	7.0	2.9	-0.8	1.6	1.6	1.6	1.6
External interest rate (percent per year)	7.3	8.2	7.7	6.0	7.1	7.3	7.3	7.1	7.1
Oil price (WEO Summer 2002)	18.0	26.8	25.0	23.0	22.5	21.5	21.0	21.0	21.0
Growth of exports of G&S (U.S. dollar terms, in percent per year)	13.0	21.3	-4.2	7.2	10.6	11.2	11.8	11.4	11.4
Growth of imports of G&S (U.S. dollar terms, in percent per year)	10.3	22.6	-1.4	6.4	11.8	12.9	11.9	11.2	11.0
2. Sesitivity analysis for external debt to GDP									
12. If real interest rate, real GDP growth rate, US$ GDP deflator growth, non-interest current account 2/ and nondebt flows (in percent of GDP) are at average of past 5 years; real GDP deflator growth is assumed zero.			26.4	24.2	21.6	18.8	16.1	13.3	10.4
13. If interest rate in 2002 and 2003 is average plus two standard deviations, others at baseline.			26.4	27.9	28.6	27.8	27.0	26.3	25.5
14. If real GDP growth rate 2002 and 2003 is average minus two standard deviations, others at baseline.			26.4	28.0	29.9	29.1	28.3	27.6	26.8
15. If US$ GDP deflator growth in year 2002 and 2003 is 0 minus two standard deviations, others at baseline.			26.4	29.2	31.7	30.8	30.1	29.4	28.5
16. If the noninterest current account (in percent of GDP) in year 2002 and 2003 is average minus two standard deviations.			26.4	27.3	28.6	27.7	27.0	26.3	25.5
17. Combination of 2-5 using one standard deviation shocks. 1/			26.4	28.6	31.1	30.2	29.5	28.8	27.9
18. One time 30% depreciation in 2002 (unchanged real exchange rate, thereafter) others at baseline.1/			26.4	35.5	35.9	35.0	34.3	33.6	32.8

Sources: Bank of Mexico; and Fund staff estimates.

1/ All variables relative to baseline, except the US dollar GDP deflator which is set at zero, as further real appreciation of the peso is considered an unlikely event.

2/ This projection implicitely assumes zero foreign assets accumulation (e.g., increase in international reserves).

Mexico: Social Indicators of Development

	Mexico (most recent estimates)	Mexico (15-20 years ago)	Latin America and Caribbean (most recent estimates)
Demographic			
Area (square kilometers)	1,908,690	1,908,690	20,504,830
Population (millions)	98.0	75.5	508.2
Urban (percent of total)	74.4	69.6	74.9
Density (population per sq. kilometer)	51.3	34.0	24.8
Population annual growth rate (percent)	1.4	2.2	1.6
Of which			
Urban	1.7	4.2	2.2
Crude birth rate (per thousand population)	24.8	33.0	23.2
Crude death rate (per thousand population)	5.2	7.0	6.5
Fertility rate (births per women)	2.6	4.5	2.7
Labor force			
Economically active population (millions)	40.4	22.0	217.2
Agriculture (percent of economically active population)	21.0	36.6	25.5
Manufacturing (percent of economically active population)	25.2	29.0	24.0
Poverty			
Extreme and moderate poverty (percent)	45.7	57.8	...
Of which			
Rural	73.3	69.3	
Extreme poverty (percent)	18.0	27.0	
Of which			
Rural	46.1	41.4	
Health			
Infant mortality (per thousand live births)	29.2	43.0	30.0
Mortality rate under 5 years of age (per thousand live births)	35.8	74.0	38.0
Life expectancy at birth (years)	73.0	69.0	70.0
Population per physician	1.7	0.9	1.4
Immunized under 5 months (percent of group)			
Measles	95.0	64.0	90.0
DPT	96.0	40.0	87.0
Oral rehydration therapy under 5 years of age (percent of cases)	87.0	...	61.0
Access to safe water (percent of population)			
Urban	94.0	95.0	93.0
Rural	63.0	50.0	62.0
Nutrition			
Cereal imports (thousands of metric tons)	6,223.0	4,780.0	27,659.0
Daily calorie intake (calories per person)	3,097.0	...	2,726.0
Daily protein supply (grams per person)	82.5	...	68.0
Prevalence of malnutrition under 5 years of age (percent of age group)	7.5	...	9.0
Education			
Gross enrollment ratios (percent of school age group) 1/			
Primary	113.5	120.0	113.0
Secondary	70.5	49.0	51.7
Pupil/teacher ratio (pupils per teacher)			
Primary	27.2	34.0	24.6
Secondary	16.0	18.0	26.0
Illiteracy rate (percent of population over 15 years)	8.6	15.0	12.0
Women			
Gross enrollment ratio (percent of school age group) 1/			
Primary	102.8	122.0	...
Secondary	71.5	55.0	...
Illiteracy rate (percent of population over 15 years)	10.5	18.0	13.8
Life expectancy (years)	76.0	73.0	72.9
Labor force (percent of total)	33.2	27.0	34.2

Source: World Bank Social Indicators of Development.

1/ Includes over and underage students.

Statement by the IMF Staff Representative
September 23, 2002

1. The following information, which does not change the thrust of the staff appraisal, has become available since the staff report (SM/02/260) was issued to Executive Directors.

Recent economic developments

2. Recent data confirm that economic activity rebounded strongly in the second quarter of 2002, following 6 quarters of contraction or stagnation. Real GDP grew by 1.2 percent on a seasonally adjusted basis, as exports were supported by stronger demand from the United States, and final domestic demand grew sharply (by 2.8 percent) following several quarters of weakness. Indicators for the third quarter are mixed. Both industrial production and non-oil exports were about unchanged in July (compared with the second quarter); however, employment in the formal sector grew by 1½ percent during this period.

3. The 12-month inflation rate rose further to 5.3 percent in August 2002 (compared with the end-year target of 4.5 percent), owing to increases in administered prices. As a result, inflation expectations have risen to close to 5 percent for 2002, notwithstanding the further decline in core inflation to under 4 percent from over 5 percent in December 2001.

4. In the first half of 2002, the overall external current account deficit is estimated to have reached 2.1 percent of GDP, slightly smaller than reported in the staff report. About 90 percent of the deficit during this period was financed by net inflows of foreign direct investment.

Recent financial market developments

5. Market sentiment towards Mexico continues to be positive. Sovereign bond spreads have narrowed from 418 basis points in mid-August to around 400 basis points (as of September 17). Mexican issuers have maintained access to international capital markets and the local corporate bond market has also remained active. Last week, the federal government issued US$1.75 billion in 20-year global bonds at a spread of 353 basis points. Most of the proceeds from the bond sale (US$1.3 billion) will be used to retire Brady bonds, while the remainder will be used to cover bond redemptions in 2003. On August 21, HSBC Holdings announced that it would acquire Bital (Mexico's fourth-largest bank) for US$1.1 billion.

6. The peso has depreciated to close to Mex$10 per U.S. dollar from Mex$9.8 per U.S. dollar at end-July, while domestic interest rates have declined slightly to below

7 percent. Gross international reserves have been stable (at approximately US$47 billion).

Policy initiatives

7. In mid-August, the government sent to congress its proposal for electricity reform, which aims at modernizing the sector and increasing capacity. It involves allowing the full participation of the private sector in electricity generation, and enabling private generators to sell electricity to large (normally corporate) consumers. These changes would entail amending two constitutional articles, which reserve for the public sector the right to sell and generate electricity.

8. As of September 26, banks will be required to establish at the Bank of Mexico (BOM) a compulsory deposit for an indefinite period of Mex$150 billion for the system. The distribution of compulsory deposits among individual banks will be determined on the basis of peso-denominated liabilities. Most of this amount (Mex$95 billion) will replace already existing deposits at the BOM, not all of which are compulsory. The new deposits will carry a lower interest rate than the ones being replaced. The authorities have indicated that this action does not change their monetary policy stance, as any net reduction in liquidity will be channeled back in full to the money market on a daily basis through the BOM's open market operations. Rather, it is intended to reduce the BOM's interest costs (strengthening its net income position while lowering that of the commercial banks) and to improve its capacity to conduct monetary policy (as the higher level of compulsory deposits will enable the BOM to maintain a daily net creditor position with the money market with less reliance on open market operations).

Sustainability analysis

9. As noted in the staff report, the sustainability analysis presented in Appendix Box 6 was based on the preliminary methodology proposed in "Assessing Sustainability" (SM/02/166) presented to the Executive Board on June 14, 2002. However, simulating shocks to domestic nominal interest rates for countries such as Mexico, that have experienced significant disinflation in recent years overstates interest rate movements associated with a two-standard deviation increase compared with a comparable shock to domestic real interest rates. Accordingly, the analysis was modified to examine the implications of a two-standard deviation shock to domestic real interest rates (Supplement 1 of the Selected Issues Paper, SM/02/289).

10. The results show a much smaller increase in the public sector debt-to-GDP ratio than the one presented in Appendix Box 6; the profile of the external debt-to-GDP ratio is unchanged. In the revised simulations (see Supplement 1), the public sector debt peaks at less than 53 percent of GDP in 2003 (following a two-standard

deviation increase in domestic real interest rates and a decline in real GDP growth). This compares with a peak of close to 70 percent in the simulations presented in the staff report, which were based on a two-standard deviation increase in nominal interest rates.

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

IMF Concludes 2002 Article IV Consultation with Mexico

On September 23, 2002 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

The economic slowdown in the United States triggered a sharp weakening in Mexican economic activity in 2001 from the rapid pace in the preceding year. There was also a marked deceleration in domestic demand growth, as disposable income was adversely affected by a contraction in employment and confidence sagged. Last year's recession, which was characterized by a 0.3 percent decline in real GDP, was the first in Mexico's recent history not associated with a domestic economic crisis. The 12-month inflation rate slowed to 4.4 percent at end-2001, well under the target of 6.5 percent. The weakness in domestic demand last year contributed to a narrowing of the external current account deficit to 2.8 percent of GDP from 3.1 percent of GDP in 2000. The current account deficit was more than financed by foreign direct investment (FDI), reflecting the US$12.5 billion purchase of Banamex by Citibank. Other capital inflows were also strong, helped by investors' perception of Mexico as a "safe haven" among emerging markets.

Economic activity rebounded strongly in the second quarter of 2002, as exports were supported by stronger demand from the United States and final domestic demand grew sharply. The 12-month inflation rate rose to 5.3 percent in August 2002, owing largely to increased transport and electricity tariffs, and a weather-related hike in food prices; the core

[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.

inflation rate continued to decline to under 4 percent. The external current account deficit continued to moderate in the first half of 2002. About 90 percent of the deficit during this period was financed by net inflows of foreign direct investment.

Net international reserves increased by US$1.7 billion during the first eight months of 2002, following a gain of over US$9 billion in 2001. Gross international reserves amounted to more than US$46½ billion at the end of August 2002, equivalent to 125 percent of short-term debt by residual maturity and 82 percent of annual gross external financing requirements.

The authorities made progress in rebalancing the policy mix in 2001 as fiscal policy was tightened on a cyclically-adjusted basis and monetary policy was relaxed. Monetary policy was tightened in September 2002 in response to an uptick in inflation expectations and the turbulence in international markets, in line with the Bank of Mexico's strategy of achieving a decline in inflation to low levels. Domestic interest rates fell during 2001 and the first four months of 2002, but that fall subsequently has been partly reversed.

Mexican financial markets have weakened since early April 2002 in response to the rise in global risk aversion and developments in Brazil. Nevertheless, market sentiment towards Mexico remains favorable, supported by the country's investment-grade rating which has contributed to a widening of the investor base. The peso depreciated from end-March 2002, which contributed to some gain in competitiveness. In any case, the peso still has appreciated significantly in real effective terms in recent years both in relation to relative consumer prices and (by less) in relation to unit labor costs.

The government has made substantial progress in improving public sector debt management, resulting in a lower cost of funding, longer maturities and reduced external vulnerability. Nonetheless, exposure to short-term interest rates and the large gross financing needs of the public sector still constitute vulnerabilities for the public sector.

Executive Board Assessment

Directors commended the authorities for maintaining prudent fiscal and monetary policies in the face of weak economic activity. As a result, inflation has declined, the external current account deficit is moderating, and international reserves have strengthened significantly. Directors noted that last year's recession was the first in Mexico's recent history not associated with a domestic economic crisis—demonstrating a resilience that distinguishes the country as a relatively "safe haven" among emerging markets.

Directors observed that the difficult external environment had weakened Mexico's economic performance in 2001, but that growth has begun to rebound this year in line with the pick up in activity in the United States. Continued skillful macroeconomic management and strong focus on trade, as well as further progress in structural reforms, will be essential for achieving faster growth and continuing to reduce poverty.

Directors welcomed the authorities' medium-term economic program (PRONAFIDE), which centers on structural reforms aimed at strengthening further the fiscal position, enhancing competitiveness and increasing productivity. Full implementation of the reforms is now essential to place the economy on a higher growth path that would facilitate poverty reduction. Directors emphasized the particular importance of reforms in the tax system to reduce reliance on oil revenues, as well as in the energy and telecom sectors, the labor market, and the judicial system, including improvements in governance.

Directors welcomed the authorities' commitment to a fiscal framework aimed at a sizable reduction in the fiscal deficit and public debt by 2006. They stressed that successfully implementing the authorities' objective of a front-loaded fiscal adjustment in 2003 would be important to further enhance Mexico's market credibility, following the easing of the fiscal policy stance this year. Achieving this objective would also reduce pressure on real interest rates, allowing room for increased private sector activity, and raising Mexico's resilience against external shocks.

In considering the mix of adjustment measures, Directors noted the authorities' firm commitment to curtail spending as needed to achieve the medium term fiscal targets. They welcomed the fact that, despite the tight spending constraints, the authorities had increased social expenditures markedly in recent years, which had led to an improvement in poverty indicators. Directors supported the authorities' intention to continue to build support for the much-needed second stage of fiscal reforms, especially the harmonization of the VAT rates, and commended the authorities' continued efforts to improve tax administration.

Directors welcomed the main findings of the fiscal ROSC mission, namely, that the government has made considerable progress in improving transparency and complying with international standards. Major initiatives included reforms to the budgetary process, timely disclosure of fiscal information, and strengthening of internal controls. The recent publication of the fiscal ROSC is an important example of this progress. Nevertheless, Directors noted that additional actions are still needed, including a redefinition of the institutional coverage of government, and presentation of the budget within a medium term context.

Directors noted that Mexico's central bank has gained considerable credibility in recent years in the conduct of monetary policy. In light of the recent uptick in inflation expectations and the turbulence in international markets, they endorsed the bank's monetary policy stance, including today's tightening of policies, as appropriately geared toward achieving a decline in inflation to low levels. An easing of monetary conditions could be considered at a later stage should prospects for economic recovery weaken, and provided inflationary expectations are successfully reduced.

Directors welcomed the authorities' intention to strengthen further the inflation targeting framework, and the announced adoption of a long-term inflation objective for 2004 and beyond. Most agreed that the "corto" continues to be a flexible and efficient monetary policy instrument that allows for appropriate adjustments in interest rates. Moving forward, some Directors saw merit in considering a shift toward the direct targeting of short-term interest rates as a means of further enhancing transparency in monetary policy—especially in a strengthened inflation targeting framework—and reducing interest rate volatility, while others noted that such a move could increase volatility in the exchange rate.

Directors welcomed the continued strengthening of the financial system, and the additional measures that are being introduced, aimed at achieving international standards. In particular, they noted the measures to reduce the Bank of Mexico's credit risk associated with the payments system, and the recent legislation to modernize the state-owned development banks. Some Directors expressed concern about the stagnation in bank credit to the private sector, but took note of the authorities' expectation that a resumption in lending could be facilitated by the reforms introduced to improve the credit infrastructure, including the framework for creditor rights, and to strengthen bank supervision.

Directors viewed the present level of international reserves as broadly adequate in the context of a flexible exchange rate regime, noting that reserves more than fully cover short-term debt. A few Directors felt that a further accumulation of reserves would be desirable to provide an extra margin of safety. As regards external competitiveness, several Directors observed that the timely implementation of productivity enhancing measures as proposed by the authorities would help allay possible concerns about the appreciation of the real exchange rate in recent years, although it was noted that Mexican exports continue to gain market share in the United States, its main trading partner.

Looking ahead, Directors noted that despite favorable economic prospects uncertainties remain, including the strength of the recovery in the U.S., volatility in equity markets, and the weakening of sentiment toward other emerging market economies. In addition, a number of Directors pointed to the risks related to the large public sector financing requirement, and the structure of public and corporate debt, and cautioned that delays in implementing the authorities' medium-term fiscal adjustment and structural reform agenda could increase the economy's vulnerability and lower growth prospects. In this context, Directors took note of the results of the stress simulations that suggest that the external sector could weather well a potential sizable capital account crisis. They welcomed the authorities' efforts to further improve public debt management through continued issues of long-term fixed-rate instruments, and by establishing benchmarks in the domestic debt market. They also welcomed the authorities' intention to undertake a World Bank-led ROSC on corporate governance, and encouraged them to continue their close monitoring of the corporate sector. In general, Directors were reassured by the authorities' well-deserved reputation for addressing adverse circumstances through prudent economic management, and by the measures that have been taken to strengthen the institutional basis for maintaining economic and financial stability.

Directors noted that Mexico's data are generally of good quality, timely, and adequate for conducting surveillance effectively.

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

Mexico: Selected Economic and Financial Indicators

	1997	1998	1999	2000	Prel. 2001
Real economy (annual percentage change)					
Real GDP	6.8	5.0	3.6	6.6	-0.3
Real GDP per capita	5.1	3.4	2.0	5.0	-1.7
Gross domestic investment (in percent of GDP)	25.9	24.3	23.5	23.5	20.7
Gross national savings (in percent of GDP)	24.0	20.5	20.5	20.4	17.8
Consumer prices (end of year)	15.7	18.6	12.3	9.0	4.4
External sector (annual percentage change)					
Exports, f.o.b.	15.0	6.4	16.1	22.0	-4.8
Imports, f.o.b.	22.7	14.2	13.2	22.9	-3.5
External current account (in percent of GDP)	-1.9	-3.8	-2.9	-3.1	-2.9
Change in net international reserves (in billions of U.S. dollars) 1/	13.5	3.7	3.9	8.2	9.2
Outstanding external debt (in percent of GDP)	34.0	41.1	34.4	25.9	22.3
Total external debt service (in percent of exports of goods, services, and transfers)	62.6	47.9	43.8	41.8	39.4
Nonfinancial public sector (in percent of GDP)					
Primary balance	3.3	1.7	2.6	2.6	2.6
Overall balance	-0.7	-1.2	-1.1	-1.1	-0.7
Net public external debt (including IMF)	27.0	20.1	19.7	15.9	15.3
Money and credit (annual percentage change)					
Monetary base	29.6	20.8	43.5	10.7	8.0
Broad money (M4a)	29.0	24.2	19.4	-12.2	16.1
Treasury bill rate (28-day cetes, in percent, annual average)	19.8	24.8	21.4	15.2	11.3

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

1/ IMF definition.

Statement by Mr. Hernan Oyarzábal , Executive Director for Mexico and Mr. Mario Beauregard, Advisor to Executive Director
September 23, 2002

An orderly adjustment of economic activity

Last year, in my statement for the 2001 Article IV Consultation on Mexico, I stressed the fact that for the first time in the last three decades Mexico experienced a smooth change of political power that was not characterized by a deep economic and financial crisis. In this opportunity, I would like to point out the fact that for the first time in many years, the marked slowdown in economic activity in 2001 took place in an orderly manner as a result of my authorities' timely and appropriate policy response to the changing economic environment.

New challenges emerged soon after we last met

The sharp slowdown in world economic activity in 2001, particularly in the United States, and the uncertainty that prevailed after the terrorist attacks on September 11, had a negative impact on Mexico's economic activity. After growing 6.6 percent in 2000, last year's GDP contracted 0.3 percent. This result in the real economy, and both the Federal Government's fiscal discipline and Banco de México's prudent monetary policy, led to a significant reduction in the inflation rate to 4.4 percent (the official target was to achieve an inflation rate not greater than 6.5 percent). As a result, nominal and real interest rates declined and the peso remained stable.

Public sector finances were negatively affected by the economic slowdown, the strength of the peso and the fall in international oil prices. Nevertheless, decisive and timely actions were key to reach the fiscal deficit target set for the year. On a cyclically adjusted basis, public finances recorded one of the most important adjustments in recent years. I would like to emphasize that these efforts have been pursued while protecting the allocation of resources to social sectors, like education and health. In particular, expenditures in social programs increased 6.1 percent in real terms during 2001.

On the external front, the deficit in the current account remained stable (2.8 percent of GDP). This deficit was financed totally with long-term external resources, particularly Foreign Direct Investment (FDI). The surplus in the capital account was 22.7 billion US dollars, of which FDI flows were 24.7 billion US dollars, 1.4 times the deficit in the current account. Net international reserves increased by 7.3 billion US dollars and the ratio of gross official reserves to short-term debt by residual maturity increased from 86.8 percent in 2000 to 122.4 percent at the end of 2001.

In sum, economic policies in Mexico were geared at maintaining economic stability and adjusting to the new economic conditions. Importantly, even during this difficult year, my authorities were able to further reduce Mexico's vulnerabilities. As a result, two of the leading rating agencies (Standard & Poor's and Fitch IBCA) upgraded Mexico's external sovereign debt rating to investment grade at the beginning of 2002 and Moody's, which upgraded Mexico to investment grade in March of 2000, improved the country's rating one additional notch. These upgrades have made Mexico more resilient to external shocks by diversifying the type of investors willing to invest in the country.

2002 continues to be a challenging year

Even though there were signs of a solid recovery in the world economy during the first quarter of 2002, it is now clear that it will not be as strong as initially expected. This year has also been characterized by an increase in investor's risk aversion. Despite this negative environment, the economic performance of Mexico has been satisfactory. Although economic growth during the first quarter was still affected by last year's economic slowdown, GDP growth during the second quarter showed clear signs of recovery (2.1 percent compared to the same period of last year). In addition, other indicators, like the global index of economic activity, industrial production, the level of both private investment and consumption, and the labor market, have been also confirming that the economic recovery is under way. This being said, it is important to recognize that Mexico's economic growth in the months ahead will be greatly influenced by the international environment, especially the economic recovery in the United States, our main trade partner.

Monetary policy has been managed prudently to achieve an annual inflation rate not greater than 4.5 percent. The monetary stance was tightened in February to prevent contagion to other prices and wage negotiations of the increase in some public sector prices that took place in January and February and that would have jeopardized the attainment of the inflation objective. The positive results of the new monetary stance on inflation expectations allowed Banco de México to relax monetary policy in April. I would like to emphasize that this latter change was not driven, as some analysts have pointed out, by concerns regarding the strength of the peso. The Board of Governors remains committed to the inflation-targeting regime in place and they are clearly aware that the central bank, having only one instrument to conduct monetary policy, can achieve only one objective. Targeting other variables, such as the output gap or the level of the exchange rate, would only undermine the credibility Banco de México has gained in recent years, placing at risk the nominal anchor of the economy. My authorities remain committed to take further action if needed to achieve the inflation target set for 2002.

On the fiscal front, the Federal Government has again confronted a difficult environment. Lower public sector revenues than programmed made it necessary to cut public expenditures in April. In parallel, important efforts have been made in order to promote a more efficient use of resources and an increase in savings in the Executive branch. Public debt management has continued to be geared at extending the maturity profile and lowering the cost of the public sector debt.

I also would like to stress that even though public sector revenues have been lower than programmed, they have improved compared to last year's. As of July, tax revenues have increased 9.4 percent in real terms compared to the same period in 2001. This result was achieved despite almost nil economic growth during the first half of the year, which highlights my authorities' efforts to broaden the tax base and to increase tax compliance. Income-tax revenues during the first seven months of this year increased 11.3 percent in real terms as a result of the reforms approved by Congress last year, while VAT revenues were lower 2.6 percent in real terms compared to the same period in 2001.

Looking ahead, the increase in international oil prices, the lower cost of the public sector debt and the savings that the administration has been able to secure do not make it necessary to cut public expenditures again in order to achieve the fiscal deficit target set for the year. This being said, I want to stress that my authorities remain fully committed to continue working in advancing the fiscal consolidation process. We recognize that tax administration cannot be a substitute for a more fundamental strengthening of non-oil revenues, but it constitutes an integral part of the overall strategy to make public finances more efficient.

On the external front, despite the uncertain international economic environment that has prevailed, the results are encouraging. Importantly, Mexico's access to international capital markets was not hindered by the higher volatility in international financial markets. Proof of this are the very successful issuances of 10- and 30-year bonds in international markets late last year and in January 2002, and last Tuesday's issuance of a 20-year bond. The deficit in the current account (2.1 percent of GDP in the first half of the year) continues to be financed through long-term capital sources, mainly FDI (90 percent). Net international reserves continue increasing, reaching a record level of 47 billion US dollars as of last Friday.

Despite the real appreciation of the peso that has taken place in recent years, the current account deficit has remained stable and consistent with the availability of long-term external resources. Besides, the share of Mexican exports in the US market has continued to increase, as noted by staff in Figure 14. Furthermore, the equilibrium real exchange rate could be expected to appreciate as per capita income and openness increase, as has been the case in Mexico in recent years. Nevertheless, the recent depreciation of the nominal exchange rate should ease some concerns regarding the level of the real exchange rate. What is important to highlight is that in the context of an economy with a flexible exchange rate regime, and the absence of both large balance of payment imbalances and large inflows of short-term capital, the adjustment has taken place in an orderly manner, with limited impact on domestic interest rates.

Remaining Vulnerabilities and Specific Issues

Staff point out some remaining vulnerabilities in the Mexican economy. At the outset, I would like to stress that my authorities remain committed to continue working to further reduce them, but at the same time it is important to emphasize the progress that has been achieved so far.

- On Mexico's gross external financing requirements, I would like to highlight that the figures reported by staff for 2002 and 2003 include a very important change compared to the figures for last year. In particular, debt amortization was reduced from 51 billion US dollars in 2001 to 37 billion in 2002 and 39 billion in 2003. These changes reflect my authority's efforts in order to improve the amortization profile of the external debt. This strategy has proved to be very successful and they will continue implementing it in the future. Just last Tuesday Mexico issued a 20-year global bond in international markets as part of this strategy. On the other hand, the flexible exchange rate regime in place ensures that the deficit in the current account will be driven mainly by the availability of long-term external resources. Thus, if capital inflows were to be reduced, the exchange rate regime in place ensures the adjustment of the current account deficit to a level consistent with the new availability of external long-term capital. Most importantly, staff's own analysis shows that gross external financing requirements are not really a source of vulnerability. Paragraph 40 of the staff report explains how a crisis like the one experienced by Mexico in 1995 and similar contagion effects like the ones felt from the crises in Russia (1998) and Brazil (1999) could be handled very well today. Having said this, it is important to highlight that there have been very important changes in the Mexican economy in recent years. Thus, replicating those crises today would constitute a very large shock whose probability of occurrence is rather low.

- With regard to the gross financing needs of the public sector and its exposure to both rollover domestic debt and an increase in peso denominated interest rates, my authorities would like to make it clear that they are fully aware of said risks and that important efforts have been made in recent years to improve the profile of the public sector domestic debt. For example, at the beginning of the Fox administration the maturity of the government's domestic debt was 538 days and as of June 2002 it has risen to 793 days. To this end, my authorities have been developing a long-term peso yield curve by issuing, since last year, ten-year fixed-rate bonds, which is complementing the issuance of three- and five-year fixed-rate bonds initiated in 2000. And as of this year, seven-year fixed-rate bonds are also being issued on a regular basis. This being said, I would like to emphasize that these developments cannot be achieved overnight. The issuance of long-term instruments brings about new financial risks to investors that call for a cautious approach to the pace at which these developments take place. On the other hand, market conditions also play a key role in determining the speed of introduction of these developments. Finally, a proactive liability management strategy continues to render good results in extending the maturity profile of the public sector external debt and in reducing its cost.

- Staff also points out the high level of foreign debt of the Mexican corporate sector. However, we would like to emphasize that the level of indebtedness of the private sector in foreign currency does not pose a systemic risk to the economy. First, most of the companies that show high levels of foreign debt are exporting firms that generate their cash flows in foreign currency. This certainly limits the exchange rate risk of the non-financial corporate sector. Second, the reduction in domestic interest rates, the existence of a long-term yield curve developed through the issuance of public debt, the more important role of Mexican institutional investors as providers of long-term resources in pesos, and the introduction of a new type of debt instruments, called "certificados bursátiles", have allowed many of these companies to substitute debt instruments denominated in pesos for foreign debt. Since last year, when these certificates were introduced to the market, there have been issues of an equivalent of 4 billion US dollars, and there is authorization to issue an equivalent of 3 billion US dollar more. Third, although bank credit to the private sector has not yet been resumed due to both demand and supply factors, my authorities remain confident that the financial reform and changes to the Mexican legislation will help in promoting a substitution of peso liabilities for foreign debt.

During the past few years my authorities have made important progress in raising their surveillance activity to the Mexican corporate sector. For example, the coverage of the sample used by my authorities to monitor developments in this sector represents approximately 70 percent of the total private debt in foreign currency. Hence, their point of view is that the coverage of this sample is sufficient to appropriately assess the risks of this sector. But, as always, if at some point in time a broader coverage is needed, they will work to expand it.

- Staff suggests that banking supervision should be further strengthened reducing the fragmentation of supervisory powers and that the Credibility of the National Banking and Securities Commission (CNBV) needs to be fostered. On the first point, I would like to point out that there is not an optimal model in the world for the structure of the banking supervision. Some countries have a single supervisory institution while others have a decentralized framework. In our view, what it is important in this regard is that there should be close coordination among the regulatory authorities, which is the case in Mexico, although there is always room for improvement. On the second point, throughout the recent years, the CNBV has strengthened significantly its credibility.

- Once again, my authorities would like to express their strong disagreement with the comparison made by the staff regarding the borrowing pattern from international banks between Mexico and Brazil. To suggest that the Mexican corporate sector is particularly vulnerable to a potential sharp retrenchment of international bank lending after looking at only one single indicator is misleading. Besides, this comparison is of limited value added because the staff, in a more complete analysis, concludes that the Mexican corporate sector is overall in good financial health and that a widespread solvency problem is unlikely. A cross-country comparison should take into account that there exist strong differences not only between the corporate sectors of the two economies, but also between the two economies themselves. We also need to highlight that said index for Mexico and Chile, and Mexico and Taiwan Province of China, is also high, a comparison that is not made in the report.

Banco de México's long-term inflation objective and the "corto"

Banco de México formally adopted an inflation-targeting framework in 2001 and announced its annual inflation objective up to 2003. Consistent with this framework, the central bank announced last July the inflation objective that will guide its monetary policy actions in the long-term, beginning in 2004. The objective was set at 3 percent with an interval of plus/minus one percentage point around the long-term goal. It is important to underline that the interval is not an indifference or tolerance margin. Rather, it is the recognition that exogenous factors beyond the control of the authorities have unpredictable effects on headline inflation.

The Consumer Price Index—the broader price index in Mexico to measure inflation—will be the reference price index. However, the Board of Governors stated that they are going to permanently assess the evolution of core inflation as an important indicator of inflationary pressures in the medium term. Last, but not least, if significant deviations from the long-term target arise, Banco de México will publicly explain their causes, its view on the future evolution of the inflation rate and the monetary policy actions that it will implement to return to an inflation path consistent with the long-term objective.

One more time, staff stresses that a policy of directly targeting interest rates would strengthen Mexico's monetary policy framework because it is an element of a more formalized inflation targeting scheme. Although I do not deny that such a change could enhance transparency, at the same time it is important to highlight that the "corto" has worked very well, something that staff recognizes in their report. In addition, the benefits of enhanced transparency need to be weighed against the costs of moving to the proposed policy. In particular, a system that targets interest rates would increase the exchange rate volatility, and this needs to be taken into account in the context of an open economy subject to sizable external shocks like in the case of Mexico. As I said last year, my authorities have analyzed other monetary policy instruments but they have not found a superior alternative. Once they are convinced they have found one, they will substitute the "corto".

The National Program to Finance Development 2002-2006 (PRONAFIDE)
In June, President Fox unveiled the PRONAFIDE, which is the medium-term strategy that will seek to create new and strengthen current domestic sources of financing within a stable macroeconomic environment. The objectives of this program are the following:

- Consolidate a stable macroeconomic environment;
- Reduce the absorption of financial resources from the government in order to promote private investment;
- Facilitate the conditions for job creation in the private sector in order to match the number of jobs required by the dynamics of the population;
- Expand the potential rate of economic growth, and
- Generate the resources needed to finance the social programs set forth in the National Development Plan 2001-2006.

In order to achieve these objectives the program features the following five strategies:

1. *Implementation of structural reforms.* My authorities remain committed to continue working with Congress in order to get approval for important structural reforms. In this regard, President Fox submitted to Congress last August a proposal to reform the electricity sector. The Ministry of Labor is leading an open dialogue with private sector representatives and union leaders in order to advance the reform to the Federal Labor Law. Congress is reviewing a proposal sent by the Executive branch to reform the budgetary process. Congress prepared a proposal to reform the Federal Law of Telecommunications that is under discussion. In the financial area, Congress has just recently approved reforms to the law of private pension funds and is currently discussing changes to the Mexican legislation that seek to strengthen the framework under which commercial banks will provide credit in the economy (Ley de Garantías y Concursos Mercantiles).

2. *A gradual and sustained increase in public sector savings.* Advancing in the fiscal consolidation process is key to further reduce the absorption of financial resources by the government.

3. *Increase in private domestic savings.* One key challenge is to increase private savings in order to finance private sector investments. In this regard, it is worth emphasizing that considerable progress has been achieved so far in increasing the availability of long-term domestic savings that resulted from the reform to the pension system for private sector workers some years ago. The development of the local bond market is also playing a key role in this regard.

4. *External savings will play a complementary role to domestic savings.* The aim is that domestic savings will be the main source of financing in the economy, though external resources, mainly FDI, will play a complementary role. Further advancing in the implementation of the structural reform agenda and in the consolidation of a stable macroeconomic environment are key elements to continue attracting long-term resources.

5. *Role of the financial sector.* The financial sector was one of the most affected by the crisis in 1995. Since then, important progress has been achieved in strengthening its legal, operational, supervisory and regulatory framework. In particular, since last year important changes have taken place and staff have made a good recollection of them in this and last year's staff reports.

Conclusion

My authorities' reform efforts and their prudent macroeconomic management are yielding good results. Mexico's economy is now more resilient and the decoupling of the country from recent crises in some emerging market economies is clear evidence that these efforts are paying off. But there is no room for complacency. Important challenges remain. Reducing poverty levels and improving income distribution being some of them. These problems demand prompt and durable solutions. At the same time, we realize that our goals in this regard will simply not be achieved if we cannot consolidate the macroeconomic stability that has been present in recent years. This is the main task at hand.