



MEXICO

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

November 2015

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 2015 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 9, 2015 consideration of the staff report that concluded the Article IV consultation with Mexico.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 9, 2015, following discussions that ended on September 30, 2015, 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 October 26, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.

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

Selected Issues

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IMF Executive Board Concludes 2015 Article IV Consultation with Mexico

On November 9, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Mexico.

Mexico has faced a complex global environment over the last year, characterized by a rise in global financial market volatility and the collapse of oil prices. Nonetheless, the economy has continued to grow at a moderate pace, and capital outflow pressures have been limited. The flexible exchange rate has helped the economy adjust to external shocks, while inflation has remained low and stable. The Mexican peso has depreciated by 16 percent in real effective terms in the last twelve months. Mexico is implementing a broad range of structural reforms, which should help lift potential growth over the medium term.

The economy is projected to grow by 2.25 percent this year. Construction activity has moderated after a strong rebound in the second half of last year. Manufacturing and services remain the main driver of growth, although weaker-than-expected U.S. demand affected manufacturing exports in early 2015. A fall in domestic oil production continues to be a drag on growth. Real GDP growth is expected to accelerate modestly to 2.5 percent in 2016, supported by strengthening external demand. Lower electricity prices and the real depreciation of the peso should boost Mexico's manufacturing production and exports, with positive spillovers to domestic demand.

Inflation remains close to the target and medium-term inflation expectations are anchored. Year-on-year headline inflation dropped below the target in early 2015 on account of lower telecommunication service prices, smaller adjustment in administered fuel prices, and the reversal of effects related to last year's tax hikes on some food items. The exchange rate pass-through has been very limited so far. Real wage growth has been broadly in line with productivity growth.

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.

The policy mix has shifted to a gradual fiscal tightening. The public sector borrowing requirement (PSBR) is projected to decline to 4.1 percent of GDP this year (from 4.6 percent in 2014). The sharp decline in oil revenues has been offset by higher-than-expected fuel excises and income taxes (related to the 2013 tax reform) and by the oil-price hedge of oil export receipts. At the same time, monetary policy conditions remain very accommodative. The Bank of Mexico has maintained the policy rate at 3 percent since June last year. The Foreign Exchange Commission has reactivated two foreign exchange intervention schemes, with the goal of increasing liquidity and reducing volatility in exchange rate markets.

Commercial bank credit growth has strengthened to 10 percent in the first half of 2015. The improvement has been broad-based across sectors. Bank balance sheets remain strong, with capital levels well in excess of requirements and low non-performing loans. Corporate and household balance sheets are also reasonably healthy, despite some increase in corporate borrowing in foreign currency in recent years.

Implementation of the key structural reforms is broadly on track. The telecommunications reform has led to a decline in service prices, and the opening of the sector has already attracted foreign direct investment. The latest auction of oil fields under the energy reform was very successful. The financial reform has strengthened consumer protection and led to increased competition in the banking sector.

The external sector position remains broadly consistent with medium-term fundamentals and desirable policy settings. The current account deficit is projected to widen to 2.25 percent in 2015, reflecting a reduction in the hydrocarbons trade balance. The 2015 cyclically-adjusted current account balance is broadly consistent with medium-term fundamentals and desirable policies.

Executive Board Assessment²

Executive Directors noted that, despite unfavorable external conditions, the Mexican economy continues to grow steadily while financial stability has been well safeguarded. However, given Mexico's open capital account, substantial external risks weigh on the outlook, notably weaker-than-expected growth in its major trading partners and key emerging market economies, and a potential resurgence of global financial market volatility. Directors considered that Mexico's strong fundamentals and credible policy frameworks will help the economy weather shocks, while the Flexible Credit Line arrangement with the Fund has provided additional insurance against tail risks. Meanwhile, steadfast implementation of the structural reform agenda,

² 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

alongside progress in improving security and the rule of law, should help lift potential growth in the medium term.

Directors commended the authorities for their commitment to gradually consolidate public finances and set the ratio of public debt to GDP on a downward trajectory. They welcomed the targeted reduction in the public sector borrowing requirement and the proposed reform of fuel excise taxes aimed at reducing carbon emissions and stabilizing tax revenues over the medium term. Directors encouraged the authorities to also eliminate inefficient electricity subsidies while protecting vulnerable households through targeted transfers.

Directors welcomed ongoing efforts to enhance fiscal discipline and accountability, while at the same time retaining sufficient flexibility to respond to changing circumstances. They supported the proposed fiscal responsibility framework for state and local governments, stressing that capacity building at the local government level is key to its success. Directors also recommended that the authorities explore possible initiatives to further strengthen the Fiscal Responsibility Law over time, including considerations of a long-term nominal anchor and tighter exceptional circumstance clauses, as well as institutional enhancements to better inform the debate on fiscal issues.

Directors considered that the accommodative stance of monetary policy remains appropriate for the near term in light of the remaining slack in the economy and the absence of wage and price pressures. However, they called on the authorities to stand ready to tighten the monetary stance if the exchange rate pass-through to inflation intensifies and second-round effects emerge.

Directors took note of the staff assessment that the external position is in line with economic fundamentals and desirable policy settings. They emphasized that the flexible exchange rate should continue to be the main absorber of external shocks. While recognizing that the temporary foreign exchange intervention schemes have helped enhance market liquidity and reduce volatility, they encouraged the authorities to limit the use of international reserves to periods of disorderly market conditions and to gradually rebuild them once pressures on asset prices subside.

Directors noted that the financial sector remains sound and that financial reforms have progressed well. They underlined the importance of close monitoring of corporate leverage, further strengthening the judicial process of contract enforcement, and improving access to finance while maintaining high credit standards especially at development banks.

Mexico: Selected Economic and Financial Indicators 1/

	2011	2012	2013	2014	2015 ^{2/}	2016 ^{2/}
(Annual percentage changes, unless otherwise indicated)						
National accounts and prices						
Real GDP	4.0	4.0	1.4	2.1	2.2	2.5
GDP per capita in U.S. dollars 3/	10,124	10,137	10,658	10,784	...	...
Gross domestic investment (in percent of GDP)	22.3	23.1	21.7	21.8	22.7	23.1
Gross domestic savings (in percent of GDP)	21.1	21.7	19.3	19.9	20.4	21.0
Consumer price index (period average)	3.4	4.1	3.8	4.0	2.8	3.1
External sector						
Exports, f.o.b.	17.1	6.1	2.5	4.5	-3.2	7.6
Imports, f.o.b.	16.4	5.7	2.8	4.9	-2.0	6.9
External current account balance (in percent of GDP)	-1.1	-1.4	-2.4	-1.9	-2.3	-2.1
Change in net international reserves (end of period, billions of U.S. dollars)	28.6	17.8	13.2	15.5	-17.2	0.6
Outstanding external debt (in percent of GDP)	24.0	28.9	31.0	32.8	37.8	37.8
Nonfinancial public sector (in percent of GDP)						
Government Revenue	22.9	23.9	24.3	23.5	22.7	22.2
Government Expenditure	26.3	27.7	28.0	28.1	26.8	25.7
Augmented overall balance	-3.4	-3.8	-3.7	-4.6	-4.1	-3.5
Money and credit						
Financial system credit to the non-financial private sector (nominal percent growth)	14.3	10.9	9.1	8.5	9.8	11.4
Broad money (M4a)	15.7	14.5	8.7	11.9	9.4	10.0
1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.						
2/ Staff projections.						
3/ IMF staff estimates.						



MEXICO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

October 26, 2015

KEY ISSUES

Outlook and Risks: Mexico has navigated successfully a complex external environment, characterized by falling commodity prices, a sharp appreciation of the U.S. dollar, and heightened volatility in international financial markets. The economy is projected to grow at 2¼ percent in 2015, with inflation close to the target. Looking ahead, growth should be supported by strengthening external demand and by the implementation of the structural reforms. The main risks are negative surprises to U.S. growth, a renewed surge in capital flow volatility, or a further decline in domestic oil production.

Macroeconomic Policies: Macroeconomic policies remain focused on maintaining strong fundamentals and safeguarding financial stability. The authorities are committed to a gradual reduction of the fiscal deficit over 2015–18, which would set the ratio of public debt to GDP on a downward path in the medium term. The accommodative stance of monetary policy has supported growth, while inflation remains low and stable. Continued steady and transparent implementation of structural reforms is critical to boost potential growth.

Advice from Previous Article IV Consultations: Consistent with past Fund advice, the authorities maintained commitment to the fiscal consolidation path over 2015–18, and identified specific measures to achieve it. The approved structural reforms are also in line with past staff advice, and implementation is broadly on track. A number of recommendations from the last FSAP report have been implemented, including strengthening of consolidated supervision and improving the legal bankruptcy framework. An FSAP update is scheduled for 2016.

Approved By
**Robert Rennhack and
 Vivek Arora**

Discussions took place in Mexico City during September 17–30, 2015. The team comprised Dora Iakova (head), A. Klemm, F. Valencia (all WHD), J. Araujo (SPR), M. Chamon (RES), J. Chow (MCM), and I. Rial (FAD). A. Herman (WHD) contributed from headquarters. Mr. Rennhack attended the concluding meetings. Messrs. Hurtado and Zuñiga-Villaseñor (OED) also participated in the meetings.

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CONTEXT

1. Mexico has faced a complex global environment over the last year. International oil prices declined by more than 50 percent since mid-2014. The drop in oil prices has had a limited impact on the current account as Mexico has a broadly balanced trade in hydrocarbons. However, it increased the fiscal consolidation burden and might affect prospects for private investment in the oil sector in the medium term. In addition, emerging market asset prices were hit by a rise in global financial volatility and a portfolio shift away from emerging markets. As a consequence, the Mexican peso has depreciated sharply against the US dollar since mid-2014, prompting the Foreign Exchange Commission to put in place a rules-based foreign exchange intervention program. Despite the increase in asset price volatility, economic activity continues to grow at a steady pace, and inflation remains low and stable.

2. In the context of high financial market volatility, policies in Mexico remain focused on maintaining strong fundamentals and safeguarding financial stability. The flexible exchange rate has helped the economy adjust to external shocks. The authorities have reiterated their commitment to reduce public sector deficits and stabilize public debt. Continued implementation of a broad range of structural reforms would help lift potential growth over the medium term.

RECENT DEVELOPMENTS

3. The economy continues to grow at a moderate pace. Growth is projected to reach 2¼ percent in 2015. Economic activity has been slower than expected in the first half of the year. Manufacturing continues to expand, although exports have been affected by weaker-than-expected U.S. demand, reflecting in part weather-related factors and port strikes early in the year. Construction activity has moderated after a strong rebound in the second half of 2014. Domestic crude oil production has continued to decline, subtracting about ¼ percentage point from growth in 2015 (Figure 1).

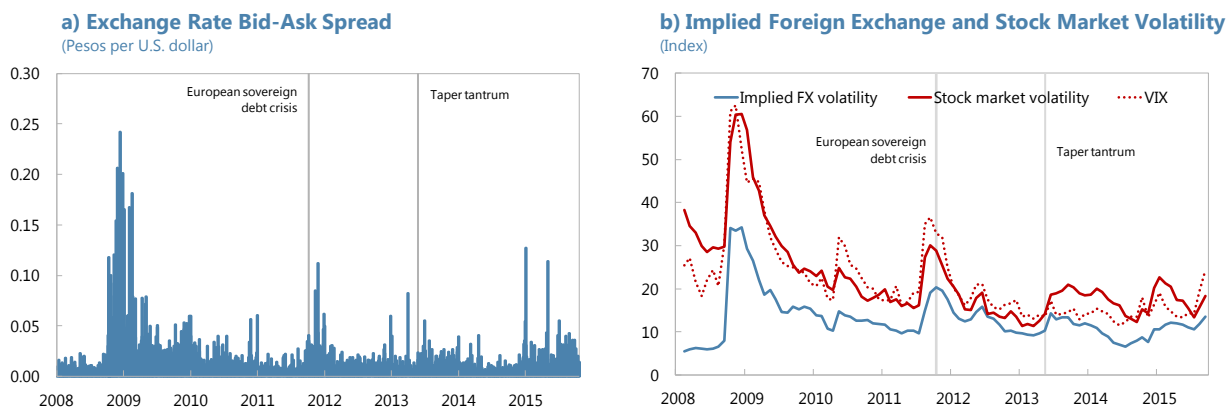
4. Inflation pressures remain contained, despite the sharp peso depreciation. The drop in year-on-year inflation since early 2015 has been due in part to a one-off decline in telecommunication service prices, lower adjustment in administered fuel prices, and the reversal of the effect of tax hikes on some food items in 2014.¹ Quarterly annualized seasonally-adjusted headline and core inflation rates have been very close to the 3-percent target since April. The exchange rate pass-through has been very limited so far, and inflation expectations remain anchored. Real wage growth is broadly in line with productivity growth (Figure 2).

¹ The price of gasoline and diesel were increased by 1.9 percent in January 2015—compared to around 11 percent in 2014—with no additional adjustments expected in 2015.

5. The mix of policies has shifted toward a gradual fiscal tightening, with monetary policy remaining accommodative. The Bank of Mexico has maintained the policy rate at 3 percent since June last year. The public sector borrowing requirement (PSBR) is projected to decline to 4.1 percent of GDP this year (from 4.6 percent in 2014, Table 2). Based on fiscal trends in the first eight months, the target is achievable, although it will require compression of spending in the remainder of the year. The sharp decline in oil revenues has been offset by higher-than-expected fuel excises and income taxes (related to the 2013 tax reform), and by the oil-price hedge.²

6. Asset prices in Mexico have been affected by the rise in volatility in global financial markets. The peso had depreciated by 30 percent against the U.S. dollar, and by 15 percent in real effective terms between mid-2014 and September. Foreign exchange bid-ask spreads and stock market volatility have increased to levels last seen during the euro area sovereign debt crisis in November 2011 and the taper tantrum, respectively. In response, the Foreign Exchange Commission reactivated two foreign exchange intervention schemes intended to increase liquidity and reduce volatility in exchange rate markets.³ In contrast, the local-currency sovereign bond market showed few effects of the turbulence: the long end of the domestic-currency yield curve has shifted up only modestly. Total non-resident ownership of sovereign debt has been broadly stable since the end of 2014, though there has been a decline in non-resident holdings of short-term paper (Figure 3). Portfolio capital inflows moderated, but stayed positive in the first half of the year. Higher frequency partial data from ETFs and mutual funds suggest that outflow pressures intensified in July and August, and corporate bond issuance in foreign currency trailed off in the third quarter (Figure 4).

Bid-Ask Spread and Financial Market Volatility



Sources: Bloomberg L.P.; and IMF staff calculations.

² Mexico's government insures its net export oil receipts by purchasing put options at a strike price equal to the oil price assumed in the budget. The income from the hedge is expected to amount to ½ percent of GDP in 2015.

³ The first scheme, activated last December, is a minimum price FX auction of US\$200 million triggered when the exchange rate depreciates by 1.5 percent vis-a-vis the U.S. dollar with respect to the previous day (the threshold has been 1 percent since July 30, 2015). The second scheme, in place since March 2015, is a preannounced daily FX auction (initially of US\$52 million, raised to US\$200 million since July 30) with no minimum price. The two schemes will be active through the end of November. Both intervention modalities have been used in the past.

7. The external sector position remains broadly consistent with medium-term fundamentals and desirable policy settings. The current account deficit is projected to widen to 2¼ percent in 2015, reflecting a reduction in the hydrocarbons trade balance. Mexico has turned into a small net importer of hydrocarbons in value terms as a result of declining oil production. The 2015 cyclically-adjusted current account balance is broadly consistent with medium-term fundamentals and desirable policies. The currency depreciation reflects in part an overshooting related to the sharp appreciation of the U.S. dollar vis-a-vis emerging market currencies in 2015, and to a smaller extent, prospects for lower-than-expected investment in the oil sector.⁴ The real effective exchange rate is assessed by staff to be moderately undervalued (3–12 percent), and the undervaluation is expected to be temporary (Box 1).

Box 1. External Sector Assessment

Mexico's external position in 2015 is broadly consistent with medium-term fundamentals and desirable policy settings. The current account deficit is expected to be around 2.3 percent this year. Staff's view is that the estimated cyclically-adjusted current account deficit is close to the norm determined by fundamentals and desirable policies (it is only ½ percentage point of GDP stronger than the norm estimated using the External Balance Assessment method from the 2015 External Sector Report).

The real effective exchange rate has depreciated by about 15 percent by September 2015 relative to its average 2014 value. The depreciation reflects to a large extent a temporary overshooting related to the sharp appreciation of the U.S. dollar against emerging market currencies, heightened volatility of the prices of risky assets, and increased hedging activities by corporations and non-resident investors in the local currency bond market. To a smaller extent, the depreciation reflects some deterioration in fundamentals.¹ In staff's view, the real effective exchange rate is undervalued by about 3–12 percent. This is consistent with the results from real effective exchange rate levels approach, which finds an undervaluation of 8 percent (Annex II). As the undervaluation is expected to be temporary, it does not call for changes in policies.

¹ The lower path of oil prices is likely to lead to lower-than-expected oil investment and production over the medium term, with negative effects on growth. A decline in oil prices also has a small negative effect on the current account balance because Mexico exports crude oil and imports refined petroleum products. The price of refined oil is less sensitive to global oil prices because of the fixed cost of refining. Staff estimates suggest that a 10 percent decline in crude oil prices reduce the oil trade balance by about 0.05 percentage point of GDP, all else equal.

External Balance Assessment Results

Current account gap (Percent of GDP)	0.5
REER gap, level regression (Percent)	-8.0

Source: IMF Staff estimates.

⁴ Anecdotal evidence suggests that the highly liquid market for the Mexican peso is often used for hedging other emerging market currency exposures; therefore, movements of the currency during periods of market stress may be unrelated to fundamentals. Staff analysis of the taper tantrum found that the peso was one of the most affected emerging market currencies in the initial phase of the episode; it rebounded at a later stage, when investors started to differentiate on the basis of fundamentals (see Box 1 in *Mexico: Arrangements Under the Flexible Credit Line*, November 2014).

Box 1. External Sector Assessment (concluded)

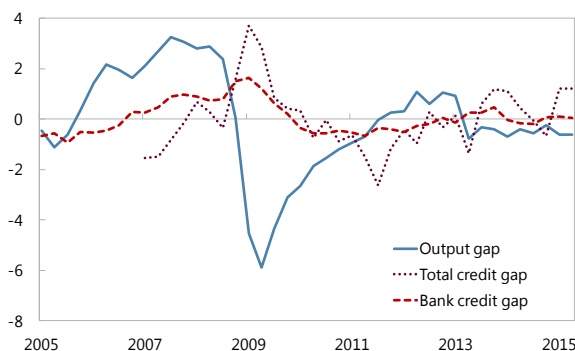
Mexico's net international investment liability position stood at 33 percent of GDP at end-2014. Gross liabilities were 75.6 percent of GDP, dominated by portfolio liabilities (37 percent of GDP) and FDI (26.3 percent of GDP). External assets stood at 42.6 percent of GDP in 2015.

Mexico remains committed to a floating exchange rate, although the authorities' framework allows for the occasional use of foreign exchange intervention to prevent disorderly market conditions. The current level of foreign exchange reserves remains adequate according to standard measures, although the 2015 FX intervention has led to a decline in the level of gross reserves from US\$195.7 billion at end-2014 to US\$182 billion in September 2015 (Figure 9 and Table 6).

8. Commercial bank credit growth has strengthened to 10 percent in the first half of 2015.

The improvement has been broad-based, driven by the successful resolution of the three home building companies and a recovery in credit demand (Figure 5). The current pace of credit growth is consistent with trend financial deepening: in the last ten years the ratio of commercial bank credit to GDP has increased at a moderate pace, averaging a gain of $\frac{3}{4}$ percentage point per year (the ratio of total bank and non-bank credit to GDP has grown on average rate by 1.1 percent).⁵ Bank balance sheets remain strong, with capital levels well in excess of requirements and low non-performing loans. Overall, the banking system has the capacity to continue supporting steady credit expansion going forward.

Output and Credit Gaps
(In percentage points)



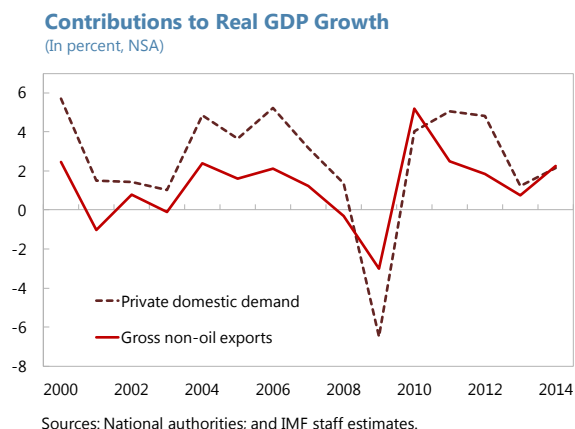
Sources: National authorities; and IMF staff calculations.

9. Implementation of the key structural reforms is broadly on track. Last year, Mexico completed the legislative process underpinning important reforms in the areas of energy, telecommunications, anti-trust, labor market, education, and the financial sector. The focus has now shifted to implementation. The telecommunications reform has led to a decline in service prices, and the opening of the sector has already attracted foreign direct investment. The second auction of oil fields under the energy reform was successful, as the contract terms were adjusted by the government after a somewhat disappointing result from the first auction. Future rounds would feature deep water oil fields, which have higher exploration and production costs, and the outcome could be more sensitive to the outlook for oil prices.

⁵ For 2015, the projected increase in the ratio of bank credit to the non-financial private sector to GDP is $\frac{3}{4}$ percentage point, while the increase in total (bank and non-bank) credit to GDP is 0.9 percentage point, in line with trend credit growth. Credit gaps in the chart are computed as percentage-point deviations from an HP-filtered credit-to-GDP ratio (with a smoothing coefficient of 1600) over the sample period 1995–2015.

OUTLOOK AND RISKS

10. Real GDP growth is expected to reach 2½ percent in 2016, supported by strengthening external demand. The baseline scenario assumes continued recovery in U.S. growth, accompanied by smooth normalization of U.S. monetary policy. Under this baseline, positive effects from higher external demand would dominate the negative impact of tightening external financial conditions for Mexico (Box 2). Lower electricity prices and the real depreciation of the currency should also help boost Mexico's manufacturing production and exports, with positive spillovers to domestic demand.⁶ Private consumption growth would continue to be supported by steady wage growth and low unemployment (Figure 6). The proposed budget for 2016 envisages a decline in the PSBR to 3.5 percent of GDP, which would imply a moderate drag on growth.⁷



Box 2. Trade and Financial Spillovers to Mexico

Mexico has close trade and financial ties to the global economy, and especially with the United States. The U.S. is by far the largest recipient of Mexico's manufacturing and agricultural exports, and is also the main source of portfolio and foreign direct investment flows to Mexico, explaining the close correlation of the business cycles of the two economies. Focusing on financial linkages, international investors held about half of total government debt in mid-2015 (including 36 percent of local currency government bonds), as well as a large share of corporate bond debt.

A structural Bayesian VAR is estimated to quantify the contribution of external spillovers to Mexico's output growth. The external variables in the system are U.S. real GDP growth, the 10-year U.S. Treasury bond rate, and the J.P. Morgan emerging market bond spread (see Selected Issues Paper, Chapter 2 for more details).

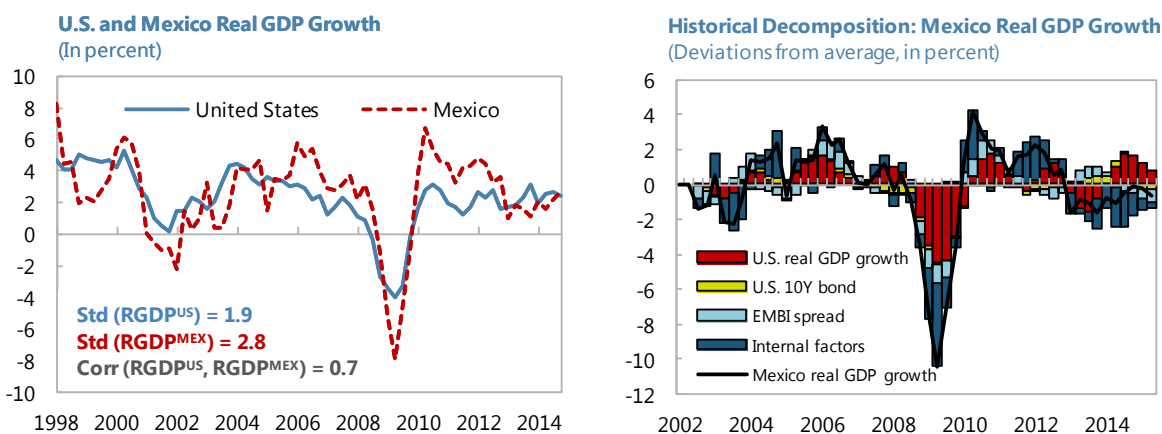
⁶ Staff estimates suggest that a 10 percent depreciation of real effective exchange rate leads to 3 percent real growth in non-oil exports over the next two years. A staff study finds that a 10 percent decline in electricity costs increases manufacturing output by 3 percent (Selected Issues Paper 2014). Electricity prices for industrial users have declined by 24 percent year-on year by July 2015, which should boost activity over the next two year by about 1.2 percentage points of GDP (cumulative).

⁷ Staff analysis suggests that the fiscal consolidation would subtract around ½ to 1 percentage point from growth next year. The estimated average fiscal multiplier over the business cycle is 0.6–0.7 (see Selected Issues Paper, Chapter 1). However, this impact would be largely offset by the positive effects of lower electricity prices and the real depreciation on manufacturing activity.

Box 2. Trade and Financial Spillovers to Mexico (concluded)

External factors explained a significant fraction of the decline in output during the financial crisis and the rebound after the crisis. However, the growth weakness in 2013–14 has been explained mainly by domestic factors (possible explanatory factors include the contraction in the construction sector in 2013, initial uncertainty relating to the tax reform and the simultaneous adoption of a number of structural reforms more generally, and a steady decline in domestic oil production). More recently, the negative contribution of external factors to growth has increased, reflecting tighter global financial conditions.

The results confirm that both real and financial spillovers are important. One percentage point increase in U.S. growth (1.8 standard deviations) raises Mexico's growth by about 1 percentage point. Meanwhile, 100 basis points increase in the EMBI spread (2.2 standard deviations) reduces Mexico growth by 0.7 percentage points. In a separate analysis, the paper finds that a rise in U.S. bond yields that is not accompanied by higher U.S. growth has a negative effect on Mexico's output.



Source: National authorities; and IMF staff calculations.

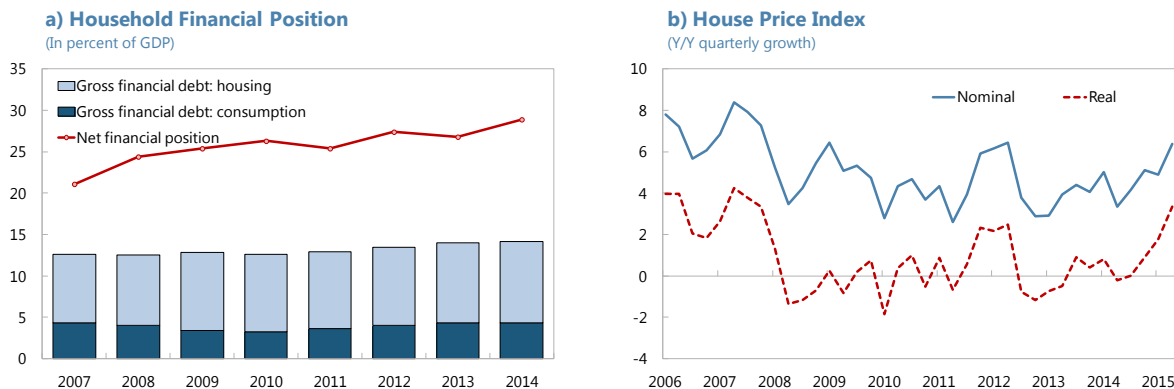
11. Credit conditions are expected to tighten somewhat, but remain broadly supportive of growth. Strong liquidity buffers would allow corporations to continue to invest even under moderately tighter external financial conditions. In addition, bank balance sheets have space to accommodate stronger credit demand. The annual growth rate of real bank credit over the medium term is projected to be around 8 to 9 percent, reflecting continued financial deepening. Domestic debt issuance is also holding up. Staff analysis finds that even in a downside risk scenario, encompassing a further depreciation of the currency, an increase in funding costs, and a decline in earnings, the large majority of corporations would remain solvent (Box 3). However, if such negative shocks materialize, economic activity may be affected as firms are likely to invest less and banks may reduce credit supply.

Box 3. Macrofinancial Linkages: Sectoral Balance Sheet Analysis

Corporations appear to be resilient to financial shocks due to low debt levels, natural and financial hedges, and large liquidity buffers. However, large negative shocks could lead them to reduce investment. Banks rely mostly on domestic deposit funding, and have sufficient capital buffers to continue to expand lending at a steady rate in the baseline scenario, or to withstand negative growth shocks in a tail risk scenario. The public sector is the most exposed to a change in global risk sentiment, although a favorable debt composition—with long maturities and a large share of debt denominated in domestic currency—should reduce vulnerabilities.

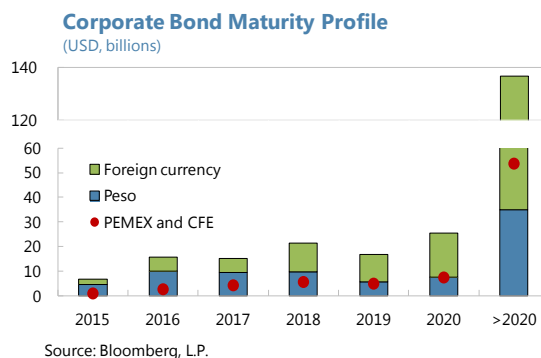
Households have very low debt. Mortgage and consumer loans amount to 10 and 5 percent of GDP respectively, and are denominated in local currency. Households hold significant positive net financial assets (in addition to non-financial assets). House prices have been broadly stable in real terms since 2008, and there are no signs of a real estate bubble.

Household Financial Position and House Prices



Sources: National authorities; and IMF staff estimates.

Corporate debt is also relatively low, although leverage has increased in recent years. Gross corporate debt was around 32 percent of GDP in 2014, of which about 40 percent is in foreign currency (a third of total corporate debt is owed by the public-owned PEMEX and CFE, so private corporate debt is only about 20 percent of GDP). As a result, leverage has increased over the last 7 years (Figure 7). The relatively high share of debt denominated in foreign currency presents a potential vulnerability. However, FX exposures are mitigated by natural and financial hedges, and by long bond debt maturities. Only 10 percent of outstanding corporate bonds mature in 2015–16, and firms have strong liquidity buffers (with a median ratio of cash-to-total debt of 22 percent).



Box 3. Macrofinancial Linkages: Sectoral Balance Sheet Analysis (continued)

Corporate Stress Tests: Financial and Growth Implications

Non-financial firms appear to be resilient to financial shocks. Stress tests on listed firms (based on end-2014 balance sheet data), presented in the Selected Issues Paper, Chapter 3, show that a combination of 30 percent exchange rate depreciation, 30 percent increase in interest expense, and 20 percent decline in earnings would reduce debt servicing capacity, but the large majority of firms would remain solvent. Abstracting from any hedging (financial or natural), the median interest coverage ratio (ICR) would decline from 3.7 in 2014 to 1.9, while the median debt-to-equity ratio would increase due to valuation effects. Assuming that firms with an ICR below 1.5 default on bank loans with 15 percent probability, banks' NPLs would increase by 1.5 percentage points. Bank capital buffers are sufficiently strong to absorb such a shock. The authorities' own analysis of corporate sector resilience has produced similar results.

Overall, the assumed combination of shocks could lower real GDP growth by about ¼ percent. As leverage increases after the shock, some corporations are likely to reduce investment. Based on cross-country estimates of the response of corporate investment to changes in leverage, the above shocks could lower real GDP growth by 0.1 percentage points (the decline in investment rates could be higher if the shocks are magnified by a sudden stop phenomenon in which corporates are unable to roll over debt). Furthermore, a tightening of bank credit could cause an additional decline in growth of about 0.2 percent (based on staff's empirical estimates of the response of bank credit to shocks to capital).

Commercial Banks' Balance Sheets

The commercial banking system remains well-capitalized, liquid, and profitable. Commercial banks' capital adequacy ratios are close to 16 percent, well in excess of regulatory requirements and among the highest in emerging economies. Mexico adopted the Basel III capital rules in 2013, and the Basel Committee has assessed Mexico as compliant earlier this year. Formal liquidity coverage ratio (LCR) minimum requirements have been in place since January this year (they are being phased in gradually over 5 years and have been set initially at 60 percent).

The average LCR of the banking system stood at 170 percent at the end of 2014, though some smaller banks have lower liquidity ratios and will have to increase reliance on longer-term financing to meet the required LCR ratio in the medium term. Non-performing remain low at 3.3 percent of total loans, and are fully provisioned. Domestic deposits are the main source of funding. Commercial banks' external debt liabilities amount only to 1.5 percent of GDP (3.3 percent of total liabilities), which reduces vulnerability to external liquidity shocks.

Box 3. Macrofinancial Linkages: Sectoral Balance Sheet Analysis (concluded)

Banks are resilient to credit, liquidity, and market risks. A stress test conducted by the bank supervisory authority (CNBV) finds that even under a significant increase in long-term rates, valuation losses will be limited and banks will remain well capitalized. In addition, there are a number of prudential regulations in place to limit foreign-exchange risks, including caps on net foreign-currency open positions (at 15 percent of capital) and strict liquidity requirements to ensure adequate resources in case of temporary liquidity shocks. Credit risks also appear to be contained. The most recent stress tests, conducted by CNBV and the Bank of Mexico, show that the banking system would remain in good financial health even in the unlikely scenario of a sharp decline of economic growth and a significant increase in interest rates (Financial Stability Council, Annual Financial Stability Report, March 2015 and Bank of Mexico Financial Stability Report, October 2014).

Linkages Across Sectors

Inter-sectoral balance sheet linkages show that contagion risks are contained. The main potential vulnerability is the significant net liability position of the public sector and of non-financial corporations vis-à-vis the rest of the world (22 percent of GDP each). A shock to the risk preferences of non-resident investors, which leads them to reduce holdings of Mexican assets, could be a key channel of transmission of global shocks to Mexico. However, this risk is mitigated by several factors. First, the external liabilities of corporations are largely in the form of equity—private non-financial corporates' gross external debt is only 8.9 percent of GDP (Table 6). Second, about 75 percent of public debt is denominated in pesos, so the foreign-currency liabilities of the public sector are relatively small, limiting vulnerability to exchange-rate changes. Finally, the central bank has boosted its reserves in recent years (to about 16 percent of GDP), and Mexico has a US\$70 billion credit line with the IMF, which should help guard against a tail event of large capital outflows. The external and public debt sustainability analyses suggest that debt would remain sustainable under plausible stress scenarios.

Mexico: Net Intersectoral Asset and Liability Positions, 2014 1/

(In percent of GDP)

	Central bank	Public sector	Banks	Other financial corps.	Nonfinancial private sector	Nonresidents
Central bank		9.1	-1.4	-0.6	0.0	-16.6
Public sector	-9.1		14.9	11.2	-1.3	22.3
Banks	1.4	-14.9		-2.5	11.3	0.1
Other financial corporations	0.6	-11.2	2.5		-3.6	0.0
Nonfinancial private sector	0.0	1.3	-11.3	3.6		22.0
Nonresidents	16.6	-22.3	-0.1	0.0	-22.0	

Sources: Standardized report forms for monetary and financial data; External debt and IIP data from Banxico; Public debt from SHCP.

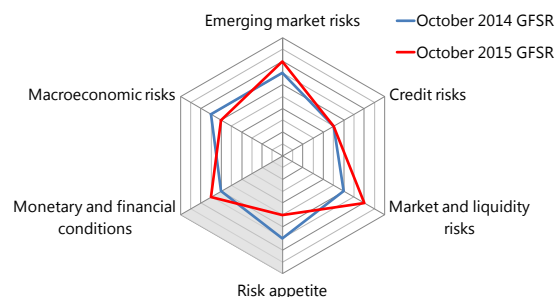
1/ Detailed gross asset and liability positions are reported in Table 8.

12. The structural reforms should raise potential growth in the medium term. Staff estimates that the reforms would boost growth to about 3–3½ percent over the medium term through higher investment, improved access to finance, and a rise in productivity.⁸ Some benefits of the reforms are already visible: private investment in natural gas pipelines, electricity generation, and telecommunications has picked up, and the financial reform has helped spur competition in the banking sector. Progress in improving security and the rule of law will be important to allow Mexico to realize the full potential of the structural reforms. The current account deficit is projected to deteriorate in the first few years of implementation of the reforms as imports of machinery and equipment pick up, but should narrow gradually in the longer term as oil production and exports increase.

13. The outlook is subject to substantial risks:

- *Weaker-than-expected trade partner growth.* Slower-than-expected recovery in U.S. growth, and particularly in U.S. manufacturing production, is the main external risk to Mexico’s outlook. It could be triggered by a weaker-than-expected impact of lower oil prices on U.S. aggregate demand, the dampening effect of slow global growth and the strong dollar, or a disorderly market reaction to liftoff.
- *A surge in global financial market volatility.* This could be triggered by continued uncertainty related to the process of U.S. monetary policy normalization, or by adverse developments in key emerging market countries. Mexico is exposed to a change in investor sentiment given its open capital account and a sizable stock of foreign portfolio investment. The global financial stability map from the October 2015 GFSR report shows that emerging market risks, and market and liquidity risks have increased relative to 2014. A protracted period of high volatility could affect funding costs and access to finance. If this risk materializes, firms are likely to reduce the pace of investment and production. As discussed in the 2014 FCL report, a tail risk scenario of sharp capital outflows would also heighten rollover risks in the large government bond market. The Flexible Credit Line is intended as insurance against tail risks.
- *A lower-than-projected path for oil prices or domestic oil production.* A further drop in global oil prices, or a failure of PEMEX to stabilize oil production—the main domestic risk—could increase further the fiscal consolidation burden and affect private investment in the oil sector. More

Global Financial Stability Map



Source: Global Financial Stability Report.
Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

⁸ Potential growth has been around 2½ percent historically. Staff estimates of medium-term potential growth have been revised down from last year, reflecting lower projections for private investment in the Mexican oil sector, a lower oil production path, and downward revisions of global growth.

generally, slower-than-expected implementation of the structural reforms could lead to lower medium-term growth.

14. The authorities share staff’s view on the near-term outlook and the main risks. They project that growth in 2016 would be in the range of 2½ to 3.6 percent, and view continued volatility in financial markets and shocks to U.S. growth as the main risks. The authorities remain more optimistic about the medium-term boost to activity related to the reforms, and believe that growth could reach 4–5 percent by 2018–20.

15. Staff and the authorities agreed that Mexico’s positive growth outlook and credible policy frameworks increase its resilience and ability to deal with financial market stress. Mexico’s medium-term growth prospects remain more favorable than those of other emerging markets. Monetary policy remains guided by a credible inflation-targeting regime while fiscal policy remains committed to ensuring sustainable debt levels. In addition, Mexico’s deep and liquid financial markets allow foreign investors to hedge exchange rate risk. Altogether, Mexico should remain an attractive destination for foreign direct investment and long-term portfolio flows in the future. These factors have contributed to broadly stable long-term yields on domestic-currency government bonds despite the recent increase in global financial market volatility.

POLICY DISCUSSIONS

A. Fiscal Policy

16. Staff welcomed the authorities’ commitment to a gradual fiscal consolidation, which is critical to maintain confidence in the strength of public finances. The 2016 budget maintained the commitment expressed in last year’s budget document to reduce the PSBR by about ½ percentage point per year from 4.1 percent of GDP in 2015 to 2½ percent of GDP in 2018, despite a significant decline in oil prices and a downside revision of the oil production path. This deficit path will initially stabilize the ratio of public debt to GDP at around 52 percent of GDP, and then set it on a downward path in the medium term (Table 2 and Figure 8). Delivering on these fiscal commitments would be important to restore fiscal buffers, and continue to maintain investor confidence and keep financing costs low.

17. The fiscal consolidation effort relies both on expenditure and revenue measures. A rise in non-oil tax revenues due to the 2013 tax reform and higher fuel excises have largely offset the 4 percentage points of GDP decline in oil revenues over the last two years.⁹ Starting in 2016, the consolidation relies mostly on expenditure rationalization. The 2016 budget envisages a decline of public spending of 1 percentage point of GDP next year, with further reductions of about

⁹ The path of oil production has been revised significantly down over the medium term (relative to the 2015 budget), reflecting a persistently lower production path for Pemex and a slower pace of private investment in exploration and production. As a result, oil revenues would remain permanently lower, rising modestly in the coming years with the projected recovery in oil prices.

¾ percentage point in the medium term, equally split between current and capital spending. By 2018, the ratio of expenditure to GDP is projected to return to its 2007–08 level. The 2016 budget also includes temporary tax incentives for investment, which should help support domestic demand next year.

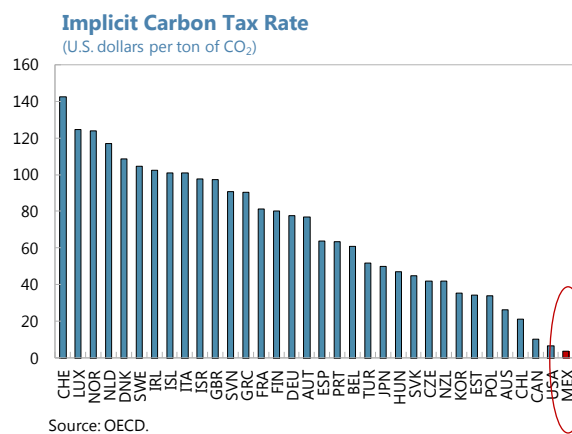
18. The decline in public investment is expected to be compensated by increased reliance on public-private partnerships. The state-owned oil company (Pemex) is bearing the brunt of the fall in public capital spending, and it is expected to rely increasingly on production and exploration partnerships with private companies. Public enterprises, including Pemex, will also be able to securitize assets and use equity financing for some of its operations, which is welcome, as long as the operations are recorded transparently in the public accounts. More generally, public-private partnerships (PPPs) would play a bigger role going forward, including in infrastructure development. Staff noted that, based on international experience, successful PPPs require thorough evaluation and good governance structures to minimize fiscal risks and contingent fiscal liabilities.

19. Staff strongly endorsed the authorities' proposal to allow gasoline and diesel prices to move more closely in line with international prices, and to fix the excise taxes per liter of fuel. The current variable excise tax is the difference between the regulated domestic price of gasoline and an international benchmark price.¹⁰ The proposal to fix fuel excises per unit of fuel is in line with staff's recommendation to increase carbon taxes in Mexico to levels commensurate with the negative health and environmental externalities associated with fossil fuel use. The proposed tax levels for gasoline and diesel are close to the optimal levels based on staff's analysis (Box 4). In addition to helping reduce Mexico's carbon emissions, this measure will help stabilize tax revenues in the medium term relative to the current scheme of variable excises.

Box 4. A Carbon Tax Proposal for Mexico

As of 2014, Mexico had the lowest carbon taxes on fossil fuels among OECD countries.

Mexico has a system of administered fuel prices, with an implicit subsidy (or tax) arising when the domestic price differs from international prices. Between 2006 and 2014, the system resulted in a positive subsidy to domestic consumers. The government has gradually reduced the subsidy in recent years by raising prices at a double-digit rate through the end of 2014.



¹⁰ Under the current regime, the difference could be positive or negative, resulting in a tax or a subsidy, depending on relative price movements.

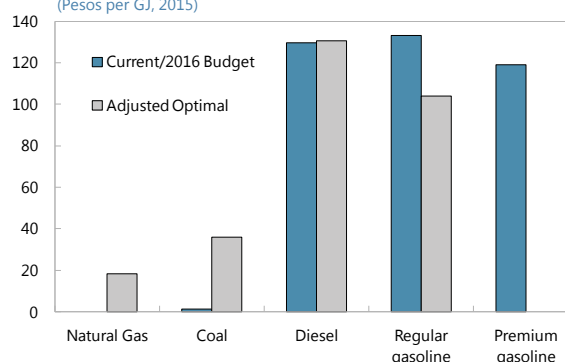
Box 4. A Carbon Tax Proposal for Mexico (concluded)

After the sharp drop in international prices since the end of last year, domestic fuel prices are now higher than international prices, resulting in positive tax revenue. The 2016 budget proposes to fix the excise tax per liter of fuel at its current level, and gradually allow fuel prices to move in line with international prices (to smooth the transition, initially prices will fluctuate within a band yet to be defined by the government).

The proposed excise tax levels for gasoline and diesel are in line with staff's estimates of optimal carbon taxes, and would help Mexico meet its carbon emission reduction goals. The estimated optimal taxes reflect the measurable negative environmental, health, and traffic-related externalities associated with fossil fuel use (chapter 4 of the Selected Issues Paper). Adoption of the proposed measure would stabilize fuel excise revenues. It would also help Mexico achieve its Paris commitments: setting carbon taxes at the proposed levels would reduce carbon emissions by 6 percent relative to the baseline.

Current Fossil Fuel Excises in Mexico

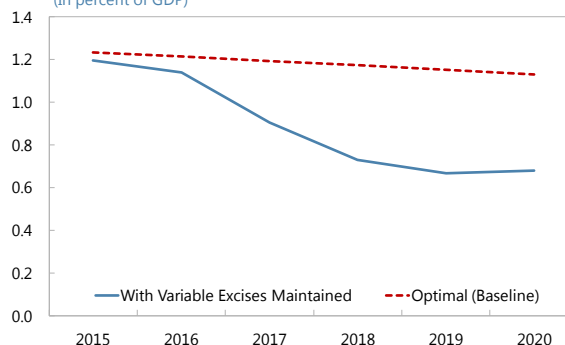
(Pesos per GJ, 2015)



Source: Chapter 3, Selected Issues Paper.

Fiscal Revenues from Fuel Excises

(In percent of GDP)



Source: Chapter 4, Selected Issues Paper.

20. Staff pointed out that the current low fuel prices provide a window of opportunity to eliminate inefficient electricity subsidies, while protecting vulnerable households. Electricity subsidies are projected to decline from $\frac{1}{2}$ percent of GDP in 2014 to about $\frac{1}{4}$ percent of GDP in 2015, reflecting the decline in oil and natural gas prices. Staff encourages the authorities to eliminate these non-targeted subsidies permanently, while compensating low income households through existing well-targeted cash transfer programs. The authorities agreed that a gradual replacement of these subsidies with more targeted support could be desirable in the medium term. They noted that the overall energy subsidies have already declined substantially with the phasing out of gasoline and diesel subsidies in recent years, and emphasized that the policy focus now is the approval and implementation of the fuel excises, which would eliminate fuel subsidies permanently.

21. Staff proposed several enhancements to the fiscal framework to enhance its role as a commitment device for fiscal discipline. The 2014 amendments to the fiscal responsibility law (FRL) improved the fiscal framework in several dimensions, but it commits to a specific PSBR target only one year ahead and has no long-term nominal anchor. In addition, the exceptional circumstances clause can be invoked even under mild negative shocks (see Selected Issues Paper, Chapter 5).

- First, the fiscal responsibility law could be modified to include an explicit ceiling for the PSBR, corresponding to a desirable path for the public debt. For example, the law could specify a fixed ceiling of 2.5 percent of GDP for 2019 and beyond.¹¹ In addition, the use of the exceptional circumstances clause should be explicitly limited to cases of large output or oil price shocks to help constrain discretion. When these clauses are invoked, the fiscal framework should define explicit rules to bring the PSBR below the ceiling. The authorities argued that public finances are going through a structural change due to the energy reform. In their view, it would be appropriate to wait until the transition is over, and there is greater certainty about the medium-term growth potential, before tightening the parameters of the fiscal responsibility law.
- Staff also pointed out that international experience suggests that the creation of a non-partisan expert fiscal council can inform the public debate of fiscal issues, and improve accountability and fiscal discipline, by providing an objective evaluation of fiscal policy. The authorities noted that the Congressional Center for the Study of Public Finances (CEFP) already executes some of the typical functions of a fiscal council. They agreed that it would be desirable to strengthen the role of the CEFP in assessing fiscal policy by ensuring that it has non-partisan professional staff and a formal mandate to assess the sustainability of fiscal policy.

22. The proposed fiscal responsibility framework for local and municipal governments is in line with best international practices. A recent constitutional reform and secondary legislation—currently in Congress—have introduced a set of rules to ensure fiscal sustainability at the local government level (see Box 5). However, implementation challenges will be significant particularly in terms of capacity building at the local government level. On a separate issue, staff noted that the proposed education infrastructure bonds, backed by future transfers from the federal to the local governments, are a fiscal liability of the states and therefore should be recorded as public debt according to international accounting standards.

¹¹ This recommendation is in the spirit of the original fiscal responsibility law, which set a zero deficit as the target; however, the definition of the “traditional” budget balance has changed over time, eroding its role as a nominal anchor. If the PSBR target is fixed at 2.5 percent after 2017, gross debt would fall to 50 percent in 2020, and would continue to decline very gradually thereafter (assuming a constant output growth rate). A stochastic simulation presented in the selected issues paper (which accounts for possible shocks to output growth) shows that setting the deficit ceiling permanently to 2.5 percent of GDP would help keep debt below 50 percent of GDP with 82 percent probability in the long term. A more ambitious ceiling of 2 percent would bring debt down faster in the baseline, and would reduce further the risk of high debt levels even in a persistent low-growth scenario.

Box 5. Proposed Fiscal Responsibility Framework for State and Local Governments

Constraints on debt issuance: Subnational governments can incur new debt only to finance investment, rollover existing debt, or finance the reconstruction costs of natural disasters, subject to local congress' approval by two-thirds majority. The Federal government will monitor compliance with debt limits. Short-term debt is allowed only for liquidity management purposes and cannot exceed 6 percent of total revenues. In addition, short-term debt has to be repaid three months before the end of the local government's term in office.

Early warning system: A publicly available early warning system will be applicable to all subnational debt, classifying it in one of three categories: stable debt, debt under surveillance, or high debt. The issuance of new debt is limited to 10 percent of non-earmarked revenues when debt is stable; 5 percent of revenues when it is under surveillance; and no issuance is allowed when it is classified as high. Subnational governments with high debt should sign an agreement with the Federal Treasury specifying an adjustment program to return to sustainable public finances.

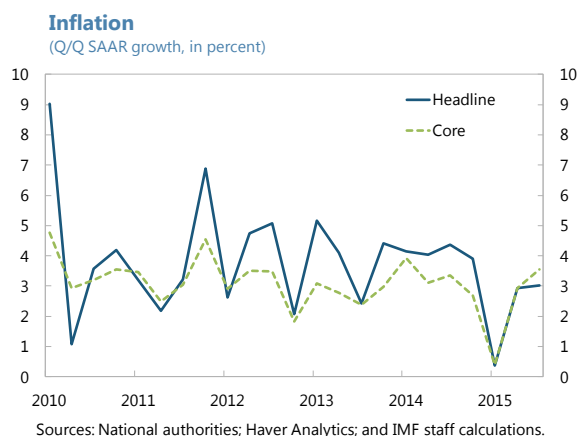
Federal guarantees: The Federal government can provide guarantees to subnational governments provided that they sign an agreement with the Federal Treasury approved by local congress, and earmark future federal transfers (under the revenue-sharing agreements) for debt repayment. Federal guarantees cannot exceed 3.5 percent of GDP (at the aggregate level), and 100 percent of disposable income (at the subnational level). Violation of the agreement leads to sanctions, including non-eligibility for future guarantees.

Other fiscal discipline rules: All subnational government liabilities, including those related to public-private partnerships, will have to be reported to a single public debt registry, which would be published on the Federal Treasury's website. The reported information should comply with the Law of Public Sector Accounting. Budgets should follow a performance-based approach, with large investment projects and public-private partnerships (PPPs) requiring a cost-benefit analysis. The budget must include five-year projections and identify main fiscal risks and potential mitigation measures. The law introduces a "sustainable budget balance" notion, based on specific debt limits determined by the law. Deviations from the sustainable budget balance are permitted only under specific adverse circumstances. In addition, the law requires subnational budgets to include a reserve fund to cover contingencies arising from natural disasters, and future payments under PPPs. The law also sets limits on the wage bill and arrears, and allows the use of excess revenues only for infrastructure spending or savings. Unused earmarked revenues under federal transfers are to be returned to the Federal Government.

B. Monetary and Exchange Rate Policies

23. Staff noted that the accommodative stance of monetary policy remains appropriate.

Inflation pressures have been subdued: after a one-off adjustment in the price level in the first quarter, core and headline inflation have stayed close to the 3-percent target on an annualized seasonally-adjusted basis. The lack of inflation pressures is partly due to significant reductions in energy and other commodity prices, which have helped keep production costs down both in Mexico and in its main trading partners. A mild pass-through from the exchange rate depreciation has been visible only in durable goods prices, with no signs of spillovers to other prices or wages. In the baseline projection, slack in the economy is expected to diminish only gradually over the next two years, keeping inflation pressures in check. Staff noted that, in this context, continued monetary accommodation would remain appropriate in the near term.



24. If upside risks to inflation materialize, some tightening of the monetary stance would be warranted. Upside risks include a more rapid closing of the output gap accompanied by stronger wage increases, or increasing cost pressures as the effects of the commodity price decline dissipate. Another key risk is that the exchange rate pass-through may intensify as importers seek to restore profit margins, which could put upward pressure on wages and the prices of non-tradables, and affect inflation expectations.¹²

25. The Bank of Mexico remains committed to keeping inflation in line with the 3 percent target. The authorities noted that they consider a number of factors in deciding on the appropriate policy rate, including the evolution of slack in the economy, wage developments, the pass-through from exchange rates to prices, and the relative monetary policy stance between Mexico and the United States. They agreed that demand pressures are likely to remain subdued in the near term. However, they noted that a rise in interest rates in the U.S. is likely to put further downward pressure on the currency, which can lead to higher pass-through and affect inflation expectations. It might also trigger greater capital outflows and exacerbate asset-price volatility, with negative consequences for confidence and growth. On balance, given the strong historical correlation of the business cycle of the two economies and financial stability considerations, they thought that moving

¹² Literature estimates of pass-through effect from a 10 percent depreciation of the Mexican peso vis-a-vis the U.S. dollar to headline inflation range from 0.2 to 0.4 after 12 months. These estimates imply that 30 percent persistent depreciation of the peso could lead to an increase in headline inflation by 0.6 to 1.2 percentage points. The low degree of pass-through seen so far could be partially due to the offsetting effect of cost deflation related to the decline in commodity prices.

in step with the Fed would likely be the best strategy to preserve price and financial stability, unless idiosyncratic domestic developments warrant a different policy stance.

26. The flexible exchange rate should continue to play a key role in helping the economy adjust to external shocks. The authorities' policy framework gives a central role to exchange rate flexibility, while allowing for temporary foreign exchange intervention to reduce excess volatility. Deep financial markets have allowed investors to hedge foreign exchange risks, while leaving yields on domestic currency debt instruments broadly unchanged. Going forward, the currency depreciation would help boost manufacturing exports.¹³

27. Staff encouraged the authorities to phase out the daily foreign exchange sales, and focus the use of reserves on periods of disorderly market conditions. In the context of relatively orderly market conditions, the daily interventions without minimum price could be phased out to conserve policy space, while continuing to rely on other intervention modalities to reduce volatility during periods of very low market liquidity. Further down the road, gradual reserve accumulation should resume once pressures on asset prices subside to restore reserve buffers. The authorities reiterated their intention to use foreign exchange interventions only on a temporary basis, and agreed that the daily interventions scheme should be phased out once volatility subsides. They also have additional instruments at their disposal to maintain smooth functioning of markets, such as targeted liquidity provision and debt duration management strategies. The FCL arrangement, which the authorities continue to treat as precautionary, remains an important complement to reserve buffers, providing protection against tail risks.

C. Financial Sector Issues

28. Progress in the implementation of the financial reform is welcome. The credit-to-GDP ratio in Mexico has been rising steadily in recent years, though it remains low compared to other emerging markets (see Box 6 and Selected Issues Paper, Chapter 7). The financial reform aims to address some of the structural impediments to credit supply, and several measures have been implemented so far. All credit providers are now required to report to the credit bureaus, the process of transferring accounts between banks and refinancing mortgage loans has been made easier, and consumer protection has been enhanced through requirements for better disclosure of information on financial products. Staff urged the authorities to complete the implementation of a remaining important aspect of the reform, namely that more federal courts hear mercantile matters, which should improve the speed and efficiency of the judicial process in contract enforcement, including the repossession of collateral.

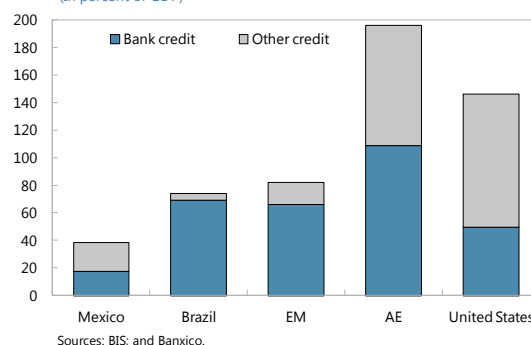
¹³ Staff analysis suggests that recent intervention announcements have had a modest effect on the level and volatility of the exchange rate. The peso appreciated by 1 to 3 percent on impact, though widening standard errors over time make it difficult to establish whether the effect is temporary or permanent (see Selected Issues Paper, Chapter 6).

Box 6. Financial Deepening in Mexico

Mexico has relatively low credit to the private sector as a share of GDP.

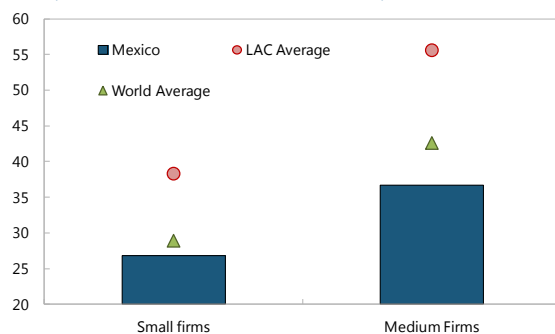
Total bank credit to the private nonfinancial sector is only 17½ percent of GDP, about a quarter of the average level in other emerging markets. Bank credit to households has been rising steadily, but remains low at 7.5 percent of GDP, and even total household debt (including credit from the publicly owned mortgage lenders Infonavit and Fovisste) is low at 15 percent of GDP. Bank credit to firms has also been rising more recently, reaching 10 percent of GDP, which is still much lower than before the Tequila crisis. Only a fraction of small and medium-sized firms have access to banks credit. Large firms rely heavily on bond issuance for financing. Even accounting for market financing, total credit to the private sector is relatively low.

Credit to the Private Sector, 2014
(In percent of GDP)



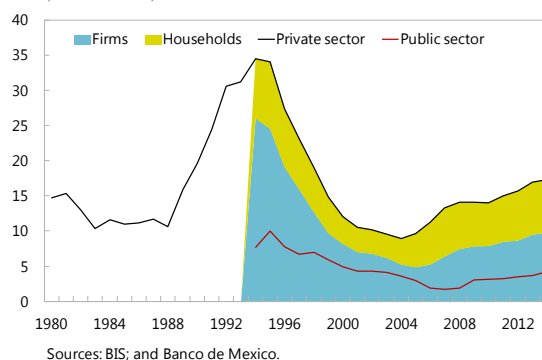
Firm Access to Credit

(Percent of firms with a bank loan or line of credit)



Recipients of Banking System Credit

(Percent of GDP)



A history of banking crises, a large informal sector, and an inefficient legal system are the main reasons for the low level of bank intermediation. The Mexican banking sector has had a tumultuous history, with two major banking crises since 1980, which ended up with a significant restructuring of the banking system. This history is likely to have had lasting effects on trust in financial institutions, through the early 2000s, both for savers who lost deposits in the crisis of the 1980s and for borrowers, who faced difficulties due to rising interest rates in the 1990s. Difficulties in collecting collateral have also limited the rate of expansion of bank lending. Another explanation for the low degree of financial intermediation is the large size of the informal sector. Finally, the level of financial education is quite low.

The 2014 financial reform aimed to address some of the impediments to credit expansion.

Its main components are: (i) shifting more mercantile matters to federal courts to ease the process of collateral collection in case of default; (ii) improved information sharing among all credit providers through the credit bureaus; (iii) strengthening financial education and transparency (by establishing an entity to collect and share comparable information on bank products; and

Box 6. Financial Deepening in Mexico (concluded)

(iv) supporting competition through provisions to facilitate the portability of bank accounts and mortgages across banks. Most elements of the reform have been implemented on time, but the important shifting of more mercantile matters to federal courts remains outstanding.

The key challenge going forward is to achieve gradual financial deepening without jeopardizing financial stability. This will require maintaining high credit standards, and strong regulatory oversight. The pace of credit growth in recent years has been appropriate, resulting in a gradual increase in the credit-to-GDP ratio. Bank credit is projected to continue to grow at a nominal rate of about 11–12 percent in the medium term, implying a rise in the credit-to-GDP ratio of about 1 percentage points per year. Such rate of credit growth would provide a mild boost to potential output growth (of about 0.05 percentage points per year).

29. Development bank credit has expanded rapidly in recent years. The reform also expanded the role of development banks in credit provision, with the goal of stimulating lending to underserved sectors. While development banks account for only 10 percent of total loans to the non-financial private sector, their credit to the nonfinancial private sector has increased 31 percent year-on-year as of June. Staff cautioned that such high rates of credit expansion may strain the capacity of development banks to evaluate credit quality. The authorities responded that development banks are subject to the same regulatory oversight as commercial banks, that rapid growth poses little risk given the low base, and that credit growth rates will slow down going forward. They viewed development banks as playing an important role in improving access to finance through programs such as guarantees for credit to small and medium enterprises, small loans to women, and others.

30. The non-bank financial sector remains sound. Pension funds, which are the most important player in local financial markets with assets of about 16 percent of GDP, maintain a conservative investment profile. The insurance sector is relatively small (6½ percent of GDP) and is well capitalized and profitable. A Solvency II-type regime was adopted in April this year, and insurance companies meet minimum capital requirements comfortably under the new regime. Top-down stress tests conducted by the authorities showed that market risks associated with potential interest rate increases remain limited for both pension funds and insurance companies.

SAFEGUARDS ASSESSMENT

31. Staff has completed the safeguards procedures for Mexico's 2014 FCL arrangement. The authorities provided the necessary authorization for Fund staff to communicate directly with the Bank of Mexico's external auditor, PricewaterhouseCoopers (PwC) México. PwC issued an unqualified audit opinion on the Bank of Mexico's 2013 financial statements on April 25, 2014. Staff reviewed the 2013 audit results and discussed these with PwC. No significant safeguards issues emerged from the conduct of these procedures.

STAFF APPRAISAL

32. Mexico's policies and policy frameworks remain very strong. The flexible exchange rate has played a key role in helping the economy adjust to external shocks. The authorities are committed to preserving sustainable public finances, maintaining price stability, and ensuring the orderly functioning of financial markets. The external position is in line with economic fundamentals and desirable policy settings.

33. Economic activity continues to grow at a moderate rate. Real GDP is projected to grow at 2¼ percent in 2015, strengthening to 2½ percent in 2016. The recovery of U.S. demand and the depreciation of the peso should provide a boost to exports, with positive spillovers to domestic demand. Over the medium term, the implementation of the structural reform agenda should boost potential growth to 3–3½ percent. Strong implementation and further progress in improving security and the rule of law is critical to realize the reforms' full potential.

34. As a highly open economy, Mexico is vulnerable to external shocks. The key external risks are a slowdown in U.S. or global growth, and a surge in financial market volatility related to uncertainty about the liftoff of U.S. interest rates or adverse developments in key emerging market countries. Mexico's strong fundamentals and positive growth outlook should help it weather well renewed bouts of volatility. Temporary foreign exchange rate intervention and targeted liquidity support remain useful tools to prevent disorderly market conditions. The Flexible Credit Line provides additional insurance against tail risks.

35. The authorities' commitment to a gradual fiscal consolidation is welcome. Delivering on the plan to reduce the PSBR to 2.5 percent of GDP by 2018 is critical to set the ratio of public debt to GDP on a downward trajectory and to maintain investor confidence. Staff strongly endorses the proposed reform to fix fuel excises at levels commensurate with the negative externalities of fossil fuel use. This reform will help Mexico achieve its commitment to reduce carbon emissions, and will set an example for other countries. It would be also desirable to eliminate poorly targeted electricity subsidies, while protecting vulnerable households through targeted transfers.

36. Further enhancements to the fiscal framework could help strengthen fiscal discipline. The 2014 Fiscal Responsibility Law has improved the fiscal framework in important ways, but some shortcomings remain. To address these, it would be desirable to add to the FRL an explicit ceiling for the PSBR, corresponding to a desirable path for public debt, combined with tighter exceptional circumstance clauses and explicit rules for returning the PSBR below the ceiling following any deviation. In addition, establishing a strong professional non-partisan fiscal council with a formal mandate to assess the sustainability of public finances can improve accountability and help inform the public debate.

37. The proposed fiscal responsibility framework for state and local governments is in line with best international practices. The framework introduces detailed rules and procedures to

ensure fiscal sustainability at the state and local government level. Nonetheless, implementation challenges will be significant particularly in terms of capacity building at the local government level.

38. Monetary policy should remain accommodative in the near term. The current accommodative stance is appropriate as the economy is expected to continue to operate below potential, and wage and price pressures are contained. However, if the pass-through to inflation intensifies, leading to second round effects, some tightening of the monetary stance would be warranted.

39. The flexible exchange rate should continue to be the main absorber of external shocks. The two foreign exchange intervention schemes have helped enhance market liquidity and reduce the risk of excess volatility. Looking ahead, the authorities should gradually phase out the daily interventions scheme with no minimum price, and give priority to the use of reserves during periods of market dysfunction. Gradual reserve accumulation should resume once generalized pressures on emerging market asset prices subside.

40. Private sector balance sheets have been resilient to financial volatility. Banks have strong capital and liquidity buffers, and are resilient to market and credit risks. Pension and insurance companies maintain a conservative investment profile. The balance sheets of non-financial firms also appear to be reasonably healthy, despite some increase in leverage. Staff welcomes the authorities' efforts to monitor closely corporate leverage, and to require publicly-listed firms to disclose more detailed balance sheet information, including on their derivative positions.

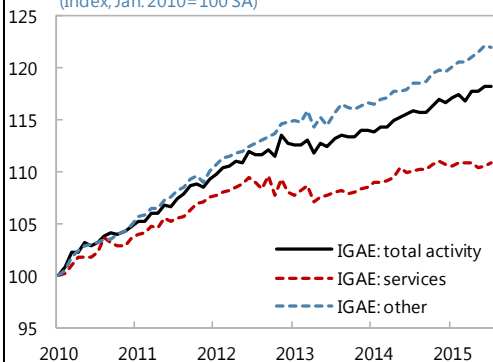
41. Progress in the implementation of the financial reform is welcome. The reform has helped increase competition among banks, strengthen consumer protection, and improve credit data collection. Staff encourages the authorities to move ahead with the shift of more mercantile matters to federal courts to ease legal hurdles related to collateral repossession. The more active role of development banks in strengthening financial inclusion is welcome, though caution is needed to avoid a relaxation of credit standards.

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

Figure 1. Mexico: Real Sector

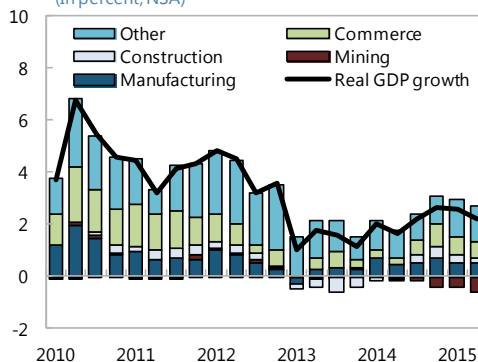
Mexico continues to grow at a moderate rate...

Monthly Indicator of Economic Activity
(Index, Jan. 2010=100 SA)



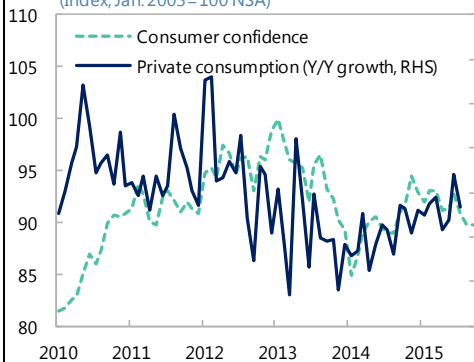
...despite a negative contribution from falling oil production.

Supply Contributions to Growth
(In percent, NSA)



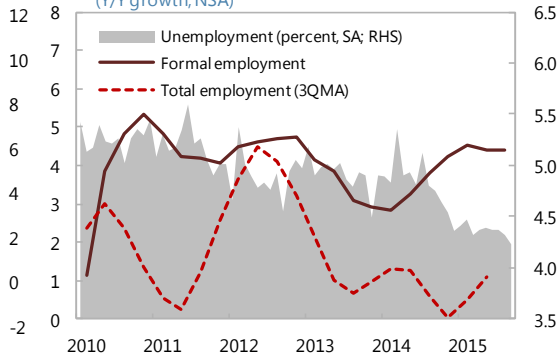
Consumption has held up...

Consumption
(Index, Jan. 2003=100 NSA)



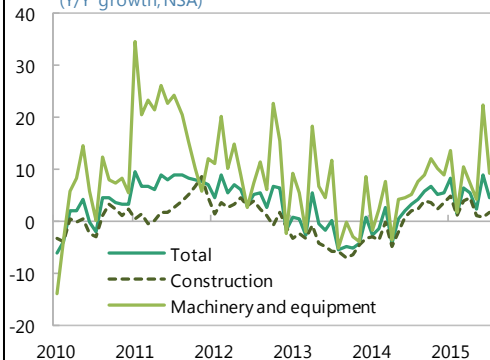
...supported by continued growth in formal jobs and a low unemployment rate.

Employment
(Y/Y growth, NSA)



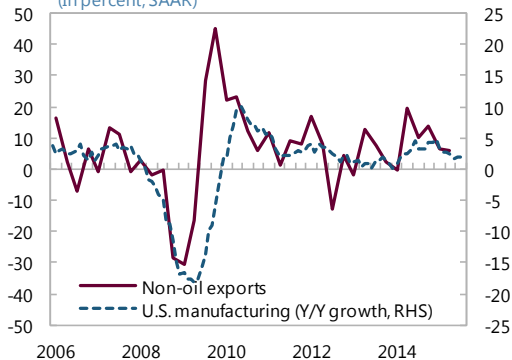
Machinery and equipment investment remains strong, though construction activity has weakened.

Gross Fixed Capital Formation
(Y/Y growth, NSA)



Real export growth has slowed down in 2015 due to weaker external demand.

Real Export Growth
(In percent, SAAR)

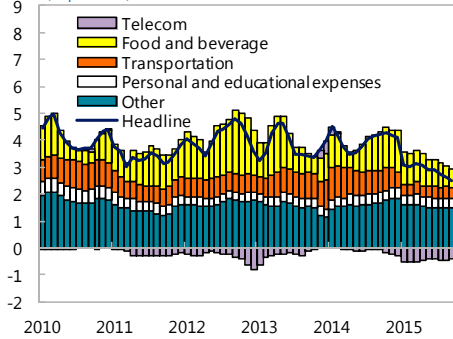


Sources: National authorities; Haver Analytics; and IMF staff calculations.

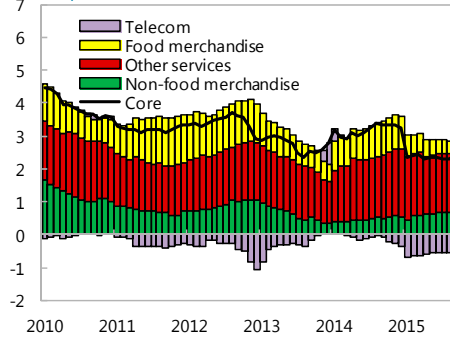
Figure 2. Mexico: Prices and Inflation

The drop in year-on-year headline and core inflation is due to a decline in the prices of telecom services and food, and a smaller change in administered fuel prices.

Contributions to Inflation
(In percent)

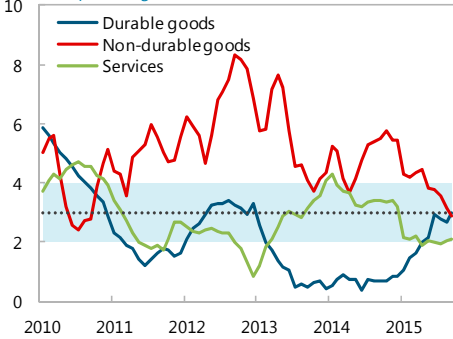


Contributions to Core Inflation
(In percent)



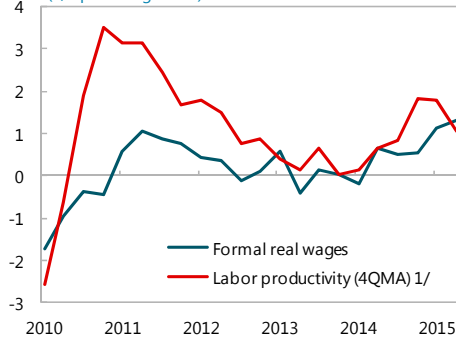
Durable goods prices (6 percent of CPI) are showing a modest pass-through from peso depreciation.

Inflation
(Y/Y percent growth)



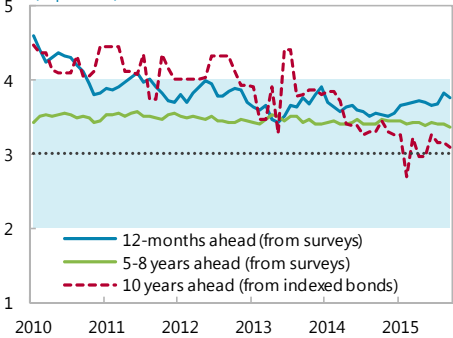
Formal real wage growth is broadly in line with productivity.

Real Wages and Labor Productivity
(Y/Y percent growth)



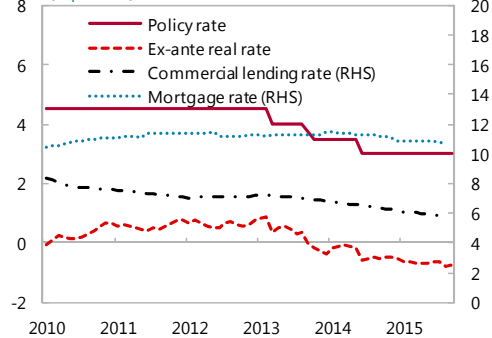
Medium-term inflation expectations remain well anchored.

Inflation Expectations
(In percent)



Lower policy rates have been followed by lower bank lending rates to corporates and to a lesser extent households.

Policy Rates and Lending Rates
(In percent)

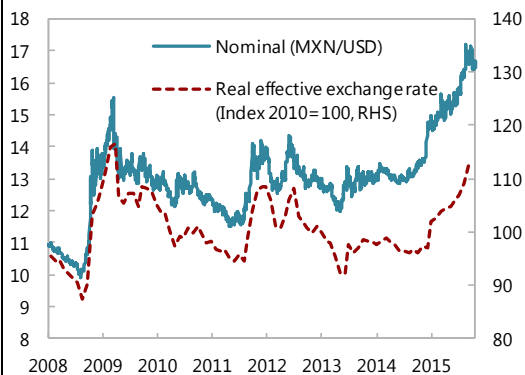


Sources: National authorities; and Haver Analytics.
1/ Based on hours worked.

Figure 3. Mexico: Financial Sector
(As of October 2015)

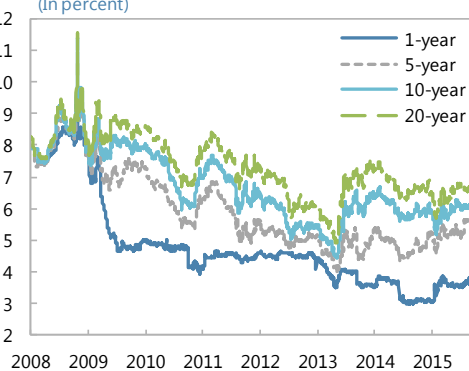
The peso has depreciated sharply vis-à-vis the U.S. dollar and in real effective terms.

Exchange Rate



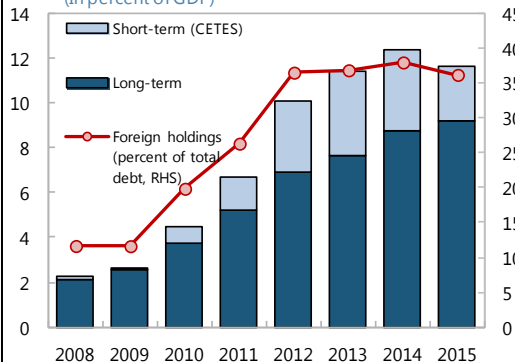
Nonetheless, government bond yields in local currency have increased only marginally since late 2014.

Local Government Bond Yields (In percent)



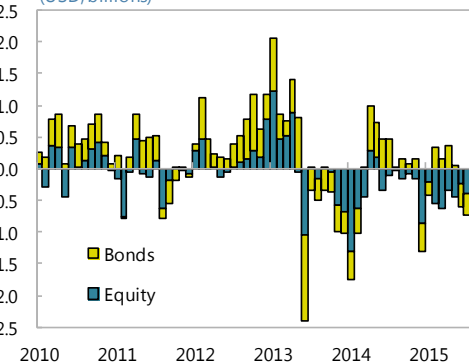
Foreign holdings of long-term debt continue to increase, although there have been outflows from short-term instruments...

Non-Residents' Holdings of Local Sovereign Debt (In percent of GDP)



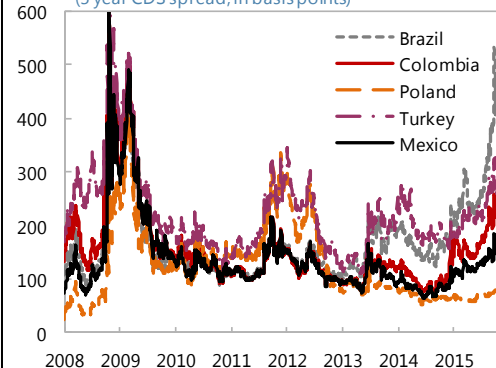
...mirrored by a decline in mutual fund flows to Mexico.

ETFs and Mutual Fund Flows (USD, billions)



Risk premiums on sovereign dollar-denominated debt...

Sovereign Risk Premiums (5 year CDS spread, in basis points)



...and corporate debt have increased, but remain lower than in most other countries.

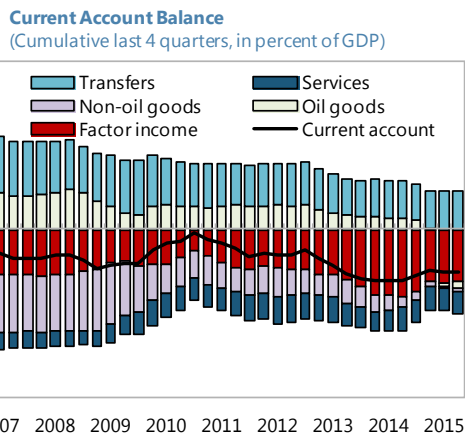
Corporate Risk Premia (CEMBI spread, in basis points)



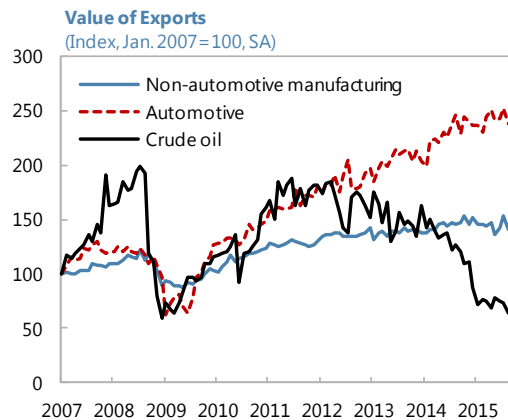
Sources: Bloomberg; National authorities; and Haver Analytics.

Figure 4. Mexico: External Sector

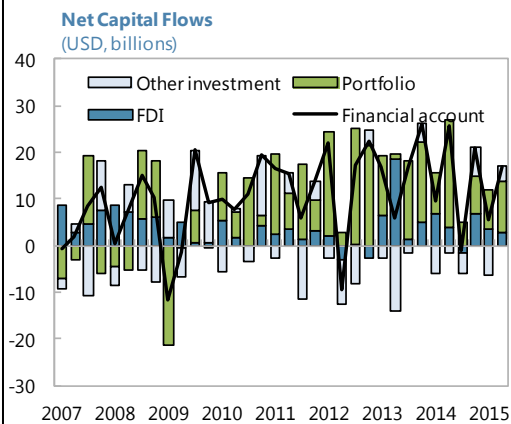
The current account deficit remains stable...



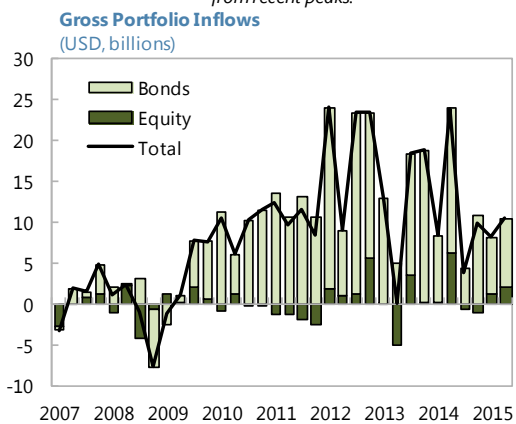
...with vibrant auto exports, stable non-auto manufacturing exports, and falling oil exports.



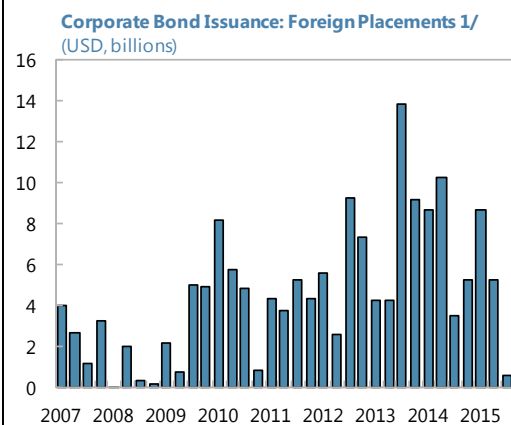
Net portfolio inflows remain robust...



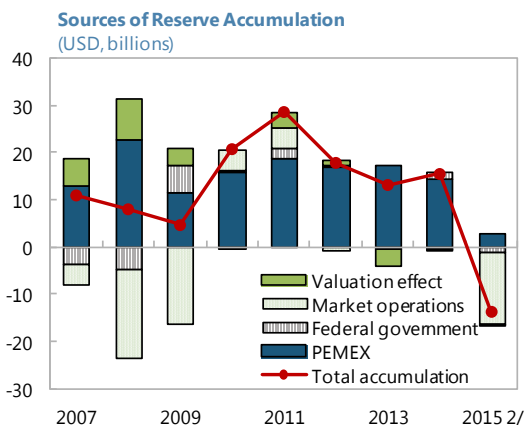
...although inflows into bond markets have come down from recent peaks.



Corporate bond issuance has remained strong.



Reserves have declined in 2015 due to FX intervention.



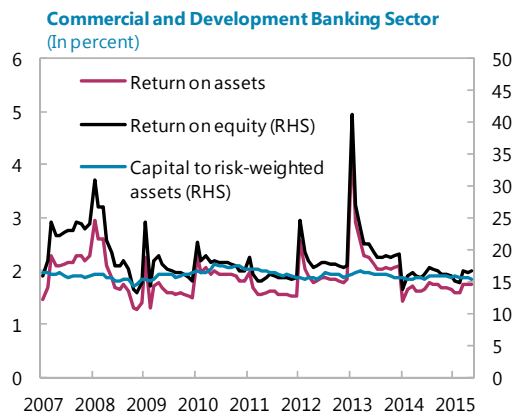
Sources: National authorities; Haver Analytics; Dealogic; and IMF staff calculations.

1/ Data through September 24, 2015.

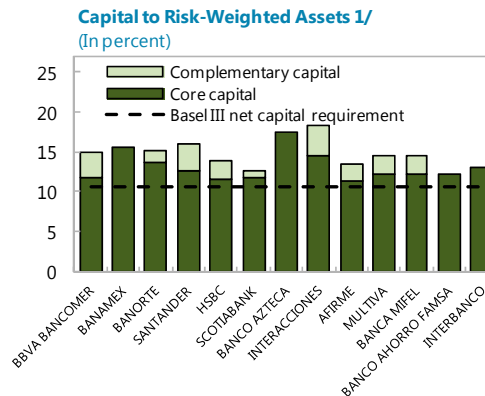
2/ Data through September 2015.

Figure 5. Mexico: Banking System

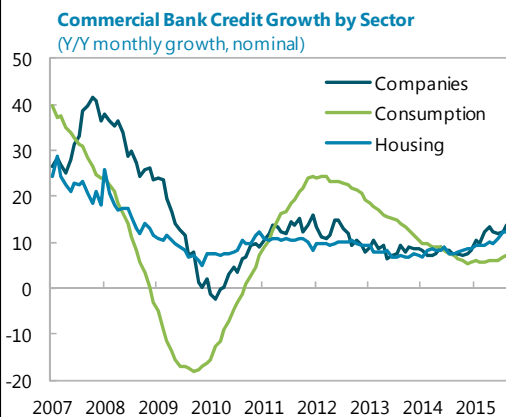
The banking sector remains profitable...



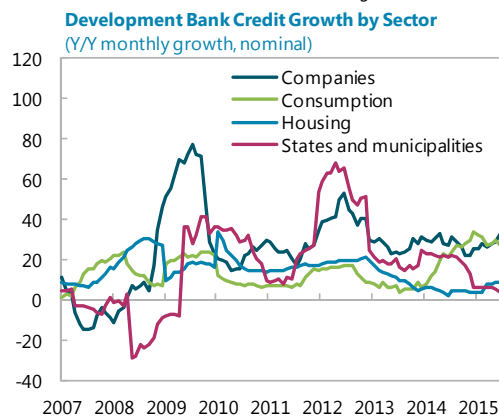
...and well capitalized.



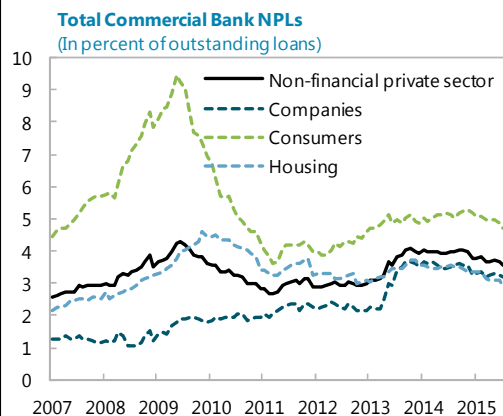
Commercial bank credit growth is picking up...



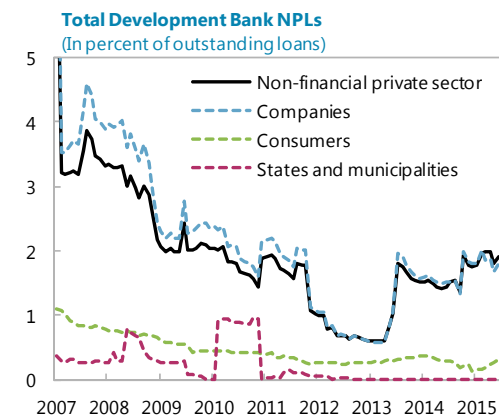
...and development bank credit growth to the private sector remains strong.



Non-performing loans at commercial banks are low...



...as are non-performing loans at development banks.

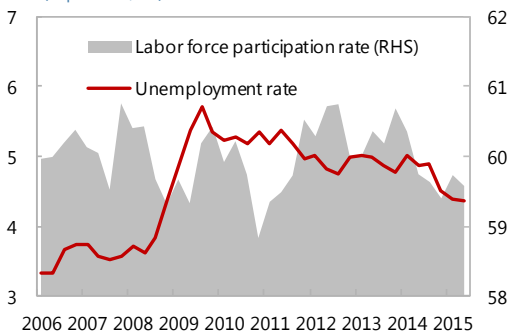


Sources: National authorities; Haver Analytics; Dealogic; Bloomberg; and IMF staff calculations.
1/As of July 2015.

Figure 6. Mexico: Labor Market Indicators

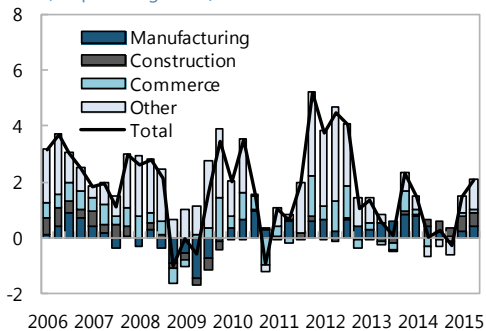
Unemployment has fallen to its lowest level since 2008, with a broadly steady labor force participation.

Unemployment Rate
(In percent, SA)



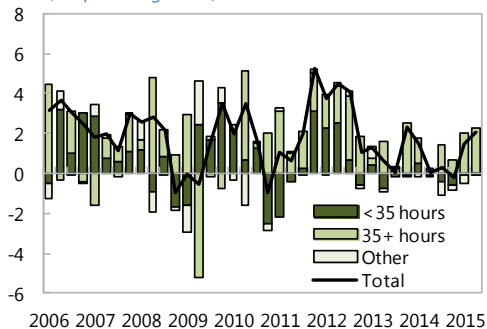
Job creation has resumed across all sectors...

Contributions to Employment Growth
(Y/Y percent growth)



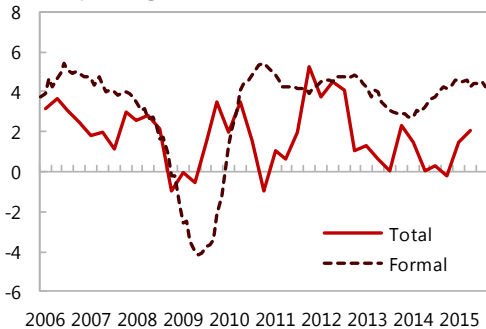
...dominated by full-time jobs...

Contributions to Employment Growth
(Y/Y percent growth)



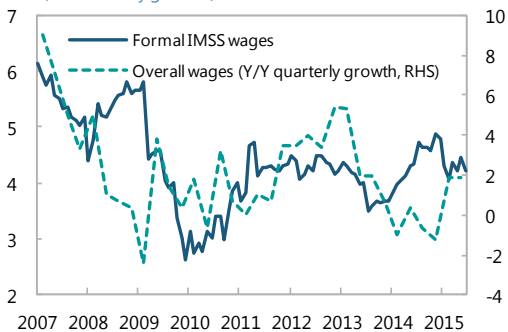
...in the formal sector...

Total and Formal Employment
(Y/Y percent growth)



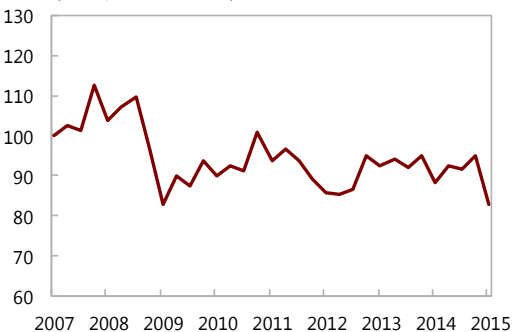
...keeping nominal wage growth steady.

Average Nominal Formal Wages
(Y/Y monthly growth)



Manufacturing unit labor costs have declined relative to main trading partners due to recent depreciation.

Unit Labor Cost Real Effective Exchange Rate
(Index, Jan. 2007=100)



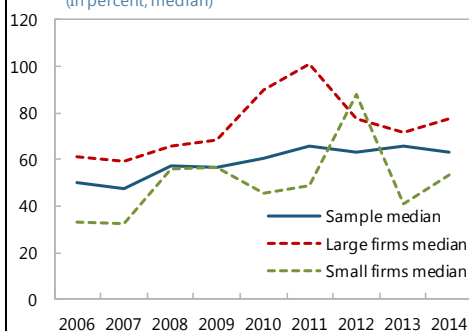
Sources: National authorities; Haver Analytics; and IMF staff calculations.

Figure 7. Mexico: Nonfinancial Corporate Sector Credit

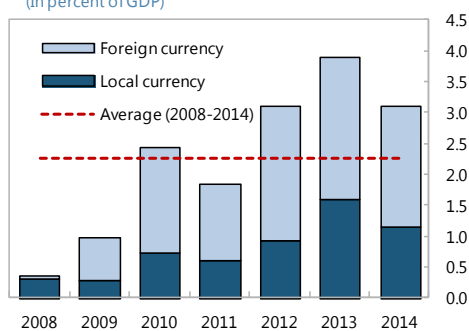
Corporate leverage has increased in recent years, though total debt remains low at about 30 percent of GDP.

Net bond issuance has been strong, especially in foreign currencies...

Total Debt to Equity
(In percent, median)



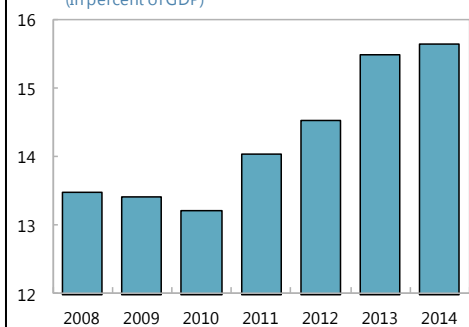
Net Issuance of Corporate Bonds 1/
(In percent of GDP)



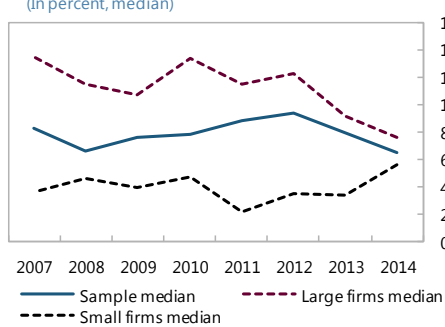
...and bank lending has increased steadily.

Profitability remains high, though it has declined in recent years among the larger firms.

Bank Lending to Nonfinancial Corporations
(In percent of GDP)



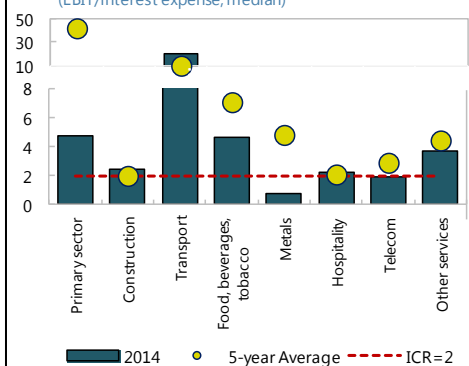
Nonfinancial Corporate Returns on Equity
(In percent, median)



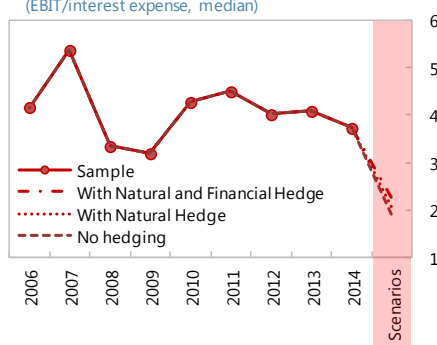
Debt-service capacity remains strong for most sectors...

...and stress tests show that firms are resilient to further exchange rate, earnings, and interest rate shocks.

Interest Coverage Ratio
(EBIT/interest expense, median)



Interest Coverage Ratio 2/
(EBIT/interest expense, median)



Sources: Bureau Van Dijk; Haver Analytics; and IMF staff calculations.

1/ This includes bonds issued by holding companies and their subsidiaries in domestic and international markets. PEMEX and CFE comprised one-third of total bonds issued during 2008-2014.

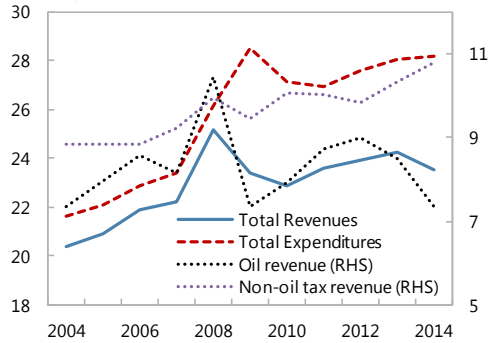
2/ The scenario assumes 30 percent depreciation of the peso against the U.S. dollar, 30 percent increase in borrowing costs, and 20 percent decline in earnings, applied to the end-2014 corporate balance sheet data. PEMEX and CFE are excluded.

Figure 8. Mexico: Fiscal Sector

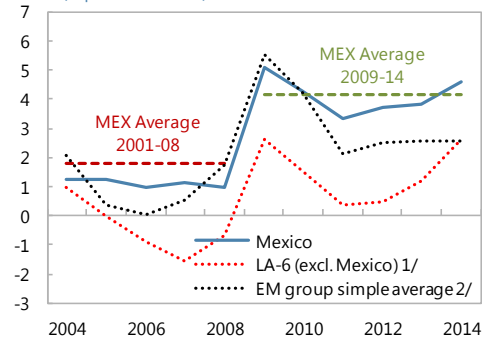
Increases in spending during the pre-crisis oil-boom have proven difficult to reverse, while oil revenues have declined...

...leaving a legacy of high public deficits...

Public Sector Revenues and Expenditures
(In percent of GDP)



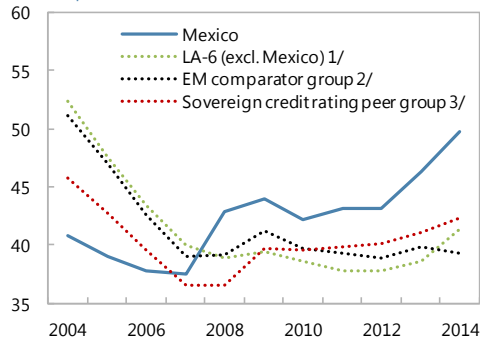
Overall Public Sector Deficit
(In percent of GDP)



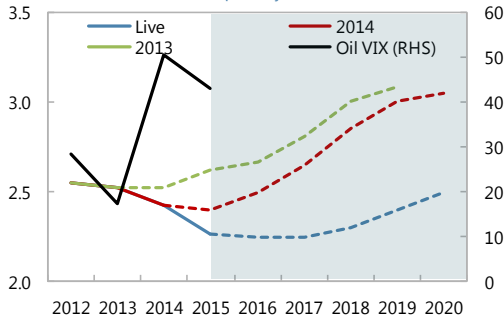
...and rising public debt.

Oil-related risks remain high, both in terms of prices and domestic production output.

Gross Public Sector Debt
(In percent of GDP)



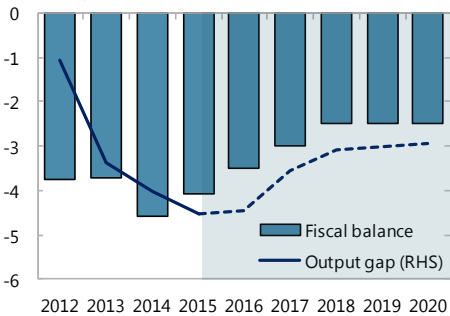
Oil Production Forecast Vintages and Oil VIX
(In millions of barrels per day)



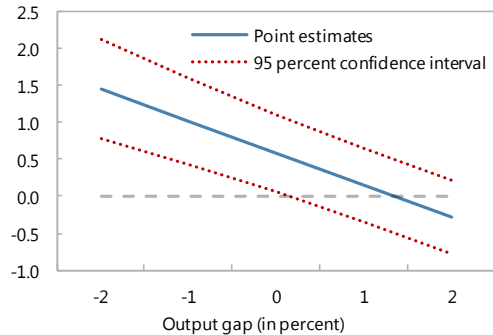
The planned fiscal consolidation should reverse these trends, helping to keep financing costs low.

The negative effects of the consolidation on growth should be manageable given relatively limited slack in the economy.

Fiscal Balance and Output Gap
(In percent of GDP)



Fiscal Spending Multipliers



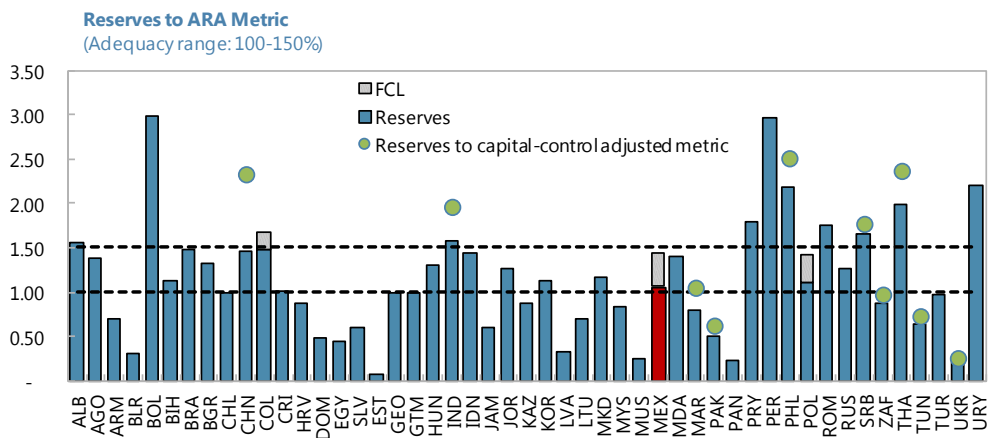
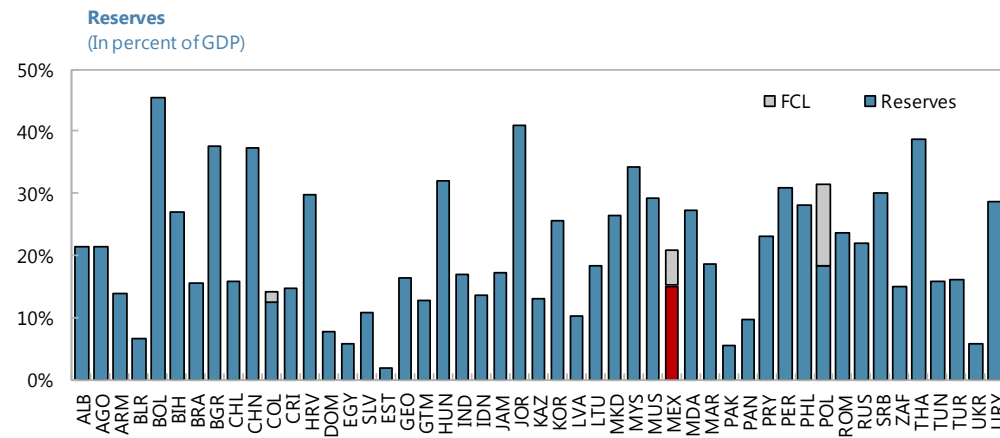
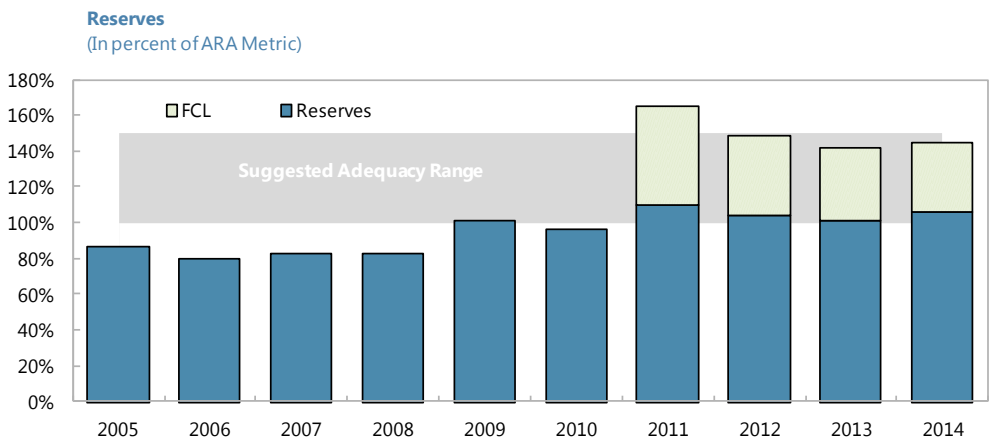
Source: National authorities; World Economic Outlook; Fitch Ratings; and IMF staff calculations.

1/ LA-6 excluding Mexico is comprised of Brazil, Chile, Colombia, Peru, and Uruguay.

2/ EM comparator group is comprised of India, Indonesia, Poland, Russia, Thailand, and Turkey.

3/ Fitch sovereign creditrating peer group includes Brazil, Chile, Colombia, India, Poland, Russia, South Africa, Thailand, and Turkey.

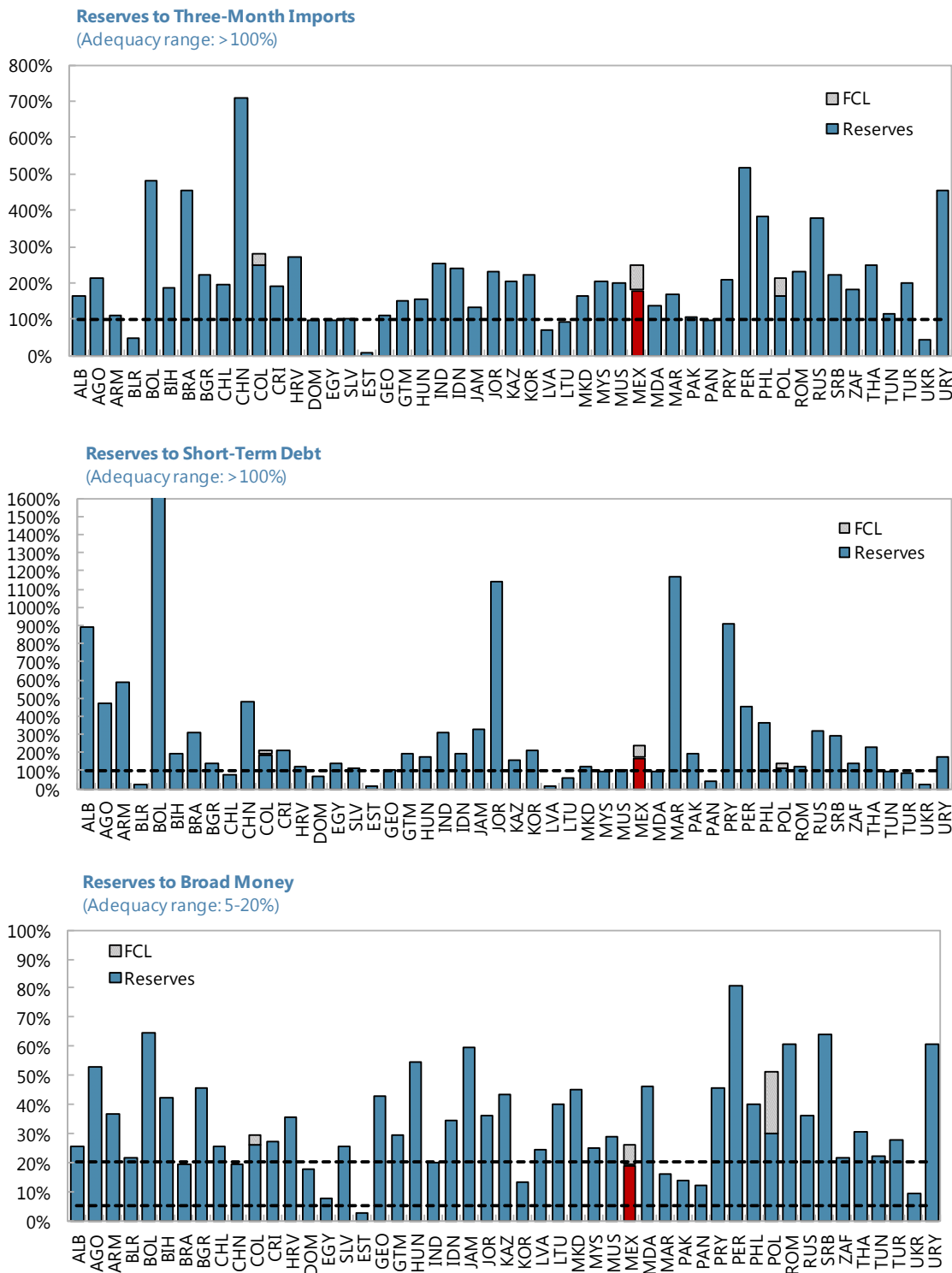
Figure 9. Mexico: Reserve Coverage in an International Perspective, 2014 1/



Sources: World Economic Outlook, Balance of Payments Statistics Database, and IMF staff estimates.

1/ The assessing reserve adequacy (ARA) metric for emerging markets comprises four components reflecting potential balance of payment drains: (i) export income, (ii) broad money, (iii) short-term debt, and (iv) other liabilities. The weight for each component is based on the 10th percentile of observed outflows from emerging markets during exchange market pressure episodes, distinguishing between fixed and flexible exchange rate regimes.

Figure 9. Mexico: Reserve Coverage in an International Perspective, 2014 (concluded)



Sources: World Economic Outlook, and IMF staff estimates.

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

I. Social and Demographic Indicators					
GDP per capita (U.S. dollars, 2014)	10,784	Poverty headcount ratio (% of population, 2012) 1/			45.5
Population (millions, 2014)	119.7	Income share of highest 20 percent / lowest 20 percent (2012)			11.1
Life expectancy at birth (years, 2013)	77.4	Adult illiteracy rate (2012)			5.8
Infant mortality rate (per thousand, 2013)	12.8	Gross primary education enrollment rate (2012) 2/			105.0
II. Economic Indicators					
	2012	2013	2014	Proj.	
				2015	2016
(Annual percentage change, unless otherwise indicated)					
National accounts (in real terms)					
GDP	4.0	1.4	2.1	2.2	2.5
Consumption	4.7	2.1	2.1	2.3	1.1
Private	4.9	2.3	2.0	2.4	2.1
Public	3.5	1.2	2.5	1.5	-5.1
Investment	5.9	-2.0	3.9	3.7	2.3
Fixed	4.8	-1.6	2.3	3.9	2.4
Private	9.0	-1.6	4.8	5.8	6.3
Public	-9.0	-1.3	-7.1	-4.8	-16.3
Inventories 3/	0.3	-0.1	0.4	0.0	0.0
Exports of goods and services	5.8	2.4	7.3	8.1	8.2
Imports of goods and services	5.5	2.6	5.7	5.6	6.8
External sector					
External current account balance (in percent of GDP)	-1.4	-2.4	-1.9	-2.3	-2.1
Exports of goods, f.o.b.	6.1	2.5	4.5	-3.2	7.6
Export volume	5.9	1.7	7.5	7.2	8.4
Imports of goods, f.o.b.	5.7	2.8	4.9	-2.0	6.9
Import volume	5.6	2.5	5.9	5.2	6.6
Net capital inflows (in percent of GDP)	4.4	5.2	4.3	1.7	2.2
Terms of trade (improvement +)	0.2	0.4	-1.9	-3.0	-1.0
Exchange rates					
Real effective exchange rate (CPI based, IFS)					
(average, appreciation +) 4/	-2.9	6.1	-1.0	-8.3	...
Nominal exchange rate (MXN/USD)					
(average, appreciation +) 5/	-6.0	3.0	-4.1	-18.9	...
Employment and inflation					
Consumer prices (average)	4.1	3.8	4.0	2.8	3.1
Core consumer prices (average)	3.4	2.7	3.2	2.3	3.0
Formal sector employment, IMSS-insured workers (average) 4/	4.6	3.5	3.5	3.7	...
National unemployment rate (annual average)	4.9	4.9	4.8	4.3	4.0
Unit labor costs: manufacturing (real terms, average) 4/	-2.6	1.0	0.0	1.1	...
Money and credit					
Financial system credit to non-financial private sector	10.9	9.1	8.5	9.8	11.4
Broad money (M4a) 6/	14.5	8.7	11.9	9.4	10.0
Public sector finances (in percent of GDP) 7/					
General government revenue	23.9	24.3	23.5	22.7	22.2
General government expenditure	27.7	28.0	28.1	26.8	25.7
Overall fiscal balance (public sector borrowing requirements)	-3.8	-3.7	-4.6	-4.1	-3.5
Gross public sector debt	43.2	46.4	49.8	51.9	52.0
Memorandum items					
Output gap	1.0	-0.2	-0.5	-0.8	-0.7

Sources: World Bank Development Indicators; CONEVAL; National Institute of Statistics and Geography; National Council of Population; Bank of Mexico; Secretariat of Finance and Public Credit; and IMF staff estimates.

1/ CONEVAL uses a multi-dimensional approach to measuring poverty based on a "social deprivation index," which takes into account the level of income; education; access to health services; to social security; to food; and quality, size, and access to basic services in the dwelling.

2/ Percent of population enrolled in primary school regardless of age as a share of the population of official primary education age.

3/ Contribution to growth. Excludes statistical discrepancy.

4/ 2015 based on data available through July 2015.

5/ 2015 based on data available through September 2015.

6/ Includes public sector deposits.

7/ Data exclude state and local governments and include state-owned enterprises and public development banks.

Table 2a. Mexico: Financial Operations of the Public Sector, Authorities' Presentation 1/

(In percent of GDP, except where noted)

	2011	2012	2013	2014	Staff Projections					
					2015	2016	2017	2018	2019	2020
Budgetary revenue, by type	22.5	22.5	23.6	23.2	22.7	22.2	22.2	22.4	22.4	22.5
Oil revenue	8.6	8.9	8.3	7.1	4.4	4.5	4.5	4.6	4.6	4.7
Non-oil tax revenue 2/	8.9	8.4	9.7	10.5	13.0	13.1	13.1	13.2	13.2	13.2
Non-oil non-tax revenue 3/	5.0	5.2	5.5	5.6	5.3	4.6	4.6	4.6	4.6	4.6
Budgetary revenue, by entity	22.5	22.5	23.6	23.2	22.7	22.2	22.2	22.4	22.4	22.5
Federal government revenue	15.9	15.7	16.8	16.8	17.4	16.6	16.7	16.7	16.8	16.7
Tax revenue, of which:	8.9	8.4	9.7	10.5	13.0	13.1	13.1	13.2	13.2	13.2
Excises (including fuel)	-0.5	-0.8	0.0	0.7	2.1	2.4	2.3	2.3	2.2	2.1
Nontax revenue	7.1	7.3	7.1	6.3	4.4	3.5	3.5	3.6	3.6	3.6
Public enterprises	6.5	6.8	6.8	6.4	5.3	5.6	5.6	5.6	5.7	5.7
PEMEX	2.7	3.0	3.0	2.6	1.9	2.3	2.2	2.3	2.3	2.4
Other	3.8	3.8	3.8	3.8	3.4	3.3	3.3	3.3	3.3	3.3
Budgetary expenditure	25.0	25.1	25.9	26.4	25.8	24.8	24.4	24.0	24.1	24.1
Primary	23.1	23.1	24.0	24.4	23.5	22.4	21.7	21.2	21.1	21.1
Programmable	19.7	19.9	20.6	20.8	19.7	18.8	18.1	17.6	17.5	17.4
Current	14.8	15.1	15.1	15.6	15.1	15.0	14.6	14.0	13.9	13.9
Wages	5.9	5.9	6.0	5.9	6.0	5.9	5.8	5.7	5.6	5.5
Pensions 4/	2.7	2.7	2.9	3.1	3.2	3.3	3.4	3.5	3.6	3.7
Subsidies and transfers	3.0	3.1	3.3	3.6	3.4	3.3	3.1	2.8	2.7	2.7
Other	3.2	3.3	3.0	3.0	2.6	2.5	2.2	2.0	2.0	2.0
Capital	4.8	4.7	5.4	5.2	4.6	3.7	3.6	3.6	3.6	3.6
Physical capital	4.5	4.4	4.6	4.8	4.1	3.6	3.5	3.5	3.5	3.5
Of which: Pemex	1.8	2.0	2.0	2.1	1.4	1.1	1.1	1.1	1.1	1.1
Financial capital 5/	0.4	0.4	0.9	0.4	0.5	0.2	0.1	0.1	0.1	0.1
Nonprogrammable	3.4	3.3	3.4	3.5	3.8	3.6	3.6	3.6	3.6	3.6
Of which: revenue sharing	3.3	3.2	3.3	3.4	3.6	3.4	3.5	3.5	3.5	3.5
Interest payments	1.9	2.0	2.0	2.0	2.3	2.5	2.7	2.8	3.0	3.0
Traditional balance	-2.5	-2.6	-2.3	-3.2	-3.1	-2.7	-2.2	-1.7	-1.7	-1.7
Adjustments to the traditional balance	1.0	1.2	1.4	1.4	1.0	0.8	0.8	0.8	0.8	0.8
Public sector borrowing requirements (PSBR)	-3.4	-3.8	-3.8	-4.6	-4.1	-3.5	-3.0	-2.5	-2.5	-2.5
Memorandum items										
Structural current spending 6/	11.3	11.3	11.6	12.2	11.8	11.6	11.4	11.3	11.2	11.0
Structural current spending real growth (y/y, in percent) 7/	7.1	3.3	1.4	7.8	0.2	1.8	1.8	2.0	2.0	2.0
Crude oil production (million barrels per day)	2.6	2.5	2.5	2.4	2.3	2.2	2.3	2.3	2.4	2.5
Crude oil export price, Mexican mix (US\$/bbl)	101	102	99	88	46	46	51	55	57	57
Structural Primary Fiscal Balance 8/	-1.5	-1.9	-1.7	-2.0	-1.5	-0.9	0.0	1.0	1.2	1.2
Gross public sector debt	43.2	43.2	46.4	49.8	51.9	52.0	52.2	51.8	51.2	50.5
Net public sector debt	37.5	37.7	40.4	43.4	45.5	45.6	45.8	45.4	44.8	44.1
Nominal GDP (billions of Mexican pesos)	14,550	15,627	16,116	17,161	18,254	19,533	20,694	21,969	23,423	25,041

Sources: Mexican authorities and IMF staff estimates.

1/ Data exclude state and local governments and include state-owned enterprises and public development banks.

2/ From 2015 onwards, in line with the 2015 Income Law, gasoline and diesel excises are classified as non-oil tax revenue.

3/ For 2015, it includes estimated inflows from the oil-price hedge for 107 billion pesos.

4/ Includes pensions and social assistance benefits.

5/ Due to lack of disaggregated data this item includes both financing and capital transfers.

6/ The 2014 amendment to the FRL introduced a cap on the real growth rate of structural current spending. The latter is defined as total budgetary expenditure, excluding: (i) interest payments; (ii) non-programable spending; (iii) cost of fuels for electricity generation; (iv) direct physical and financial investment of the federal government; and expenditure by state productive enterprises and their subsidiaries.

7/ The cap on structural current spending real growth was set at 2.0 percent for 2015 and 2016.

8/ Adjusting revenues for the economic and oil-price cycles.

Table 2b. Mexico: Financial Operations of the Public Sector, GFSM 2001 Presentation 1/

(In percent of GDP, except where noted)

	2011	2012	2013	2014	Staff Projections					
					2015	2016	2017	2018	2019	2020
Revenue 2/	23.7	23.9	24.3	23.5	22.7	22.2	22.2	22.4	22.4	22.5
Taxes	10.1	9.8	10.4	10.8	13.0	13.1	13.1	13.2	13.2	13.2
Taxes on income, profits and capital gains	5.3	5.1	5.9	5.7	6.6	6.5	6.5	6.6	6.7	6.7
Taxes on goods and services	4.3	4.3	4.1	4.7	6.0	6.2	6.2	6.2	6.2	6.2
Value added tax	3.7	3.7	3.5	3.9	3.9	3.9	3.9	3.9	4.0	4.0
Excises 2/	0.6	0.6	0.6	0.8	2.1	2.4	2.3	2.3	2.2	2.1
Taxes on international trade and transactions	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other taxes	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Social contributions	1.7	1.8	1.7	1.7	1.6	1.5	1.5	1.5	1.5	1.5
Other revenue	11.9	12.3	12.2	10.9	8.1	7.6	7.6	7.7	7.7	7.8
Property income 3/	7.0	7.2	7.0	6.3	4.3	3.5	3.5	3.5	3.5	3.5
Other	4.9	5.1	5.1	4.7	3.8	4.1	4.1	4.1	4.2	4.2
Total expenditure 2/	27.1	27.7	28.0	28.1	26.8	25.7	25.2	24.9	24.9	25.0
Expense	22.2	22.9	22.6	22.9	22.1	21.8	21.6	21.2	21.3	21.3
Compensation of employees	5.9	5.9	6.0	5.9	6.0	5.9	5.8	5.7	5.6	5.5
Purchases of goods and services	3.2	3.3	3.0	3.0	2.6	2.5	2.2	2.0	2.0	2.0
Interest 4/	2.4	2.5	2.5	2.6	2.8	3.0	3.2	3.5	3.6	3.7
Subsidies and transfers	4.2	4.6	4.0	3.8	3.4	3.3	3.1	2.8	2.7	2.7
o/w fuel subsidy	1.1	1.4	0.7	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Grants 5/	3.3	3.2	3.3	3.4	3.6	3.4	3.5	3.5	3.5	3.5
Social benefits 6/	2.7	2.7	2.9	3.1	3.2	3.3	3.4	3.5	3.6	3.7
Other expense 7/	0.5	0.6	0.9	1.0	0.5	0.4	0.4	0.2	0.2	0.3
Net acquisition of nonfinancial assets 8/	4.9	4.8	5.5	5.2	4.7	3.8	3.7	3.7	3.7	3.7
Gross Operating Balance	1.5	1.0	1.7	0.6	0.6	0.3	0.7	1.2	1.2	1.2
Overall Fiscal Balance (Net lending/borrowing)	-3.4	-3.8	-3.7	-4.6	-4.1	-3.5	-3.0	-2.5	-2.5	-2.5
<i>Primary net/lending borrowing</i>	-1.0	-1.2	-1.2	-2.0	-1.3	-0.5	0.2	1.0	1.1	1.2
Memo items:										
Oil revenue	8.6	8.9	8.3	7.1	4.4	4.5	4.5	4.6	4.6	4.7
Non-oil tax revenue	8.9	8.4	9.7	10.5	13.0	13.1	13.1	13.2	13.2	13.2
Non-oil non-tax revenue	5.0	5.2	5.5	5.6	5.3	4.6	4.6	4.6	4.6	4.6
Structural primary balance 9/	-1.5	-1.9	-1.7	-2.0	-1.5	-0.9	0.0	1.0	1.2	1.2
Gross public sector debt 10/	43.2	43.2	46.4	49.8	51.9	52.0	52.2	51.8	51.2	50.5
Net public sector debt 11/	37.5	37.7	40.4	43.4	45.5	45.6	45.8	45.4	44.8	44.1
Structural current spending 12/	11.3	11.3	11.6	12.2	11.8	11.6	11.4	11.3	11.2	11.0
<i>Structural current spending real growth (y/y, in percent) 13/</i>	7.1	3.3	1.4	7.8	0.2	1.8	1.8	2.0	2.0	2.0
Crude oil production (million barrels per day)	2.6	2.5	2.5	2.4	2.3	2.2	2.3	2.3	2.4	2.5
Crude oil export volume (million barrels)	488	460	434	417	425	401	403	422	458	497
Crude oil export price, Mexican mix (US\$/bbl)	101	102	99	88	46	46	51	55	57	57

Sources: Mexico authorities; and Fund staff estimates and projections.

1/ Data exclude state and local governments and include state-owned enterprises and public development banks.

2/ Revenue and expenditure figures differ from official data, because gasoline and diesel subsidies have been classified as expense in this table.

3/ For 2015, it includes estimated inflows from the oil-price hedge for 107 billion pesos, which are treated as revenues arising from an insurance claim.

4/ Interest payments differ from official data due to adjustments to account for changes in valuation and interest rates.

5/ Includes revenue sharing between federal government and state and local governments.

6/ Includes pensions and social assistance benefits.

7/ Includes Adefas and other expenses, as well as the adjustments to the "traditional" balance not classified elsewhere.

8/ This category differs from official data on physical capital spending due to adjustment to account for Pidiregas amortizations included in budget figures.

9/ Adjusting revenue for the economic and oil-price cycles.

10/ Corresponds to the gross stock of PSBR. It is calculated as the net stock of PSBR as published by the authorities, plus adjustments (to reflect additional public sector's liabilities not included in the headline official figures) plus public sector financial assets.

11/ Corresponds to the net stock of PSBR (i.e., gross stock net of public sector financial assets) as published by the authorities.

12/ The 2014 amendment to the FRL introduced a cap on the real growth rate of structural current spending. The latter is defined as total budgetary expenditure, excluding: (i) interest payments; (ii) non-programable spending; (iii) cost of fuels for electricity generation; (iv) direct physical and financial investment of the federal government; and expenditure by state productive enterprises and their subsidiaries.

13/ The cap on structural current spending real growth was set at 2.0 percent for 2015 and 2016, and equal to potential growth thereafter.

Table 3. Mexico - Central Government's Public Sector Financial Balance Sheet
(In billions of pesos)

	2009			2010			2011			2012			2013			2014
	Opening balance	Transactions	Other flows 1/	Opening balance	Transactions	Other flows 1/	Opening balance	Transactions	Other flows 1/	Opening balance	Transactions	Other flows 1/	Opening balance	Transactions	Other flows 1/	Opening balance
Net worth	....			....			....			....			....			....
Nonfinancial assets	....			....			....			....			....			....
Net financial assets	-4,063.4			-4,382.3			-4,813.2			-5,450.6			-5,890.8			-6,504.9
Financial Assets 2/	1,185.9	-209.9	-46.1	929.9	-47.7	-86.5	795.7	98.7	-59.5	834.9	94.0	-73.5	855.4	212.2	-101.5	966.1
Liabilities	5,249.3	103.5	-40.7	5,312.1	404.0	-107.2	5,608.9	487.7	188.8	6,285.5	596.1	-135.4	6,746.3	696.6	28.2	7,471.0
Memorandum items:																
Net financial worth (in % of GDP)	-33.2			-36.2			-36.2			-37.5			-36.6			-37.9
Financial assets (in % of GDP)	9.7			7.7			6.0			5.7			5.3			5.6
Liabilities (in % of GDP)	42.8			43.9			42.2			43.2			41.9			43.5
GDP nominal prices	12,257			12,094			13,282			14,550			16,116			17,161

Sources: Mexico authorities; and Fund staff estimates and projections.

1/ Includes exchange rate and various accounting adjustments.

2/ Liquid financial assets excluding those classified as financial assets with policy purposes by official authorities.

Table 4. Mexico: Summary Balance of Payments

	2012	2013	2014	Projections					
				2015	2016	2017	2018	2019	2020
	(In billions of U.S. dollars)								
Current account	-16.4	-30.5	-25.0	-26.7	-26.2	-30.1	-36.8	-37.4	-36.6
Merchandise goods trade balance	0.0	-1.2	-2.8	-7.5	-5.4	-8.0	-13.8	-14.1	-14.1
Exports	370.8	380.0	397.1	384.8	414.0	457.0	499.6	542.7	585.1
o/w Manufactures 1/	302.7	315.3	338.0	348.2	380.9	420.7	460.1	498.9	537.6
o/w Petroleum and derivatives	53.0	49.5	42.6	23.8	22.1	24.4	27.5	30.8	33.7
Imports	-370.8	-381.2	-400.0	-392.3	-419.3	-464.9	-513.4	-556.8	-599.2
o/w Petroleum and derivatives	-41.1	-40.9	-41.5	-29.8	-28.3	-31.7	-34.9	-37.0	-38.5
Net other goods 2/	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Net services	-14.6	-12.0	-13.9	-10.2	-12.7	-13.8	-15.0	-15.8	-16.2
Net factor income	-24.7	-39.2	-31.5	-33.5	-35.7	-39.6	-43.4	-47.3	-50.5
o/w Interest payments	-20.4	-23.3	-25.3	-29.8	-33.1	-38.8	-44.4	-49.4	-52.3
o/w Remitted profits	-8.3	-11.5	-4.0	-5.9	-5.9	-6.3	-6.2	-6.0	-6.7
o/w Reinvested earnings	-9.1	-15.7	-13.1	-9.5	-10.0	-10.1	-10.8	-11.4	-11.5
Net transfers (mostly remittances)	22.6	21.7	22.9	24.2	27.2	30.9	35.2	39.5	44.0
Financial Account	51.8	65.9	55.3	19.5	26.8	30.3	36.9	37.7	38.4
Foreign direct investment, net	-3.0	31.7	15.9	15.1	19.3	23.6	25.3	27.2	27.4
Direct investment into Mexico	19.5	44.9	24.2	22.1	26.7	31.4	33.5	35.9	36.6
Direct investment abroad	-22.5	-13.1	-8.3	-7.0	-7.4	-7.8	-8.2	-8.7	-9.3
Portfolio investment, net	71.5	48.2	45.2	20.4	23.0	28.9	26.9	30.1	30.1
Liabilities	80.0	50.3	45.9	22.9	25.6	31.7	29.7	33.1	33.3
Public Sector	56.9	33.2	36.0	14.0	13.5	20.7	21.7	23.1	25.2
o/w Local currency domestic-issued bonds	46.6	22.0	23.1	2.0	6.0	12.3	13.0	13.7	14.5
Private sector	23.1	17.1	9.9	8.8	12.1	11.0	8.0	10.1	8.1
Assets	-8.5	-2.1	-0.7	-2.4	-2.6	-2.7	-2.9	-3.0	-3.2
Other investments, net	-16.7	-14.1	-5.7	-16.1	-15.5	-22.2	-15.3	-19.6	-19.0
Liabilities	-10.4	13.2	15.2	-6.7	1.1	-4.1	3.8	0.6	2.6
Assets	-6.3	-27.3	-20.9	-9.4	-16.6	-18.1	-19.1	-20.2	-21.5
Errors and Omissions	-18.0	-17.6	-14.0	-10.0	0.0	0.0	0.0	0.0	0.0
Change in net international reserves	17.8	13.2	15.5	-17.2	0.6	0.2	0.1	0.3	1.9
o/w PEMEX-related transactions	16.9	17.3	10.0	0.0	0.0	0.0	0.0	0.0	1.6
o/w Market transactions (incl. interventions)	-0.6	0.0	-0.2	-24.5	0.0	0.0	0.0	0.0	0.0
Valuation adjustments	-0.3	4.6	0.8	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)								
Current account balance	-1.4	-2.4	-1.9	-2.3	-2.1	-2.3	-2.7	-2.6	-2.4
o/w Hydrocarbons trade balance 3/	1.0	0.7	0.1	-0.5	-0.5	-0.6	-0.5	-0.4	-0.3
o/w Petroleum and derivatives exports	4.5	3.9	3.3	2.1	1.8	1.9	2.0	2.1	2.2
o/w Non-hydrocarbons trade balance	-1.0	-0.8	-0.3	-0.1	0.1	0.0	-0.5	-0.5	-0.6
o/w Manufactures exports 1/	25.5	25.0	26.2	30.0	30.9	32.4	33.6	34.5	34.8
Net capital inflows	4.4	5.2	4.3	1.7	2.2	2.3	2.7	2.6	2.5
Net FDI inflows	-0.3	2.5	1.2	1.3	1.6	1.8	1.8	1.9	1.8
Net portfolio inflows	6.0	3.8	3.5	1.8	1.9	2.2	2.0	2.1	1.9
Net other investment inflows	-1.4	-1.1	-0.4	-1.4	-1.3	-1.7	-1.1	-1.4	-1.2
Memorandum items									
Hydrocarbons exports volume growth (in percent)	-5.7	-1.3	-4.9	2.6	-4.9	0.6	4.5	8.0	7.7
Non-hydrocarbons exports volume growth (in percent)	6.3	1.8	7.9	7.3	8.8	9.2	7.0	5.8	5.0
Hydrocarbons imports volume growth (in percent)	-3.1	3.4	-5.3	12.9	0.6	3.1	3.0	3.1	2.9
Non-hydrocarbons imports volume growth (in percent)	5.8	2.5	6.1	5.0	6.7	8.3	7.9	6.0	5.0
Crude oil export volume (in millions of bbl/day)	1.3	1.2	1.1	1.2	1.1	1.1	1.2	1.3	1.4
Gross international reserves (in billions of U.S. dollars)	167.1	180.2	195.7	178.5	179.1	179.3	179.4	179.6	181.5
Gross domestic product (in billions of U.S. dollars)	1,187	1,262	1,291	1,161	1,234	1,299	1,368	1,448	1,546
Sources: Bank of Mexico; Secretariat of Finance and Public Credit; and Fund staff projections.									
1/ Total exports are defined net of imports by the maquila sector. Correspondingly, total imports do not include maquila sector imports.									
2/ Goods procured in ports by carriers.									
3/ Oil, oil derivatives, petrochemicals and natural gas.									

Table 5. Mexico: Financial Soundness Indicators 1/

(In percent)

	2010	2011	2012	2013	2014	2015 2/
Capital Adequacy						
Regulatory capital to risk-weighted assets	16.9	15.7	15.9	15.6	15.5	15.3
Regulatory Tier 1 capital to risk-weighted assets	14.9	13.6	13.8	13.4	13.6	13.7
Capital to assets	10.4	9.9	10.6	10.4	10.8	10.5
Gross asset position in financial derivatives to capital	56.5	77.5	77.1	73.5	56.0	55.0
Gross liability position in financial derivatives to capital	55.6	79.6	76.1	72.7	59.6	57.3
Asset Quality						
Nonperforming loans to total gross loans	2.0	2.1	2.4	3.2	3.0	3.0
Provisions to Nonperforming loans	200.6	189.6	185.2	147.5	132.7	129.1
Earnings and Profitability						
Return on assets	1.8	1.5	1.8	2.1	1.7	1.7
Return on equity	16.8	15.5	17.5	19.3	15.9	16.5
Liquidity						
Liquid assets to short-term liabilities	58.2	55.3	49.5	47.7	47.1	46.6
Liquid assets to total assets	43.3	41.7	36.3	36.0	36.0	35.9
Customer deposits to total (noninterbank) loans	87.9	83.1	88.8	88.6	88.1	88.3
Trading income to total income	5.0	3.6	4.8	7.4	4.0	4.5
Sources: Financial Soundness Indicators						
1/ End of period, unless otherwise noted.						
2/ Data for end-May.						

Table 6. Mexico: Financial Indicators and Measures of External Vulnerabilities

	2008	2009	2010	2011	2012	2013	2014	2015	Latest available data
Financial market indicators									
Exchange rate (per U.S. dollar, average)	11.2	13.5	12.6	12.4	13.2	12.8	13.3	15.8	October
(year-to-date percent change, + appreciation)	-1.8	-21.4	6.5	1.7	-6.0	3.0	-4.1	-18.9	October
28-day treasury auction rate (percent; period average)	7.7	5.4	4.4	4.2	4.2	3.8	3.0	3.0	September
EMBIG Mexico spread (basis points; period average)	254	302	187	186	188	189	182	249	October
Sovereign 10-year local currency bond yield (period average)	8.4	8.0	7.0	6.8	5.7	5.6	6.0	5.9	October
Stock exchange index (period average, year on year percent change)	-9.8	-5.5	31.6	8.0	10.6	5.6	1.4	3.2	October
Financial system									
Bank of Mexico net international reserves (US\$ billion)	85.4	90.8	113.6	142.5	163.5	176.5	193.2	185.5	August
Financial system claims on non-financial private sector (year on year percent change)	3.7	7.8	17.3	15.8	15.0	14.6	8.7	11.1	July
Nonperforming loans to total gross loans	2.7	3.1	2.3	2.4	2.5	3.3	3.3	3.0	May
External vulnerability indicators									
Gross financing needs (billions of US\$)	76.0	77.5	68.8	103.5	108.6	149.1	163.7	130.2	Proj.
Gross international reserves (end-year, billions of US\$) 1/	95.2	99.9	120.6	149.2	167.1	180.2	195.7	182.0	September
Change (billions of US\$)	8.0	4.6	20.8	28.6	17.8	13.2	15.5	-13.8	September
Months of imports of goods and services	3.7	5.1	4.8	5.1	5.4	5.7	5.9	5.7	August
Percent of broad money	18.4	17.2	17.5	21.2	19.3	19.2	21.0	22.0	August
Percent of foreign portfolio liabilities	34.9	41.7	39.4	47.8	38.9	38.0	40.9	40.4	June
Percent of short-term debt (by residual maturity)	161.7	243.4	215.3	217.8	168.7	155.1	170.4	173.5	June
Percent of ARA Metric 2/	87.0	100.1	96.1	113.5	103.5	101.9	108.6	108.4	June
Percent of GDP	8.6	11.2	11.5	12.7	14.1	14.3	15.2	15.8	June
Gross total external debt (in percent of GDP)	18.2	21.2	23.2	24.0	28.9	31.0	32.8	34.3	June
<i>Of which:</i> In local currency	1.8	2.7	4.6	6.0	10.2	11.1	11.1	11.0	June
<i>Of which:</i> Public debt	11.7	13.1	14.7	15.6	20.4	21.4	22.3	23.8	June
<i>Of which:</i> Private debt	6.4	8.1	8.4	8.4	8.5	9.6	10.5	10.5	June
Financial sector	0.4	0.6	1.6	1.4	1.1	1.3	1.4	1.0	June
Nonfinancial sector	6.1	7.5	6.9	7.0	7.4	8.3	9.1	9.5	June
Gross total external debt (billions of US\$)	200.0	189.8	243.8	281.4	342.8	391.6	423.1	423.3	June
<i>Of which:</i> In local currency	19.6	24.0	48.5	69.8	121.2	140.3	143.9	135.5	June
<i>Of which:</i> Public debt	129.2	117.6	155.0	182.9	242.5	270.1	287.3	293.7	June
<i>Of which:</i> Private debt	70.7	72.3	88.8	98.6	100.3	121.5	135.8	129.6	June
Financial sector	4.1	5.0	16.4	16.0	12.6	16.5	17.8	12.8	June
Nonfinancial sector	66.6	67.3	72.4	82.5	87.7	104.9	117.9	116.9	June
External debt service (in percent of GDP)	5.8	8.6	5.7	6.8	8.0	10.2	11.6	13.0	Proj.
Sources: Bank of Mexico; National Banking and Securities Commission; National Institute of Statistics and Geography; Secretary of Finance and Public Credit; and IMF staff estimates									
1/ Excludes balances under bilateral payments accounts. For 2009, includes the allocation of SDR 2.337 billion in the general allocation implemented on August 28, 2009, and another SDR 0.224 billion in the special allocation on September 9.									
2/ The ARA metric was developed by the Strategy and Policy Review Department at the IMF to assess reserve adequacy. Weights to individual components were revised in December 2014.									

Table 7. Mexico: Baseline Medium-Term Projections

	2011	2012	2013	2014	Staff projections					
					2015	2016	2017	2018	2019	2020
(Annual percentage change, unless otherwise indicated)										
National accounts (in real terms)										
GDP	4.0	4.0	1.4	2.1	2.2	2.5	2.9	3.1	3.2	3.3
Consumption	4.5	4.7	2.1	2.1	2.3	1.1	1.3	2.1	2.5	2.6
Private	4.8	4.9	2.3	2.0	2.4	2.1	2.3	2.6	2.6	2.7
Public	2.4	3.5	1.2	2.5	1.5	-5.1	-5.8	-1.5	2.0	2.4
Investment	5.4	5.9	-2.0	3.9	3.7	2.3	6.6	7.0	5.2	4.8
Fixed	7.8	4.8	-1.6	2.3	3.9	2.4	6.8	7.2	5.4	4.9
Private	12.1	9.0	-1.6	4.8	5.8	6.3	8.2	8.0	5.9	5.3
Public	-4.1	-9.0	-1.3	-7.1	-4.8	-16.3	-1.8	2.1	2.1	2.4
Inventories 1/	-0.5	0.3	-0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	8.2	5.8	2.4	7.3	8.1	8.2	9.0	7.0	5.9	5.1
Oil exports	-4.6	-5.7	-1.3	-4.9	2.6	-4.9	0.6	4.5	8.0	7.7
Non-oil exports	8.8	6.3	2.5	7.7	8.3	8.6	9.2	7.0	5.8	5.0
Imports of goods and services	8.0	5.5	2.6	5.7	5.6	6.8	8.2	7.8	6.0	5.0
Oil imports	0.0	-3.1	3.4	-5.3	12.9	0.6	3.1	3.0	3.1	2.9
Non-oil imports	8.3	5.7	2.6	6.0	5.5	6.9	8.4	7.9	6.1	5.1
Net exports 1/	0.0	0.1	-0.1	0.5	0.9	0.6	0.4	-0.2	0.1	0.1
Consumer prices										
End of period	3.8	3.6	4.0	4.1	2.6	3.1	3.0	3.0	3.0	3.0
Average	3.4	4.1	3.8	4.0	2.8	3.1	3.0	3.0	3.0	3.0
External sector										
Current account balance (in percent of GDP)	-1.1	-1.4	-2.4	-1.9	-2.3	-2.1	-2.3	-2.7	-2.6	-2.4
Non-hydrocarbon current account balance (in percent of GDP)	-2.3	-2.4	-2.8	-2.0	-1.8	-1.6	-1.8	-2.2	-2.2	-2.1
Exports of goods, f.o.b.	17.1	6.1	2.5	4.5	-3.2	7.6	10.4	9.3	8.6	7.8
Imports of goods, f.o.b.	16.4	5.7	2.8	4.9	-2.0	6.9	10.9	10.4	8.5	7.6
Terms of trade (improvement +)	-0.4	0.2	0.4	-1.9	-3.0	-1.0	-1.1	-0.2	0.2	0.1
Crude oil export price, Mexican mix (US\$/bbl)	100.9	101.8	98.8	87.7	46.4	45.9	50.6	54.6	56.7	57.4
(In percent of GDP)										
Non-financial public sector										
Overall balance	-3.4	-3.8	-3.7	-4.6	-4.1	-3.5	-3.0	-2.5	-2.5	-2.5
Primary balance	-1.0	-1.2	-1.2	-2.0	-1.3	-0.5	0.2	1.0	1.1	1.2
Saving and investment 2/										
Gross domestic investment	22.3	23.1	21.7	21.8	22.7	23.1	24.3	25.6	26.5	27.3
Fixed investment	21.7	22.3	21.1	20.9	21.8	22.2	23.4	24.7	25.7	26.5
Public	5.2	4.6	4.3	4.0	3.7	3.1	3.0	3.0	3.0	3.1
Private	16.5	17.8	16.7	16.9	18.1	19.1	20.4	21.7	22.6	23.4
Gross domestic saving	21.1	21.7	19.3	19.9	20.4	21.0	21.9	22.9	23.9	24.9
Public	1.8	0.8	0.8	-0.6	-0.4	-0.4	0.0	0.5	0.5	0.6
Private	19.3	20.8	18.5	20.4	20.8	21.4	22.0	22.4	23.4	24.4
Memorandum items										
Financial system credit to non-financial private sector	14.3	10.9	9.1	8.5	9.8	11.4	11.0	11.2	11.9	12.1
Output gap	-0.4	1.0	-0.2	-0.5	-0.8	-0.7	-0.3	0.0	0.0	0.0

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

1/ Contribution to growth. Excludes statistical discrepancy.

2/ Reported numbers may differ from authorities' due to rounding.

Annex I. Risk Assessment Matrix¹

Potential Deviations from Baseline

Source of Risk	Up/Downside	Risk ²	Impact ²	Policy Response
Sharp asset price adjustment and decompression of credit spreads as investors reassess underlying risk, Fed policy rate path, and increases in U.S. term premiums.	↓	H	H	Exchange rate flexibility, and provision of liquidity to alleviate potential disorder in the government bond market.
Persistent dollar strength.	Both	H	M	Strengthens competitiveness, but may trigger financial instability. Maintain exchange rate flexibility, with temporary FX interventions to smooth excessive volatility.
Structurally weak growth in key advanced and emerging economies.	↓	M	H	Shocks to U.S. growth, including indirectly through slowing growth in other key economies, are particularly important. Steadfast implementation of structural reforms to increase competitiveness.
Risks to energy prices due to: (i) increased volatility or (ii) persistent low prices triggered by supply factors reversing only gradually and weaker demand.	↓	M	L	Exchange rate flexibility, continued use of financial hedges, maintaining energy reform momentum.
Slow implementation of the structural reforms, reducing the expected growth benefits.	↓	M	M	Ensure transparent and rules-based implementation; strengthen capacity-building in the new regulatory bodies.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

2/ Low (L), Medium (M), High (H).

Annex II. Mexico External Sector Assessment Report

	Mexico	Overall Assessment
Foreign asset and liability position and trajectory	<p>Background. Mexico's NIIP was -33 percent of GDP in 2014 (gross foreign assets and liabilities are 42 percent and 76 percent of GDP, respectively). Portfolio liabilities were 37 percent of GDP, of which around one third are holdings of local-currency government bonds. The ratio of NIIP to GDP is projected to remain steady over the medium term.</p> <p>Assessment. While the NIIP is sustainable, the large gross foreign portfolio liabilities holdings could be a source of vulnerability to global financial volatility.</p>	<p>Overall Assessment:</p> <p><i>In 2015, Mexico's external sector position is broadly consistent with medium-term fundamentals and desirable policy settings.</i></p> <p><i>The REER has depreciated sharply during the first nine months of 2015 and is assessed to be moderately undervalued. The undervaluation is likely to be temporary. The positive effects of the weaker exchange rate on the current account may materialize with a lag, and would be at least partially offset by lower net oil exports.</i></p> <p>The FCL provides an added buffer against global tail risks.</p> <p>Potential policy responses:</p> <p>As the external sector position is broadly consistent with medium-term fundamentals, there is no reason to alter the planned policy settings. The authorities have committed to reducing the public sector borrowing requirement from 4.6 percent of GDP in 2014 to 2.5 percent of GDP in 2018. The consolidation relies on a gradual increase in tax revenues related to the 2013 tax reform, rising fuel excises, and expenditure rationalization. At the same time private investment is expected to rise, counteracting the impact of rising public saving on the current account. The central bank set monetary policy to ensure that the inflation remains close to the</p>
Current account	<p>Background. In 2015, the current account deficit is projected to increase from 1.9 to 2.3 percent of GDP due to a weakening hydrocarbon trade balance. The cyclically-adjusted current account deficit is estimated to be 1.7 percent of GDP. Over the medium term, private investment related to the structural reforms is expected to rise, matched by greater public sector savings and a gradual increase in private savings as a result of higher oil production.</p> <p>Assessment. Mexico's CA appears to be broadly in line with the level consistent with medium term fundamentals and desirable policy settings. The EBA model estimates a cyclically-adjusted current account norm of -2.3 percent in 2015, implying a positive CA gap of 0.6 percent of GDP in 2015 (reflecting in part the upward influence on the CA norm of fiscal policies of other countries). The staff assessment is similar, with a gap between 0 and 1 percent of GDP.</p>	
Real exchange rate	<p>Background. As of September 2015, the REER has depreciated by 15 percent relative to the average 2014 value. The depreciation can be explained in part by temporary overshooting, reflecting the sharp appreciation of the U.S. dollar vis-à-vis most currencies and the high volatility in emerging market asset prices, and, to a lesser extent, by weaker growth prospects related to lower-than-previously expected investment and production in the domestic oil sector. The floating exchange rate has been a key shock absorber in an unsettled global environment.^{1/}</p> <p>Assessment. The EBA level REER regression estimates a moderate undervaluation of 8 percent in 2015, consistent with the EBA estimate of a small positive current account gap. The index approach yields higher undervaluation (18 percent). Staff puts less weight on the index approach as it has shown the peso to be persistently undervalued for the last 8 years. Considering all the estimates, and the uncertainties around them, staff assesses Mexico's real effective exchange rate to be moderately weaker than the level that would be consistent with fundamentals (with a gap ranging from -3 to -12 percent).</p>	
Capital and financial accounts: flows and policy measures	<p>Background. During 2010-14, a large share of capital inflows has gone into purchases of locally-issued government paper and other portfolio investments. Going forward, the structural reforms are expected to lead to higher FDI, while portfolio inflows into government paper are likely to slow down.</p> <p>Assessment. While the rising local currency share and long duration of sovereign debt reduce the exposure of government finances to depreciation risks, the strong presence of foreign investors leaves Mexico exposed to a reversal of capital flows and an increase in risk premiums. The authorities have refrained from capital flow management measures, in line with their view that an open capital account reduces policy uncertainty and supports long-term growth. Capital flow risks should also be mitigated by the prudent macroeconomic policies.</p>	

	Mexico (concluded)	
FX intervention and reserves level	<p>Background. The central bank remains committed to a floating exchange rate, using intervention occasionally to prevent disorderly market conditions.^{2/} The central bank usually builds up reserves through purchases of the net foreign currency proceeds of the state oil company. In 2015, FX reserves are expected to decline due to the dollar auctions.^{3/}</p> <p>Assessment. The current level of foreign reserves is adequate for normal times according to a range of reserve coverage indicators. The Fund FCL arrangement has been an effective complement to international reserves against global tail risks.</p>	3 percent target. The authorities have a flexible exchange rate policy, and use foreign exchange intervention occasionally to prevent disorderly market conditions.
Technical Background Notes	<p>1/ Following the tapering announcement by then Federal Reserve Chairman Bernanke in May 21, 2013, Mexico's currency experienced one of the sharpest depreciations across emerging markets, falling by nearly 8.4 percent by end-June 2013, but followed by a rapid recovery.</p> <p>2/ Since December 8, 2014, the Bank of Mexico has operated a rule-based intervention mechanism, in which up to USD 200 million are auctioned whenever the peso loses more than 1.5 percent (lowered to 1 percent since July 30) of its value compared to the previous session's official exchange rate. A similar program had been in place before April 2013.</p> <p>3/ Since March 11, 2015, the Bank of Mexico has auctioned USD 52 million daily (raised to USD 200 million since July 30). This program is set to expire at end-November.</p>	



MEXICO

October 23, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The Western Hemisphere Department

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FUND RELATIONS

(As of September 2015)

The 2015 Article IV discussions were held in Mexico City during September 17–30. The staff team comprised Dora Iakova (head), Alexander Klemm, Fabian Valencia (all WHD); Julian Chow (MCM); Isabel Rial (FAD); Juliana Araujo (SPR), and Marcos Chamon (RES). A. Herman (WHD) contributed from headquarters. Robert Rennhack participated in the concluding meetings. The mission met with the Deputy Minister of Finance, the Governor of the Bank of Mexico, senior staff of several government ministries and agencies, representatives of regulatory agencies, and private sector representatives. Messrs. Carlos Hurtado and Gerardo Zúñiga (OED) attended most meetings.

Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4. Comprehensive economic data are available for Mexico on a timely basis. It subscribes to the SDDS, and economic data are adequate to conduct surveillance.

Membership Status: Joined December 31, 1945

General Resources Account:	SDR Million	Percent of Quota
Quota	3,625.70	100.00
Fund holdings of currency	2,997.65	82.68
Reserve position in Fund	628.09	17.32
New Arrangement to Borrow	491.79	

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	2,851.20	100.00
Holdings	2,718.71	95.35

Outstanding Purchases and Loans: None

Latest Financial Arrangements

Type	Arrangement Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
FCL	Nov 26, 2014	Nov 25, 2016	47,292.00	0.00
FCL	Nov 30, 2012	Nov. 29, 2014	47,292.00	0.00
FCL	Jan 10, 2011	Nov 29, 2012	47,292.00	0.00
FCL	Mar 25, 2010	Jan 09, 2011	31,528.00	0.00
FCL	Apr 17, 2009	Mar 24, 2010	31,528.00	0.00

Projected Payments to the Fund (SDR million):

	2015	2016	Forthcoming 2017	2018	2019
Principal					
Charges / Interest	0.02	0.11	0.11	0.11	0.11
Total	0.02	0.11	0.11	0.11	0.11

Exchange Rate Arrangement: Mexico has a free floating exchange rate regime since November 2011. Mexico maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on November 7, 2014. The relevant staff report was IMF Country Report No. 14/319.

Technical Assistance

Year	Dept.	Purpose
2015	STA	Balance of Payments
2015	FAD	Supervision of Subnational Finances
2014	FAD	Tax Policy and Compliance
2014	STA	Sectoral Balance Sheets
2014	STA	National Accounts
2014	STA	Balance of Payments
2013	MCM	Post-FSAP Follow Up
2012	FAD	Pension and Health Systems
2012	FAD	Treasury
2012	FAD	Tax Regimes for PEMEX
2011	FAD	Custom Administration
2011	FAD	Tax Policy
2010	FAD	Fiscal Risks Management
2010	FAD	Treasury
2010	LEG	AML/CFT Risk Based Supervision
2009	STA	National Accounts
2009	FAD	Fiscal Framework
2009	LEG	AML/CFT Risk Based Supervision

Resident Representative: None

RELATIONS WITH THE WORLD BANK AND BANK-FUND COLLABORATION UNDER THE JMAP

A. Relations with the World Bank

Mexico has had a longstanding partnership with the World Bank Group. The Country Partnership Strategy (CPS) FY14–19—which was jointly prepared with the Government of Mexico—focuses on the World Bank Group’s twin goals (ending extreme poverty and promoting shared prosperity) and is fully aligned with the Mexico’s National Development Plan (NDP) for 2013–18. It describes the Bank’s engagement with Mexico as a partnership to achieve development results through selective and tailored packages of financial, knowledge, and convening services. IBRD lending has remained an important part of this engagement throughout the years.

As a member of the OECD and the G20, Mexico has maintained economic stability through times of recent crisis, and increased economic and social well-being over the last two decades. Mexico’s exposure to the IBRD increased with the onset of the global financial crisis as lending surged to US\$10.6 billion in FY10–12. As of August 2015, the World Bank’s exposure was US\$14.6 billion which has positioned Mexico as the second largest borrower in the world in terms of IBRD debt outstanding. The increase of the Single Borrower Limit up to US\$19.0 billion provides the Bank with further financial space to support Mexico’s efforts in achieving its development agenda.

The active portfolio consists of 13 IBRD projects and 7 GEF operations for a net commitment of US\$2.4 billion and an undisbursed balance of US\$1.5 billion. In FY15, the World Bank approved US\$850 million in 3 loans to support Mexico in the areas of social protection and the education sector. For FY16 the pipeline includes 3 operations supporting projects in energy efficiency, access to finance and solid waste.

B. Bank-Fund Collaboration Under the JMAP

The Bank and Fund teams have discussed the following priorities:

- A well-funded and effective government. Increasing transparency, operational efficiency and progressivity of public expenditures, improving public sector performance through better budget and financial management as well as a systemic coverage and mitigation strategy of fiscal risks are some other areas that require additional attention.
- Comprehensive reforms to boost productivity and potential output growth. To increase productivity and assure that such gains are widespread, focus should be placed on policies and programs that foster sound financial sector development generate a competitive business environment, foster innovation and upgrade infrastructure.

- Social protection. Mexico's social security, social assistance and labor market programs face important equity and efficiency challenges due to fragmentation, weak design and coverage gaps. Reforms are needed to build a more inclusive, effective and integrated social protection system that provides protections from income shocks and helps smooth consumption over the life cycle with due attention for their impact on the labor market.
- Climate change and environmental protection. Increasing risks posed by climate change and the cost of environmental degradation highlight the importance of efforts to reduce Mexico's environmental and carbon footprint of growth, including in areas such as energy efficiency and renewable energy, water management, urban planning, solid waste and natural resource use.

STATISTICAL ISSUES

Data provision is adequate for surveillance. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). In a number of cases, the periodicity and timeliness of disseminated data exceed SDDS requirements. A data ROSC update was completed on June 24, 2015 and was published as IMF Country Report No. 15/176. There are various areas where improvements could be made, as detailed below. The authorities are aware of this situation and are continuing work in this regard.

The national accounts statistics generally follow the recommendations of the *System of National Accounts, 2008 (2008 SNA)*. Source data and statistical techniques are sound and most statistical outputs sufficiently portray reality. A broad range of source data are available, with economic censuses every five years and a vast program of monthly and annual surveys. For most surveys, scientific sampling techniques are used. Nonetheless, most samples exclude a random sample of small enterprises. Some statistical techniques need enhancement. For example, taxes and subsidies on products at constant prices are estimated by applying the GDP growth rate, a deviation from best practice.

During 2014 STA conducted a reassessment of the data module of the ROSC that covered national accounts. As compared with the 2010 ROSC, the reassessment was based on the newest (May 2012) vintage of the Data Quality Assessment Framework (DQAF) and against those specified in the Special Data Dissemination Standard (SDDS). The data ROSC reassessment found that national accounts statistics are generally of a high quality, adequate to conduct effective surveillance and adequately meet users' needs. Since 2010, Mexico has made significant improvements on the methodological and dissemination aspects of data quality. Nevertheless, areas for further improvement and refinement exist, in particular, on the resources devoted to collecting state and local government source data and seasonally-adjusted data, explaining data revisions, and on compiling data on changes in inventories and on the volume of taxes on products.

INEGI has published annual sectoral accounts and balance sheets following the System of National Accounts 2008 (2008 SNA) classifications of assets and sectors for the period 2003–2012 in November 2013. These accounts were revised recently and published on June 30, 2014. STA

conducted a mission during 2014 to assess the possibility for developing quarterly sectoral accounts and balance sheets and agreed with the Mexican authorities on a work plan for developing these accounts. INEGI and Banxico agreed to collaborate in the compilation of quarterly stocks and flows of financial assets and liabilities by institutional sectors.

The concepts and definitions for both the CPI and PPI meet international standards. The PPI is only compiled by product and not by economic activity. A ROSC mission on prices was conducted in November 2012.

Although some items 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.¹ Several measures to improve external debt statistics have been carried out, including the compilation of data on external liabilities of the private sector and 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). In 2014, STA conducted a technical assistance on external sector statistics. The main purpose of the mission was to assist the balance of payment statistics compilers in further strengthening their data collection and compilation system for external sector statistics. In particular, the mission focused on foreign direct investment, financial derivatives, bank accounts used in foreign exchange operations, capital account, and financial intermediation services indirectly measured. The mission also assisted in addressing specific issues related to the adoption of the methodology of the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6).

The authorities compile fiscal statistics following national concepts, definitions, and classifications that make international comparison difficult. The statistics are comprehensive and timely, except for states and municipalities. The new government accounting law mandates accounting standards that follow international standards for all levels of government, and that take into account the information needs of international organizations and national accounts. A full adoption of uniform accounting standards at the sub-national level will be crucial to obtain a precise measure of public fixed investment in national accounts, among others.

The authorities are committed to reporting government financial statistics in GFSM 2001 format, as well as data for the GFS Yearbook.

The methodological foundations of monetary statistics are generally sound. However, the recording of financial derivative and, to a lesser extent, repurchase agreements transactions are overstating the aggregated other depository corporations (ODC) balance sheet and survey. Availability of data on other financial intermediaries such as insurance companies and pension funds allow for the

¹ Since the release of the balance of payments figures for the second quarter of 2010 (August, 25, 2010), Banco de Mexico has been publishing a new format that follows the guidelines of the Fifth edition of the Balance of Payments Manual.

construction of a financial corporation's survey with full coverage of the Mexican financial system, which is published on a monthly basis in International Financial Statistics.

Mexico is reporting Financial Soundness Indicators (FSIs) for Deposit Takers on a monthly basis.

Mexico: Table of Common Indicators Required for Surveillance								
As of Oct. 13, 2015								
		Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Data Quality-Methodological Soundness ⁸	Data Quality Accuracy and Reliability ⁹
Exchange Rates		Oct. 2015	Oct. 2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹		Sep. 2015	Sep. 2015	M	M	M		
Reserve/Base Money		Sep. 2015	Sep. 2015	W	W	W	LO, O, O, LO	LO, O, O, O, O
Broad Money		Aug. 2015	Aug. 2015	M	M	M		
Central Bank Balance Sheet		Sep. 2015	Sep. 2015	W	W	W		
Consolidated Balance Sheet of the Banking System		Aug. 2015	Aug. 2015	M	M	M		
Interest Rates ²		Oct. 2015	Oct. 2015	D	D	D		
Consumer Price Index		Sep. 2015	Sep. 2015	Bi-W	Bi-W	Bi-W	O, O, LNO, O	LO, LNO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing ³ -Gen. Government ⁴		Aug. 2015	Aug. 2015	M	M	M	LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ -Central Government		Aug. 2015	Aug. 2015	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵		Aug. 2015	Aug. 2015	M	NA	M		
External Current Account Balance		Q2 2015	Q2 2015	Q	Q	Q	LO, LO, LNO, LO	LO, O, O, O, LO

Exports and Imports of Goods and Services		Aug. 2015	Aug. 2015	M	M	M		
GDP/GNP		Q2 2015	Q2 2015	Q	Q	Q	O, O, O, LO	LO, O, LO, LO, O
Gross External Debt		Q2 2015	Q2 2015	Q	Q	Q		
International Investment Position ⁶		Q1 2015	Q1 2015	Q	Q	Q		

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

⁸ Reflects the assessment provided in the data ROSC completed on July, 2014, except consumer prices which is based on the ROSC completed on 2012. For the dataset corresponding to the variable in each row, the assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁹ Same as footnote 8, except referring to international standards concerning source data, assessment and validation of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.



MEXICO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

October 23, 2015

Prepared By

Staff of the International Monetary Fund

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PUBLIC DEBT SUSTAINABILITY ANALYSIS

Public debt is expected to remain sustainable given projected increases in interest rate costs and a moderate recovery of the economy in the medium term. Under the baseline, the public debt-to-GDP ratio is forecast to decline to about 50 percent by 2020 from the current level of 52 percent. Gross financing needs are about 11 percent of GDP in 2015, declining to 9 percent at the end of the forecasting period. The DSA suggests that public debt is sustainable under various shocks. A negative and sustained growth shock represents the major risk to the debt outlook. Even under such scenario gross debt remains slightly below 60 percent of GDP, without showing signals of an explosive trajectory. The impact of other shocks is smaller given that Mexico's debt structure results in a relatively low direct interest and exchange rate pass-through to the budget. The public debt profile indicators are below early warning benchmarks. The main risks arise from the large share of debt held by non-residents—about 52 percent of total debt.

A. Comparison Previous Assessment

The baseline debt projection has increased slightly relative to last year's DSA (2014 Mexico staff report). Gross public debt is 3 percentage points higher in 2015 relative to previous projections (from 48.9 to 51.9 percent to GDP) and 1.6 percentage points higher by the end of the projection period. Main factors explaining the different debt path are:

- **Higher primary deficit in the initial period, and stronger consolidation thereafter.** The primary deficit for 2014 was 0.4 percentage points higher than originally expected. This is partially compensated by stronger consolidation efforts starting in 2015 (i.e., a primary deficit of 1.3 compared to 1.4 in the previous DSA).
- **Worse growth prospects for the whole projection period.** The real GDP growth path is lower compared to last year's projection over the whole projection period.
- **Higher peso depreciation in the initial period.** While the previous DSA assumed a peso depreciation of 2.6 percent in 2014 and 0.9 percent thereafter, the current projections include a higher actual depreciation in 2014 (4.1 percent), and a significantly higher depreciation rate for 2015 (18.6 percent).
- **Worse financing conditions.** The cost of financing increased relative to previous assessment. Although Mexico's sovereign yields remain low, they increased from 173 in 2014 to 293 in 2015.¹

B. Baseline and Realism of Projections

- **Debt-levels.** As a result of the planned fiscal consolidation, gross debt levels are projected to decline from a peak of 52 percent of GDP in 2016 to about 50 of GDP by 2020. Staff projects that

¹ As of August 25, 2015.

gross financing needs will be 10.8 percent of GDP in 201 (similar to the previous year), and will decrease to 8.7 percent of GDP by 2020.

- **Growth.** Mexico's debt dynamics are highly sensitive to surprises in GDP growth, as indicated by the response to growth shocks under the DSA stress tests. The median forecast error for real GDP growth is low and in line with other emerging countries. There is no evidence of a systematic projection bias in the baseline assumption for growth that could undermine the DSA assessment. Current output growth projections at 2.2 percent for 2015 are in line with official estimates.²
- **Sovereign yields.** Despite the volatility observed in most emerging markets in recent months, Mexico's sovereign yields remain low, with the 10-year local currency bond yield at around 6 percent as of September 3, 2015. The spread with U.S. government bonds yields of the same maturity has remained on average at 380 basis points for the last three months. Spreads on foreign currency-denominated bonds have increased by about 80 basis points since last December. The local-currency sovereign yield curve has shifted up, but only slightly. Given the upward projections for the US Libor rates over the medium-term, the effective nominal interest rate on Mexico's sovereign debt is projected to rise from 6.1 percent in 2014 to 7.6 percent by 2020.
- **Fiscal adjustment.** In the baseline projection, the structural primary balance (adjusted by the cycle and oil prices) improves between 2015 and 2020. On the revenue side, the consolidation effort is driven by higher non-oil revenues that follow from the effects of the 2013–14 tax and energy reforms. Higher non-oil revenues more than compensate for the fall in oil revenues related to lower international oil prices and lower domestic production of crude oil. On the spending side, projections assume compliance with the structural spending rule,³ as well as some savings from the 2015 cuts and the zero-based budgeting exercise in 2016. Considering the distribution of fiscal adjustment episodes provided in the DSA template, and pre-2009 Mexican evidence, the projected 3-year adjustment of the structural primary balance of 1.5 percent of GDP seems feasible.
- **Maturity and rollover risks.** Given current debt structure (average maturity close to 8 years, 82 percent share of government securities at fixed interest rates, and only 24 percent of debt denominated in foreign currency), the immediate effect of interest rate changes on the budget is very low. The long maturity structure also reduces rollover risks. A 100 basis points shock to the yield curve across maturities is estimated to raise the interest bill by just 0.1 percentage points of GDP. Similarly, a shock to the real exchange rate would have a relatively small impact on the debt stock, given the large share of debt denominated in local currency (about 76 percent).

² SHCP projects growth for 2015 between 2.0 and 2.8 percent.

³ The 2014 amendments to the fiscal responsibility law introduced a cap on the growth structural current spending (comprising about 50 percent of all primary spending) from 2015.

C. Shocks and Stress Tests

- **Primary balance shock.** A deterioration of 0.8 percentage point of GDP in the primary balance in 2016–17 increases public debt to 51.6 percent of GDP by the end of the projection period. The gross financing needs also increase moderately. Effective interest rates on public debt do not deviate significantly from the baseline.
- **Growth shock.** Real output growth rates are lowered by 1 standard deviation (2.8 percentage points) for 2 years starting in 2016. The decline in growth leads to a deterioration of nominal primary balance compared to the baseline—as nominal revenues fall against unchanged expenditure plans—reaching -1.4 percent of GDP by 2017. Accordingly, the debt-to-GDP ratio increases to about 58.5 percent during the growth shock, and to 56.8 percent by the end of the projection period. Gross financing needs climb up to 12.2 percent of GDP in 2018, and stabilize at around 10 percent at the end of period.
- **Interest rate shock.** Interest rates are assumed to increase by 200 bps starting in 2016. The government’s interest bill increased gradually, reaching an implicit average interest rate of almost 8.5 percent by 2020, almost 1 percent higher than in the baseline. Similarly, the debt-to-GDP ratio and gross financing needs increase, reaching 51.7 and 9.3 percent of GDP respectively by 2020.
- **Real exchange rate shock.**⁴ A permanent real exchange rate depreciation of 15 percent increases debt by 1.9 percentage point of GDP. Gross financing needs increase by 0.2 percentage point in 2016 and by 0.4 percentage point in 2018.
- **Combined shock.** A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). In this case, debt would stabilize at around 61 percent of GDP, without showing signals of an explosive trajectory. Gross financing need peak at 13.3 percent in 2018 and stabilize at 11.6 at the end of the period.

⁴ Given the observed very low pass-through of depreciation to inflation in Mexico so far, this shock uses the low pass-through elasticity of 3 percent rather than the default value of 25 percent.

Figure 1. Mexico Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

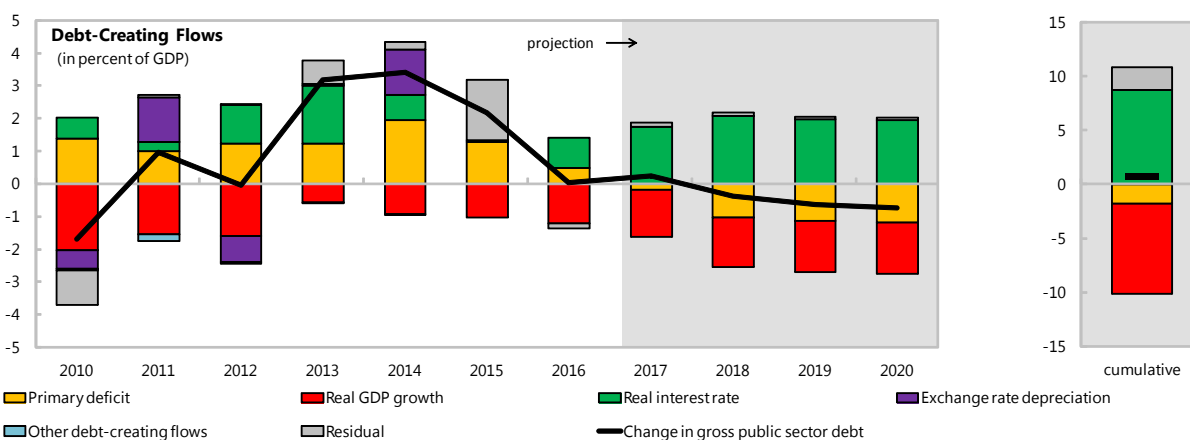
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators^{1/}

	Actual			Projections						As of September 09, 2015		
	2004-2012 ^{2/}	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	41.2	46.4	49.8	51.9	52.0	52.2	51.8	51.2	50.5	EMBI (bp) 264		
Public gross financing needs	10.7	12.1	13.6	10.8	10.1	9.0	10.9	9.6	8.8	CDS (bp) 147		
Real GDP growth (in percent)	2.8	1.4	2.1	2.2	2.5	2.9	3.1	3.2	3.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.3	1.7	4.3	4.1	4.4	2.9	3.0	3.3	3.5	Moody's	A3	A3
Nominal GDP growth (in percent)	8.3	3.1	6.5	6.4	7.0	5.9	6.2	6.6	6.9	S&Ps	BBB+	A
Effective interest rate (in percent) ^{3/}	6.9	6.0	6.1	4.3	6.4	6.6	7.3	7.5	7.6	Fitch	BBB+	A-

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{8/}
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	-0.2	3.19	3.42	2.2	0.0	0.3	-0.4	-0.6	-0.7	0.7	
Identified debt-creating flows	-0.6	2.48	3.18	1.4	0.0	0.3	-0.4	-0.6	-0.7	-0.1	
Primary deficit	-0.3	1.2	2.0	1.3	0.5	-0.2	-1.0	-1.1	-1.2	-1.8	
Primary (noninterest) revenue and grants	22.7	24.3	23.5	22.7	22.2	22.2	22.4	22.4	22.5	134.3	
Primary (noninterest) expenditure	22.4	25.5	25.4	23.9	22.7	22.0	21.3	21.3	21.3	132.5	
Automatic debt dynamics ^{4/}	-0.3	1.3	1.2	0.1	-0.5	0.4	0.7	0.5	0.5	1.7	
Interest rate/growth differential ^{5/}	-0.5	1.2	-0.2	-1.0	-0.3	0.3	0.5	0.4	0.4	0.4	
Of which: real interest rate	0.6	1.8	0.8	0.1	0.9	1.8	2.1	2.0	1.9	8.7	
Of which: real GDP growth	-1.0	-0.6	-0.9	-1.0	-1.2	-1.4	-1.5	-1.6	-1.6	-8.4	
Exchange rate depreciation ^{6/}	0.2	0.1	1.4	...	...	...	...	...	...	...
Other identified debt-creating flows	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization proceeds (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities (Specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{7/}	0.4	0.7	0.2	1.9	-0.2	0.1	0.1	0.1	0.1	2.1	



Source: IMF staff.

1/ Public sector is defined as the central government, state-owned enterprises, public sector development banks, and social security funds.

2/ Based on available data.

3/ Defined as interest payments divided by debt stock at the end of previous year.

4/ Derived as $((r - p(1+g) - g + ae(1+r))/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).5/ The real interest rate contribution is derived from the denominator in footnote 4 as $r - \pi(1+g)$ and the real growth contribution as $-g$.6/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

7/ For projections, this line includes exchange rate changes during the projection period.

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

Figure 2. Mexico: Public DSA - Composition of Public Debt and Alternative Scenarios

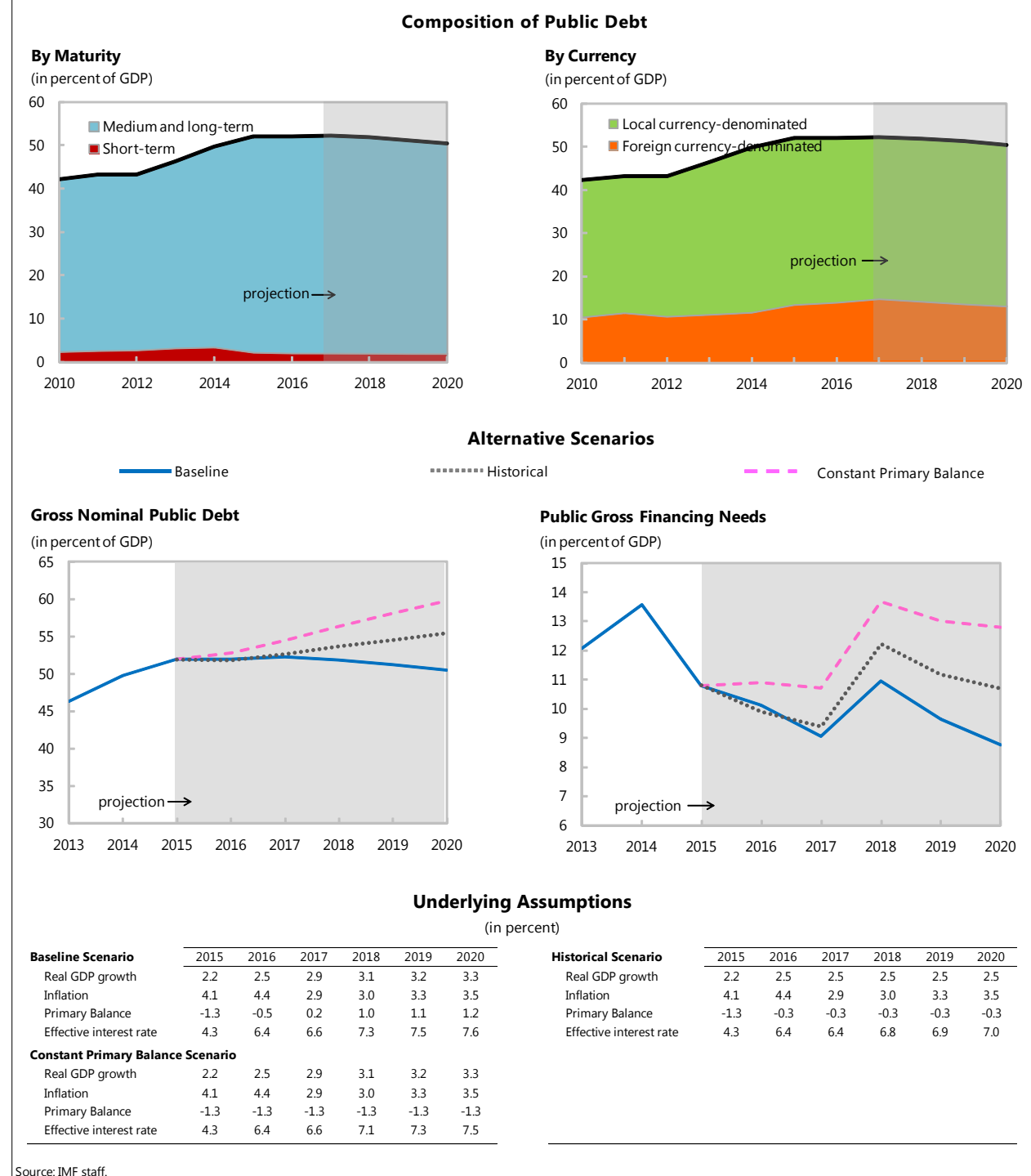
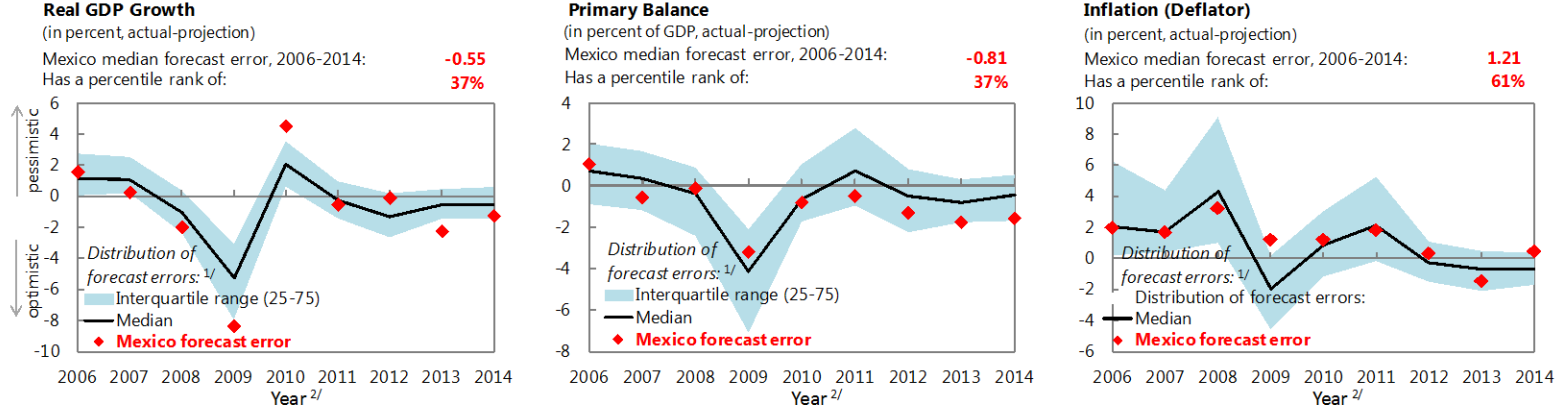


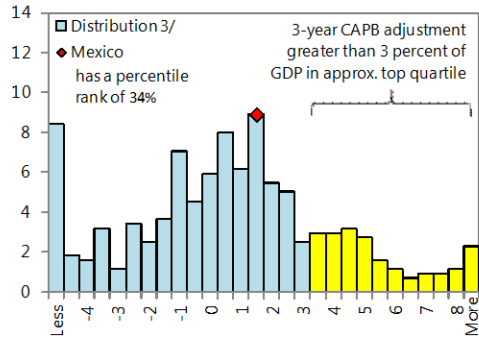
Figure 3. Mexico Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

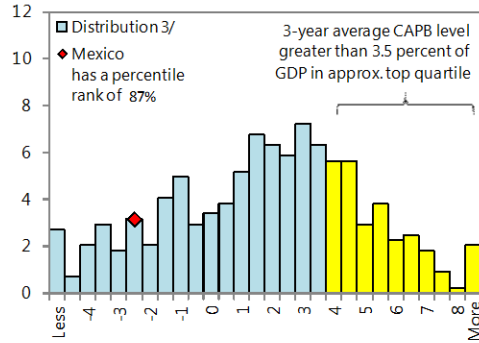


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis

Real GDP growth
(in percent)

Not applicable, since Mexico does not match the criteria for this analysis

Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Mexico: Public DSA - Stress Tests



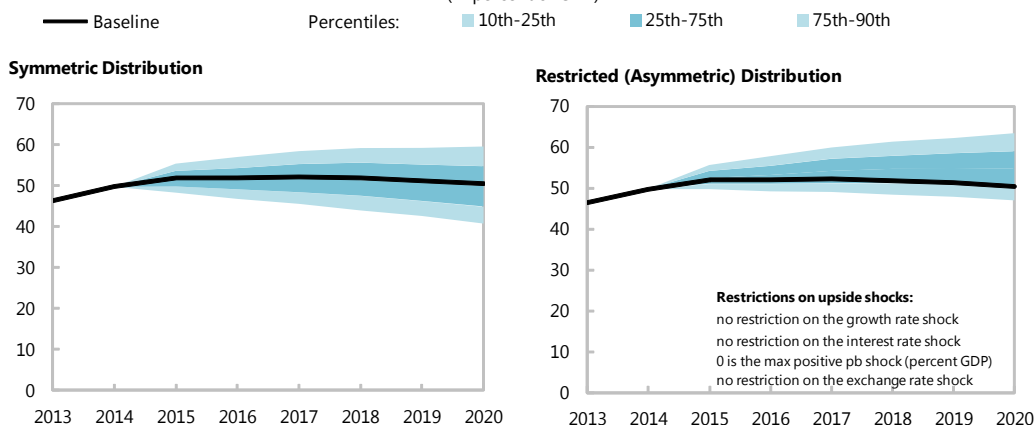
Figure 5. Mexico Public DSA Risk Assessment

Heat Map

Debt level ^{1/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs ^{2/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile ^{3/}	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

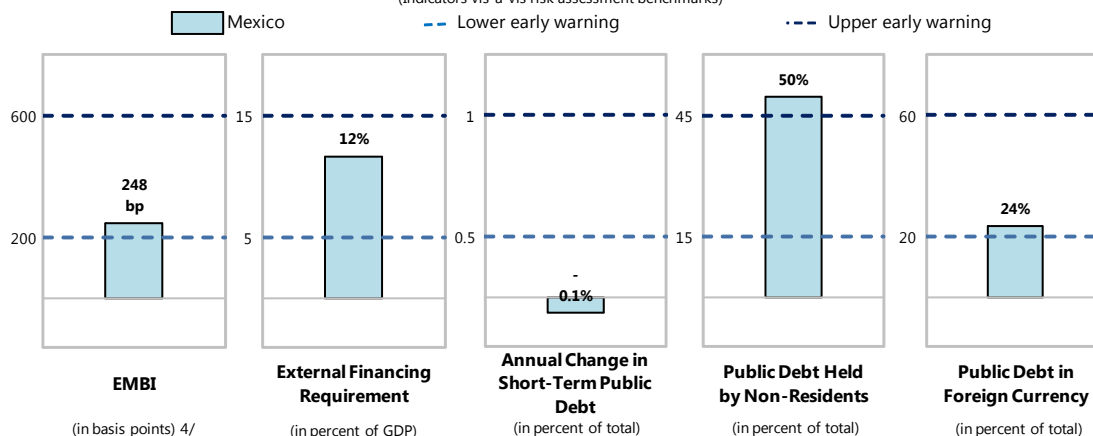
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

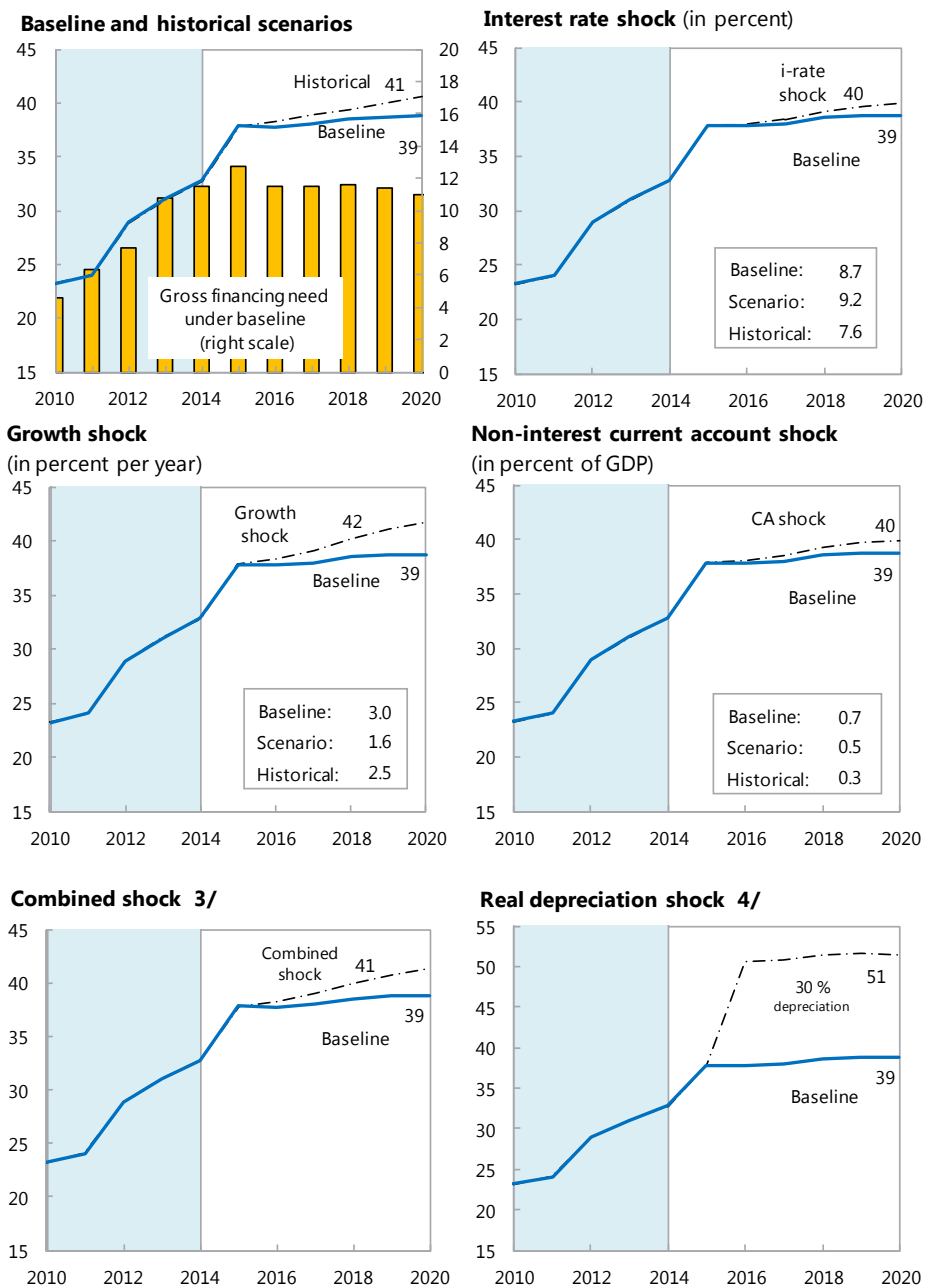
4/ An average over the last 3 months, 11-Jun-15 through 09-Sep-15.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

Mexico's external-debt-to GDP ratio continues to be low and sustainable (expected at 38 percent projected for end-2015), and is expected to remain stable over the medium term.

Most shock scenarios would increase external debt by just a few percentage points. The largest increase would occur under a depreciation scenario. Indeed, the depreciation of peso is the main reason for the rise in the external debt to GDP share from 33 percent and end-2014. However, even in the unlikely event of a further 30 percent real exchange rate depreciation, the debt-to-GDP ratio would increase to just over 50 percent, which would still be manageable. The reason for this contained increase is that almost half of Mexico's public external debt is now denominated in pesos. Debt dynamics also benefit from the low interest rates and long maturities of the existing debt.

Figure 6. Mexico: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

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

4/ One-time real depreciation of 30 percent occurs in 2014.

Table 1: Mexico: External Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							Debt-stabilizing non-interest current account 6/ -0.8
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020		
1 Baseline: External debt	23.2	24.0	28.9	31.0	32.8	37.8	37.8	38.0	38.5	38.7	38.8		
2 Change in external debt	2.0	0.8	4.9	2.1	1.7	5.0	-0.1	0.2	0.5	0.2	0.0		
3 Identified external debt-creating flows (4+8+9)	2.7	-2.4	0.1	0.9	-0.8	0.1	-0.4	-0.6	-0.3	-0.5	-0.7		
4 Current account deficit, excluding interest payments	-0.9	-0.4	-0.3	0.6	0.0	-0.3	-0.6	-0.7	-0.6	-0.8	-1.0		
5 Deficit in balance of goods and services	3.8	2.7	1.4	1.2	1.0	1.5	1.4	1.7	2.1	2.0	2.0		
6 Exports	27.4	29.9	31.2	32.7	31.8	35.5	35.9	37.7	39.1	40.2	40.8		
7 Imports	31.2	32.6	32.6	32.8	33.7	37.0	37.3	39.3	41.2	42.2	42.8		
8 Net non-debt creating capital inflows (negative)	-1.1	-0.4	-0.6	-2.4	-1.6	-1.4	-1.6	-1.9	-1.9	-1.9	-1.8		
9 Automatic debt dynamics 1/	4.6	-1.7	1.0	2.7	0.8	1.8	1.8	1.9	2.1	2.2	2.2		
10 Contribution from nominal interest rate	1.8	1.5	1.7	2.0	2.0	2.6	2.7	3.0	3.2	3.4	3.4		
11 Contribution from real GDP growth	-1.2	-0.8	-1.0	-0.4	-0.6	-0.8	-0.9	-1.0	-1.1	-1.2	-1.2		
12 Contribution from price and exchange rate changes 2/	4.1	-2.3	0.3	1.1	-0.5	...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	-0.7	3.3	4.7	1.3	2.6	4.9	0.3	0.8	0.9	0.7	0.7		
External debt-to-exports ratio (in percent)	84.8	80.4	92.6	94.9	103.1	106.5	105.2	100.9	98.5	96.4	95.0		
Gross external financing needs (in billions of US dollars) 4/	48.1	74.9	90.8	135.9	148.2	147.5	141.6	149.7	158.6	165.4	169.1		
in percent of GDP	4.6	6.4	7.7	10.8	11.5	10-Year	10-Year	12.7	11.5	11.5	11.6	11.4	11.0
Scenario with key variables at their historical averages 5/						37.8	38.3	38.9	39.4	39.9	40.6	-0.9	
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Real GDP growth (in percent)	5.1	4.0	4.0	1.4	2.1	2.5	2.8	2.2	2.5	2.9	3.1	3.2	3.3
GDP deflator in US dollars (change in percent)	-15.3	11.6	-2.6	-2.7	0.2	3.1	7.5	-12.0	3.7	2.3	2.1	2.6	2.9
Nominal external interest rate (in percent)	7.5	7.3	7.2	6.8	6.5	7.6	1.1	7.0	7.5	8.3	9.0	9.4	9.3
Growth of exports (US dollar terms, in percent)	28.3	16.4	6.0	3.4	4.5	8.3	12.7	-1.5	7.4	10.5	9.4	8.7	8.0
Growth of imports (US dollar terms, in percent)	-22.5	16.5	5.3	5.4	5.2	7.9	12.6	-1.2	7.2	10.9	10.4	8.5	7.6
Current account balance, excluding interest payments	0.9	0.4	0.3	-0.6	0.0	0.3	0.4	0.3	0.6	0.7	0.6	0.8	1.0
Net non-debt creating capital inflows	1.1	0.4	0.6	2.4	1.6	1.6	0.8	1.4	1.6	1.9	1.9	1.9	1.8

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period, excluding reserve accumulation.

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

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