August 2004
IMF Country Report No. 04/254

Mexico: 2003 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 Article 2003 IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 20, 2003, with the officials of Mexico on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 17, 2003. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of October 15, 2003 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 15, 2003 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Mexico.

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

Selected Issues Paper

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

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

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INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Mexico

Approved by Charles Collyns and G. Russell Kincaid

September 17, 2003

- Discussions for the 2003 Article IV consultation with Mexico took place in Mexico City during June 9–20. The mission met with Finance Secretary Gil-Diaz; Bank of Mexico Governor Ortiz and other members of the Monetary Board; officials from the Office of the President, the Ministry of Finance, the Bank of Mexico, the Ministry of Economy, and the Ministry of Labor; supervisors of banks and financial institutions; the Mexican Stock Exchange; major banks, financial institutions and rating agencies; and political analysts.

- The team comprised G. Meredith (Head), R. Krieger, E. Faal (all WHD); E. Jenkner (FAD); N. Thacker (PDR); and M. Vera-Martin (ICM). C. Muñiz, the Fund's senior resident representative, assisted the mission. Mr. Collyns (WHD) and Mr. Beauregard (Alternate to the Executive Director) also participated in the policy discussions.

- The 2002 Article IV consultation was concluded on September 23, 2002, and the staff report was published as IMF Country Report No. 02/237.

- At the conclusion of the 2002 consultation, Directors commended the authorities for prudent economic management in the face of a difficult external environment. Directors welcomed the authorities' commitment to further fiscal consolidation, emphasizing the need for front-loaded adjustment. Directors stressed the need to implement the authorities' structural reform agenda, notably in the areas of the tax system, the financial sector, labor market institutions, the judicial system, and the energy sector.

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

- Comprehensive economic data are available for Mexico on a timely basis, and are adequate to conduct surveillance. Mexico has subscribed to the Special Data Dissemination Standard, and its metadata are posted on the Fund's Data Standards Bulletin Board (Annex I).

- A statistical ROSC for Mexico was completed in May 2003 and published as IMF country report No. 03/150.

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I. INTRODUCTION

1. **Mexico's political transition to a full-fledged democracy has been smooth, and important progress has been made in building a sound institutional framework for policymaking**. Prudent macroeconomic policies in the aftermath of the 1994–95 crisis, combined with the impact of NAFTA and other structural reforms, have boosted productivity and raised export shares. Inflation has fallen to low single-digit levels. Tight fiscal management has significantly reduced the public sector deficit and debt, and the debt structure has been strengthened. Market sentiment toward Mexico remains positive, and domestic financial intermediation has become deeper and more diversified. These achievements have allowed Mexico to weather a difficult environment in recent years without major financial strains or loss of confidence in the policy framework.

2. **Nevertheless, economic growth has been disappointing in recent years (Text Table 1).** After a strong performance during 1997–2000, output fell in 2001 in response to the U.S. downturn. While growth rebounded in the first half of 2002, it has slowed since, with real GDP growing at only 1.4 percent in the four quarters ended in the second quarter of 2003. This weakness reflects both the effect of the delayed U.S. recovery and sluggish domestic spending, especially of business investment. Nevertheless, most observers still expect the economy to recover in the second half of this year in response to stronger U.S. activity and favorable financial conditions. Inflation should fall below 4 percent by end-year, approaching the Bank of Mexico's (BOM) longer-term objective of 3 percent.

Text Table 1. Mexico: Growth of Real GDP (1993 prices)
(Contribution to growth over previous period, seasonally adjusted)

	2001	2002	Proj. 2003	Qtr. 1 2002	Qtr. 2 2002	Qtr. 3 2002	Qtr. 4 2002	Qtr. 1 2003	Qtr. 2 2003
Gross domestic product	**-0.3**	**0.9**	**1.5**	**0.5**	**0.9**	**0.6**	**0.0**	**-0.4**	**1.2**
Of which:									
Total domestic demand	0.5	1.0	2.0	-0.1	1.8	-0.4	0.4	-1.2	1.2
Consumption	1.8	0.7	1.7	-0.3	0.5	0.4	0.1	0.5	0.9
Private	1.9	0.8	1.4	0.1	0.5	0.3	0.0	0.6	0.8
Public	-0.2	-0.1	0.3	-0.3	0.0	0.1	0.1	0.0	0.1
Fixed investment	-1.3	0.2	0.3	0.0	0.1	-0.1	0.0	0.0	0.2
Inventory change	0.0	0.0	-0.1	0.1	1.2	-0.7	0.3	-1.7	0.0
Net exports	-0.7	-0.1	-0.4	0.6	-0.9	1.0	-0.4	0.8	0.0

Source: Fund staff estimates and projections..

3. **Moreover, progress in advancing the authorities' structural reform agenda has been limited in some important areas.** The administration remains committed to the reform program outlined in its 2002 medium-term plan (PRONAFIDE). But support in congress—where the administration's party (the Partido Acción Nacional, or PAN) is in a minority—has been lacking. As a result, while financial sector reforms have moved ahead, less has been achieved in other areas, notably electricity generation, labor market regulation, and tax

reform.[1] Lack of progress in these areas has dampened private investment and led to increasing concerns about Mexico's medium-term competitiveness. The inconclusive results of the July lower-house elections failed to dispel uncertainties, and political analysts believe there is only a limited window of opportunity for passing measures before campaigning for the 2006 presidential elections begins.

4. **The pace of fiscal consolidation has also fallen short of that envisaged earlier.** The broad public-sector deficit for this year is likely to be above that projected in PRONAFIDE and endorsed by the Board last year, with the favorable impact of higher world oil prices only partially offsetting a wider non-oil deficit. Public debt has edged up in relation to GDP, in contrast to the declining path called for in PRONAFIDE. Current spending is expected to rise further in relation to GDP this year, while non-oil tax revenues will remain roughly constant at the lowest level in the OECD.

5. **The Fund's policy advice to Mexico in recent years has focused on the need for further fiscal consolidation, inflation reduction, structural reforms, financial modernization, and measures to crisis-proof the economy.** In some of these areas, particularly those under the control of the executive branch of the government, progress has been impressive, notably in lowering inflation, modernizing the financial system, and strengthening the structure of debt. Mexico has participated in an FSAP, and was the first major emerging market country to issue bonds with collective action clauses (CACs) last March. On the other hand, after marked achievements in the latter half of the 1990s, progress in fiscal consolidation and structural reforms has recently been limited. The authorities have broadly shared the Fund's views on the priorities in these areas, but political constraints have hindered passage of key reform legislation, as it has been difficult to channel the longer-term economic benefits of these policies into broad popular support.

6. **Against this background, the main issues in this year's consultation discussions were**:

- **Structural reforms.** The authorities and staff agreed on the need for reforms, which the authorities aimed to advance in the new session of congress. While acknowledging the political difficulties, staff emphasized that significant steps would be needed to meet broadly held objectives for income growth and poverty reduction. The key areas remained: tax reform to reduce reliance on oil revenues and aid fiscal consolidation; energy sector reform to increase capacity in line with growing demand; and measures to raise labor market flexibility.

- **Fiscal consolidation.** There was agreement on the need for further consolidation. The authorities intended to pursue consolidation in 2004 in the context of a tax reform plan. Staff expressed concern that spending pressures might make it difficult to

[1] The medium-term reform agenda is described in Box 2 of the 2002 Staff Report (IMF Country Report No.02/237).

reduce the deficit even if tax reform led to higher revenues, and suggested that fiscal discipline could be enhanced by setting and regularly updating medium-term objectives for broad definitions of deficits and debt that would effectively discipline annual budget formation.

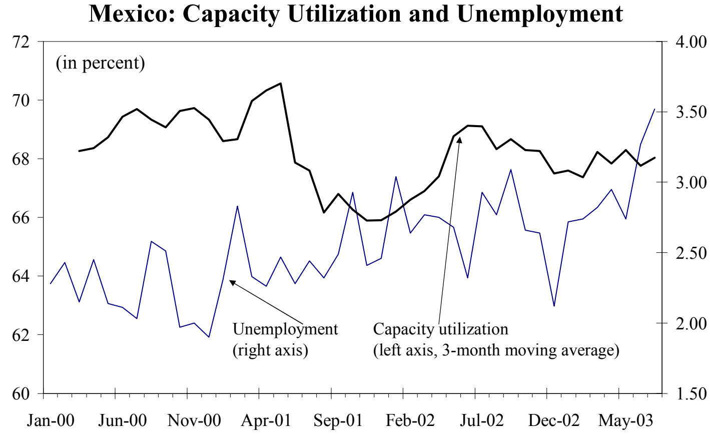
II. Recent Economic Developments

7. **After a brief recovery in the first half of 2002, real growth slowed to 1½ percent in the second quarter of 2003 over the previous year** (Figure 1 and Table 1). The hesitant U.S. recovery has played an important role, as almost 90 percent of Mexico's non-oil exports are destined to the United States. In addition, Mexico's export share in the U.S. market has edged down since late 2002, reflecting both the earlier appreciation of the peso and increased competition from other countries, notably China. On the domestic side, delays in structural reforms and uncertainties about regional and global developments have dampened private investment, while household spending has been held back by stagnant employment.

8. **Slow growth has led to rising economic slack.** Capacity utilization in manufacturing remains below mid-2001 levels, while the estimated output gap has widened to 2¼ percent of GDP.[2] The open unemployment rate has risen to 3½ percent, and the number of registered workers in the formal sector has declined since 2001 (Figure 1).

9. **Wage growth and underlying inflation have continued to decelerate.** Contractual wage increases fell to 5¾ percent in 2002 from 9 percent in 2001, and further to 5¼ percent in the first half of 2003 (Figure 2). In spite of lower wage growth, higher administered and agricultural prices pushed up headline inflation to 5¾ percent at end-2002, compared with the BOM's target of 4½ percent; core inflation, in contrast, dropped further to 3¾ percent. The depreciation of the peso through 2002 and rising headline inflation boosted inflation expectations to a peak of 4½ percent in early 2003. As the peso recovered and earlier price shocks unwound in the first half of 2003, headline inflation dropped to 4 percent in August, while core inflation has stabilized at about 3½ percent.

Mexico: Capacity Utilization and Unemployment

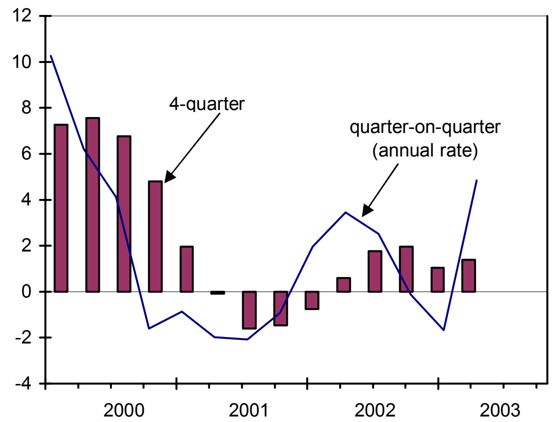


Source: Mexican authorities.

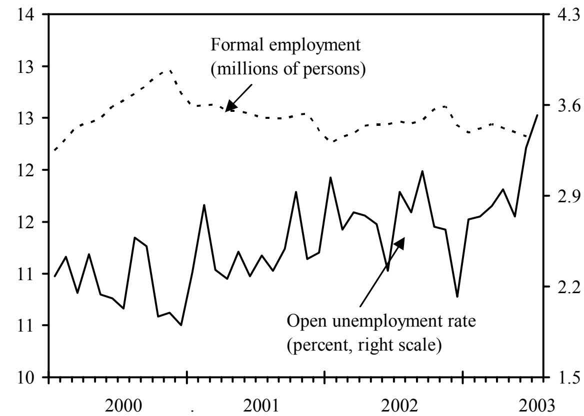
[2] The output gap is calculated as the deviation of actual GDP from an estimated trend level using a Hodrick-Prescott filter.

Figure 1. Mexico: Real Sector Developments

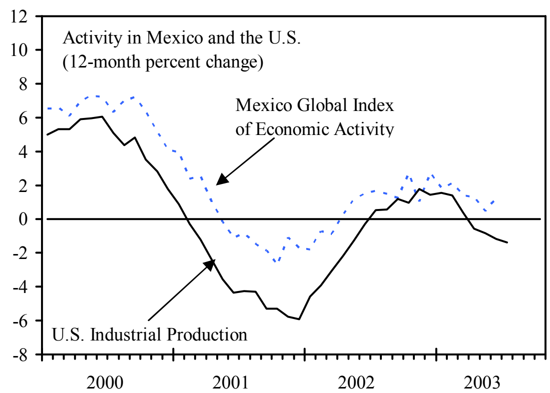
Real GDP growth weakened in late 2002 and the first half of 2003...



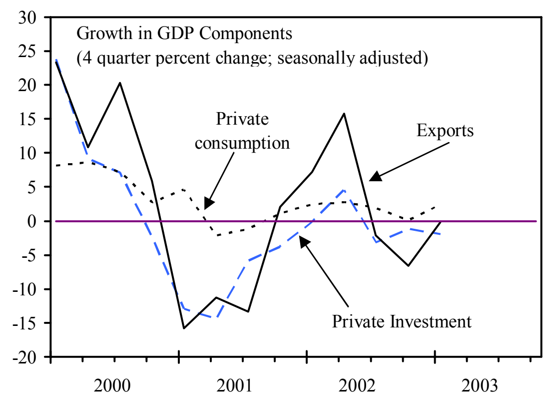
... and conditions in the labor market were sluggish



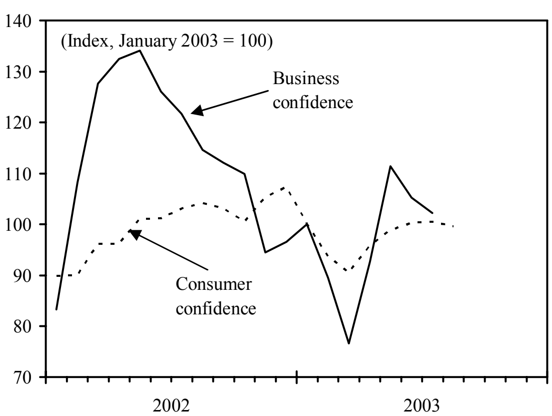
... as external demand suffered from a decline in U.S. activity.



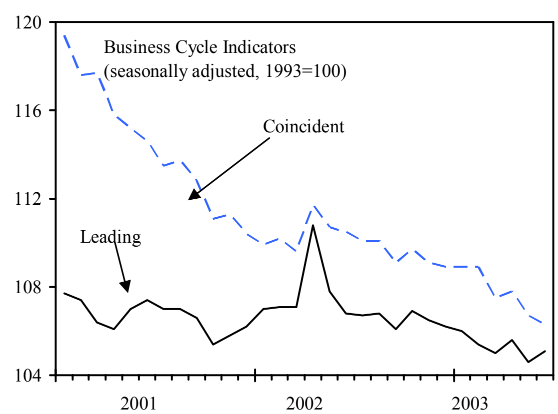
Domestic demand also faltered, especially private consumption and investment.



Confidence indicators improved in March but have declined since May...

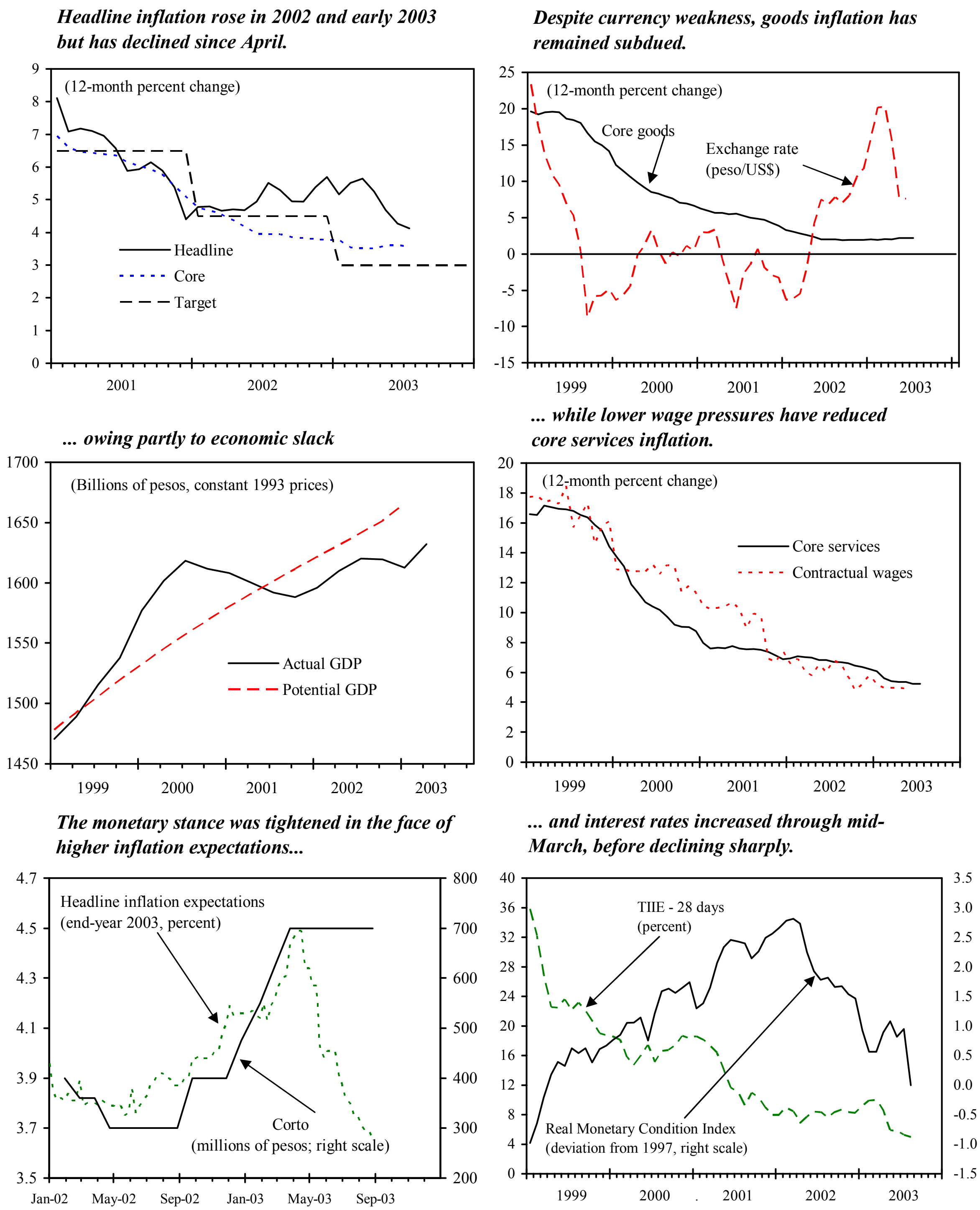


...and cyclical indicators continue to show weakness.



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

Figure 2. Mexico: Inflation and Monetary Policy



Source: Mexican authorities, and Fund staff estimates.

10. **The BOM tightened its monetary stance starting in September 2002 in response to rising inflation expectations, although monetary conditions continued to ease in the first half of 2003.** The "*corto*", or borrowed reserves objective, was increased to a record Mex$700 million by March 2003 as inflation expectations rose well above the 3 percent target for end-2003. In addition, the BOM shortened the reserve accumulation period from 28 days to one day in April 2003. After rising to about 10½ percent in early March, short-term market rates fell below 5 percent in July as external financing conditions eased, inflation expectations fell, and domestic activity remained weak. The staff's real monetary conditions index (MCI) suggests that this drop in interest rates, following the earlier depreciation of the real effective exchange rate, led to a significant easing in monetary conditions from early 2002 through mid-2003 (Figure 2).[3]

11. **The current account deficit narrowed to 2¼ percent of GDP in 2002, and declined further to 1¼ percent in the first half of 2003.** Stagnant non-oil export volumes since 2001 have been more than offset by higher oil exports and a contraction in imports (Figure 3 and Table 2). In addition, external interest payments have fallen in an environment of declining interest rates, while remittances from abroad have risen. The deficit has been largely financed by FDI inflows. Private external borrowing has moderated since mid-2002, as firms have increasingly switched from foreign to domestic capital markets to meet their financing needs.

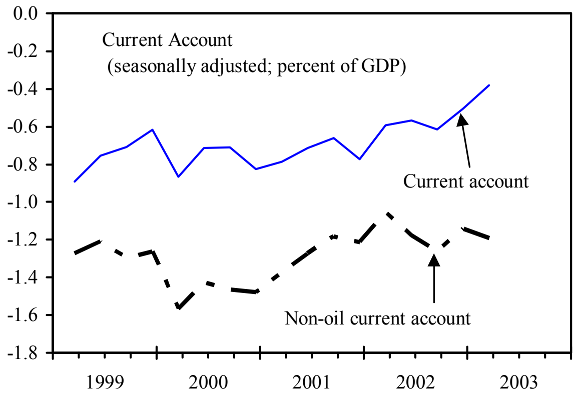
12. **Financial strains in the region, increasing global risk premia, and concerns about the pace of structural reforms weighed heavily on the peso during 2002**. About half of the real effective appreciation of nearly 30 percent during 1999–2001 was unwound by early 2003 (Table 1). The peso then recovered somewhat from March to June 2003, as global uncertainties declined and a new plan for moderating reserve accumulation was announced. It fell back to near earlier lows during the summer, however, as domestic interest rates declined further and concerns were raised in markets about external competitiveness.

13. **A new reserve management mechanism was implemented in May to slow the pace of reserve accumulation and lower the cost associated with carrying those levels of reserves.** Up to this time, the authorities had followed an approach of buying all of the net foreign exchange receipts of the federal government and PEMEX, and raising net international reserves (NIR) by an equivalent amount. The new mechanism involves selling

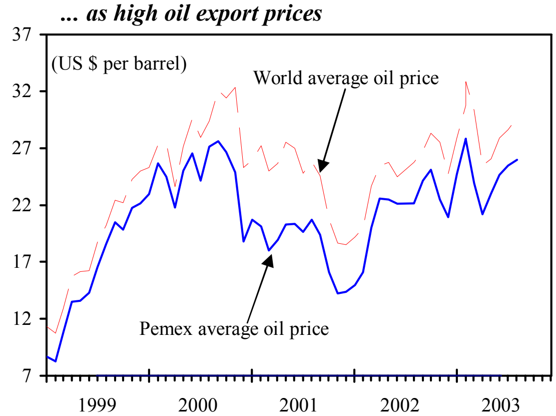
[3] The MCI is a weighted sum of the real effective exchange rate and the real short-term interest rate (the 28-day *cetes* rate less a survey measure of inflation expectations), with weights of 0.25 and 0.75 respectively. The weights are based on typical values for other open economies with trade shares similar to Mexico's.

Figure 3. Mexico: External Sector

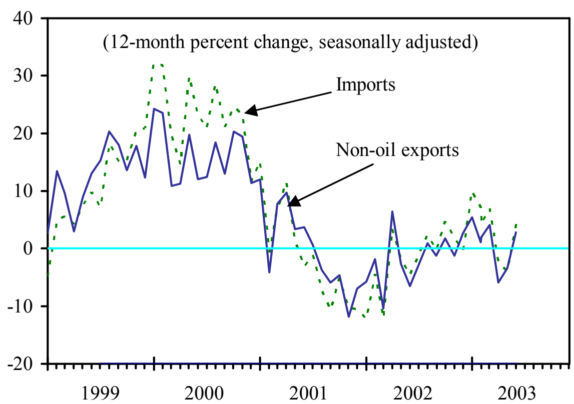
The current account deficit has continued to narrow...



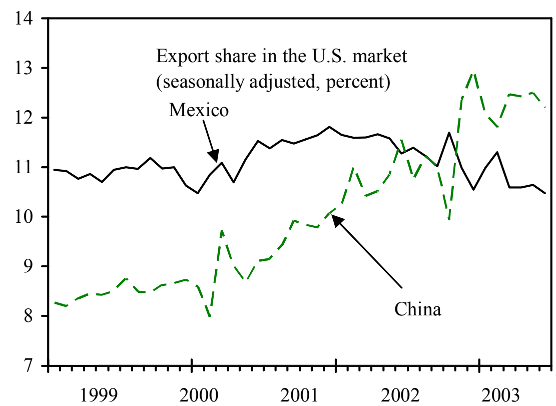
... as high oil export prices



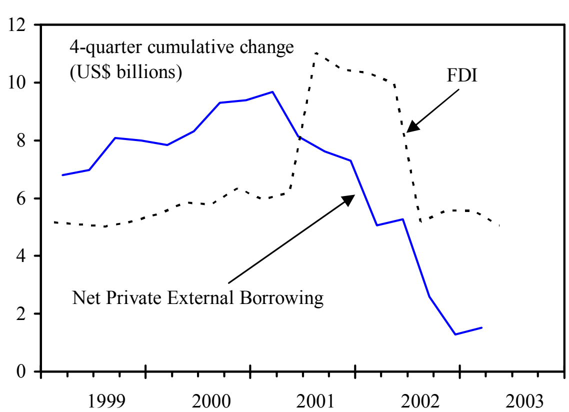
... and weak imports have offset sluggish non-oil exports...



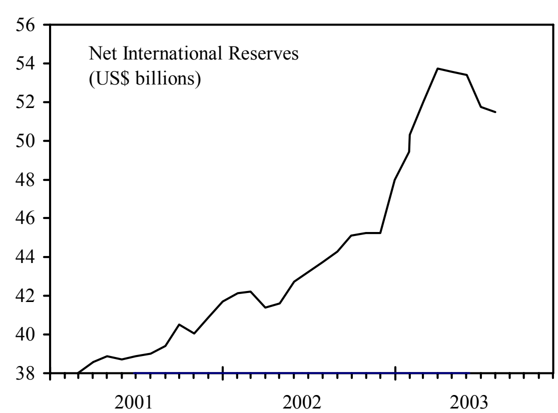
… Mexico's export market share in the U.S. shows signs of stagnating.



Capital inflows have moderated as FDI has declined and firms have switched to domestic borrowing.



NIR rose sharply in the first half of 2003, but have declined somewhat recently.



Source: Mexican authorities, and Fund staff estimates.

half of the BOM's accumulation of reserves in the previous quarter to the market, as discussed in Box 1.[4] From the time the mechanism was implemented in May through end-August, NIR fell by about US$2 billion to US$51.5 billion, both because of sales of reserves under the mechanism and the foreign currency needs of the federal government. Gross international reserves amounted to 137 percent of estimated short-term external debt by residual maturity at end-March 2003.

14. **Progress in fiscal consolidation was limited in 2002** (Figure 4 and Table 3)**.** The public sector borrowing requirement excluding nonrecurring revenues, or the "augmented" deficit—at 3.4 percent of GDP—was below the budgeted level, primarily due to higher oil revenues, lower interest costs, and shortfalls in public investment spending from budget estimates.[5] Non-oil tax revenue also fell well short of budget, however, reflecting lower-than-expected gains from tax and administrative reforms and weak activity. The ratio of gross augmented public debt to GDP rose to 49½ percent in 2002 from 48 percent in 2001, largely because of a rise in the peso value of external debt due to currency depreciation.

15. **The 2003 budget calls for the augmented deficit to remain unchanged at 3.4 percent of GDP, compared with the PRONAFIDE objective of just below 3.0 percent.** During the first half of the year, revenues were boosted by unexpectedly high oil prices and nonrecurring revenues. The outturn for the augmented deficit was broadly in line with the budget, however, as expenditures also exceeded previous estimates, and shortfalls in income tax revenues were only partially offset by strong VAT receipts.[6]

16. **Bank balance sheets have strengthened significantly in recent years.** Nonperforming loans have fallen, while loan-loss provisions have increased. In addition, further steps have been taken to increase the system's resilience to shocks and bring it into line with Basle Core Principles, including strengthening the prudential framework, harmonizing

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[4] An accompanying selected issues paper on reserve adequacy examines the implications of the mechanism for reserve accumulation.

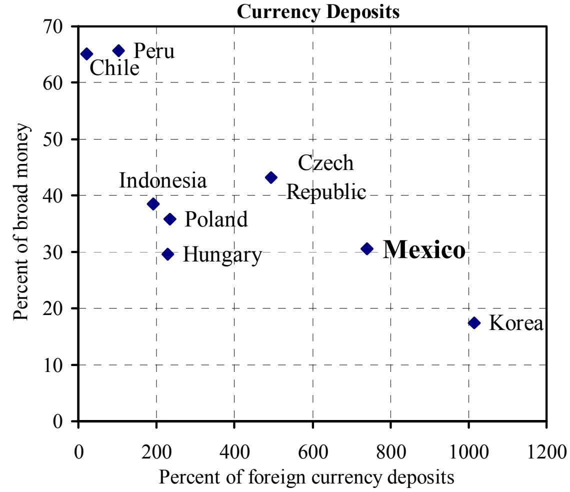
[5] This measure of the deficit includes both the traditional deficit around which the formal budget law is drafted, as well as other public sector borrowing requirements. As indicated in Table 3, the main components of the latter are the servicing cost of debt issued for bank restructuring (IPAB and FARAC), borrowing associated with public investment projects (PIDIREGAS), and financial requirements of the development banks. Similarly, the "augmented" stock of public debt adds the debt associated with these operations to the traditional definition.

[6] During the first half, income tax revenues fell short of the budget by over 0.2 percent of GDP due to late changes to the tax law and a Supreme Court ruling against the salary credit tax (ISCAS) introduced in 2002. It is unclear how many firms will receive reimbursement of the ISCAS, but the cost is estimated at 0.1–0.3 percent of annual GDP. Higher VAT receipts reflected changes in payment modalities, specifically a shift to monthly payments and to cash versus accrual accounting.

Box 1. Mexico: Adequacy of International Reserves—An Update

Mexico's financial vulnerability indicators compare favorably with several other emerging market economies with floating exchange rates. At end-2002, Mexico's reserves were equivalent to 126 percent of short-term debt with a remaining maturity of less than a year, and 100 percent of gross external financing requirements, up from 105 percent and 86 percent respectively at end-2001 (see figures). In terms of foreign currency deposits at banks, reserves reached about 740 percent at end-2002.

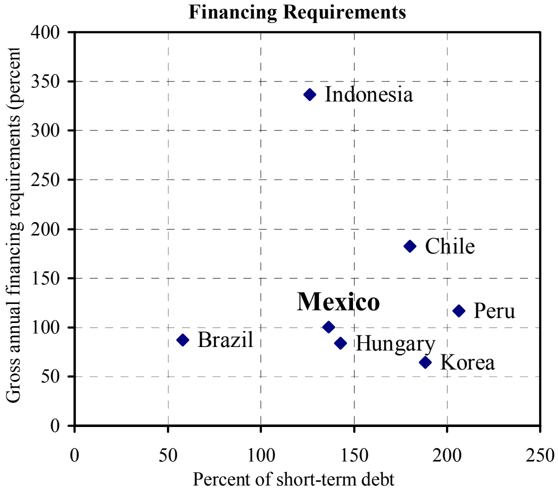
Gross Reserves to Broad Money and Foreign Currency Deposits



Source: Mexican Authorities and Fund staff estimates.

To reduce the "carry costs" of rising reserves, the Mexican authorities announced, on March 20, a new "rules-based" mechanism to reduce their accumulation.[1] Accordingly, in each quarter the Bank of Mexico (BOM) sells an amount equal to 50 percent of the gross foreign reserves accumulated in the previous quarter.[2] This amount will be announced at the beginning of each quarter, and daily sales will equal the total divided by the number of working days. The mechanism is asymmetric, as there is no stipulation that the BOM will purchase dollars in the foreign exchange market if reserves were to fall.[3] The first auction started on May 2, with US$32 million being sold on a daily basis during May 2 to July 31. For the quarter between August and October, the BOM will sell US$14 million per day with cumulative sales of US$878 million, compared with US$2.1 billion during May to July.

Gross Reserves to Short-Term Debt and Financing Requirements



Source: Mexican Authorities and Fund staff estimates.

Under the mechanism, reserve accumulation depends principally on oil export receipts and government financing operations (including PEMEX) in international markets. Initial estimates (by market analysts and the BOM) suggested that total sales in 2003 would be US$3–4 billion. Given the volatility in oil prices, it is difficult to anticipate the outcome for the remainder of the year.[4]

Based on current projections for the balance of payments, it is estimated that, to maintain recent ratios of reserves to short-term debt and gross financing requirements, the BOM must accumulate reserves of about US$2½ billion per year on average. Projections of actual reserve accumulation are sensitive to assumptions for oil prices and external financing. Assuming these determinants do not deviate markedly from recent levels, reserves would accumulate at a rate that would maintain or raise reserve adequacy ratios.

1/ "Carry cost" is defined as the opportunity cost of holding international reserves as opposed to domestic assets.

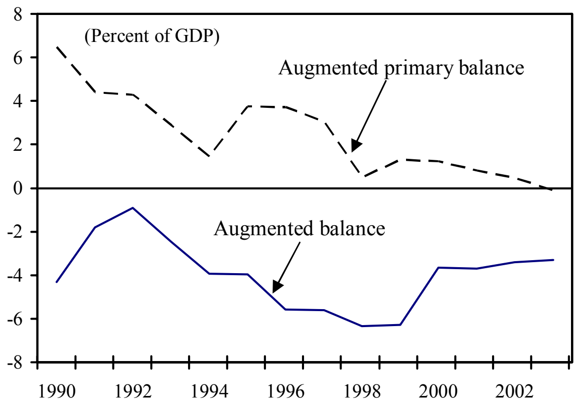
2/ "Quarter" refers to a three-month period starting one month after each calendar quarter, e.g. May to July.

3/ However, if the amount to be auctioned in any quarter is less than US$125 million, the mechanism would be temporarily suspended. Reactivation will not take place until there is an accumulation of reserves greater than US$250 million.

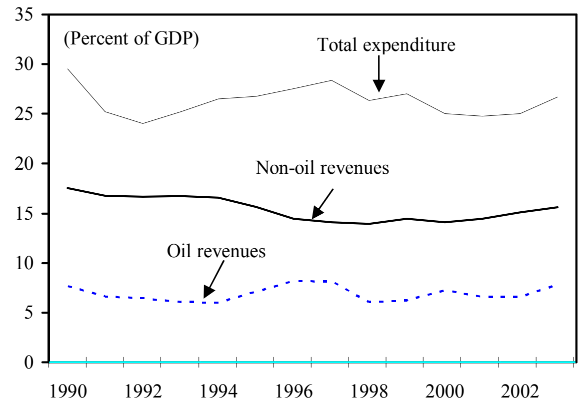
4/ The precise impact is difficult to judge, as the oil price assumptions underlying the initial estimates were not specified. In general, given the current level of oil exports, each US$1 per barrel decline in the world oil price reduces annual export receipts by US$750 million. The historical "beta" between reserve changes and oil export receipts is about 0.3.

Figure 4. Mexico: Fiscal Sector

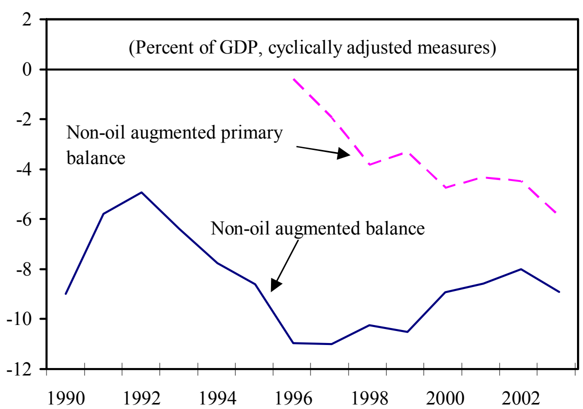
Fiscal consolidation is expected to stall in 2003, while the primary surplus decreases.



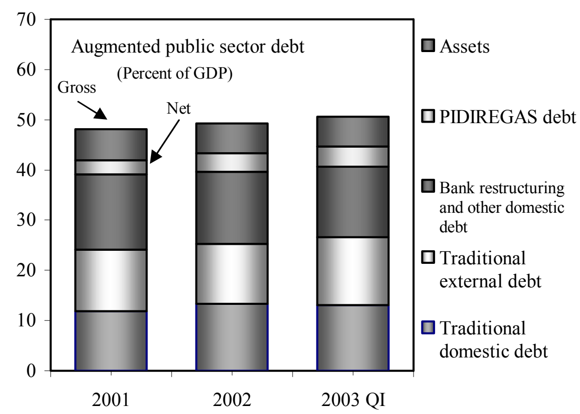
Non-oil revenue as a share of GDP remains relatively low ...



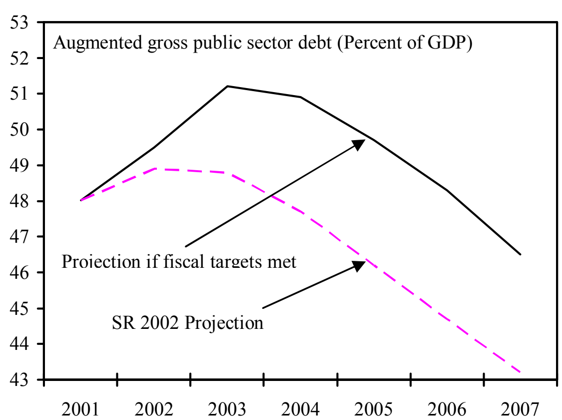
...and the non-oil balances are worsening.



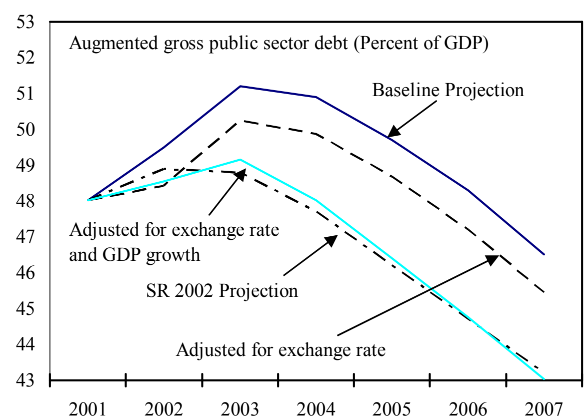
The debt-to-GDP ratio has increased...



..and is projected to remain above previous projections, even if fiscal targets are met from 2004 on...



... due to weaker assumptions for the exchange rate and GDP growth.

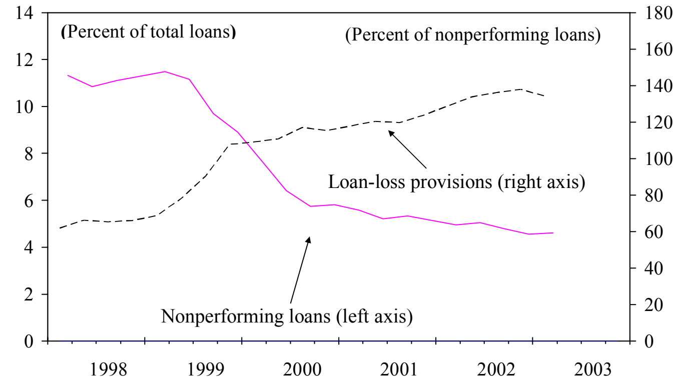


Source: Mexican authorities, and Fund staff estimates.

1/ Augmented balance excluding oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, IEPS on gasoline) and PEMEX operational expenditure.

regulations for state and private banks, improving bank governance, and facilitating loan recovery procedures. In the payments system, measures are being taken to reduce the BOM's credit risk, and legislation improving the legal framework has been enacted. Legislation is planned to expedite the resolution of problem banks, including a proposed prompt corrective action framework to respond to any problems in a timely fashion.

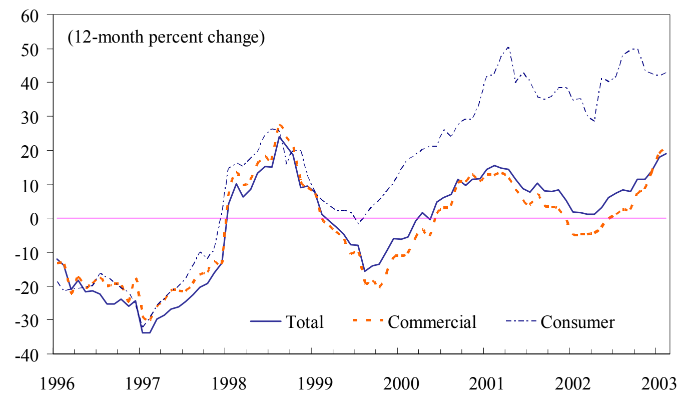
Mexico: Banking Indicators, 1998-2003



Source: Mexican authorities

17. **Bank lending to the private sector has recovered somewhat since the sharp drop in 2000, led by expanding consumer credit**. A recent pick-up in commercial lending has raised overall loan growth to close to 16 percent (12-month basis) in June 2003. Growth in nonbank credit, especially in the mortgage sector, continues to be brisk.

Mexico: Bank Credit to the Private Sector



Source: Bank of Mexico.

18. **Domestic institutional investors are playing a significant role in developing local capital markets.** Assets of private pension funds rose to US$36 billion in mid-2003 (16 percent of total financial assets) from US$27 billion at end-2001. The private pension system was modified in April 2003 to increase participation and allow greater investment diversification.[7] Market deepening has led to a rise in the average maturity of domestic public debt, a lengthening of the yield curve, and an expansion of the corporate bond market. Risk management in the financial sector continues to improve; pension funds, for example, have implemented a value-at-risk methodology that is monitored daily by regulators.

19. **Although corporates continue to be modestly leveraged, they carry a substantial foreign currency mismatch in their balance sheets, with about two thirds of total debt being denominated in foreign currencies.** At the same time, most of the firms with external debt carry out substantial sales abroad. Operating profits increased by 10 percent in the first quarter of 2003 compared with the same period in 2002. However, after including valuation

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[7] Restrictions remain on investment in local equities and international instruments. While they are designed to prevent excessive risk taking, they also can inhibit efficient portfolio allocation.

losses (due mainly to the rise in external debt caused by peso weakness), profits declined by 19 percent.

20. **Market sentiment toward Mexico remains generally positive, as reflected in its investment-grade status.**[8] Turbulence in emerging markets in 2002 was weathered well, and sovereign bond spreads have declined to a range of 200–250 basis points since March 2003 (Figure 5). The government has already completed its 2003 external financing requirements, including the successful issuance of three bonds with collective action clauses (CACs). In addition, Mexico became the first country to redeem all of its Brady bonds.

III. Economic Outlook and Risks

21. **While recent indicators have been mixed, activity is still expected to gather strength in the second half of 2003 and in 2004.** The staff projects GDP growth of 1½ percent for 2003 as a whole, rising to 3½ percent in 2004. Demand is expected to be boosted by U.S. recovery, reduced global uncertainties, real exchange rate depreciation, and improving credit availability as a result of financial sector reforms.[9] Headline inflation is expected to fall below 4 percent by end-year (the upper limit of the BOM's "variability interval"), and converge to 3 percent by end-2004. The current account deficit would widen somewhat to 2½ percent of GDP in 2004 as world oil prices fall back (Text Table 2).

Text Table 2. Mexico: Medium-Term Projections

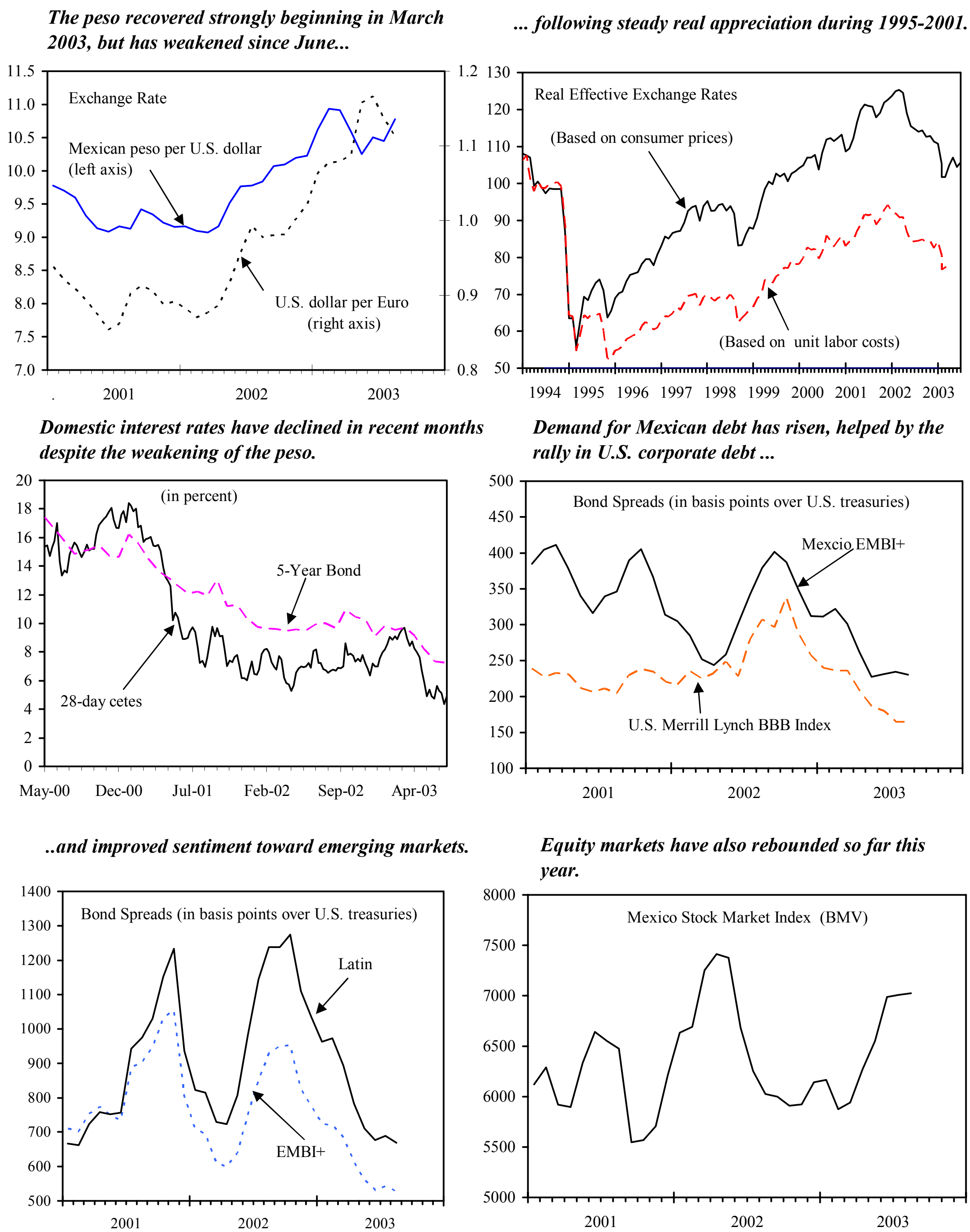
		Staff Projections					
	2002	2003	2004	2005	2006	2007	2008
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP	0.9	1.5	3.5	3.8	4.0	4.3	4.5
Consumer prices (end of year)	5.7	3.8	3.0	3.0	3.0	3.0	3.0
Savings and investment							
Gross domestic investment	20.3	19.2	18.8	18.9	19.0	19.3	19.8
Fixed investment	18.9	19.1	19.3	19.7	19.7	19.9	19.9
Gross national saving	18.1	17.4	16.4	16.1	16.2	16.6	17.0
(In percent of GDP)							
Nonfinancial public sector							
Augmented balance (PSBR excl. nonrecurring revenues)	-3.4	-3.3	-2.5	-2.0	-1.7	-1.5	-1.5
Augmented primary balance	0.5	-0.1	0.6	1.3	1.8	1.9	1.7
External sector							
External current account balance	-2.2	-1.8	-2.4	-2.8	-2.8	-2.7	-2.8

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

[8] Moody's upgraded Mexico's outlook to positive in March 2003; in July, it reiterated Mexico's Baa2 rating.

[9] The BOM lowered its growth forecast for this year to 2 percent in July; the August private consensus forecast calls for growth of 1¾ percent in 2003 and 3¾ percent in 2004.

Figure 5. Mexico: Financial Market Developments



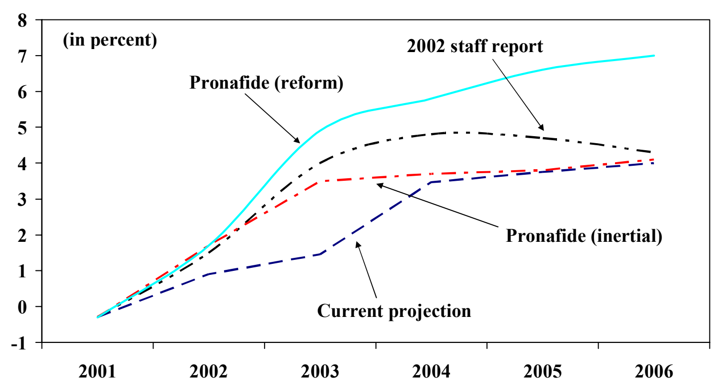
Source: Mexican authorities, and Fund staff estimates.

22. **Despite the boost to revenues from higher oil prices, the augmented deficit is projected to remain roughly in line with the budget at 3.3 percent of GDP in 2003.**[10] Higher oil revenues will be partly spent on public investment, and also used to offset lower non-oil revenues. Expenditure is also expected to exceed budget estimates, in part due to the cost of the voluntary separation program and higher spending by public enterprises. As a result, the non-oil primary deficit would increase by 1½ percent of GDP. While this widening would provide support to activity, underlying consolidation would fall substantially short of the path envisaged in last year's PRONAFIDE scenarios. In particular, there would be significantly greater reliance on oil and nonrecurring revenues, and no progress in curtailing primary expenditure growth. The public debt-to-GDP ratio would edge up for the second consecutive year, mainly due to exchange rate depreciation and slow growth, in contrast to the declining path projected in PRONAFIDE.

23. **While the staff's near-term growth forecast is somewhat below the latest consensus, the downside risks remain significant.** Any further delay in U.S. recovery and/or setbacks to the passage of structural reforms would adversely affect confidence and activity. There is also the question of the durability of the decline in global risk premia and the implications for yield spreads and capital inflows. Beyond the easing in monetary conditions that has already occurred, there is little scope for counter-cyclical policy actions in response to adverse developments while the credibility of fiscal and monetary policies remains to be fully established.

24. **Over the medium term, the staff projects a return to more robust growth, but the prospects depend importantly on the depth of structural reforms.** On the assumption of partial implementation of the administration's reform agenda (the staff's baseline scenario), real GDP growth is projected to average 4 percent during 2004–08. The current account deficit would widen to close to 3 percent of GDP, reflecting an acceleration in domestic

Mexico: Growth Scenarios 2002-06



Source: Mexican authorities and staff estimates.

[10] The WEO projection for 2003 assumes a price of US$23.85 per barrel for the Mexican mix compared with US$18.35 in the budget. The budget includes adjustors such that, if total revenues exceed budget estimates, one quarter of the excess should be saved, one quarter transferred to the Oil Stabilization Fund (OSF), and the remaining half spent on infrastructure projects. In the event of shortfalls in oil revenues, the OSF could, in principle, be drawn down by an amount up to 50 percent of its balance. In practice, because the OSF contained only Mex$76 million (0.001 percent of GDP) as of end-June, expenditures would be cut by practically the full amount of any shortfall.

demand and lower world oil prices (Table 6). FDI would continue to finance most of this deficit. However, downside risks associated with the difficult political climate for passing structural reforms remain significant, and continued delays in implementation would likely undermine activity and investor confidence.[11]

25. **While high oil prices are likely to hold down the augmented deficit this year, achieving the authorities' medium-term objectives and reducing fiscal vulnerabilities will require substantial consolidation measures.** Risks to the fiscal outlook include: mounting spending pressures; continued weak economic growth; a sharp decline in world oil prices;[12] uncertainties about the scope and impact of tax reform, and the potential up-front cost of public pension reform. If these risks are realized, little progress would be made toward debt reduction over the medium term even with substantial consolidation measures in other areas. To illustrate the impact of a stalling of the fiscal consolidation process, the staff has constructed an alternative "no policy change" scenario that assumes that no new measures are taken to reduce the deficit (Box 2 and Text Table 3). Even adhering to this path would require considerable effort given existing spending pressures and rigidities, as well as the other risks described above. Under this scenario, the augmented deficit would exceed 4 percent of GDP over the medium term, pushing up gross public debt to 53 percent of GDP by 2008, as opposed to about 45 percent under the consolidation baseline.

Text Table 3. Mexico: Alternative "No Policy Change" Fiscal Scenario

(In percent of GDP)

	Staff Projections					
	2003	2004	2005	2006	2007	2008
Budgetary revenue	**23.4**	**22.4**	**21.8**	**21.7**	**21.6**	**21.3**
Tax revenue	11.8	11.6	11.8	11.8	11.8	11.8
Nontax revenue	5.1	4.4	3.5	3.4	3.3	3.1
Public enterprises	6.5	6.4	6.5	6.5	6.5	6.4
Budgetary expenditure	**23.9**	**23.0**	**23.1**	**23.3**	**23.2**	**23.3**
Primary	21.2	20.4	20.3	20.3	20.3	20.3
Interest payments and other	2.7	2.5	2.8	3.0	2.9	3.0
Traditional balance	**-0.5**	**-0.6**	**-1.3**	**-1.6**	**-1.7**	**-2.0**
Adjustments to the traditional balance	2.8	2.7	2.3	2.3	2.3	2.2
Augmented balance (PSBR excl. nonrecurring revenues)	**-3.3**	**-3.3**	**-3.6**	**-3.9**	**-3.9**	**-4.1**
Augmented primary balance	-0.1	-0.2	-0.3	-0.4	-0.5	-0.6

Sources: Mexican authorities and Fund staff estimates.

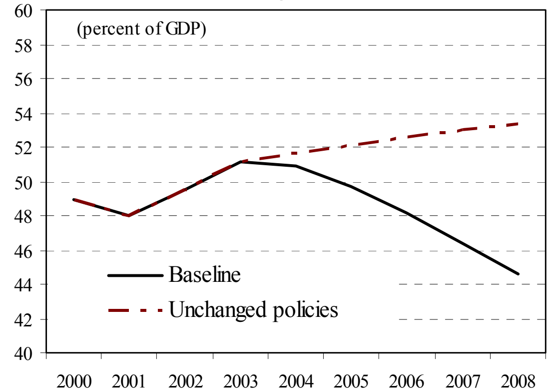
[11] The staff's projection for potential output growth over this period has been reduced to an average of 3½ percent from 4¼ percent in the 2002 Article IV staff report, in part reflecting a more conservative assumption about implementation of structural reforms.

[12] Oil revenues have increased from just over 6 percent of GDP in 1998–99, when Mexico's export price averaged US$13 per barrel, to 7½ percent in 2001–03, with an export price of US$21.20.

Box 2. Mexico: Assessment of Debt Sustainability

The staff's baseline fiscal scenario projects a decline in gross public debt from 50 percent of GDP in 2003 to 44 percent by 2008, assuming that consolidation measures are implemented that lower the augmented deficit to 1½ percent of GDP over this period (Panel A). The staff has also constructed a "no policy measures" scenario that assumes no expenditure adjustments, with primary spending remaining constant as a percent of GDP at its 2003 level.[1] On this assumption, the gross debt ratio would rise gradually to 53 percent of GDP by 2008, highlighting the necessity of pursuing active consolidation measures.

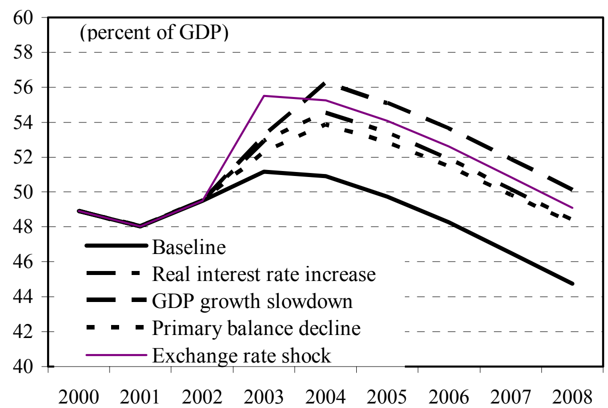
A. Gross Public Debt: Baseline Scenario Versus Unchanged Fiscal Policies



Sources: Mexican Authorities and Fund staff estimates.

The baseline debt path is sensitive to various shocks. In an update of the sustainability analysis undertaken for last year's Article IV consultation, the robustness of the baseline path was tested by applying standardized sensitivity tests.[2] Panel B shows two standard deviation shocks, lasting two years, to the real effective interest rate, GDP growth, and the primary balance, as well as the impact of a one-off 30 percent depreciation in the Mexican peso. The debt-to-GDP ratio would be most affected by an isolated shock to GDP growth, which implies an increase in the ratio of 6 percentage points over the baseline projection. Nonetheless, in all cases the debt dynamics would turn around once the shock subsides. This suggests that debt sustainability is robust to a variety of temporary shocks to the key variables, if active fiscal consolidation measures are pursued.

B. Debt Sustainability Shocks



Source: Mexican Authorities and Fund staff estimates.

1/ Excluding potential infrastructure investment in 2003 financed out of excess revenues. The increase in the deficit over the medium term in the "no policy measures" scenario is mainly driven by declining oil revenues.

2/ The staff's work broadly follows the methodology in "Assessing Sustainability," (www.imf.org). Its main departure from this framework is the replacement of the nominal interest rate shock with a two-standard-deviation shock to the real effective interest rate over baseline, rather than its low historical average. An isolated shock to the nominal interest rate implied an unrealistically large shock to the real interest rate, as nominal interest rates and inflation were on a sharp downward trend in recent years.

IV. Policy Discussions

A. Fiscal Policy

26. **While the authorities remain committed to further fiscal consolidation, they have not yet formulated specific objectives for the 2004 budget.** They acknowledged that building widespread political support for further consolidation would be difficult, especially given the already low level of the traditional definition of the deficit (½ percent of GDP) on which budget discussions focused. In addition, it was not clear how much revenue could be generated from tax reform measures in the absence of a political consensus on their scope and content.[13] Staff and the authorities concurred that there was a potential risk that revenue gains from tax reform could go toward meeting expenditure pressures as opposed to deficit reduction.[14]

27. **Staff underscored the need to reinvigorate the underlying fiscal consolidation process, especially for the augmented deficit and debt**. The existing broad debt-to-GDP ratio of about 50 percent was one that had been associated with financing problems in some other emerging-market countries in the past. Notwithstanding the strengthening of Mexico's debt structure, the recent edging up in the ratio raised the risk of an upward drift that could eventually trigger market concerns (Box 2). The authorities were confident that the recent upward movement in the ratio mainly reflected the temporary effects of low growth and real exchange rate depreciation, which they expected to fade. They saw the most likely scenario as a steady decline in the debt-to-GDP ratio, with continued strengthening in the debt structure. Adhering to the PRONAFIDE path for the augmented deficit, as the staff advocated, would put the debt-to-GDP ratio on a downward trajectory. But it would require more ambitious consolidation measures than implied by recent developments.[15] As a substantial step in this direction, with economic activity expected to recover, the staff suggested aiming at lowering the augmented deficit to 2½ percent of GDP in 2004, with an associated improvement in the cyclically adjusted non-oil primary balance of about 1 percent of GDP. While large, this adjustment would only partially reverse the estimated deterioration in 2002–03 of 1½ percent of GDP. As conventionally measured, the fiscal impulse would amount to -¾ percent of GDP,

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[13] It was estimated that the original tax reform proposal submitted in 2001, which would have harmonized the VAT rate on almost all items at 15 percent, would have raised about 1½–2 percent of GDP in additional revenues. New proposals are likely to be less ambitious. Preliminary discussion have focused on: a more modest extension of the VAT that would eliminate some zero ratings but stop short of a harmonized rate; coordinating the introduction of a state-level VAT; reducing the income tax rate while broadening the base; and various administrative improvements to reduce tax avoidance and evasion.

[14] An example is recent legislation mandating an increase in education outlays from 5½ percent of GDP in 2002 to 8 percent by 2006, although implementation may partly depend on the availability of revenues.

[15] Even if future deficits could be held in line with PRONAFIDE, debt paths would be significantly above those envisaged in the plan.

although the actual contractionary effect would depend on the quality of measures taken and the impact on confidence in medium-term prospects. Within the context of a substantial adjustment effect on a cyclically adjusted basis, there could be some scope to allow automatic stabilizers to operate in response to adverse output developments, although such an adjustment should be applied symmetrically in the face of favorable as well as unfavorable shocks.

28. **The authorities strongly reaffirmed the importance of meeting announced deficit targets to underpin credibility.** Thus far, annual budget deficits based on the traditional definition of the deficit had been consistent with the 2002 PRONAFIDE. The emphasis on observing "headline" deficit objectives was underscored by the design and operation of budget adjustors that implied spending adjustments in response to unexpected revenue deficiencies. Consistent with their commitment to retaining credibility, the authorities believed that the need for fiscal restraint to meet deficit objectives could be even greater if economic conditions were adverse than if they were favorable, as these would be circumstances in which market sentiment might be most fragile.

29. **The authorities indicated that Mexico's definition of the augmented balance and public debt was broader than that used by many other countries.** In addition, PIDIREGAS borrowing was used to finance desirable public infrastructure investment, and thus did not reduce public sector net worth. Staff acknowledged that debt issued to finance productive public investment did not, in principle, reduce net worth, but noted several practical issues that would need to be addressed in implementing a "net worth" approach. These included the difficulty in judging the productivity of spending under PIDIREGAS projects, and the need to take into account other unmeasured government liabilities, such as unfunded pension liabilities. In any event, staff noted that the level of public investment in Mexico did not appear high by international standards, and that PIDIREGAS borrowing for public investment represented less than half of the difference between the traditional and broad deficit measures, with the balance largely attributable to the servicing costs of debt issued for bank restructuring. Finally, there was a need to place an important weight on reducing financing vulnerabilities, which were related to gross public debt as opposed to net worth.

30. **The authorities believed that, in conjunction with tax reform, it would be important to enact the fiscal responsibility principles proposed earlier to ensure that deficits fell from current levels**. The proposed principles required, among other things, that the traditional definition of the budget be balanced over a four-year period. Staff agreed with the general approach of establishing clear medium-term objectives that would effectively discipline annual budget discussions.[16] In contrast to existing proposals, however, staff suggested that such a framework be designed around augmented definitions of the deficit and

[16] Although PRONAFIDE has been useful as a guide for budget negotiations, it has no formal status in the annual budgeting framework, as discussed in more detail in Chapter II of *Mexico—Selected Issues* (www.imf.org).

debt, with proper adjustment for oil revenue volatility; [17] that it allow scope for counter-cyclical policies as fiscal credibility became well established; and that it set clear objectives for declining ratios of public debt-to-GDP over time. Staff also emphasized that transparency would be key in ensuring successful implementation of any fiscal rule and, in this context, that it would be helpful to focus public debate more on augmented measures of deficits and debt to inform public opinion about the nature of the fiscal problem.

31. **The mission stressed the need to address the issues identified in the 2002 fiscal ROSC report.** Key recommendations included: aligning the institutional coverage of government with international standards by excluding commercial public enterprises; presenting budgets in a rolling medium-term framework with clearly specified fiscal objectives; and incorporating timely information on sub-national governments in the fiscal accounts. The staff welcomed the authorities' intention to publish a revised public sector definition more in line with the new Government Finance Statistics (GFS) in the near future.

B. Monetary Policy and Exchange Rate Management

32. **BOM officials and staff agreed that the recent easing of monetary conditions was appropriate,** given the decline in headline inflation and inflation expectations, lower wage growth, and indicators of economic slack.[18] Prospects appeared favorable for bringing end-year inflation within the upper limit of the "variability interval" (with a target centered on 3 percent, and a margin of ±1 percent)**.** BOM officials noted that, if the global economy failed to recover in the second half of the year, they would not resist a further market-induced easing in monetary conditions, provided that inflation continued to converge to target. Indeed, monetary conditions subsequently eased somewhat through the summer, as the peso reversed its earlier strength. Nevertheless, the *corto* was left unchanged as inflation expectations continued to decline.

33. **BOM officials believed that the *corto* has been very useful as an operating instrument.** In particular, the approach has allowed the authorities to clearly signal their intentions in terms of reducing inflation, while allowing relatively large and rapid declines in interest rates in response to observed declines in inflation. They believe that such movements would have been difficult to achieve without a loss of credibility if interest rates had been used as an operating instrument. While acknowledging this advantage during the process of disinflation, staff was of the opinion that the rather loose relationship between the levels of the *corto* and that of monetary conditions could be problematic from the point of view of keeping inflation within a narrow target range (Box 3). The staff also believed this loose connection could lead to confusing signals being

[17] In this context, the background paper on fiscal issues notes that the balance in the existing Oil Stabilization Fund (OSF) is currently almost nil, even though oil prices have consistently exceeded budget estimates since the OSF was established.

[18] A selected issues paper discusses a structural model of inflation in Mexico.

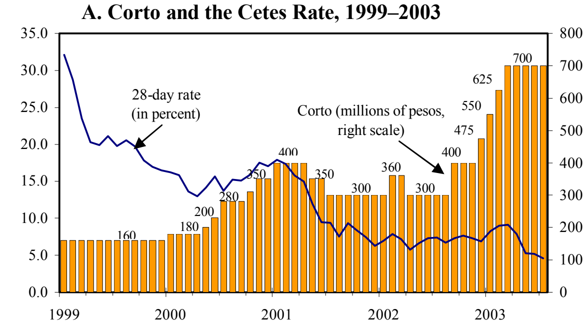
Box 3. Mexico: The Corto, Monetary Conditions, and Interest Rate Volatility

Monetary policy in Mexico has been implemented since 1995 via changes in the "*corto*"—the aggregate quantity of funds banks borrow from the BOM to satisfy the requirement that their reserve balances be zero . The BOM achieves its objective for the *corto* by adjusting peso liquidity through open market operations. Borrowing from the BOM takes place at a penalty interest rate equal to twice the market rate. Other things equal, a higher *corto* should drive up the expected marginal cost of funds for banks, and thus market interest rates.[1]

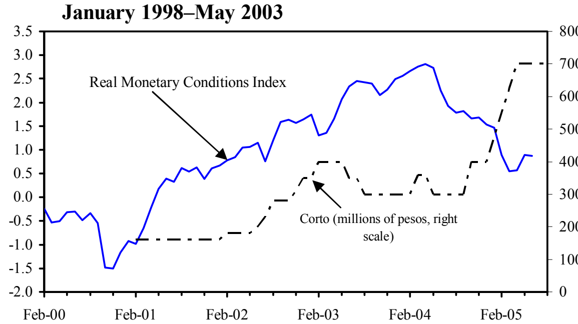
In terms of its general effectiveness, a sustained decline in inflation has been achieved since 1999 using the *corto* as an operating instrument. At the same time, in the staff's view the relationship between the *corto* and the level of market interest rates has been rather inconsistent (Panel A). This, according to the staff, raises questions about the tightness of control over monetary conditions in the near term, expressed in terms of variables that have a more direct link to the economy, such as interest rates and the exchange rate (Panel B). [2]The recent sharp decline in market rates in the face of a high *corto* underscores such questions. A related question is whether use of the *corto* contributes to interest rate volatility in Mexico. In this regard, the staff calculations in Panels (C) and (D) suggest that, while the volatility of the peso has been similar to that of other countries with floating exchange rates, interest rates in Mexico have typically been considerably more volatile.

The BOM has argued that use of *corto* allows market interest rates to adjust flexibly to shocks, notably to the exchange rate. The authorities have also underscored that any evaluation of the efficiency of the corto must be based on its impact on inflation and inflation expectations. They also emphasized that the corto is a signaling device and that market participants extract the signal of the monetary stance from an information set that includes monetary conditions, the direction and amount of changes in the corto and, possibly, the frequency with which it is modified. In addition, they noted that interest rate fluctuations in Mexico have been the natural result of a credible disinflation process carried out in the context of an instrument with an indirect impact on interest rates. Therefore, the authorities stressed that their objective has not been to reduce interest rate volatility, but rather to minimize the cost of disinflation, arguing that this is better achieved with an instrument that allows significant flexibility of interest rates, so that they can be reduced as inflation and risk premiums decrease. Moreover, the authorities highlight the difference between interest rate volatility and flexibility in the context of a disinflationary process.

A. Corto and the Cetes Rate, 1999–2003

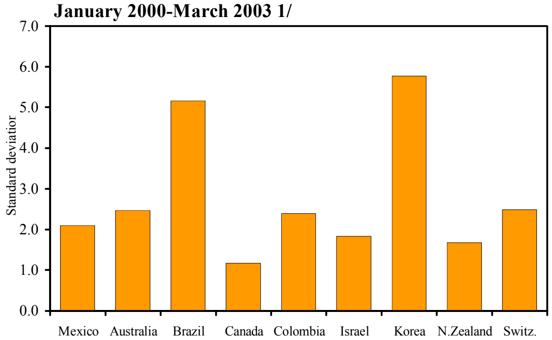


B. Real Monetary Conditions Index and Corto, January 1998–May 2003



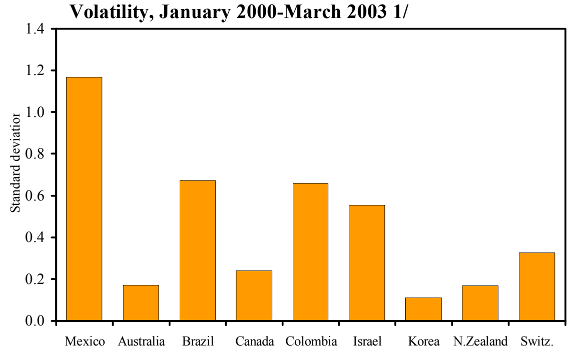
1/ An increase in the real monetary conditions index indicates a tightening of the policy stance.

C. Intercountry Comparison of Exchange Rate Volatility, January 2000-March 2003 1/



1/ National currency per U.S. dollar.

D. Intercountry Comparison of Interest Rate Volatility, January 2000-March 2003 1/



1/ Monthly money market rates (IFS); for Mexico the bank funding rate. (BOM).

Sources: Bank of Mexico, INS, IFS, and Fund staff estimates.

1/ For a discussion of Mexico's policy framework see Carstens, A., and A. Werner, 1999, "Mexico's Monetary Policy Framework under a Floating Exchange Rate Regime," Bank of Mexico Working Paper No. 9905.

2/ The real monetary conditions index is calculated as 75 percent of the change in the real 28-day cetes rate since 1997 plus 25 percent of the change in the log REER index (1994=100), also since 1997.

sent to markets if the authorities needed to move the *corto* to offset market-induced changes in monetary conditions that were inappropriate from a monetary policy perspective. The authorities disagreed with these views, insisting that the efficiency of the corto must be evaluated on the basis of its success in contributing to reductions in inflation and inflation expectations. They also emphasized that the other staff concern is unwarranted, since at present markets understand very well the way the corto works.

34. **The staff argued that shifting to an interest rate as an operating instrument would be increasingly desirable as inflation converged to the long-term target**. It would enhance the controllability of inflation, and facilitate the clear communication of policy actions by tying them to a variable of direct impact on output, inflation, and the exchange rate. This approach had been quite successful in other countries with inflation-targeting regimes. The authorities noted that they continuously assess the relative merits of various policy instruments. Thus far, the conclusion had been that there is no clearly superior alternative to the "*corto*". In particular, given the exposure of the economy to external shocks, as well as the volatility of domestic markets, use of an interest rate as the operating instrument could imply large and frequent movements in the instrument, causing excessive volatility in the exchange rate, inflation expectations, and medium-term interest rates, with adverse effects on the economy.

35. **BOM officials agreed that further refinements to the inflation-targeting framework should be considered in due course.** They noted that the establishment of a fixed schedule for policy announcements beginning in 2003 had been effective in improving transparency and market dynamics. On the choice of the measure of inflation to target, they concurred with staff that core inflation could be a more appropriate objective from some perspectives, but felt that there are more advantages in using a broader indicator like the CPI as a reference index. Regarding the publication of inflation forecasts, BOM officials noted that considerable information was already provided in monthly inflation reports and quarterly macroeconomic reviews.[19] They also underscored the technical difficulties in producing appropriate forecasts, especially given the attention that market participants would likely pay to them.

36. **The authorities are firmly committed to letting the exchange rate be determined by market forces.** In this context, Mexico's low level of dollarization in the banking system reduces the macroeconomic risk of currency movements, facilitating greater flexibility in exchange rate policy.[20] The authorities expressed the view that market sentiment toward the peso had become increasingly symmetric in recent years, with the perceived risks of appreciation better balancing those of depreciation. This change in sentiment had allowed the

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[19] Specifically, the Bank of Mexico's monthly *Monetary Policy Implementation Report* and *Quarterly Inflation Report*.

[20] A selected issues paper analyzes the reasons for the low level of dollarization in Mexico.

exchange rate to provide a useful buffer against external shocks, without jeopardizing policy credibility. Staff endorsed the transparent approach to exchange rate management in Mexico's context, noting that exchange rate volatility did not appear to be unduly complicating policy formation or undermining macroeconomic performance.

37. **The authorities emphasized that the new mechanism for slowing the accumulation of foreign reserves did not change their transparent approach to exchange rate and reserve management**. Staff and the authorities agreed that the present level of reserves was adequate, both in terms of coverage of short-term external debt and Mexico's gross financing needs (Box 1). In the near term, assuming world oil prices remained high, further reserve accumulation was likely under the new mechanism. Nevertheless, staff noted that the longer-term path for reserves would depend importantly on the level of world oil prices and public-sector external financing, including the prospect that some PIDIREGAS projects would be financed domestically.[21] In light of these uncertainties, staff emphasized that the reserve accumulation mechanism should be reviewed over time to ensure that reserves remain adequate in relation to external risks. The authorities affirmed their intention to ensure that reserves remained at an appropriate level.

C. Financial Sector Issues

38. **The Mexican authorities have actively pursued reforms aimed at modernizing and strengthening the financial sector**. The 2001 FSSA concluded that the resilience of the financial system to shocks had increased in recent years, and systemic problems were not likely. Since then, additional measures have been introduced to reduce the BOM's credit risk and increase the liquidity of instruments used for repo operations, in line with international best practice and the recommendations of the FSSA. The beneficial effects of financial reforms are beginning to be felt in the form of higher credit growth and diversification of financial instruments.

39. **The authorities noted that legislation is in progress on a comprehensive framework for prompt corrective action to resolve problem banks.** Key elements would include a clear timeline for early intervention and resolution, improved coordination among supervisory agencies, and strengthened rules to dissolve and liquidate banks.

40. **The staff stressed that a significant challenge ahead would be to further deepen financial intermediation without excessive risk-taking.** While expressing confidence in the stability of the banking system, the authorities emphasized the high priority they attach to strengthening supervisory oversight of nonbank institutions. They noted that there are no signs of instability in the nonbank sector, but that rapid growth in recent years warrants closer supervision to avoid inappropriate risk-taking. The authorities also expressed concern that

[21] This would reduce the foreign currency inflows associated with external financing, which are sold automatically to the BOM.

competition among banks might not be sufficiently strong, as indicated by recent increases in fees and charges, but emphasized that this would be addressed by measures to increase transparency of costs as opposed to direct controls.

D. External Sector Policies

41. **Concerns have arisen about the leveling off of Mexico's share of U.S. imports since 2001, in contrast to the continuing rise in China's share** (Figure 3). In this context, widespread complaints have been voiced in the private sector that the renminbi is undervalued, creating unfair competition for Mexican exports. Staff expressed the view that, with the peso freely floating against the U.S. dollar, issues of overall Mexican competitiveness could not be ascribed to nominal exchange rate rigidities in other countries. It was also unrealistic to expect the Mexican share of U.S. imports to continue to rise at the pace observed since the mid-1990s, as the share of exports in Mexican output was reaching a level similar to that in other open economies (Box 4). At the same time, staff and the authorities agreed that restoring robust medium-term growth in real incomes, while maintaining competitiveness, could only be achieved through advancing the structural reform agenda.

42. **The authorities are continuing efforts to liberalize trade outside of North America, including the negotiation of a bilateral agreement with Japan**.[22] While the free trade agreement between the United States and Central American countries could affect Mexico's *maquiladora* sector somewhat, the authorities believed that the impact would be minimal because of Mexico's more established trade links with North America, and because the sectors that would be most affected had already fallen in size. The government is conducting studies to further examine competitiveness issues, including the impact from the phasing out of textile quotas at end-2004.

E. Vulnerabilities

43. **Substantial progress has been made in strengthening the structure of public debt.** Public external debt has fallen further from 15 percent of total debt in 2000 to 13½ percent in 2002, and efforts have been made to lengthen maturities and switch to fixed-rate instruments. Mexico's pioneering issuance of international bonds with CACs under New York law earlier this year reflected the high degree of market confidence in Mexico's debt-management policies.[23]

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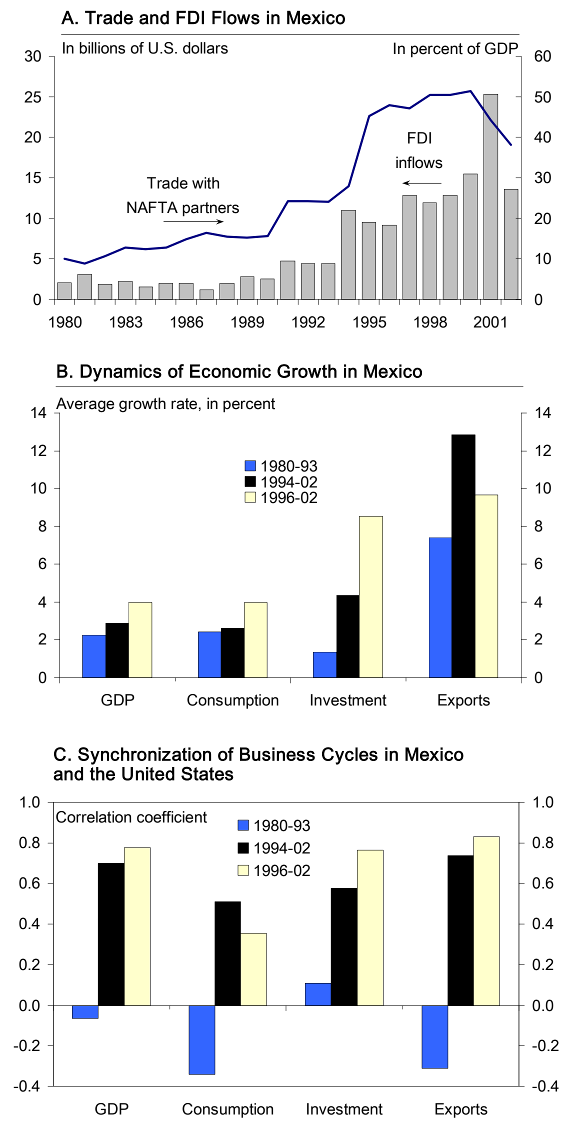
[22] Mexico has a trade restrictiveness index level of 6 (on a scale of 1 to 10, with 10 as most restrictive), reflecting mainly a relatively high most favored nation tariff of 16.5 percent.

[23] Analysis of yield spreads indicates that investors demanded little or no premium for the inclusion of CACs.

Box 4. Mexico: Changes in the Economy after NAFTA—Benefits and Challenges[1]

NAFTA has helped spur a dramatic increase in trade and financial flows between Mexico and other member countries., Mexico's exports to the United States and Canada tripled in dollar terms between 1993 and 2000, and Mexico's trade (the sum of exports and imports) with NAFTA partners rose from 25 percent of GDP in 1993 to more than 50 percent in 2000 (Panel A). The agreement contained provisions that improved the relative standing of foreign investors in Mexico and expanded the sectors in which they could operate. This helped boost FDI flows to Mexico. The share of NAFTA partners in total FDI flows to Mexico increased from 50 percent in 1994 to roughly 80 percent in 2000.



Stronger trade and financial linkages have affected growth dynamics in Mexico. Contributions of exports and investment to GDP growth have increased substantially following the agreement. Recent research suggests that NAFTA induced a significant increase in total factor productivity in Mexico.[2] Mexican GDP growth rose from an annual average of 2 percent in 1980-1993 to an annual average of roughly 4 percent in 1996-2002 (Panel B).

Moreover, NAFTA appears to have been associated with significant changes in the Mexican business cycles. For example, there has been a moderation in the size of business cycle fluctuations. The agreement has also fostered an increased synchronicity of business cycles in Mexico and the United States, as reflected in a marked rise in cross-country correlations of the major macroeconomic aggregates (Panel C).

However, the growth of Mexico's trade with NAFTA partners has begun to stagnate in recent years. After registering impressive growth rates in the second half of the 1990s, export growth to NAFTA partners has decreased substantially during the past two years (Panel A). This dramatic change has been the result of a combination of cyclical and structural factors. First, after a prolonged period of expansion in the 1990s, the U.S. economy has slowed during the past two years. Second, some emerging market economies, particularly China, have been rapidly expanding their market shares in the United States. Mexico's NAFTA advantage could erode in coming years, because the United States has recently strived to sign new regional and bilateral trade arrangements through which other developing countries would also gain preferential access to the U.S. market.

These developments emphasize the importance of undertaking structural reforms to improve the competitiveness of the Mexican economy in international markets. For example, it is critical to undertake reforms aiming at relaxing rigidities in the labor market and improving the efficiency of energy and telecommunication sectors.

1/ These issues are discussed in greater detail in M. A. Kose, 2003, "Before and After: Macroeconomics of NAFTA", IMF Working Paper, forthcoming.

2/ See, for instance, J.E. Lopez-Cordova, 2002, "NAFTA and Mexico's Manufacturing Productivity: An Empirical Investigation using Micro-level Data", Inter-American Development Bank Working Paper.

44. **Nevertheless, some vulnerabilities remain in public financing.** Three quarters of domestic debt is still either short-term or linked to short-term interest rates. Furthermore, gross financing needs of the public sector, estimated at US$78 billion in 2003, are sizable. The authorities intend to further strengthen the debt structure by continuing to increase the share of fixed-rate domestic instruments, while lengthening average maturity. This is seen as complementary to the deepening on the demand side of the domestic bond market associated with increased activity by institutional investors. Increased demand, in turn, has reflected the prudent economic policy framework and the resulting rise in credibility and financial stability.

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

46. **Nevertheless, Mexico's gross external financing requirements create moderate potential vulnerabilities to adverse shifts in market sentiment.** For this year, gross external financing requirements are estimated at US$57 billion, equivalent to around 8 percent of GDP. Mexico weathered difficult external conditions last year quite well, as sustained market confidence and an investment-grade rating have largely insulated it from financial strains elsewhere in the region. The situation would be quite different, though, if assessments of Mexico's creditworthiness were to weaken, increasing the risk of constraints on market access. In any case, the immediate risks are low, as the government has already met its external financing requirement for the year and liquid market conditions resulted in strong capital inflows to the private sector during the first half of the year.

47. **Similarly, constraints on market access could cause liquidity problems for the corporate sector.** Corporate sector results for 2002 suggest that defaults and financing difficulties were associated with company-specific problems, as opposed to systemic factors. Stress tests suggest that overall liquidity and solvency would not be significantly affected by a combined adverse shock of two standard deviations to the exchange rate, interest rates, and economic growth. However, if these shocks were accompanied by market access limitations (in the form of only 80 percent rollover of one year's amortizations), most firms would face liquidity problems. In such a scenario, gross debt of firms in liquidity distress would amount to around 3 percent of GDP (Annex IV).

F. Other Issues

48. **The authorities give high priority to improving governance and reducing corruption, which are serious problems in Mexico.** [24] Staff noted that widespread concerns remained about governance of public enterprises, and suggested that it could be improved through, for example, the vertical disintegration of PEMEX to foster competition, establishment of corporate structures that promote greater autonomy, commercial reorientation of operations, and strengthened regulatory oversight. The authorities indicated that their strategy consists of improvements in the regulatory framework; judicial reform; better audits and controls of public sector operations; stricter sanctions on corrupt practices; more transparency in the public sector; and better administration of public property. Actions include legislation enabling access to public sector information and mandating financial disclosure by federal civil servants, and more transparent bidding practices in public enterprises. Legislation improving private corporate governance and protecting minority shareholders' rights has also been enacted.

49. **Notwithstanding the decline in per capita real income during 2001–02, Mexico has made further progress in reducing poverty.** Based on the 2002 income and expenditure survey and official poverty measures, the authorities estimate that absolute poverty fell from about 24 percent of the population in 2000 to 20 percent in 2002. The decline was more pronounced in rural than urban areas. In absolute terms, 3.4 million individuals moved out of poverty. The authorities' view is that these developments reflect, among other factors, a strengthening of social programs, increased remittances from abroad (which are an important income source for the poor), and lower prices of basic stables.[25]

50. **Mexico is a party to the major international anti-terrorism conventions**. It has endorsed the methodology adopted by the IMF, World Bank, and FATF for assessing systems to prevent money laundering and terrorist financing. Mexico is also party to the OECD convention; a final report on actions in this area is expected to be submitted by June 2004. The recent passage of the Information Act is aimed at increasing transparency.

V. Staff Appraisal

51. **The substantial progress made in strengthening policies in the years immediately following the 1994–95 crisis has allowed Mexico to weather difficult external conditions since 2001 relatively well.** Progress in policy implementation has continued in important areas, notably modernizing the financial sector, strengthening the structure of public debt,

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[24] Mexico ranked 63 out of 113 countries in the latest ranking of corruption by Transparency International.

[25] For example, the coverage of social programs such as Oportunidades and Procampo was extended significantly (by 70 percent in the case of Oportunidades), while remittances rose from US$6.6 billion in 2000 to US$9.9 billion in 2002.

and bringing inflation down to low levels. Furthermore, the latest economic downturn has not been associated with a domestic financial crisis, but rather reflects in large part an unfavorable external environment.

52. **Recent progress in structural reforms and fiscal consolidation has been slower than earlier envisaged by staff and the authorities, however, largely because of difficulties in forging a political consensus.** The process of lowering the public debt-to-GDP ratio has stalled, and the public finances remain vulnerable to adverse movements in oil prices and interest rates. Congressional approval of key structural reforms to boost growth, generate employment, and improve the fiscal accounts is urgently needed. Poverty remains endemic, and there exist sizable regional disparities.

53. **Staff are concerned that progress in fiscal consolidation has faltered.** The augmented deficit has remained at around 3½ percent of GDP in recent years, the overall debt-to-GDP ratio has edged up, and revenues have been increasingly reliant on high oil prices. With economic recovery likely to gather momentum, it will thus be important to provide renewed impetus to fiscal adjustment in 2004, consistent with achieving PRONAFIDE's medium-term goals. Early actions to restart the consolidation process are critical given the medium-term challenges posed by spending pressures in the areas of social services, agriculture, infrastructure, and pension reform. Achieving fiscal adjustment through reforms that increase efficiency and boost confidence in medium-term sustainability would help to minimize any negative impact on short-term growth.

54. **Annual budget discussions should be formally linked to a medium-term framework, and be framed in terms of augmented fiscal definitions.** A fiscal responsibility law could provide an appropriate framework for observing medium-term targets, including for the overall debt path, and for reconciling objectives in the areas of tax, expenditure, and social sector policies. Given its importance, however, design of the framework deserves careful consideration. Staff encourage the authorities to set and regularly update specific objectives for the augmented deficit and debt to discipline annual budget discussions.

55. **Deep and significant structural reforms are needed to achieve the broadly-shared goal of raising income growth and reducing poverty over the medium term.** Key areas for reforms include: the energy sector; tax system; labor market; and the judicial system. However, implementing these reforms will not be easy given political differences. At the same time, there seems to be increasing recognition of the need for action in these areas and the costs of continued inertia in terms of weak growth, external vulnerabilities, and adverse debt dynamics.

56. **The BOM's monetary policy stance has been appropriately geared to achieving a decline in inflation to 3 percent in 2003 and beyond.** Staff share the authorities' view that headline inflation will converge toward the target by end-2003 given the decline in

expectations, weak activity, and decelerating wage growth. At the same time, the recent easing in monetary conditions should provide support to activity in the period ahead.

57. **The authorities are encouraged to shift to interest rate targeting in the context of a more formalized inflation-targeting framework, as inflation and interest rates stabilize at low levels**. The *corto* has allowed for large and rapid adjustments in interest rates, which were desirable when inflation was declining rapidly. An approach based on short-term interest rates as an operating instrument, however, may provide a higher degree of monetary control for keeping inflation within a narrow target range, and could also enhance the communication of monetary policy actions. The recent shift to daily reserve accumulation periods could facilitate a future shift to using a short-term interest rate as an operating instrument.

58. **Mexico's flexible exchange rate regime has been effective in cushioning the economy from external shocks in recent years.** The recent level of external competitiveness appears to be broadly consistent with a sustainable balance of payments position. International reserves remain adequate in the context of a flexible exchange rate, both in their coverage of short-term external debt and Mexico's gross annual financing needs. The staff agrees that the new rules-based mechanism for accumulating foreign reserves does not change the authorities' transparent approach to reserves management and commitment to a market-determined exchange rate. Nevertheless, flexible implementation is needed over time to ensure that reserves remain adequate.

59. **Mexico's banking system remains sound and well-regulated.** Further steps taken in 2002 to move into full compliance with the Basle Core Principles are welcome. In addition, the minimal level of informal dollarization allowed banks to easily withstand the impact of currency depreciation in 2002. Yet financial intermediation is only starting to recover from the collapse in bank lending associated with the 1994–95 crisis. A significant challenge in the period ahead is to deepen financial activity without excessive risk-taking, and to streamline financial rules and regulations to encourage innovation and competition. The staff supports the high priority attached by the authorities to strengthening oversight of nonbank institutions, which have grown rapidly in recent years.

60. **The authorities are encouraged to address the outstanding issues identified in the 2002 fiscal ROSC.** Key recommendations include publishing a revised public sector definition excluding commercial enterprises from the coverage of general government, and incorporating medium-term macroeconomic and fiscal projections in the economic guidelines underlying annual budgets.

61. **The staff supports the authorities' commitment to continue reducing vulnerabilities relating to public debt.** In addition to sustained progress with fiscal consolidation, the structure of the debt stock would be strengthened by continuing to increase issuance of fixed-rate, domestic-currency instruments and extending the yield curve. Regarding vulnerabilities linked to private debt, the deepening of the domestic bond market

associated with the rapid growth of institutional investors should diversify financing sources, lowering liquidity and contagion risk and reducing foreign currency mismatches in firms' balance sheets.

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

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

Table 1. Mexico: Selected Economic and Financial Indicators

	2000	2001	2002	Staff projections 2003	2004
(Annual percentage change, unless otherwise indicated)					
National accounts in constant prices					
Real GDP	6.6	-0.3	0.9	1.5	3.5
Net exports 1/	-1.8	-0.7	-0.1	-0.4	0.3
Total domestic demand	8.3	0.4	1.0	1.9	3.1
Private final consumption	8.2	2.7	1.2	2.0	5.0
Public consumption expenditure	2.0	-1.2	-1.3	2.7	-2.6
Gross fixed private investment	8.7	-4.4	-2.8	0.0	8.5
Gross fixed public investment	27.2	-13.0	7.3	5.5	-10.9
External sector					
Exports, f.o.b.	21.8	-3.7	0.6	4.3	5.5
Export volume	19.2	2.5	-3.4	-0.5	7.2
Imports, f.o.b.	23.1	-1.7	-1.3	2.7	7.9
Import volume	19.7	-2.4	-0.7	-0.1	6.4
Terms of trade (deterioration -)	-0.7	-6.7	4.7	2.1	-3.0
Exchange rates					
Nominal exchange rate (US$/Mex$)					
(average, depreciation -)	1.1	1.2	-3.4	...	...
Real effective exchange rate (CPI based)					
(average, depreciation -)	10.0	8.3	-0.2	...	...
Real effective exchange rate (ULC based)					
(average, depreciation -)	11.2	7.9	-0.8	...	...
Employment and inflation					
Consumer prices (end of year)	9.0	4.4	5.7	3.8	3.0
GDP gap (end of year)	2.6	-1.5	-2.0	-2.3	-2.0
IMSS employment 2/	5.9	1.0	1.0	...	...
Real manufacturing wages	5.8	6.4	2.2	...	...
Money and credit					
Broad money (M2)	-7.6	9.9	8.9	9.2	8.7
Treasury bill rate (28-day cetes, in percent, annual average)	15.2	11.3	7.1	6.3	5.8
Real interest rate (in percent, annual average)	6.8	7.2	1.5	1.7	2.3
(In percent of GDP)					
Nonfinancial public sector					
Augmented balance (PSBR excluding nonrecurring revenues)	-3.7	-3.7	-3.4	-3.3	-2.5
Augmented primary balance 3/	1.2	0.8	0.5	0.0	0.6
Non-oil augmented balance	-8.9	-8.6	-8.1	-9.1	-7.7
Traditional balance 4/	-1.1	-0.7	-1.2	-0.5	0.2
Savings and investment					
Gross domestic investment	23.8	20.9	20.3	19.2	18.9
Public investment	4.5	4.3	4.1	4.3	3.8
Private investment	16.8	15.4	14.8	14.7	15.5
Change in inventories	2.5	1.3	1.4	0.1	-0.4
Gross national savings	20.7	18.0	18.1	17.4	16.5
Public savings	0.9	0.5	0.8	1.1	1.3
Private savings	19.9	17.5	17.3	16.3	15.2
External current account balance	-3.1	-2.9	-2.2	-1.8	-2.4
Non-oil external current account balance	-5.9	-4.9	-4.5	-4.7	-4.7
(In percent of exports of goods, nonfactor services, and transfers)					
Public external debt service 5/	26.0	22.6	16.6	15.3	12.8
(In billions of U.S. dollars, unless otherwise indicated)					
Change in net international reserves (increase -)	-8.2	-5.3	-7.1	-5.9	-3.8
Gross official reserves in percent of short-term debt 6/	89.5	104.8	126.4	143.6	162.2
Gross external debt (in percent of GDP, end of period)	28.3	26.0	26.7	29.1	29.0
Oil export price (US$/bbl)	24.8	18.6	21.3	23.8	20.5

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

1/ Contribution to growth.
2/ A measure of formal sector employment.
3/ Treats bank restructuring transfers (including IPAB, FARAC and debtor support programs) as interest expenditure.
4/ Includes privatization proceeds as revenue.
5/ Includes the IMF and public development banks and trust funds net of the collateral of Brady bonds.
6/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

Table 2. Mexico: Summary Balance of Payments; 1997-2008

	2001	2002	2003	2004	2005	2006	2007	2008
			Staff Projections					
		(In billions of U.S. dollars)						
Current account	**-18.1**	**-13.9**	**-11.0**	**-15.5**	**-18.8**	**-19.6**	**-20.2**	**-22.1**
Merchandise trade balance, f.o.b.	-10.0	-7.9	-6.5	-9.5	-12.4	-12.7	-12.8	-13.8
Exports	100.8	101.5	105.8	111.6	120.9	132.8	145.4	158.2
Of which:								
Petroleum and derivatives	12.8	14.5	17.9	14.8	14.2	15.2	15.8	15.4
Manufactures 1/	83.6	82.8	83.0	91.4	100.9	111.4	122.9	135.7
Imports	-110.8	-109.4	-112.3	-121.1	-133.3	-145.6	-158.2	-172.0
Factor income	-13.9	-12.2	-12.6	-12.9	-13.7	-14.5	-15.3	-16.4
Other services and transfers	5.8	6.2	8.1	6.9	7.3	7.7	7.8	8.1
Financial account	**22.7**	**26.9**	**16.9**	**19.3**	**22.6**	**23.4**	**24.1**	**25.9**
Public sector	0.5	-2.3	5.9	6.5	6.5	7.1	6.6	6.2
Medium- and long-term borrowing	-2.7	-2.3	5.7	6.4	6.5	7.1	6.6	6.4
Disbursements	17.7	10.9	18.7	16.6	16.9	16.9	15.5	15.3
Amortization 2/	20.3	13.3	12.9	10.2	10.4	9.8	8.8	8.9
Other, including short term borrowing	3.2	0.1	0.1	0.1	0.0	0.0	-0.1	-0.1
Private sector	22.2	29.1	11.0	12.8	16.1	16.4	17.6	19.7
Direct investment 3/	24.8	13.6	11.4	13.6	14.3	15.1	16.0	17.0
Bonds and loans 4/	3.5	3.8	0.7	1.0	2.3	2.8	3.2	2.7
Banking system	-3.1	0.4	0.3	-0.5	0.8	1.3	1.2	0.7
Corporate sector	6.6	3.5	0.4	1.5	1.5	1.5	2.0	2.0
Equity investments and change in assets abroad	-6.1	11.7	-1.1	-1.7	-0.5	-1.5	-1.7	0.0
Equity investments	0.2	-0.1	0.1	0.3	0.4	0.4	0.4	0.5
Change in assets abroad 3/	-6.3	11.8	-1.3	-2.0	-0.9	-2.0	-2.1	-0.5
Errors and omissions and valuation adjustments	0.6	-5.8	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-5.3	-7.1	-5.9	-3.8	-3.8	-3.9	-3.9	-3.9
		(In percent of GDP, unless otherwise indicated)						
Memorandum items:								
Current account balance	**-2.9**	**-2.2**	**-1.8**	**-2.4**	**-2.8**	**-2.7**	**-2.7**	**-2.8**
Nonoil current account balance	-4.9	-4.5	-4.7	-4.7	-4.9	-4.9	-4.8	-4.7
Nonoil trade balance	-3.6	-3.5	-4.0	-3.8	-3.9	-3.9	-3.8	-3.6
Merchandise exports	16.2	15.9	17.2	17.4	17.9	18.6	19.2	19.7
Merchandise imports	17.8	17.2	18.2	18.8	19.7	20.4	20.9	21.5
Gross financing needs (billions of US$) 5/	73.0	63.8	56.8	58.3	59.5	63.8	68.5	72.3
Gross international reserves 6/								
End-year (billions of US$)	44.8	50.7	56.0	59.8	63.6	67.4	71.3	75.2
Months of imports of goods and services	4.3	4.7	4.8	4.7	4.5	4.4	4.3	4.2
Months of imports plus interest payments	3.8	4.2	4.3	4.1	4.0	3.9	3.9	3.7
Percent of short-term debt (by residual maturity) 7/	104.8	127.0	143.4	162.0	157.6	163.8	157.5	158.8
Percent of gross financing requirent 8/	79.1	99.7	102.6	107.3	106.1	112.6	110.5	109.8
IMF (net purchases, billions of US$)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Crude oil export volume (millions of bbl/day)	1.7	1.7	1.9	1.8	2.0	2.2	2.3	2.3
Crude oil price (US$/bbl)	18.6	21.3	23.8	20.5	17.6	17.2	17.2	16.8
Gross total external debt	26.0	26.7	29.1	29.1	29.0	28.9	28.7	27.3
Of which: Public external debt 9/	15.8	16.0	17.9	18.2	18.4	18.5	18.4	17.2
Gross total external debt (billions of US$)	162.5	169.9	178.9	186.8	196.0	206.4	216.7	218.6
Of which: Public external debt 9/	98.5	102.0	110.4	117.3	124.2	131.8	139.0	138.1
Public external debt service (in percent of exports of goods, services, and transfers) 9/	22.6	16.6	15.3	12.8	12.8	11.9	10.8	10.4
		(Annual percentage change)						
Export volume	2.5	-3.4	-0.5	7.2	9.1	9.1	8.4	8.1
Non-oil exports	2.3	-3.6	-1.8	8.7	8.9	8.9	9.0	9.0
Import volume	-2.4	-0.7	-0.1	6.4	8.8	8.0	7.6	7.7
Consumer goods	17.4	7.8	7.7	8.7	10.0	9.0	8.0	8.0
Intermediate goods	-5.2	-1.4	-2.2	5.3	8.0	8.1	7.3	7.5
Capital goods	-7.9	-6.2	1.2	9.1	10.1	6.7	7.8	8.0

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$12.5 billion Citibank acquisition of Banamex. This is reflected in an equal equal increase in private sector assets in the same year, followed by partial drawdown in the following years.
4/ Includes financing of PIDIREGAS.
5/ Defined here as the sum of the current account deficit, debt amortization (including 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 financing requirement excludes pre-payments of public sector debt and reserve accumulation.
9/ Includes the IMF and public development banks and trust funds.

Table 3. Mexico: Financial Operations of the Public Sector

(In percent of GDP)

	2001	Prel. 2002	Budget 2003	Staff Projections 2003	2004	2005	2006	2007	2008
Budgetary revenue	**21.8**	**22.6**	**22.4**	**23.4**	**22.4**	**21.8**	**21.7**	**21.6**	**21.3**
Tax revenue	11.2	11.9	12.0	11.8	11.6	11.8	11.8	11.8	11.8
Nontax revenue 1/	4.9	4.2	4.1	5.1	4.4	3.5	3.4	3.3	3.1
Public enterprises	5.7	6.5	6.3	6.5	6.4	6.5	6.5	6.5	6.4
Of which: PEMEX	1.8	2.4	2.3	2.5	2.4	2.5	2.5	2.5	2.4
Budgetary expenditure	**22.5**	**23.7**	**22.9**	**23.9**	**22.1**	**21.5**	**21.0**	**20.8**	**20.6**
Primary	19.3	20.8	20.1	21.2	19.6	18.8	18.1	18.0	17.9
Programmable	15.8	17.2	16.5	17.5	16.1	15.3	14.7	14.6	14.5
Current 2/	13.2	14.0	14.1	14.5	13.6	12.9	12.3	12.1	12.1
Capital 3/	2.6	3.2	2.4	3.1	2.4	2.4	2.4	2.4	2.4
Nonprogrammable 4/	3.5	3.6	3.6	3.7	3.5	3.4	3.4	3.4	3.4
Of which: revenue sharing	3.4	3.5	3.4	3.3	3.4	3.3	3.3	3.3	3.3
Interest payments and other 5/	3.2	2.9	2.8	2.7	2.5	2.8	2.9	2.8	2.7
Traditional balance	**-0.7**	**-1.2**	**-0.5**	**-0.5**	**0.2**	**0.3**	**0.6**	**0.8**	**0.7**
Adjustments to the traditional balance	**3.0**	**2.1**	**2.9**	**2.7**	**2.7**	**2.3**	**2.3**	**2.3**	**2.2**
Plus: PIDIREGAS	0.8	0.8	1.4	1.3	1.4	1.1	1.1	1.0	1.0
IPAB	0.9	0.5	0.3	0.3	0.4	0.4	0.3	0.3	0.3
Budgetary adjustments	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
FARAC	0.1	0.4	0.2	0.2	0.1	0.1	0.2	0.2	0.2
Debtor Support	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development banks 6/	0.1	-0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Less: Nonrecurring revenue	0.7	0.7	0.4	0.5	0.2	0.2	0.2	0.2	0.2
Augmented balance (PSBR excl. nonrecurring revenue)	**-3.7**	**-3.4**	**-3.4**	**-3.3**	**-2.5**	**-2.0**	**-1.7**	**-1.5**	**-1.5**
Augmented primary balance 7/	**0.8**	**0.5**	**0.0**	**0.0**	**0.6**	**1.3**	**1.8**	**1.9**	**1.7**
Memorandum items:									
Cyclically adjusted augmented balance 8/	**-3.7**	**-3.2**	**-3.3**	**-3.0**	**-2.4**	**-2.0**	**-1.7**	**-1.5**	**-1.6**
Cyclically adjusted non-oil augmented primary balance	-4.3	-4.5	-5.2	-5.8	-4.8	-3.8	-3.2	-3.2	-3.2
Non-oil primary impulse 9/	-0.8	0.1	0.3	0.4	-0.7	-0.7	-0.4	0.0	0.1
Non-oil augmented balance 10/	-8.6	-8.1	-8.5	-9.1	-7.7	-6.9	-6.5	-6.2	-6.0
Cyclically adjusted non-oil augmented balance	-8.6	-8.0	-8.4	-8.8	-7.7	-6.9	-6.5	-6.2	-6.0
Oil revenue	6.6	6.7	7.1	7.8	7.2	6.8	6.7	6.7	6.5
Non-oil tax revenue 11/	9.7	10.0	10.2	10.1	10.1	10.1	10.1	10.1	10.1
Real primary expenditure growth (incl. PIDIREGAS) 12/	-2.1	4.8	7.2	8.8	-3.7	-2.0	0.5	3.3	3.7
Gross public sector debt	48.0	49.5	50.0	51.1	50.9	49.7	48.2	46.4	44.6
Net public sector debt	42.0	43.5	44.2	45.5	45.2	44.1	42.7	41.0	39.4
Nominal GDP (Mx$ billions)	5830	6153	6574	6489	6902	7375	7898	8485	9133

Sources: Mexican authorities; and Fund staff estimates.

1/ Includes Mex$11billion (0.2 percent of GDP) in 2002 and Mex$8 billion (0.1 percent of GDP) in 2003 in nonrecurring revenues taken from unclaimed pension provisions.

2/ For 2003 includes Mex$6 billion, or 0.1 percent of GDP, in additional outlays for the voluntary separation program.

3/ For 2002 includes Mex$49 billion, or 0.8 percent of GDP, in transfers to development banks associated with the cost of closing Banrural. For 2003 includes Mex$18 billion, or 0.3 percent of GDP, in projected infrastructure outlays and transfers to the Oil Stabilization Fund on account of higher-than-prorammed revenues.

4/ Includes a loan to governors of Mex$15 billion (0.2 percent of GDP) in 2002, which is projected to be repaid with interest in 2003.

5/ Also includes transfers to IPAB and the debtor support programs

6/ Includes a reduction in the net financial requirements of development banks of Mex$49 billion, or 0.8 percent of GDP, in 2002— effectively offsetting the effect of closing Banrural on the overall PSBR.

7/ Treats transfers to IPAB, debtor support programs and FARACas interest payments.

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

9/ Apart from the cyclical adjustment described above, revenue is adjusted to exclude oil export revenue and nonrecurrent income. Expenditure excludes interest payments, including the costs of bank restructuring and debtor support programs, and the financial requirements of development banks.

10/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, IEPS on gasoline) and PEMEX operational expenditure.

11/ Total tax revenue excluding IEPS on gasoline.

12/ Excludes Banrural spending in 2002.

Table 4. Mexico: Summary Operations of the Financial System

	1999 Dec.	2000 Dec.	2001 Dec.	Prel. 2002 Dec.	Proj. 2003 Dec.
	(In billions of Mexican pesos)				
Bank of Mexico					
Net international reserves	264.2	347.4	416.2	535.4	588.9
In U.S. dollars	27.4	35.6	44.9	50.4	56.3
Net domestic assets	-75.4	-138.5	-191.0	-271.5	-327.0
Net credit to nonfinancial public sector	-193.2	-287.5	-185.1	-116.8	...
Net credit to financial public sector	82.3	95.9	109.8	98.3	...
Net credit to commercial banks	10.5	43.4	-26.0	-44.0	...
Other	24.9	9.7	-89.7	-209.0	-327.0
Monetary base	188.8	208.9	225.2	263.9	261.9
Banking system					
Net foreign assets	69.5	68.8	124.3	123.1	125.8
Net domestic assets 1/	1,474.7	1,301.4	1,143.8	1,330.9	1,461.1
Net credit to nonfinancial public sector	229.0	381.5	302.4	364.6	400.3
Credit to private sector	747.5	715.4	662.0	773.4	788.4
Credit to FOBAPROA/IPAB and cetes especiales	632.9	419.1	383.3	325.3	409.1
Other net	-134.7	-214.6	-204.0	-132.4	-136.7
Medium- and long-term foreign obligations 1/	288.6	278.5	246.4	264.1	291.4
Other net liabilities 1/	-13.5	28.6	-166.1	-297.5	-122.0
Liabilities to private sector 1/	1,269.1	1,063.1	1,187.7	1,487.4	1,417.5
	(In annual percentage change, unless otherwise indicated)				
Memorandum items:					
Real monetary base	27.8	1.6	3.3	10.9	1.5
Real M1a 1/ 2/	12.5	6.2	16.3	6.5	2.5
Of which:					
Currency in circulation	26.1	1.8	4.8	10.4	1.5
Checking accounts	2.6	7.0	23.3	4.3	2.9
Real M2	3.0	-20.3	6.7	17.3	5.2
Real M2a 1/ 3/	8.4	3.7	11.6	4.9	...
Of which:					
Bank time deposits	-14.4	-37.8	-25.8	-22.3	...
Securities issued by federal government	32.2	3.3	-20.8	-0.4	...
Securities issued by private sector entities	-21.3	5.7	-18.0	30.7	...
Real M3a 1/4 /	7.6	4.1	11.4	4.7	...
Real M4a 1/ 5/	6.2	2.9	10.8	4.4	...
Monetary base velocity (GDP to monetary base) 1/	-16.7	8.0	4.3	-9.9	...
M2a velocity (GDP to M2a) 1/	-1.9	5.8	-3.5	-4.8	...
Real credit to the private sector 1/	-10.6	-12.2	-11.4	10.5	5.8
Commercial banks	-22.8	-28.8	-31.7	...	...
Development banks	-28.0	-12.1	-14.9	...	...
Memorandum items					
Nonperforming loans to total loans	8.9	5.8	5.1	4.6	...
Loan-loss provisions to nonperforming loans	107.8	115.4	123.8	138.1	...

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

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

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

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

4/ M2a plus deposits held by nonresidents.

5/ M3a plus deposits held in nonresident affiliates and branches of Mexican banks.

Table 5. Mexico: Indicators of External Vulnerability

(12-month percentage change, unless otherwise indicated)

	2001	2002				2003			
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Jul.	Aug.
Market indicators									
Exchange rate (per U.S. dollar, end-period)	9.14	9.03	10.00	10.17	10.31	10.79	10.44	10.52	11.05
(year-to-date percent change)	-4.2	-1.4	8.9	11.9	14.2	4.6	1.2	2.1	7.1
28-day treasury auction rate (percent; end-period)	6.8	7.5	8.1	8.6	7.0	8.4	5.1	4.1	4.3
EMBI+ Mexico (basis points; end of period)	308	251	323	436	331	291	237	230	230
Stock exchange index in U.S. dollar terms (year-to-date percent change)	12.7	17.0	-7.3	-19.2	-14.8	-7.7	15.1	20.0	21.0
Financial system									
Bank of Mexico net international reserves (in billions of U.S. dollars)	44.9	46.3	45.6	46.6	50.4	54.2	55.3	55.5	54.1
Monetary base	7.8	22.6	17.2	15.8	17.2	10.2	13.3	15.8	...
Real M2a 1/	11.6	10.5	9.6	5.6	4.9	4.5	6.0	5.7	...
Real adjusted credit to the private sector 2/	0.8	-3.4	1.0	2.8	7.8	...	...	...	...
Commercial banks' nonperforming loans (percent of total loans) 3/	5.1	5.0	5.0	4.8	4.6	4.6	...	...	...
Commercial banks' loan loss provision (percent of nonperforming loans) 3/	123.8	128.9	133.8	136.2	138.1	134.3	...	...	...
External sector									
Terms of trade (percent change)	-0.4	-6.7	3.3	4.6	4.5	-0.5	0.5	...	...
Pemex crude export price (year-to-date average; US$/barrel)	21.6	17.0	19.7	21.1	21.5	26.5	24.4	25.5	26.0
Real effective exchange rate (CPI based; year-to-date average) 4/	8.3	13.2	6.5	2.5	-0.2	-17.4	-14.7	...	...
Real effective exchange rate (ULC based; year-to-date average) 4/	8.0	9.2	3.4	-0.1	-2.5	-14.7	...	...	...
Exports (year to date, annual percentage change) 5/	-4.8	-7.9	-2.9	0.0	1.5	7.4	2.4	1.8	...
Of which									
Non-oil	-3.0	-6.6	-2.6	-0.3	0.4	1.5	-1.2	-1.6	...
Imports (year to date, annual percentage change) 5/	-3.5	-8.9	-3.9	-0.9	0.2	3.8	0.5	0.3	...
Of which									
Consumer goods	18.3	-3.6	4.1	5.8	7.2	13.9	1.9	1.6	...
Capital goods	-6.8	-14.0	-8.0	-7.7	-6.7	-5.5	-7.2	-6.6	...
Trade balance (in billions of U.S. dollars; year-to-date)	-10.0	-1.6	-3.1	-4.5	-7.9	-0.4	-1.6	-2.2	...
Nonfinancial public sector external debt (percent of GDP) 6/	12.3	12.1	11.2	12.2	11.5	...	...	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 6/ 7/	0.6	0.7	0.7	0.7	0.4	...	...	...	...
Private sector external debt (percent of GDP)	10.6	10.3	10.1	10.9	10.6	...	...	...	...
Private sector short-term external debt (percent of GDP)	3.1	2.9	2.9	2.9	2.9	...	...	...	...
Commercial banks' foreign credit lines (roll-over rates in percent)	17.3	48.8	42.3	39.2	29.4	58.0	...	...	...
Of which:									
Banks domiciled in the United States and Canada	22.4	7.7	45.5	30.4	13.4	52.4	...	...	...
Banks domiciled in the European Union	12.4	49.7	21.0	22.8	165.2	68.6	...	...	...
Memorandum items:									
Gross international reserves to short-term debt (by residual maturity, percent) 7/	120.8	126.5	125.2	125.0	136.5	...	...	...	...
Monetary base to gross international reserves (percent)	54.8	51.4	47.5	45.0	51.2	40.2	41.3	...	...

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/ Does not include loans associated with FOBAPROA/IPAB debt-restructuring programs.
3/ From January 1997 stricter accounting rules were introduced. Through December 1998 includes Banamex, Bital, Banorte, BBV, Citibank, Confía, Inverlat, Santander, and Serfin. From January 1999 includes Banamex, BBVA/Bancomer, Bital, Banorte, Santander, and Serfin.
4/ Increase = appreciation.
5/ In U.S. dollar terms net of maquila.
6/ Includes development banks. Excludes PIDIREGAS which at end-2001were equivalent to $18 billion (2.9 percent of GDP).
7/ The short-term debt by residual maturity includes pre-payment of debt.

Table 6. Mexico: Medium-Term Macroeconomic Projections

	2002	Staff Projections 2003	2004	2005	2006	2007	2008
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP	0.9	1.5	3.5	3.8	4.0	4.3	4.5
Consumer prices (end of year)	5.7	3.8	3.0	3.0	3.0	3.0	3.0
Consumer prices (average)	5.0	4.6	3.4	3.0	3.0	3.0	3.0
External sector							
Exports, f.o.b.	0.6	4.3	5.5	8.3	9.9	9.4	8.8
Imports, f.o.b.	-1.3	2.7	7.9	10.0	9.2	8.7	8.8
Terms of trade (deterioration -)	4.7	2.1	-3.0	-1.9	-0.3	0.0	-0.3
Interest rates							
Treasury bill rate (average 28-day cetes)	7.1	6.3	5.8	6.6	7.6	7.6	7.6
Real interest rate	1.5	1.7	2.3	3.5	4.5	4.5	4.5
(In percent of GDP)							
Nonfinancial public sector							
Augmented balance							
(PSBR excl. nonrecurring revenues) 1/	-3.4	-3.3	-2.5	-2.0	-1.7	-1.5	-1.5
Augmented primary balance 2/	0.5	0.0	0.6	1.3	1.8	1.9	1.7
Savings and investment							
Gross domestic investment	20.3	19.2	18.8	18.9	19.0	19.3	19.8
Fixed investment	18.9	19.1	19.3	19.7	19.7	19.9	19.9
Public	4.1	4.3	3.8	3.4	3.3	3.1	3.0
Private	14.8	14.7	15.5	16.3	16.5	16.7	17.0
Inventories	1.4	0.1	-0.5	-0.8	-0.7	-0.6	-0.1
Gross national saving	18.1	17.4	16.4	16.1	16.2	16.6	17.0
Public sector	0.8	1.1	1.3	1.3	1.6	1.7	1.5
Private sector	17.3	16.3	15.1	14.8	14.7	14.9	15.5
External current account balance	-2.2	-1.8	-2.4	-2.8	-2.8	-2.7	-2.8

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 traditional balance less the net cost of bank restructuring and debtor-support operations, net PIDIREGAS investment expenditures, some budgetary adjustments and net financial requirements of the development banks; it excludes privatization and other nonrecurrent revenues.

2/ Treats bank restructuring transfers as interest expenditure.

MEXICO—FUND RELATIONS

(As of May 31, 2003)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	2,585.80	100.00
Fund holdings of currency	2,279.35	88.15
Reserve position in Fund	306.53	11.85
Financial transaction plan transfers (net)	87.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	290.02	100.00
Holdings	289.18	99.71

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

V. **Financial Arrangements**: **None**

VI. **Projected Obligations to the Fund**: **≤ SDR 50,000** (annually 2004-2007)

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

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

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

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 observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). 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 mid-year of the subsequent year) data are published and submitted to congress, ensuring that revisions are transparent and subject to public scrutiny.

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

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

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

Mexico—Core Statistical Indicators
As of August 20, 2003

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	August 22	May 30	March 31.	July 31	June 31	July 31	July	May	Fourth quarter 2002	First quarter 2003	First quarter 2003	March
Date Received	August 21	June 25	May 8	August 8	July 31	August 8	August 15	August 15	March 13	May 2	May 15	May 8
Frequency of Data 1/	D	M	W	M	M	M	Bi-W	M	Q	Q	Q	M
Frequency of Reporting 1/	D	M	W	D M	M	M	Bi-W	M	Q	Q	Q	M
Source of Update 2/	N	A	N	A	A	A	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	M

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—AN UPDATE OF CORPORATE SECTOR VULNERABILITIES[1]

The corporate sector in Mexico remains highly segmented, with access to bank and bond financing available mainly to top-tier companies, while small- and medium-sized firms rely mostly on suppliers' credit. Most Mexican firms finance their operations through suppliers' credit, with 63 percent of firms using this source in the second quarter of 2003. Firms reported that high interest rates and economic uncertainty are the main reasons for not using bank credit.

Vulnerability Analysis[2]

Leverage continues to be modest. On average, the debt-to-equity ratio remains at around one for the firms represented in the sample, although it is over 2 for smaller companies.

Despite increased bond issuance in the domestic market, the ratio of foreign currency debt to total debt has remained high (64 percent). Neither the authorities nor market participants believe that the Mexican corporate sector is hedging its foreign currency exposure through derivative operations in a significant volume.

The maturity structure of debt has improved further in 2003. The ratio of short-term debt to total debt was 48 percent at end-2003Q1, down from 51 percent a year earlier.

Refinancing risks are reduced by increasing access to domestic capital markets. Listed firms in the stock exchange (BMV) have US$15.7 billion in foreign exchange debt falling due in 2003, and US$9.2 billion in 2004. The authorities do not believe the rollover of corporate external payments will cause problems, as the local capital market is now providing financing for external amortizations.

The net open foreign exchange position of the corporate sector was negative US$11 billion at end-2003Q1—with assets of US$28.8 billion and liabilities of US$39.8 billion. The maturity profile of foreign currency liabilities remains sound, with 65 percent being long-term. About 10 percent of firms hold 67 percent of total foreign currency liabilities. These firms carry out more than half their sales abroad, and 75 percent of their assets are foreign currency denominated. Companies in the construction sector have the weakest profile, as 76 percent of their foreign currency liabilities are due in the short term.

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[1] This appendix updates the analysis prepared in the study 'The Mexican Corporate Sector: A Vulnerability Analysis' (IMF Country Report No. 02/238).

[2] The analysis is based on data for publicly traded firms on the Mexico Stock Market (BMV). The sample is not representative of the entire corporate sector, but it reflects well the companies that have access to debt financing, especially external financing.

Companies in default and with financial difficulties during the last year are limited to specific sectors (mining, telecommunications, and construction), mainly due to the global weak economic demand, high leverage, and weak commodity prices. These difficulties appear not to be systemic.

Stress Test Analysis[3]

The liquidity and solvency of the corporate sector would not be affected by a combined adverse shock (of two standard deviations) to the exchange rate, interest rate, and growth. However, if the shock were accompanied by domestic and external market access limitations that constrained the rollover rate to 80 percent of the debt amortizations in the upcoming year; then most of the firms would face liquidity problems, perhaps with default being widespread. In this case, gross debt of the firms in liquidity distress would amount to around 3 percent of GDP.

Mexico—Corporate Sector Stress Tests (2003Q1) 1/
(In millions of U.S. dollars, unless otherwise indicated)

	Number of companies technically insolvent or illiquid	Aggregate size of Technical Default (TD)	Total accounting capital of companies in TD	Gross debt of companies in TD	Gross debt of firms in TD (in percent of GDP)
Solvency Test					
Two-standard deviation (STD)					
Exchange rate and interest rate shocks	0	0	0	0	0
Including also a growth shock	0	0	0	0	0
Eight-STD shock to exchange rate, interest rates, and growth shocks	10	-2,042	5,626	9,551	1.5
Liquidity tests					
Exchange rate shock (2 STD)	2.0	67	1,543	1,011	0.2
Interest rate shock (2 STD)	4.0	388	4,249	2878	0.5
Exchange rate and interest rate shocks (2 STD)	4.0	495	4,249	2878	0.5
As above, including growth shock	4.0	447	4,249	2878	0.5
As above but rollover of only 80 percent	15.0	3,108	25,946	19,540	3.1
As above but rollover of only 50 percent	24.0	9,072	34,446	29,535	4.8

1/ The tests were performed over a sample of the 25 listed firms with the largest foreign exchange exposure.

Source: Bank of Mexico; and staff estimates.

3 The tests were performed over a sample of the 25 listed firms with the larger ratios of foreign exchange liabilities to total liabilities. The methodology is described in more detail in the study "The Mexican Corporate Sector: A Vulnerability Analysis," (IMF Country Report No.02/238).

Mexico: External Sustainability Framework, 2000-08
(In percent of GDP, unless otherwise indicated)

	Actual			Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Baseline scenario									
1 **External debt**	**28.4**	**27.3**	**27.9**	**30.2**	**30.2**	**30.0**	**29.9**	**29.6**	**28.1**
2 Change in external debt	-8.5	-1.1	0.6	2.3	-0.1	-0.2	-0.1	-0.3	-1.5
3 Identified external debt-creating flows (4+5+6)	-5.1	-2.3	-0.3	1.2	-0.4	-0.2	-0.3	-0.4	-0.4
4 Current account deficit, excluding interest payments	0.7	0.9	0.5	0.6	0.9	0.9	0.7	0.7	0.8
5 Net non-debt creating capital inflows (negative)	-1.8	-3.2	-1.8	-1.6	-1.7	-1.7	-1.7	-1.7	-1.7
6 Automatic debt dynamics	-4.0	0.1	1.0	2.3	0.4	0.6	0.7	0.6	0.5
7 Contribution from nominal interest rate	2.3	2.0	1.7	1.7	1.8	2.1	2.3	2.3	2.3
8 Contribution from real GDP growth	-2.0	0.1	-0.2	-0.4	-1.0	-1.1	-1.1	-1.2	-1.3
9 Contribution from price and exchange rate changes	-4.3	-2.0	-0.4	1.0	-0.3	-0.5	-0.5	-0.5	-0.5
10 Residual, incl. change in gross foreign assets (2-3)	-3.5	1.2	0.9	1.1	0.3	0.1	0.2	0.2	-1.1
Key Macroeconomic and External Assumptions									
Real GDP growth (in percent)	6.6	-0.5	0.9	1.5	3.5	3.8	4.0	4.3	4.5
Exchange rate appreciation (US dollar value of local currency, change in perc	1.1	1.2	-3.3	-8.4	-1.8	-1.5	-1.5	-1.5	-1.5
GDP deflator in US dollars (change in percent)	13.2	7.9	1.2	-4.4	0.9	1.5	1.5	1.5	1.5
Nominal external interest rate (in percent)	7.6	7.7	6.3	5.8	6.0	7.4	8.0	8.0	8.2
Growth of exports (US dollar terms, in percent)	21.3	-4.2	0.6	3.0	5.5	7.8	9.3	9.0	8.4
Growth of imports (US dollar terms, in percent)	22.6	-198.6	-0.7	3.1	7.9	9.7	9.0	8.5	8.7
II. Stress Tests for External Debt Ratio									
1. Real GDP growth, nominal interest rate, non-interest current account, and non-debt inflows are assumed to be at historical average; real GDP deflator assumed zero. 1/			**27.9**	**28.4**	**28.3**	**28.0**	**27.8**	**27.5**	**26.0**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004 1/			**27.9**	**31.1**	**32.0**	**31.8**	**31.7**	**31.5**	**30.1**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004 1/			**27.9**	**31.5**	**33.5**	**33.4**	**33.4**	**33.1**	**31.7**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004. 1/			**27.9**	**30.4**	**32.3**	**32.2**	**32.1**	**31.9**	**30.4**
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004 1/			**27.9**	**30.8**	**31.1**	**30.9**	**30.8**	**30.5**	**29.1**
6. Combination of 2-5 using one standard deviation shocks. 1/			**27.9**	**30.1**	**31.7**	**31.6**	**31.5**	**31.2**	**29.8**
7. One time 30 percent nominal depreciation in 2003			**27.9**	**38.7**	**38.7**	**38.7**	**38.8**	**38.7**	**37.4**

Source: Mexican authorities; and Fund staff estimates.

1/ Average for the last five years is used as the historical average for the simulations.

Statement by the IMF Staff Representative
October 15, 2003

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

1. **The government has reduced its official growth forecast for 2003 from 3 percent to 1.5 percent, in line with the latest WEO projection.** Recent indicators confirm the slow pace of recovery. Growth in the global indicator of economic activity weakened further in July, as the 12-month change fell to 0.9 percent from 1.2 percent in June. The consumer confidence index continued to decline in August and September, while business confidence improved somewhat. In line with sluggish activity, unemployment reached a new peak of 4 percent in August, while formal sector employment fell to its lowest level since December 1998.

2. **The peso has depreciated sharply since July, reflecting weak economic activity and concerns about prospects for structural reforms.** The exchange rate has fallen to a new low of about MEX$11.3/US$ in recent days, following the announcement by Moody's that PEMEX's debt rating is being reviewed for possible downgrading (currently its rating is higher than that of the federal government). Since the peak in May, the peso has depreciated by almost 12 percent against the U.S. dollar, while the real effective exchange rate has depreciated by about 8 percent.

3. **CPI data for September indicate that the 12-month change in headline inflation was stable at 4 percent, while core inflation remained subdued at around 3½ percent**. Inflation expectations for end-2003 have continued to decline, reaching 3.7 percent in September, suggesting that the recent fall in the peso has not jeopardized prospects for reducing inflation to below 4 percent by end-year (the upper limit of the central bank's "variability interval").

4. **With monetary conditions having eased further as a result of peso depreciation, the Bank of Mexico (BOM) left the *corto* unchanged at its meeting last week, citing the favorable prospects for inflation to decline within the target range by end-year**. After remaining close to 5 percent since the spring, short-term market interest rates have risen by almost 100 basis points in recent days in response to the weakness in the peso.

5. **Trade data for August showed a smaller-than-expected deficit.** Imports declined by 3.4 percent from the year-ago level, while exports have declined marginally as higher oil exports partially compensated for a 5 percent decline in manufacturing exports. Net international reserves stood at US$52.1 billion on October 3, compared with the peak of US$54.0 billion in early May. On October 7, the government issued US$1 billion of 10-year bonds to pre-fund 2004 financing requirements. The bond was issued with a yield of 6.063 percent, implying a spread of 179 basis points over U.S. treasuries.

6. **Fiscal data through end-August suggest that the objectives for the traditional and augmented deficits for 2003 are likely to be met.** Public finances continue to be boosted by higher-than-projected oil revenues. Through end-September, the price of the Mexican mix has, on average, been about US$6 above the budget assumption of US$18.35 per bond, while the exchange rate has been significantly more depreciated than anticipated. Spending has also exceeded budget estimates, however, and income tax receipts remain weak.

7. **Political negotiations on structural reforms continue, without any major breakthroughs.** A working group, chaired by Secretary of Finance Gil Díaz, has been deliberating on tax reform, with a proposal having been advanced to reduce the VAT rate from 15 percent to 10 percent, while broadening the base. The states would also introduce a common 2 percent VAT. The administration has also presented a draft bill to opposition legislators that would increase the scope for private-sector involvement in electricity generation.

8. **The 2004 draft budget will be submitted to congress by mid-November.** The Secretary of Finance has indicated an objective for the narrow definition of the deficit of 0.3 percent of GDP, broadly in line with the 2002 medium-term framework (PRONAFIDE). No objective has yet been announced for the augmented deficit.

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

IMF Concludes 2003 Article IV Consultation with Mexico

On October 15, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

After a strong performance from 1997 to 2000, output fell in 2001 in response to the U.S. downturn. While growth rebounded in the first half of 2002, it has stalled since, reflecting both the delayed U.S. recovery and sluggish domestic spending. In spite of lower wage growth, higher administered and agricultural prices pushed up headline inflation to 5.7 percent at end-2002, compared with the Bank of Mexico's (BOM) target of 4.5 percent. Stagnant non-oil export volumes since 2001 have been more than offset by higher oil exports and a contraction in imports, leading to a narrowing in the current account deficit. The current account deficit has been almost entirely financed by FDI inflows.

Real GDP remained subdued in the first half of 2003, with growth of 1.4 percent (seasonally adjusted) in the four quarters ending in the second quarter. While recent indicators of activity have been mixed, most observers still expect the economy to recover in the second half of the year, in line with U.S. recovery. Headline inflation also continued to rise in the first months of 2003, but then dropped significantly to 4 percent in August and September, as inflation expectations declined and earlier price shocks unwound. Core inflation fell to 3.5 percent in

[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.

April, and then stabilized around that level through September. The current account deficit continued to moderate in the first half of 2003. Private external borrowing also declined in the first half of the year, as firms increasingly switched from foreign to domestic capital markets to meet their financing needs.

During 2002 and the first quarter of 2003, net international reserves increased by US$9.3 billion, largely due to the impact of high oil prices on PEMEX receipts. A new mechanism was implemented in May to slow the pace of reserve accumulation and lower the cost associated with carrying those levels of reserves. Gross international reserves amounted to 106 percent of short-term debt by residual maturity at end-September 2003.

The pace of fiscal consolidation, viewed in terms of the broad public sector deficit, has been slower than envisaged in the authorities' 2002 medium-term plan. While the budget target of an augmented deficit of 3.4 percent of GDP for 2003 is likely to be met, higher oil revenues are expected to offset shortfalls in other revenues, increasing the sensitivity of the fiscal situation to swings in oil prices. Expenditures are also expected to exceed budget estimates.

The BOM tightened its monetary stance starting September 2002 in response to rising inflation expectations. With the subsequent reduction in both headline inflation and inflation expectations, prospects are favorable for bringing end-year headline inflation below 4 percent. After rising to about 10 percent in early March, short-term interest rates fell below 5 percent in July, but have increased in recent weeks in response to the weakness in the peso. At the same time, the recent depreciation of the peso implies that monetary conditions have eased further, providing support to activity.

Market sentiment toward Mexico remains positive, as reflected in its investment-grade status. Turbulence in emerging markets in 2002 was weathered well, and sovereign bond spreads have declined to a historical low of 200 basis points in recent weeks.

The government has made significant progress in strengthening the structure of public debt. Public external debt, for instance, has fallen further from 15 percent of total debt in 2000 to 13½ percent in 2002. The government successfully issued five bonds with collective action clauses this year. The latest issue (US$1 billion of 10-year bonds) would pre-fund part of the 2004 financing requirements on terms favorable to Mexico. In addition, Mexico became the first country to redeem all of its Brady bonds. Nevertheless, some public debt vulnerabilities remain, with a large portion of domestic debt either short-term or linked to short-term interest rates, and a significant gross financing need of the public sector.

Executive Board Assessment

Executive Directors commended the Mexican authorities for their substantially strengthened policies, which have helped underpin macroeconomic stability and investor confidence and enabled Mexico to successfully weather the difficult global and regional conditions of recent years. They welcomed in particular the continued modernization of the financial sector, the strengthened structure of the public debt, the reduction in inflation to low levels, and the progress made in reducing poverty. The key challenges going forward will be to diversify the sources of economic growth, and strengthen medium-term growth prospects sufficiently to achieve significant further reductions in poverty.

Against this background, Directors urged the authorities to restart quickly the process of fiscal consolidation and reinvigorate the implementation of productivity-enhancing structural reforms—areas in which recent progress has been disappointing owing to difficulties in forging the needed political consensus. Of particular importance will be rapid approval and implementation of structural reforms with respect to the tax system, the energy sector, the labor market, and the judicial system, which together will help boost private investment and employment and maintain competitiveness in an environment of heightened global competition. It was noted in this context that further efforts to build greater public awareness of the importance of these reforms will be helpful for achieving the appropriate degree of ambition in their scope and speed. Directors supported the authorities' efforts to improve governance, fight corruption, and enhance transparency, and they encouraged them to persevere in these efforts.

Directors endorsed the authorities' medium-term fiscal framework, which calls for further fiscal adjustment to lower the public debt-to-GDP ratio. To achieve this objective, the authorities will need to give renewed impetus to the consolidation process in 2004, while ensuring effective management of oil revenues. Over the medium term, they will also need to address the challenges posed by the significant reliance of public sector revenues on oil prices and the growing spending pressures. Fiscal reforms based on measures that increase efficiency and boost confidence in sustainability will help strengthen the foundations for faster medium-term growth while limiting any near-term negative consequences.

Directors welcomed the authorities' recent efforts to renew tax reform discussions. A broad-based tax reform would enhance the efficiency of the tax system and promote fiscal stability. Directors agreed with the view that formally linking the annual budget discussions to a medium-term plan that incorporates a comprehensive view of fiscal developments would serve to strengthen the fiscal framework. In addition, a fiscal responsibility law would provide a useful framework for setting medium-term targets, including for the debt path, and for reconciling the tax, expenditure, and social sector policy objectives. Directors suggested that the authorities set and regularly update specific medium-term objectives for the augmented deficit and debt to underpin the annual budget discussions.

Directors commended the Bank of Mexico for implementing a prudent and forward-looking monetary policy, which has served to boost market confidence and promote financial stability. They considered that declining inflation expectations and economic slack will contribute to the convergence of inflation toward the target by end-2003, while the recent easing in monetary conditions will help support activity in the period ahead.

In discussing the operating procedures for monetary policy, Directors noted that the *corto* has allowed for large and rapid adjustments in interest rates, and contributed to Mexico's impressive record in reducing inflation. Many Directors considered, however, that as inflation and interest rates stabilize at low levels, a short-term interest rate target would provide a greater degree of monetary control and increase transparency, thereby helping to keep inflation within a narrow target range and communicating the authorities' monetary policy intentions more clearly. At the same time, given the importance of correct timing and careful management of the transition process, they considered that the authorities are best qualified to define the appropriate timing.

Directors observed that Mexico's flexible exchange rate regime has been effective in cushioning the economy from external shocks. They agreed that the new rules-based mechanism to reduce the pace of accumulation of foreign reserves does not change the authorities' transparent approach to reserves management and the commitment to a market-determined exchange rate. Directors encouraged the authorities to ensure that reserves remain adequate.

Directors welcomed the authorities' efforts to further strengthen the financial regulatory framework. Important challenges in the period ahead will be to deepen financial intermediation without excessive risk-taking, and to streamline financial rules and regulations to encourage innovation and competition. In this regard, Directors welcomed the high priority attached by the authorities to strengthening oversight of the rapidly growing nonbank institutions.
They commended Mexico's continued efforts to combat money laundering and the financing of terrorism.

Directors endorsed the authorities' commitment to continue to reduce vulnerabilities relating to the public debt through increasing issuance of fixed-rate, domestic-currency instruments and extending the yield curve. Directors commended Mexico's leadership in debt management, including its recent inclusion of collective action clauses in sovereign debt contracts and the early redemption of all outstanding Brady bonds. Directors were encouraged by Mexico's efforts to deepen the domestic bond market, which will foster the diversification of financing sources for the private sector and reduce reliance on foreign currency-denominated private debt, thus alleviating a potential risk factor.

Directors recognized that Mexico's data are generally of high quality, and are adequate to conduct surveillance effectively. They encouraged the authorities to implement the recommendations of the 2003 statistical Report on the Observance of Standards and Codes.

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

Mexico: Selected Economic and Financial Indicators

	1998	1999	2000	2001	Prel. 2002
(Annual percentage changes, unless otherwise indicated)					
National accounts and prices					
Real GDP	5.0	3.6	6.6	-0.3	0.9
Real GDP per capita 1/	4.0	2.6	4.8	-1.8	-0.6
Gross domestic investment (in percent of GDP)	24.3	23.5	23.8	20.9	20.3
Gross national savings (in percent of GDP)	20.5	20.5	20.6	18.0	18.1
Consumer price index (end of period)	18.6	12.3	9.0	4.4	5.7
External sector					
Exports, f.o.b. 2/	1.1	14.8	21.8	-3.7	0.6
Imports, f.o.b.	12.7	10.6	23.1	-1.7	-1.3
External current account balance (in percent of GDP)	-3.8	-2.9	-3.1	-2.9	-2.2
Change in net international reserves (end of period, in billions of U.S. dollars)	2.1	0.6	2.8	7.3	7.1
Outstanding external debt (in percent of GDP)	39.4	36.9	28.3	26.0	26.7
Total debt service ratio					
(in percent of exports of goods, services, and transfers)	47.9	43.8	42.5	39.1	32.7
Nonfinancial public sector (in percent of GDP)					
Augmented overall balance	-6.3	-6.3	-3.7	-3.7	-3.4
Traditional overall balance	-1.2	-1.1	-1.1	-0.7	-1.2
Net public sector debt	50.0	46.6	42.2	42.0	43.5
Money and credit					
Monetary base	20.8	43.5	10.7	8.0	17.0
Broad money (M4)	26.8	19.4	15.8	16.2	10.8
Treasury bill rate (28-day cetes, in percent, annual average)	24.8	21.4	15.2	11.3	7.1

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

1/ IMF staff estimates.
2/ Includes net proceeds from in-bond industries.

Statement by Mario Beauregard, Alternate Executive Director for Mexico
October 15, 2003

At the outset, I would like to thank staff for conducting a thorough analysis of the Mexican economy. The high-quality staff report and selected economic issues paper will serve well to elevate the public debate on the economic policy in Mexico. Although there are some areas where differences of opinion persist, my authorities share most of the staff appraisal and many of staff's recommendations.

Background

Mexico has further consolidated its position as a leading emerging market economy in Latin America and the world. Macroeconomic stability has been preserved despite the negative external environment characterized by a slow economic recovery in Mexico's main trading partner as well as crises in emerging markets in the region. Under strict fiscal discipline, the structure and maturity of the public sector debt have improved; monetary policy has been managed prudently; external accounts are in order; access to international capital markets has increased; international reserves stand at historically high levels; public external debt service as a percentage of exports has more than halved since 2000; and financial strength indicators have evolved satisfactorily. Investor confidence is also revealed by the flows of Foreign Direct Investment (FDI) to Mexico: as a percentage of total FDI flows to Latin America, those directed to Mexico rose from 21 per cent in 2000 to 32 percent in 2002 and there are indications that this trend has continued in 2003. In sum, Mexico's economic fundamentals have continued to improve, and the economy is well prepared to take advantage of a global economic recovery.

Regarding economic growth projections for this and next year, we remain confident that economic activity in the United States will resume strongly by the end of 2003 and that this trend will continue throughout 2004. Once manufacturing activity in the US starts to grow, it will boost economic activity in Mexico. Hence, we share staff's economic growth projections for this and next year.

Looking forward, though, the challenges are still significant; one of the most important being to diversify Mexico's sources of economic growth by developing a strong domestic market. Even though macroeconomic stability has been preserved, the immediate challenge lies in reaching consensus on bold structural reforms.

A long road map of reforms ...

The past ten years have been crucial for Mexico. Key structural reforms have made the Mexican economy more resilient to external shocks and have set the ground for sustainable economic growth. It is important to stress though that not all reforms reside in the economic area; changes in the political sphere--in particular the reform to Mexico's electoral institutions--are also fundamental in explaining where we stand today. The latter is important taking into account Mexico's economic history, characterized by recurrent deep economic and financial crises coinciding with the change of administration. As staff stressed in the report, the smooth presidential succession in 2000 was an important step forward for Mexico in order to consolidate the nascent democratic system.

I would like to highlight a positive development that is not easily noticeable and which I think is crucial in explaining investor sentiment towards Mexico: the commitment of my authorities, legislators and the population at large to preserve macroeconomic stability. They now acknowledge there are no easy or magic solutions to overcome adverse global economic trends. This commitment has materialized in strict fiscal and prudent monetary policies in recent years.

This being said, we acknowledge that structural reforms are needed if Mexico wants to further consolidate its status and continue progressing towards combating poverty. Competition in international markets is very strong and only through the implementation of bold structural reforms will the Mexican economy be able to enhance its competitiveness. To this aim, since taking over, this administration has stressed the need for implementation of substantive reforms and has already presented to Congress proposals to reform the fiscal area (2001), the energy sector (2002) and the financial sector (2000-2002), and discussions are well advanced in the areas of telecommunications and labour. A proposal to reform the public pension system is also ready.

Despite these efforts, however, limited progress has been achieved so far. With a divided Congress, the Executive branch has lacked the support of the opposition to approve these reforms. This does not mean, however, that further efforts will not be pursued. In fact, in his latest address to Congress, last September, the President reiterated to the different political parties the need to work together to reach consensus in these important areas. He stressed that Mexico is at a critical juncture and that not advancing in these areas in a substantive way would be in detriment of the economy's competitiveness.

The months ahead will be critical. After the Lower House elections of last July, prospects to reach consensus have improved. Even though no political party has majority in this Chamber and the opposition (PRI) has majority in the Senate, there is now a better understanding of the importance of the reforms. This change in attitude deserves a broader explanation. On one hand, the world economic slump made it clear that Mexico needs to strengthen its domestic sources of growth. If the domestic economy is to be an alternative source of economic growth, we need to enhance Mexico's attractiveness to domestic and foreign investments. Another factor is the speed at which other economies have been advancing in their reforms. Without the implementation of the required structural reforms, Mexico's competitiveness vis-à-vis other economies is clearly at risk.

We acknowledge there is only a limited window of opportunity to approve the reforms. That is why my authorities will concentrate efforts on the fiscal and energy reforms in the months ahead.

The above being said, I do not want to leave the impression that there has not been progress in terms of structural reforms in Mexico in the last few years. An area where substantial progress has been achieved is the financial sector. So far, 25 reforms to laws and amendments to rules and regulations have been enacted (17 in 2001, 7 in 2002 and 1 in 2003) which have improved the functioning of markets and enhanced corporate governance. A reform to the private pension system was also approved in 2002. Furthermore, work is well advanced in the development of a new banking resolution strategy, which would imply changes to many laws affecting the financial sector.

Another crucial area where substantive progress has been achieved is transparency. The Federal Transparency and Access to Government Public Information Law was enacted by Congress in April last year. It mandates, since June this year, all public entities to publish and update information on several topics as a routine procedure, including their functions, budget, operations, internal reports and contracts, as well as to answer to information requests by any citizen.

In sum, the message I would like to convey to the Executive Board is that my authorities are strongly committed to continue following strict fiscal and prudent monetary policies and to advance in the implementation of the structural reform agenda. What has been achieved so far took many years of hard work. The challenge now is to preserve those gains and continue enhancing the competitiveness of the economy.

Fiscal Policy

My authorities' track record in pursuing fiscal consolidation is unquestionable. While in 2003 almost all countries with solid financial positions experienced deterioration in their fiscal position, Mexico did not relax its fiscal stance. Indeed, something that markets recognize and that have earned Mexico investment grade status is precisely the relevance and efforts my authorities place to this important issue. However, in order to further consolidate Mexico's fiscal accounts, we cannot simply put aside the context in which said efforts are pursued. Without trying to lessen the importance of further fiscal consolidation, my authority's efforts have been hampered by a very difficult economic environment. Still, they would like to reaffirm their commitment to continue with the fiscal consolidation effort.

For the 2004 budget, my authorities do have a clear and precise objective: to continue pursuing fiscal consolidation through strict fiscal discipline. However, we consider that the adjustment should be smoother than the one suggested by the staff. This is the case because the Mexican economy is now on the lower part of the business cycle and actual GDP is well bellow potential. Therefore, in cyclically adjusted terms, staff's proposed contraction is too severe and less realistic to achieve. In this vein, President Fox announced last Wednesday that the government will pursue a fiscal deficit of 0.3 percent of GDP in 2004, a figure consistent with a reduction of next year's PSBR that is in line with the downward trend defined in PRONAFIDE.

Regarding public debt management, there are two important developments that took place on the external front that are worth mentioning. First, Mexico's decision to include Collective Action Clauses in their sovereign debt contracts under New York law and, second, the redemption of all outstanding Brady Bonds, which benefit Mexico by substituting this debt with new one with better financing conditions. On the domestic front, the government continued to reduce the vulnerability of public financing by shifting domestic securities issues towards fixed-rate securities and away from floating and indexed-rate securities. Furthermore, the average maturity of the public sector domestic debt increased from 816 days at the end of 2002, to 914 days at the end of June 2003. It is worth mentioning that in December 2000 this figure stood at 542 days. Hence, considerable progress has been achieved so far but it should be recognized this is a gradual process and my authorities believe it is better to advance hand-in-hand with the market.

In reference to staff's comments on the difficulty in judging the productivity of spending under PIDIREGAS projects, my authorities would like to reiterate that such projects are judiciously evaluated before any authorization is granted and so far have had positive and high internal rates of return that validate the decision to approve them.

We agree with staff that the broader definitions of fiscal deficit and debt provide more meaningful information regarding the overall fiscal situation and fiscal consolidation needs. That is why my authorities developed those statistics and have been using them since May 2001. In fact, information on the PSBR and the augmented debt is available to the public. Finally, the analysis by staff of the fiscal situation in Mexico and possible avenues for reform are well taken and my authorities will evaluate them carefully.

Monetary and Exchange Rate Policies

I would like to underscore the commitment of my authorities to achieving the long-term inflation target of 3 percent. Recent information confirms that inflation continues its declining trend towards that objective. My authorities agree with staff that the current monetary policy stance is appropriate, and that the recent easing in monetary conditions should provide support to economic activity in the period ahead. They also share staff's view that the flexible exchange rate regime has worked well. I would therefore limit my comments to four issues: i) a brief comment on recent changes to the inflation-targeting framework in Mexico, ii) the reference index used in said framework, iii) the "corto" and iv) the mechanism to reduce the speed of accumulation of international reserves.

i. Banco de Mexico further strengthened the inflation-targeting framework since our last Board meeting. In this regard, since January this year the Board of Governors has been announcing its monetary policy decisions on predetermined dates. This change helps to mitigate the uncertainty regarding the timing of the monetary authority's decision to modify its stance; fosters a more efficient operation of financial markets, and improves the transparency of monetary policy. In sum, it reinforces the effectiveness of monetary policy measures.

ii. My authorities have clearly justified the decision to set the Consumer Price Index as the reference for the inflation target. First, the CPI is the best-known price indicator and the most widely used by the public to measure the cost of living; second, the CPI is also widely used as reference in contracts and negotiations; and third, the CPI is published in a timely manner at regular intervals and it is not subject to revisions. Nonetheless, they acknowledge that core inflation is a very important indicator of medium-term pressures and it will remain an essential input for monetary policy decisions.

iii. Banco de Mexico's operating instrument, known as the "corto", has a very strong record of accomplishment. During last year's Article IV Board discussion most Directors agreed that the "corto" continued to be a flexible and efficient monetary policy instrument that allowed for appropriate adjustments in interest rates. There is no reason to think that this assessment should change since the "corto's" effectiveness is proved by the relevant data. In this regard, inflation has continued its declining trend and it is now approaching the long-term objective as originally planned by my authorities. I would like to reiterate, as I did last year, that one of the most important advantages of the "corto" is that it allows for a spontaneous distribution of the adjustment to external and domestic shocks between the exchange rate and interest rates. This characteristic is of utmost importance to an economy like Mexico's, which has been subject to a high degree of volatility and, up until relatively recently, to an intense pass-through of exchange rate fluctuations to domestic prices. Another advantage of the "corto" is that it allows for either reductions or increases in market interest rates as economic conditions change without explicit intervention of the central bank.

Staff insists that shifting the operational instrument to an interest-rate target would be increasingly desirable as inflation converges to its long-term target. The Board of Governors of Banco de Mexico has indeed evaluated the convenience of adopting an interest rate objective as an operational instrument. They have stated that "the lesser volatility experienced by domestic markets brings us closer to a situation in which the necessary conditions to migrate would be met. Nonetheless, given the high degree of uncertainty currently affecting international markets and the vulnerability of domestic markets stemming from structural problems of the public finances, the adoption of an interest rate instrument will not likely occur in the near future".

Regarding Box 3, the staff argues that "the recent sharp decline in market interest rates in the face of a high corto" puts into question the usefulness of this operating instrument. In this regard, I would like to point out that my authorities have publicly explained the way the "corto" works. The important factor is not the level of the "corto" *per se*, but the signalling effect embedded in changes in the operating instrument. Every time the "corto" has been changed, it has influenced interest rates and inflation expectations in line with my authorities' objectives. Hence, we do not see any inconsistency in the reduction of market interest rates and high levels of the "corto". On the contrary, it confirms that the signalling effect of changes in the monetary policy stance through the "corto" has worked well in affecting inflation expectations, as originally intended.

iv. We concur with staff that the current level of international reserves is appropriate. The mechanism to reduce the accumulation of reserves that was introduced last March has been working very well. Even though there is no formal process to review this mechanism, my authorities do constantly monitor the adequacy of the level of reserves.

Financial Sector

My authorities' efforts to strengthen Mexico's financial system have rendered good results. I would like to highlight two important developments in this sector. First, direct financing of commercial banks to the non-banking private sector recorded a 6.4 percent real annual increase in June, registering the seventh straight month of positive gains. It is worth mentioning that such gains have not been reported since my authorities began to measure this indicator in 1995. Second, the deepening of the domestic financial sector has continued. Financial savings increased at a real annual rate of 5.5 percent in the first half of 2003 and securities issued by the private sector recorded a real annual increase of 32 percent during same period.

In order to continue strengthening this sector, a package of legal reforms designed to promote bank lending was approved by Congress in May. One of the most important was the creation of the *Fideicomiso de Garantía*, a trust established to guarantee the fulfilment of debtor's obligations. The reform seeks to reduce transaction costs related to the recovery of collateral, thus reducing risk premiums and broadening the possibilities available to use as collateral. The reform's main achievements are the increased certainty and speed with which legal procedures are concluded. In addition to the deepening of the financial markets, my authorities are pursuing policies oriented to enhance the transparency of banking sector costs, which will strengthen competition, and smooth access to better financial conditions and products to a broader public.

Vulnerability Assessment

We concur with staff's assessment that Mexico's vulnerabilities are moderate and derive mainly from the public finances. In this regard, my authorities have reiterated that if the fiscal reform is not approved, they are committed to adjust as necessary to further pursue fiscal consolidation. Furthermore, an area where substantial progress has been reported by staff that mitigates this negative risk is the "robust sustainability of Mexico's debt". Along the same lines, the projected medium-term current account deficit is manageable and its financing has been, and we expect will continue to be, largely financed by FDI flows.

My authorities have a strong difference of opinion with staff with regard to the comparison they made on the debt-to-GDP ratio and its association with financing problems in other emerging market economies. As we have said in the past, such comparisons may cause more problems than benefits. It is thus important to take into account other factors—such as the overall macroeconomic policy and the debt maturity structure—in order to arrive to such bold conclusions. It should be noted that Mexico is not the only country with investment grade that has a debt-to-GDP ratio near the threshold of 50 percent, and that financing problems are not perceived in any of those countries, including Mexico. Moreover, staff's assessment of debt sustainability concludes that Mexico's debt is robust to a variety of temporary shocks to key variables.

With regard to potential risks in the corporate sector, we believe that if they were to materialize, they would not have a systemic impact on the economy. Mexican firms have been very active since last year in substituting debt denominated in local currency raised in the domestic market for debt denominated in foreign currency. Besides, many of the companies that carry large amounts of foreign currency debt are also export-oriented firms, making it unlikely a systemic crisis-scenario such as the one described by staff.

At the end, a better economic development and income distribution are the main objectives

Governments must pursue sustainable economic growth rates aimed at improving living standards *for all*. Although macroeconomic stability is a necessary condition towards achieving those goals, it is not a sufficient one. Other factors, such as a sound social safety net, improvements in human capital, better judiciary system and low corruption, have an impact in attaining those goals.

Recent studies demonstrate that Mexico has been able to advance in this area in the last few years. However, the challenges are still enormous; poverty levels and income distribution in Mexico have improved thanks to a more stable macroeconomic environment, among other factors. A study by the Economic Commission for Latin America and the Caribbean (ECLAC) of the United Nations shows that between 2000 and 2002, extreme and moderate poverty decreased 17.1 and 4.1 per cent, respectively, and that Mexico reduced income inequality in the country from 1999 to 2002.[1] These results are in line with those reported by the Mexican government last July and by the World Bank recently.

As I said earlier, the importance of macroeconomic stability is fully recognized in Mexico. But, at the same time, everyone acknowledges that the quest is still long. In this regard, today's discussion will further help to understand the importance of preserving what we have achieved so far.

[1] The Gini index fell by 5.1 percent during the period analyzed by ECLAC. Social Panorama of Latin America, 2002-2003, ECLAC.