© 2005 International Monetary Fund

December 2005
IMF Country Report No. 05/427

Mexico: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Mexico

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 22, 2005, 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 19, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of November 9, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 9, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Mexico.

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

Selected Issues Paper

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Mexico

Approved by Anoop Singh and Carlo Cottarelli

October 19, 2005

Discussions. A staff team held discussions in Mexico City during July 5–15 and September 21–22, 2005. The team met with the Minister of Finance; members of the Board of the Bank of Mexico; officials from the Ministry of Finance, Bank of Mexico, the Ministry of Economy, the Ministry of Social Services, supervisors of Financial Institutions, and representatives of the private sector and academic community.

Team. The staff team comprised Caroline Atkinson (Head), Steve Phillips, Gil Mehrez, Vincent Moissinac (all WHD); Ales Bulir (PDR); Marco Espinosa (MFD); and Mazen Soueid (ICM). Anoop Singh (WHD) joined the mission for the final discussions, and Mr. Schwartz (Executive Director) and Mr. Calderon (Senior Advisor) also participated.

Previous consultation. The 2004 Article IV consultation was concluded on October 18, 2004, with the Staff Report issued as IMF Country Report No. 04/419. Directors commended the authorities for their continued pursuit of sound macroeconomic policies. Directors emphasized that the key challenges going forward would be to bring inflation down to the long-term objective, reduce debt vulnerabilities, reinvigorate the program of structural reforms, and establish stronger mechanisms to ensure that a substantial portion of the oil windfall is saved.

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

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

Selected Issues Papers. The companion Selected Issues paper comprises four chapters: (i) Mexico's saving rate, its evolution and determinants; (ii) the evolution of bank credit in a context of significant financial sector reforms; (iii) the development of the local debt market and its implications; and (iv) the informal sector and its effects.

Contents

I. Context and Key Issues 3

II. Recent Developments....................4

III. Report on the Discussions....................14
A. Outlook....................14
B. Fiscal Policy....................15
C. Monetary and Exchange Rate Policy....................20
D. Financial Sector Issues and Policies....................22
E. Vulnerabilities and Measures to Boost Resilience....................23
F. Structural Reforms and Competitiveness....................25

IV. Staff Appraisal....................28

Tables
1. Selected Economic, Financial, and Social Indicators, 1998–2006....................31
2. Financial Operations of the Public Sector, 2001–2006....................32
3. Summary Balance of Payments, 2002–2010....................33
4. Summary Operations of the Financial System, 1999–2005....................34
5. Financial Soundness Indicators, 2001–2005....................35
6. Indicators of External Vulnerability, 2001–2005....................36
7. Baseline Medium-Term Projection....................37
8. Millennium Development Goals....................38

Boxes
1. Bank Credit Growth....................6
2. The Mexican Energy Sector Amid Rising Fuel Prices....................17
3. Competitiveness of the Mexican Economy....................27

Figures
1. Real Sector Developments....................5
2. Inflation and Monetary Policy....................8
3. Fiscal Sector....................10
4. External Sector....................11
5. Financial Market Developments....................13

Annexes
I. Fund Relations....................39
III. Relations with the World Bank....................41
IV. Table of Common Indicators Required for Surveillance....................42
V. Debt Sustainability Analysis, 2005–2010....................43

I. CONTEXT AND KEY ISSUES

1. **A shift in policies and economic structure over the last decade has fortified Mexico's economic fundamentals and produced a stronger and more stable economy.** Fiscal consolidation has reduced the ratio of gross public debt to GDP below 50 percent, and the structure of the public sector balance sheet has been strengthened. Monetary policy has brought inflation down to the low single-digits and gained increasing credibility, in the context of an inflation targeting regime and floating exchange rate. A series of reforms has strengthened the financial sector and boosted its development, while NAFTA contributed to opening the economy further and integrating it in the world economy—with fast-growing manufacturing links to the U.S. At the same time, the multi-party democracy has developed. These improvements are reflected in Mexico's investment-grade rating, uninterrupted access to foreign capital at low cost, and resilience to shocks, such as the 2001–02 recession of the world economy.

2. **Still, as the authorities well recognize, challenges remain to entrench macroeconomic credibility fully, and achieve rapid sustainable growth.** Fiscal policy has earned broad credibility as annual targets have been met. But it has yet to be set in a medium-term framework that would promote effective management of oil wealth over time and further strengthen the public sector balance sheet. Inflation has come down, but remains above the central bank's 3 percent target. Most fundamentally, structural reforms are needed to achieve a transition to high growth. Although there is now broad acknowledgement of the need for reforms—in the energy and telecommunications sectors, the labor market, judicial system, tax system, and regulatory and business environment—political stalemate has frustrated the achievement of many elements of the reform agenda established by the administration of President Fox. Constitutional disputes between the executive and congress this year suggest that the practice of multi-party democracy continues to evolve, even as the country prepares for the July 2006 elections that will turn over the presidency as well as all seats in congress.

3. **Recent Article IV consultations with Mexico have emphasized consolidation of the public finances and management of oil income, continued inflation reduction and enhancements of the monetary policy framework, and the need for structural reforms.** By and large, staff has agreed with the authorities on their objectives of continued progress in these areas, and so the discussions have usually centered on the specifics, and the appropriate pace, of moving ahead. On fiscal policy, saving of rising government oil income has generally been less than suggested by the Fund (although in 2004 savings turned out to be greater than projected at the time of the consultation). The authorities have emphasized that political consensus in favor of saving oil income has been weak, especially as projected oil prices have continued to rise. They have pointed in particular to Mexico's large investment needs, including in the oil sector, with a potentially high return. On monetary policy, disinflation has proceeded, and continuing development of the inflation targeting framework has addressed issues of transparency and communication, although a detailed inflation forecast is not published. On the structural policy front, the Fund has supported the wide agenda defined by the Fox administration, much of which required congressional approval, while regretting that implementation of this agenda has fallen short of the authorities' goals.

4. **In this context, the 2005 consultation discussions focused on:**

- **Fiscal policy:** the need for a medium-term framework to promote fiscal consolidation and improve management of oil wealth.
- **Monetary policy:** evaluation of the policy stance following a period of rapid tightening, and the operational development of the inflation targeting framework.
- **Financial markets:** the implications of the significant reforms and development of credit and bond markets in recent years and the remaining financial reform agenda.
- **Competitiveness and reforms:** the challenges to raise productivity, competitiveness and growth.
- **Safeguarding confidence and stability** in the run-up to the 2006 election and over the medium-term.

II. RECENT DEVELOPMENTS

5. **The economic recovery that began in mid-2003 continued into 2005, but at a substantially slower pace (Figure 1).** A broad-based expansion of economic activity in 2004, driven by a rebound of private consumption and private investment, took growth up to 4.4 percent. Growth slowed to 2.8 percent in the first semester of 2005,[1] mainly reflecting sector-specific developments, including a soft patch in U.S. industrial production, re-tooling in the automobile sector, and lower agricultural yields. At the same time, domestic demand began to moderate, and an increasing share of demand fell on imports rather than domestic production.

6. **The economic recovery was accompanied by a boost to confidence, capacity utilization, and formal employment.** By early 2005, business confidence recovered to its pre-recession level, as did capacity utilization in manufacturing, although both have slipped in recent months. Formal employment grew by 4.6 percent from end-2003 to July 2005. Still, the labor market remains dominated by informal employment (see Selected Issues paper). Out of the economically active population of more than 43 million, only 12.8 million persons were employed formally in the private sector as of mid-2005.

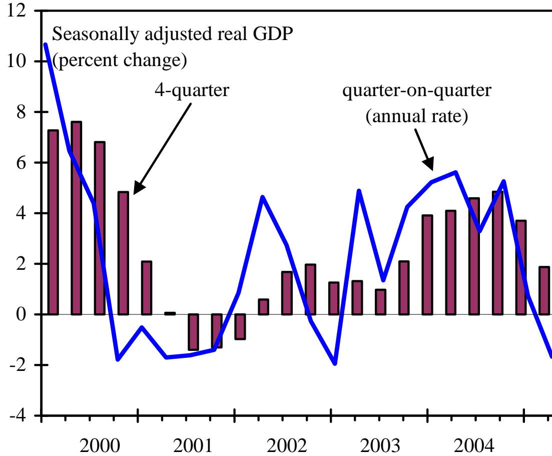
7. **Bank credit to the private sector has grown at a fast pace, starting in mid-2003.** Consumer and housing bank credit showed the fastest rates of growth, but from a very low base. Nonbank financial intermediaries continue to play an important role in these new markets (Box 1), although bank lending in these sectors is catching up. The availability of new credit has helped the recovery of investment, especially in the housing sector. Private investment expenditure was up more than 8 percent in 2004 and by 6 percent in the first half of 2005.

---

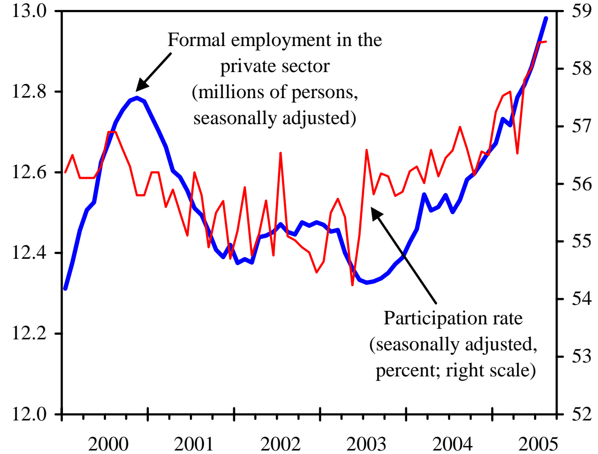
[1] Compared to the corresponding semester of 2004. Measured relative to the previous semester, seasonally-adjusted growth was 1.2 percent (on an annualized basis).

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

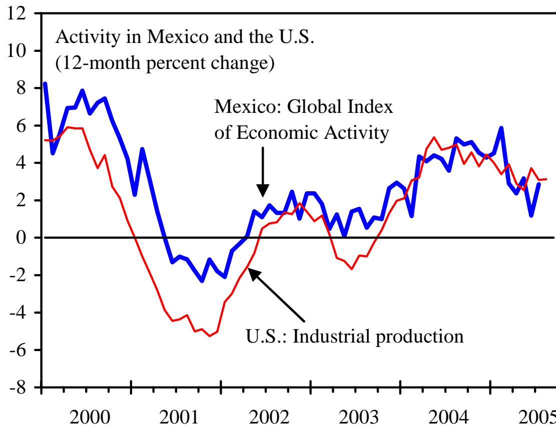
The economic recovery lost momentum in early 2005...



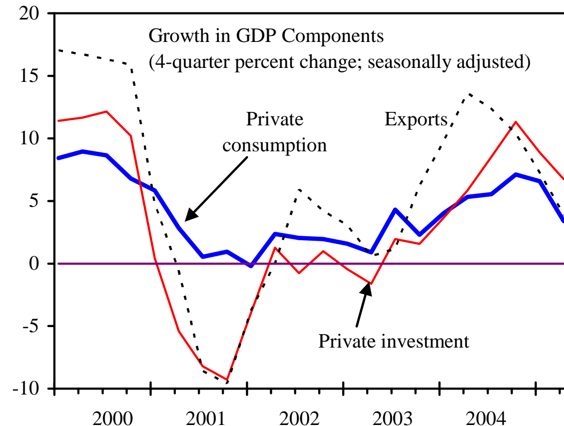
...although formal private sector employment has continued to rise.



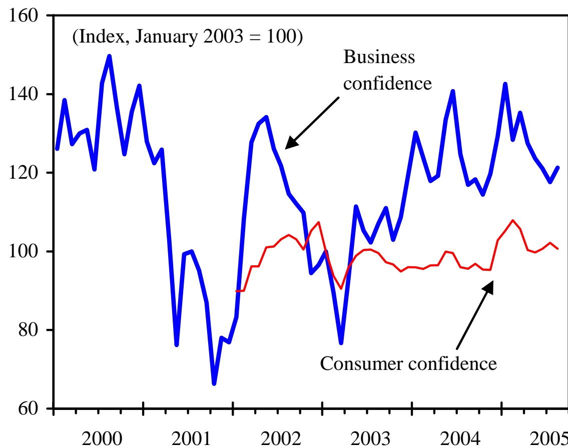
Mexican activity has moved closely with U.S. industrial production...



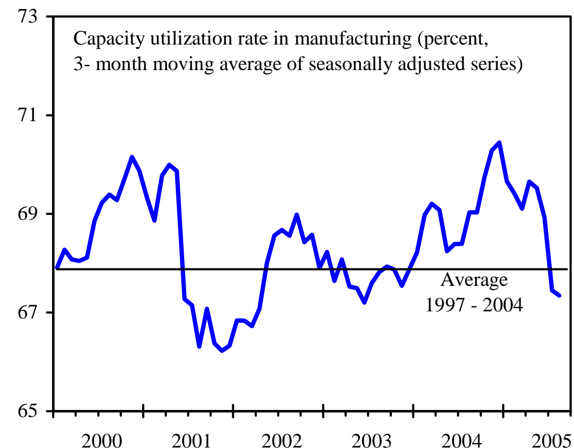
...causing exports to slip recently, while domestic demand has also slowed.



Business confidence has recently edged down.



Capacity utilization in the manufacturing sector fell abruptly at mid-2005.

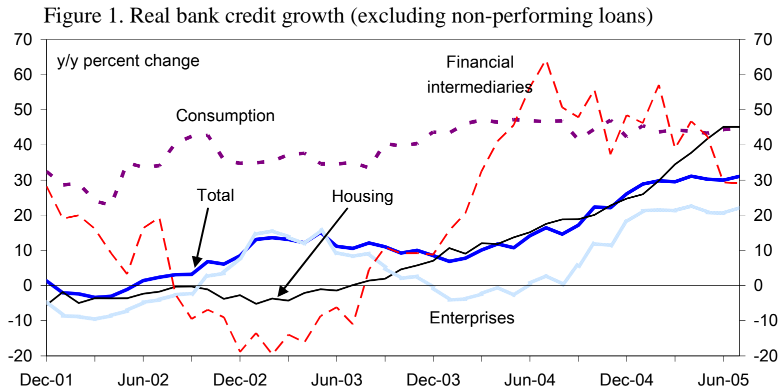


Sources: Mexican authorities; U.S. Federal Reserve; and Fund staff estimates.

Box 1. Bank Credit Growth

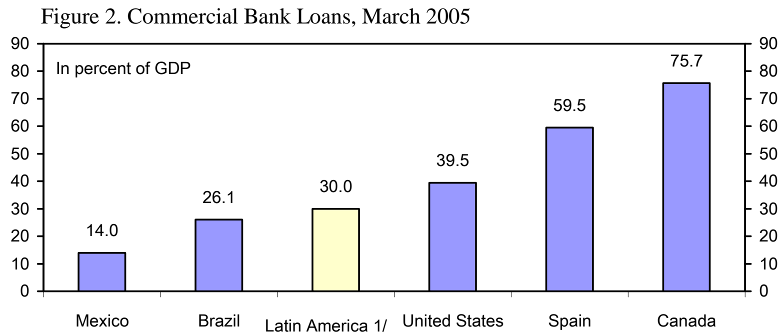
Following years of contraction, commercial bank lending to the private sector has resumed growing—and at a fast pace. Credit growth has been relatively rapid in consumer and housing lending, markets first taken up by nonbank intermediaries following the 1994–95 financial crisis (Figure 1).

Figure 1. Real bank credit growth (excluding non-performing loans)



The underlying factors are multiple: the recovery of activity and confidence; continuing disinflation; greater competition in the financial sector; and banking reforms which strengthened balance sheets while improving tools to assess the creditworthiness of potential borrowers and enforce collateral (see Selected Issues paper for a description of the reforms and a study of their effects). In the housing sector, government guarantees and direct lending programs leading to the introduction of conforming mortgages have also played a key role.

Figure 2. Commercial Bank Loans, March 2005



1/ Ratio for 1999–2002.

Table 1. Sources of Financing to the Non-Financial private sector

	Stocks (in percent of GDP)			Real percentage change	
	Dec-03	Dec-04	Jun-05	Dec-03 Dec-04	Jun-04 Jun-05
Total Financing	28.8	28.0	27.6	2.6	3.0
Foreign Financing	8.4	7.3	6.9	-8.6	-6.8
Domestic Financing	20.3	20.7	20.7	7.3	6.7
Commercial Banks	9.2	9.5	9.8	9.6	14.7
Development Banks	1.2	0.6	0.6	-43.2	-41.9
Non-bank Financial Intermediaries	2.6	3.0	3.1	21.6	17.3
Debt Issuance	2.1	2.1	1.9	5.7	-6.7
INFONAVIT 1/	5.3	5.4	5.3	7.8	3.1
Memo:					
Households	10.6	11.5	12.0	14.1	14.1
Consumer credit	2.1	2.8	3.2	41.3	42.0
Mortgage credit	8.5	8.7	8.8	7.4	6.5
Credit to companies	18.1	16.5	15.6	-4.2	-4.2
Foreign Financing	8.4	7.3	6.9	-8.6	-6.8
Domestic Financing	9.7	9.2	8.7	-0.3	-2.0

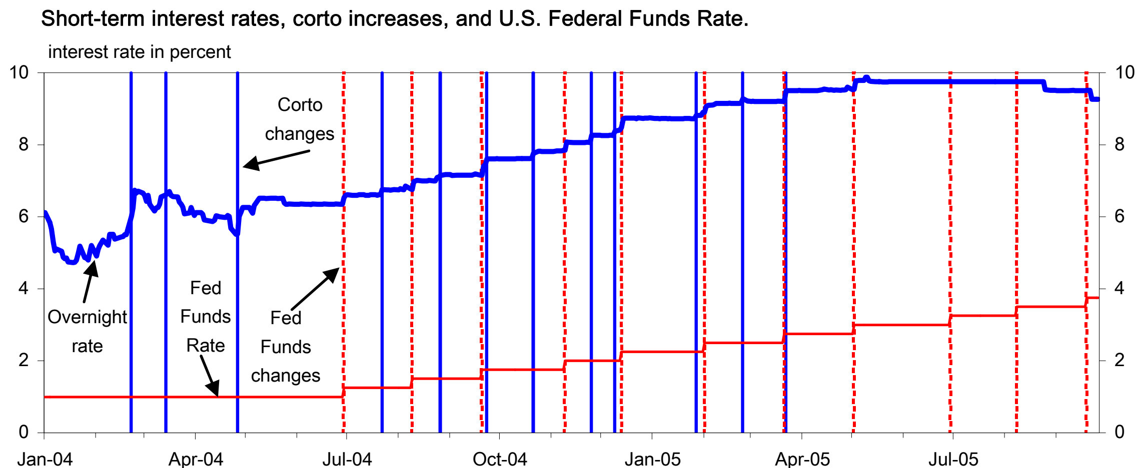
1/ INFONAVIT is a public fund financing housing developers and mortgages with a fixed portion of social security contributions.

Although bank credit still lags that of other countries (Figure 2), its fast growth—provided it continues to be based on adequate risk management frameworks—will continue to enhance banks' financial intermediation and growth-promoting role. So far, despite the rapid growth of new lending, the stock of total bank financing as a share of GDP has increased only moderately because banks have also been writing off non-performing loans, many from the 1994–95 crisis, at a fast pace.

Importantly, other domestic sources of financing, such as corporate debt, are also expanding. Nonbank financial intermediaries (Sofoles), whose lending is now close to a third of commercial banks' financing, have shown particularly fast growth (Table 1). These institutions do not take deposits and are licensed to grant credit to specific segments of the economy. The bulk of their financing comes from the government, but they have started to tap the private market. Mortgage Sofoles are the most important type.

8. **After rising through 2004, inflation has moderated in 2005, although it remains somewhat above the 3 percent target—as does expected inflation (Figure 2).** The 12-month headline inflation rate peaked at 5.4 percent in November 2004, but declined thereafter with the unwinding of last year's supply shocks as well as a moderation of core inflation. Headline inflation moved below 4 percent in August 2005. Overall core inflation—which had been little affected by supply shocks—has also come down, to 3.3 percent, while wage increases have been steady at around 4½ percent. Nevertheless, inflation expectations for end-2006, and for the next several years, remain somewhat above the official inflation target—averaging about 3.7 percent as of September.[2]

9. **The Bank of Mexico (BoM) signaled an end to its monetary tightening cycle in June 2005, and initiated an easing in August.** The tightening of monetary conditions in this cycle was substantial—with the overnight interbank interest rate rising from about 5 percent in early 2004 to near 10 percent by spring 2005. From early 2004, the BoM has taken a number of steps to enhance its communication with markets, including through beginning to signal a desired minimum level of interest rates. While retaining its traditional *corto* instrument, the BoM started using changes in the corto to signal changes in the overnight interbank rate, and directed the market's attention to the shorter, more focused press releases following its regular monetary policy meetings. From May 2004, the BoM used these statements also to link movements in the overnight interest rate to hikes in the U.S. Fed Funds rate. In June 2005, the BoM dropped this link to U.S. policy and emphasized instead

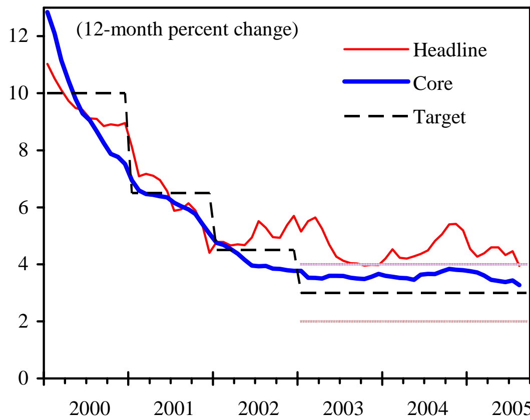


the need to maintain the present monetary stance, signaling the end of the tightening cycle. Two months later, the BoM announced that monetary conditions could ease by up to 25 bp (but without changing the corto). In September, a further 25 basis point cut was signaled, bringing the interbank rate down to 9¼ percent (still with no change in the corto).

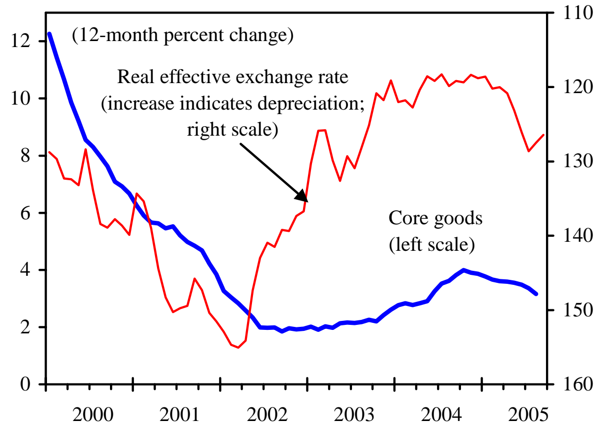
[2] While this is within the 2–4 percent inflation "variability range," the authorities have emphasized that the inflation target is 3.0 percent.

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

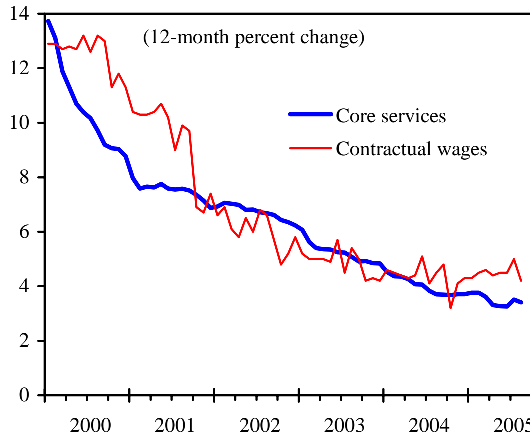
Headline and core inflation are above the BOM's target of 3 percent, but edged down recently.



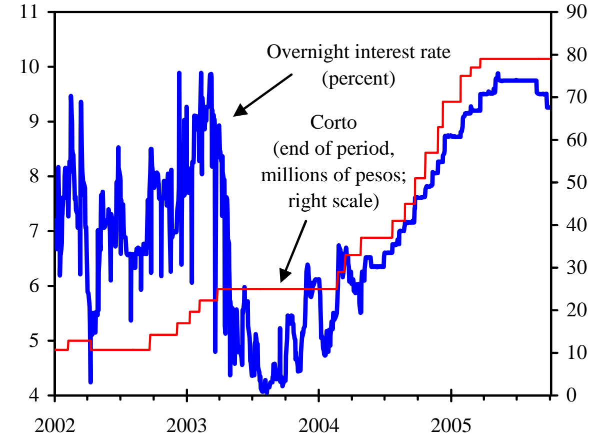
Not only headline inflation, but also core goods inflation, accelerated in 2004.



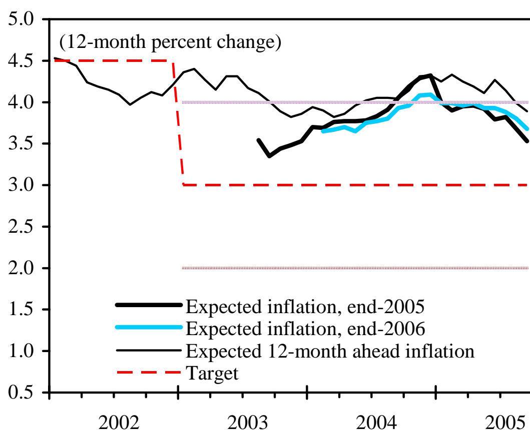
Wage increases have been fairly steady, at around 4.5 percent, since late 2003.



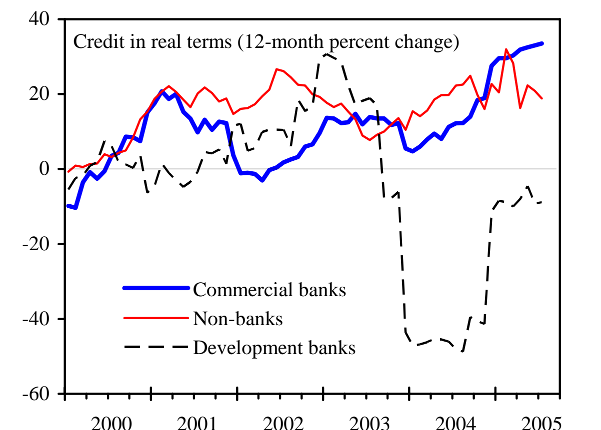
After a substantial policy tightening from early 2004, the BoM began to ease in August 2005.



Inflation expectations have come down, but still exceed the central bank's 3% target.



Tighter monetary conditions have not yet dented the growth of bank and nonbank credit.



Sources: Mexican authorities; and Fund staff estimates.

10. **The fiscal accounts improved in 2004 on the strength of rising oil revenues and restraint of current expenditures (Figure 3).** The authorities achieved their target for the traditional deficit, 0.3 percent of GDP, and the broadly-defined deficit (the augmented deficit) narrowed to 2 percent of GDP, from 3.1 percent in 2003. After rising in 2003, current expenditure returned to its 2002 level as a share of GDP. Rising oil revenue helped finance an increase in capital expenditure, particularly in the oil sector. However, the 2004 outcome on the augmented deficit also reflected in part a "temporary saving" from oil revenues, in that 0.4 percent of GDP of funds earmarked for additional PEMEX investment were not yet spent in 2004. Gross public debt declined to 46.5 percent of GDP, in part through the write-off of some of the bank restructuring debt.

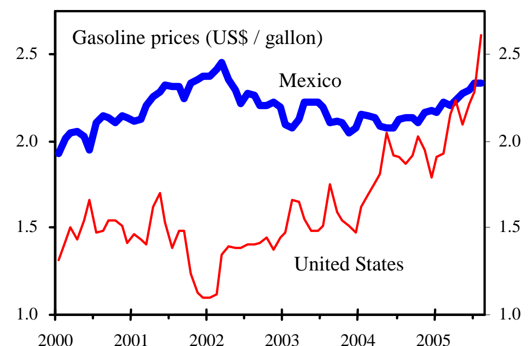
11. **In 2005, oil revenues are rising again, but the impact on the broader deficit is being more than offset by a deterioration in the non-oil fiscal balance.** The spot price of Mexican oil averaged US$ 41.6/bl through September, almost 15 dollars above the price assumed in the budget. Oil income for the year is now projected by staff to be up by about ½ percentage point of GDP from 2004 (and about 1 percentage point over budget projections). So far, it appears that under the annual budgetary rules, this excess revenue will go to compensate for shortfalls in non-oil revenue, and toward transfers for additional investment spending by PEMEX and the states, as implied by the budget law (this year, less than 0.1 percent of GDP will be available to be sent to the oil stabilization fund). In contrast to 2004, the composition of spending appears to have tilted back toward current expenditures, and staff project that the non-oil augmented deficit will widen this year, by 0.8 percent of GDP.

Public Sector Debt, 2004

	2004
(In percent of GDP)	
Federal government	23.3
External	8.9
Domestic	14.4
Public enterprises	1.7
Development banks	2.2
Gross traditional public sector debt	28.7
Adjustments to traditional public sector debt	17.9
PIDIREGAS	5.6
IPAB	9.6
FARAC	2.1
Gross augmented public sector debt	46.5
Domestic	30.3
External	16.2
Net augmented public sector debt	41.2

Source: Mexican authorities.

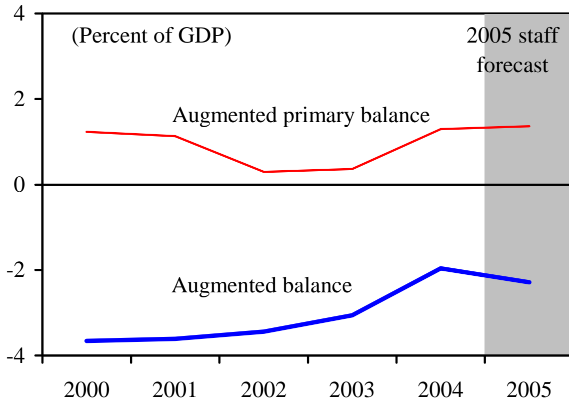
12. **As in previous years, the increase in the government's oil revenue was moderated by energy pricing policies that shielded consumers from rising world prices.** Most significantly, gasoline prices "at the pump" have increased only in line with the domestic inflation rate, as a once substantial excise tax on gasoline has been steadily reduced. Revenue on this tax has fallen from a peak of 1.8 percent of GDP in 2002 to 0.7 percent of GDP in 2004, and to a projected 0.2 percent of GDP this year.



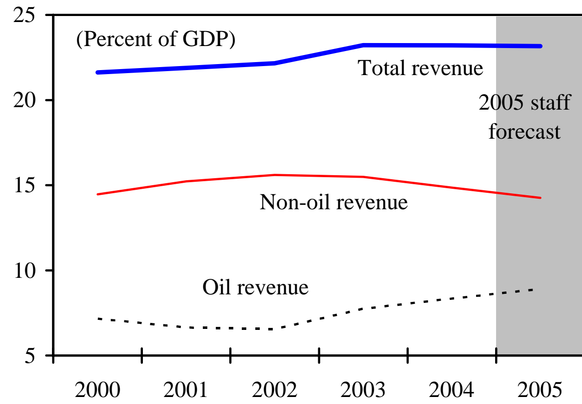
13. **The external current account balance has been broadly stable recently, with a continued rise in oil exports and household remittances compensating for some widening of the non-oil trade deficit (Figure 4).** With the recovery of economic activity in 2004, imports of investment and especially consumer goods grew strongly. Weak auto

Figure 3. Mexico: Fiscal Sector

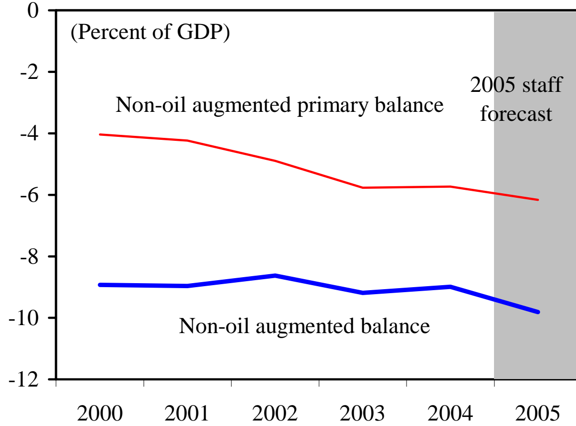
The augmented fiscal deficit has narrowed since 2000, largely reflecting lower interest costs.



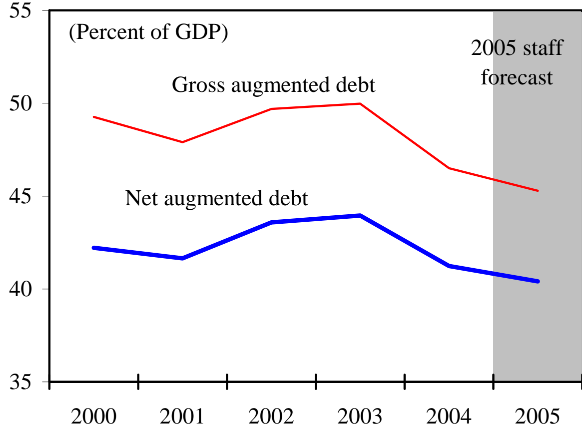
Rapid growth in oil revenue since 2002 has offset a decline in non-oil revenue.



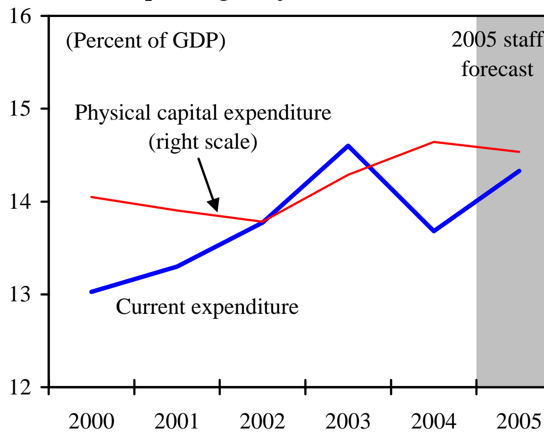
Although the non-oil balances weakened after 2002...



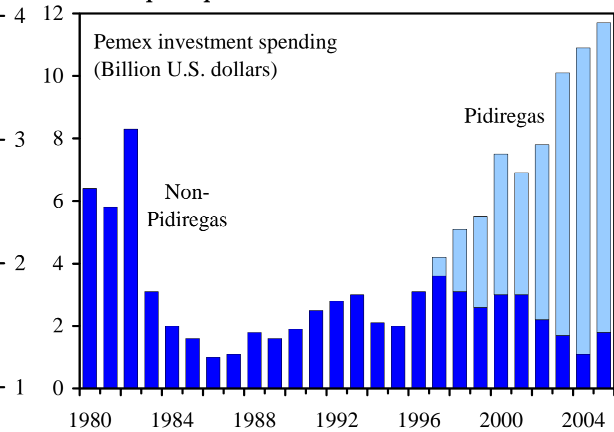
...public debt declined, as a share of GDP, in 2004 and 2005.



Capital spending increased after 2002, while current spending has fluctuated...



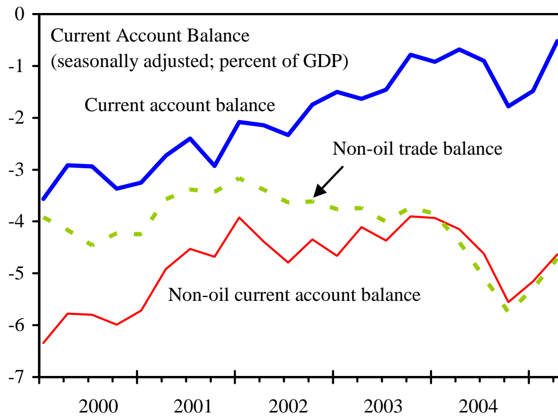
...with the Pidiregas playing a large role in the recent pickup in investment in Pemex.



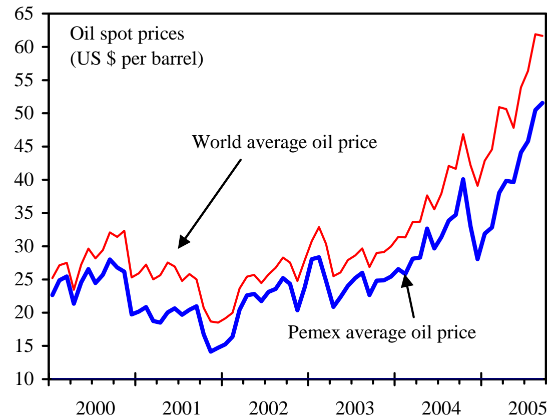
Sources: Mexican authorities; and Fund staff estimates.

Figure 4. Mexico: External Sector, 2000 - 2005

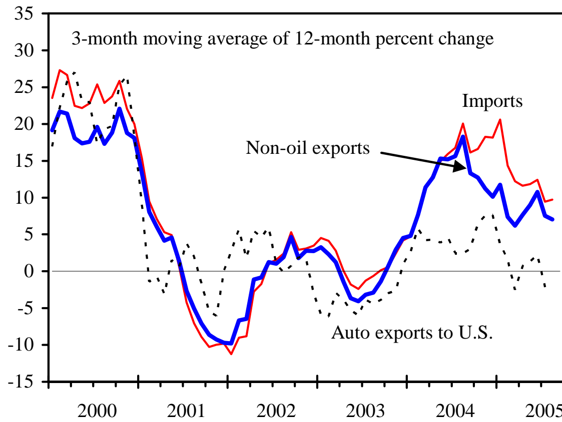
Since 2003, the annual current account deficit has stayed around 1 percent of GDP...



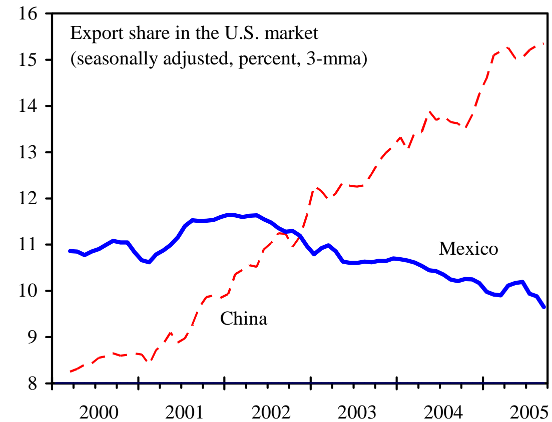
... helped by increasing oil export prices ...



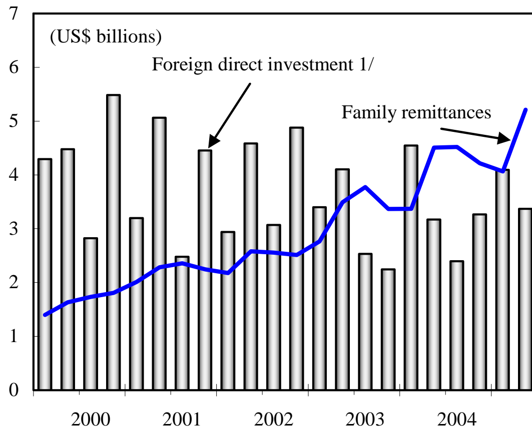
... while non-oil exports have not kept pace with imports lately.



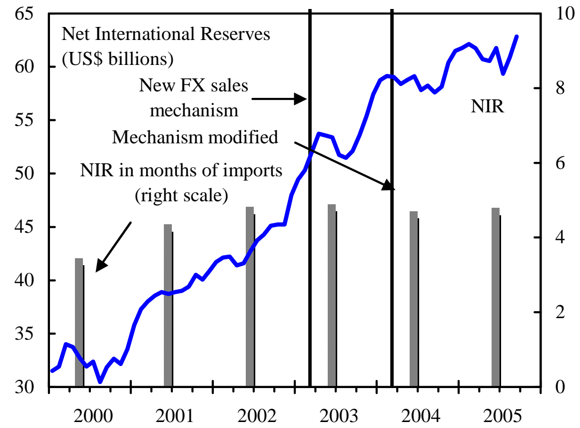
Mexico's export share in the U.S. market has declined since early 2002.



Recorded inbound family remittances continue to grow rapidly, more than tripling over the last 5 years.



NIR has continued to rise.



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

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

exports to the U.S., and enhanced competition from China, slowed non-oil exports. On the other hand, oil exports and household remittances[3] continued to grow.

14. **Mexican financial markets have recently performed strongly, as have other emerging markets (Figure 5).** Sovereign bond spreads have continued to decline. As elsewhere in Latin America, both the stock and currency markets have tended to strengthen. At end-September, the stock market was up more than 70 percent (in domestic currency terms) since end-2003, with much of that gain coming since April of this year. From late April through early August, the peso gained some 7 percent against the dollar, amid indications that foreign investors were increasingly attracted by the significant interest rate differential with the U.S. and growing signs that the BoM's effort to reduce inflation would succeed.[4] The BoM has continued to abstain from market purchases of foreign exchange, but rising foreign exchange receipts from the state-owned oil company (PEMEX) have tended to push NIR upward.[5] NIR reached US$ 61 billion by end 2004, about 4½ months of Mexico's imports and 1.6 times its short-term external liabilities.

Mexico: Recent Private Capital Inflows
(In billions of U.S. dollars)

	2004					2005	
	I	II	III	IV	Annual	I	II
Portfolio inflows	-1.4	-0.8	2.0	0.3	0.1	4.2	3.7
Bonds	1.0	-0.4	2.2	0.1	3.0	3.7	3.3
Short-term inflows	-1.4	-0.2	1.5	0.8	0.7	1.7	-0.5
Banks	0.0	0.0	0.8	-1.3	-0.5	-0.8	-0.9
Nonbanks	-1.4	-0.2	0.7	2.0	1.2	2.5	0.4

Source: Bank of Mexico

15. **The authorities have taken further steps to reduce vulnerabilities associated with the public debt.** The average maturity of the domestic debt of the federal government was extended to 3.1 years by June 2005, up from 2.6 years in early 2004 (and 1.5 years in 2000). Exposure to currency depreciation has declined further as the public sector's annual foreign exchange earnings from oil now exceed US$ 30 billion, against interest payments on its foreign debt of US$ 9 billion. Furthermore, the authorities used the oil stabilization fund to hedge the government's external oil revenue for 2005. Finally, at mid-year the authorities

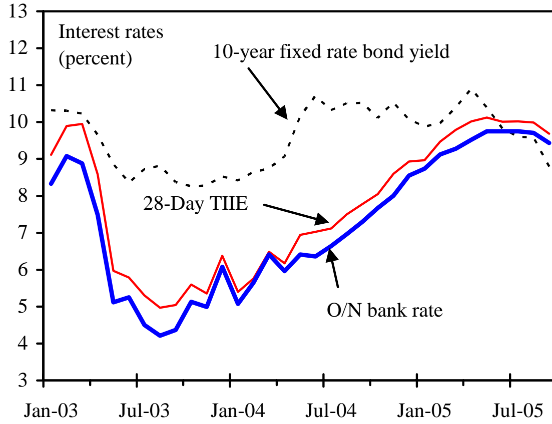
[3] Recorded family remittances increased from about US$6 billion in 1999 to almost US$17 billion in 2004, more than 20 percent annually, partly reflecting improved statistical coverage of remittances flows.

[4] Subsequently, the peso shed about 3 points of this gain, through end-September.

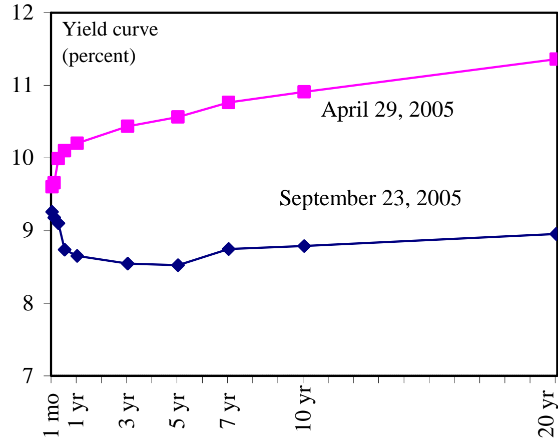
[5] The BoM accumulates NIR mainly as a result of the considerable foreign exchange cash surplus being run by the public sector (including PEMEX). To moderate the rate of NIR increase, the BoM sells a pre-announced portion of the resulting increase back into the market, a rules-based mechanism in place since 2003.

Figure 5. Mexico: Financial Market Developments

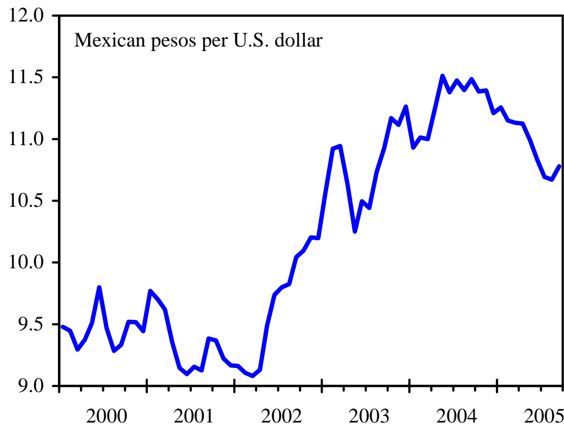
Short-term interest rates have risen by about 500 basis points from lows in 2003...



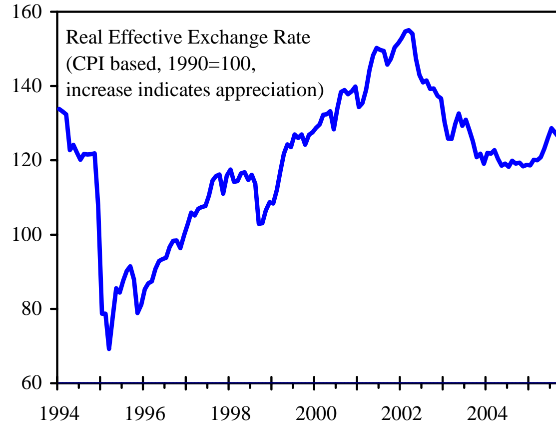
...and the domestic yield curve now prices in a reduction in rates in the near term.



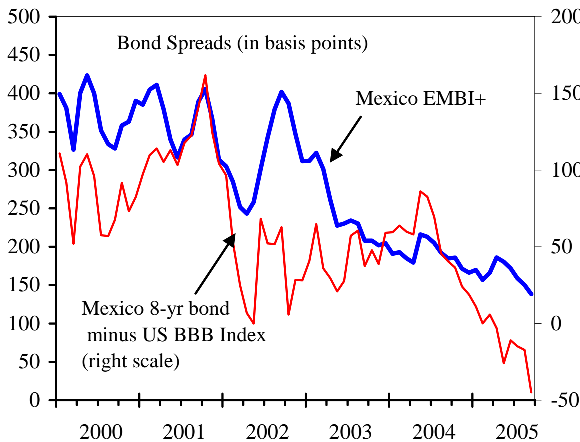
The peso has strengthened against the dollar in 2005, after a depreciation of 20 percent in 2002-03...



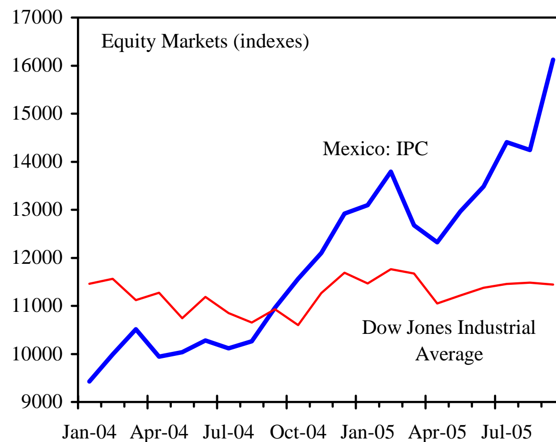
...which had reversed the real exchange rate appreciation of 1999 - 2001.



Mexico's EMBI+ spread has fallen below 175 basis points ...



... and the stock market has outperformed U.S. markets.



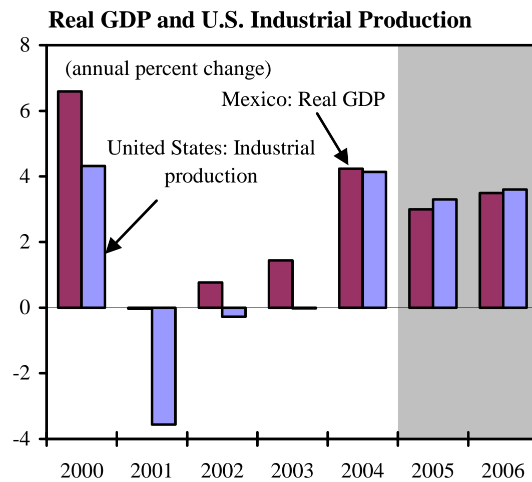
Sources: Bloomberg LP; Mexican authorities; and Fund staff estimates.

announced that the federal government had accumulated enough foreign currency liquidity to allow it to forego any external bond issues through 2007.[6]

III. Report on the Discussions

A. Outlook

16. **It is clear that GDP growth for 2005 will be lower than last year's strong pace.** This moderation reflects a slowdown of growth already seen in the first half of 2005—though the consensus view is that much of this weakness reflected sector-specific shocks that may soon fade. Accordingly, staff project growth of about 3 percent in 2005, picking up to 3½ percent in 2006. With a fast-developing financial sector and a continued recovery of investment, domestic demand should support growth. At the same time, the link with the U.S. economy, especially U.S. industrial production, will continue to be key to Mexico's growth performance. The staff's projection is therefore contingent on the current consensus view that U.S. manufacturing will pick up from its recent downturn. The authorities broadly shared this view of the outlook, while considering growth in 2005 likely to be somewhat higher.



17. **Inflation is projected to converge gradually to the 3 percent target.** Staff expect that inflation will end 2005 at somewhat below 4 percent, declining to about 3½ percent at end-2006 and 3 percent in 2007. The projection for 2006 and 2007, somewhat below those of private forecasters, assumes no new substantial supply shocks; it also assumes that the BoM will conduct policy with a focus on achieving the 3 percent target, and that private perceptions of the credibility of that objective will continue to strengthen, albeit gradually. The BoM has indicated that it expects inflation to end this year somewhat below 4 percent, and to decline further in 2006.[7]

18. **The main uncertainties for the near-term outlook include developments in the U.S. economy, global liquidity conditions and the possibility of shifts in confidence.** A moderate slowdown in the U.S. would have an immediate adverse effect on Mexico's economy through its impact on exports, confidence, and FDI (a more challenging U.S. shock scenario is discussed in Section IV). Sectoral considerations will also be important, including the performance of new auto models manufactured in Mexico for the U.S. market.

---

[6] Such external "prefinancing" does not necessarily extend to other parts of the public sector, such as PEMEX-related debt. In addition to external bond issues, part of the prefinancing was achieved through an exceptional US$2.9 billion purchase of foreign exchange from the BoM in July 2005.

[7] While the BoM did not offer a specific forecast for 2006, the government's budget proposal assumes inflation will end that year at 3.0 percent.

Confidence could also become more fragile if for example, as few consider likely, the political environment were to deteriorate such that doubts began to surface about the commitment to macroeconomic discipline.

19. **Medium-term growth prospects have upside potential, depending on the prospects for political breakthrough on structural reforms.** While the authorities continue to project somewhat higher medium-term growth than the staff (3.6 percent versus 3.1 percent), this relatively small difference reflects staff's more conservative judgment of the growth effects of financial sector reforms and the ongoing recovery of investment, and is within the margin of error of such estimates. Staff and the authorities agree that a transition to a significantly higher growth path requires comprehensive structural reforms. As noted, reforms critical to unwind the most pressing supply-side constraints have been identified for some time in the energy sector, telecommunications, labor market, judicial system, governance and the regulatory system.

B. Fiscal Policy

20. **The authorities emphasized their commitment to maintaining fiscal discipline, noting also the broad public consensus for such discipline.** The traditional deficit target was met in 2004, as has been the case in recent years. Furthermore, the deficit has been declining during the past few years and the draft budget for 2006 aims at a small surplus on the traditional measure. The augmented deficit had also been reduced, and this was supporting a gradual decline in the public debt/GDP ratio.

21. **Regarding 2005, the authorities expected again to meet their deficit target, with the windfall (unbudgeted) oil revenue used to offset non-oil revenue shortfalls and expenditure overruns from budgeted levels.** Oil windfall revenues are projected to be close to 1 percent of GDP, of which about one third would be transferred, according to budget rules, for investment projects by PEMEX and the states. The remaining unbudgeted oil revenues would be used mainly to compensate for revenue shortfalls from budgeted levels, and additional expenditures partly to accommodate spending changes made by congress. Thus the non-oil augmented deficit would widen in 2005, more than offsetting the slight improvement of 2004. Still, the overall fiscal outcome was expected to be adequate to support a small decline in the public debt ratio.

Mexico: Fiscal Indicators, in percent of GDP

	2001	2002	2003	2004	Budget 2005	Staff Projection 2005	Proposed Budget 2006	Staff Projection 2006
Traditional balance	-0.7	-1.2	-0.6	-0.3	-0.2	-0.2	0.2	0.2
Augmented balance	-3.6	-3.4	-3.1	-2.0	-2.4	-2.3	-1.5	-1.4
Non-oil augmented balance 1/	-9.0	-8.6	-9.2	-9.0	-8.8	-9.8	-8.3	-9.8
Oil revenue (gross) 2/	6.7	6.5	7.7	8.3	7.8	8.9	8.0	9.7
Gross augmented debt	47.9	49.7	50.0	46.5	...	45.3	...	43.4

1/ Based on gross oil revenue, net of PEMEX operational expenditure and interest.
2/ Gross oil revenue, including fuel excise tax.

22. **The mission recognized that broad fiscal discipline had been maintained in recent years, but noted that the fiscal position has come to rely increasingly on high oil prices.** Oil-related revenue is estimated to have increased by almost 2½ percentage points of GDP since 2002, reaching nearly 40 percent of revenue in 2005. Government receipts would have increased by a further 1½ percent of GDP if increases in world market prices had been fully transmitted to domestic consumers, rather than offset with reductions in gasoline excise taxes—see Box 2. The mission noted that budgetary expenditures had risen somewhat during this period, while part of the additional oil income essentially compensated for declining non-oil revenues (partly reflecting a phased income tax reduction approved in 2004). The overall result, comparing 2005 to 2002, was a reduction of the overall augmented deficit by about 1 percent of GDP, but a significant widening of the *non-oil* augmented deficit by about 1¼ percent of GDP.[8] Thus, if oil prices were to decline compensating measures would need to be taken swiftly to avoid a weakening of the fiscal position. The authorities noted their efforts to direct new spending away from programs that would create spending inertia, although they recognized that additional spending was being undertaken by states, as a result both of rising transfers and borrowing on the strength of future transfers. They noted also that in 2004 unbudgeted oil revenues helped to support additional investment, particularly in PEMEX, where public investment could have a high financial return, and represented a form of saving.

23. **Setting fiscal policy in a context of oil income volatility and uncertainty over future oil prices is inherently complex.** The authorities observed that the system of budget adjustors used in Mexico in recent years was focused on addressing fluctuations of oil prices affecting a single budget year**.** The approach helped assure achievement of annual fiscal deficit targets, but it was not geared toward managing income from a multi-year oil price boom.[9] Moreover, without an established mechanism for identifying "temporary excess" oil income, disputes on its size and use had dragged on in congress. Indeed, the authorities noted the broader difficulty of finding consensus with the congress on fiscal policy—as illustrated by the fact that the 2005 budget had gone to the Supreme Court, and still remains under dispute.

24. **The authorities agreed that Mexico would benefit from a new medium-term framework for setting the fiscal policy stance and managing oil income.** They pointed to a reform proposal now in congress, which would take a more medium-term approach, based on an oil reference price. The proposed budget law would establish, as an ongoing target, that each annual budget be balanced when evaluated at an oil reference price. The authorities expected that a zero balance on the traditional measure would be consistent with an augmented fiscal deficit of about 1½ percent of GDP and a tendency for the public debt ratio to decline.[10] In contrast to past practice, the oil price used in the budget would aim to capture a long-run, or underlying price,

---

[8] From 2002 to 2005, the augmented deficit excluding gross oil revenues is projected to have widened by 1.3 percent of GDP. The non-oil augmented deficit (defined as the deficit excluding oil revenues *net* of PEMEX operational expenditure and interest) widened by 1.2 percent of GDP.

[9] As staff noted, without a medium-term perspective on the oil price, if oil prices stay high for some time or rise from year to year, most of the defined oil windfall oil in a given year could become part of the budget assumption in the following year, associated with a permanent increase in spending.

[10] In terms of accounting, excess oil income that flows into the oil saving funds when oil prices are high would be recorded as a expenditure in the traditional budget measure (a transfer payment, above-the-line), while withdrawals from those funds when oil prices are low would be recorded as above-the-line income. The augmented budget measure would adjust for this.

Box 2. The Mexican Energy Sector Amid Rising Fuel Prices

The energy sector is a smaller part of the Mexican economy than in many other oil-exporting countries. At the same time, the sector is critical to the fiscal accounts, because the sector is entirely state-owned, and because non-oil tax revenue is low, although the policy of smoothing of domestic gasoline prices somewhat dampens the fiscal gains (and losses) from changing world oil prices. The existing fiscal framework for managing oil income focuses on achieving annual fiscal deficit targets; it is not designed to save a large share of the income from a multi-year oil price boom.

The energy sector is a relatively small part of Mexico's economy. After domestic energy needs are met, Mexico is able to export oil in an amount that represented about 4 percent of GDP in 2004. For comparison, this oil export/GDP ratio was around 15–20 percent for Ecuador, Norway, Russia, and Trinidad and Tobago, and 30–50 percent for Algeria, Nigeria, Saudi Arabia, and Venezuela.

Domestic use takes up a substantial part of Mexico's energy production—and some fuels are imported. Of crude oil production, about 45 percent is consumed in Mexico and the rest exported. Mexican production covers about 90 percent of domestic consumption of refined oil products, and about 80 percent of domestic use of natural gas; imports provide the balance.

Mexican oil has a somewhat lower than average value. Mexican oil production is mainly heavy crude, and the price of the Mexican oil mix tends to be some US$5–10/barrel below the world average (APSP) petroleum price. The size of this discount has widened recently, implying that recent "oil windfall" gains have been somewhat less in Mexico than for other oil exporters.

Nevertheless, oil income is of great significance to the Mexican public finances, reflecting state ownership of the sector and the low level of non-oil tax revenue. The fully state-owned company PEMEX is the sole producer of crude oil, natural gas and refined products, and the sole marketer of refined products in Mexico, as required by the country's constitution. With rising prices, PEMEX's total sales reached US$69 billion in 2004, or about 10 percent of GDP. PEMEX accounts for a critical share of public sector revenue, which reached nearly 40 percent in 2005. This reflects also that non-oil tax revenue in Mexico is relatively small, about 10 percent of GDP.

Investment and oil reserves: For many years, PEMEX investment had been relatively low, below the level required to maintain a stable level of proven reserves. After 1996, however, oil investment has grown steadily, through expansion of PIDIREGAS investments.[1/] From an average annual US$7 billion in 2000–02, PEMEX investment in 2003–05 is expected to average US$11 billion (an increment of about 0.6 percent of annual GDP). Currently, proven oil reserves are the equivalent of about 11 years of annual oil production. PEMEX expects the reserve replacement ratio to reach 100 percent by 2010, if the recent investment rate is maintained.

PEMEX governance issues: PEMEX's board is comprised of government officials and union representatives. Without a clear mandate to maximize the value of PEMEX, there is a potential lack of transparency and accountability of the management process, allowing the company to pursue a range of objectives. The fact that PEMEX's budget is part of the federal budget assures that any quasi-fiscal activity by PEMEX will be reflected in the fiscal statistics, but this relationship may at times constrain the company's ability to maximize its value. Moreover, the ban on private equity financing requires PEMEX to have relatively high debt, and it also prevents the Mexican government from diversifying its assets away from the high-volatility energy sector and thereby reducing the volatility of its income.

[1/] PIDIREGAS investments are infrastructure projects first executed and financed by the private sector and later transferred, as well as the debt associated to them, to the public sector.

Box 2. The Mexican Energy Sector Amid Rising Fuel Prices (continued)

Macroeconomic impacts of rising oil prices

With no private ownership in the Mexican energy sector, when world oil prices rise, all incremental income accrues to the public sector.

From a macroeconomic viewpoint, an increase in world oil prices could be thought of as an increase in a tax on consumption of oil, but this effect is largely offset in Mexico, as consumers are shielded from rising world prices. The government's oil windfall (based on all sales, domestic and foreign) exceeds the nation's windfall (which arises only from exports). In practice, however, the government's windfall is dampened because gasoline excise taxes are adjusted to smooth the price paid by domestic consumers. Domestic gasoline prices are administered, generally set to rise at a rate similar to that of inflation. For example, as world oil prices have risen, revenue from the gasoline excise fell from 1.8 percent of GDP in 2002 to a projected 0.2 percent of GDP in 2005. (Moreover, most consumers receive electricity at a subsidized price, with a fiscal cost of 0.8 percent of GDP recently.)

In terms of short-term economic growth, rising oil prices may be expected to have a slightly negative effect in Mexico. Again, the Mexican private sector receives no profit income from the energy sector. In practice, much of the potential drag on domestic demand from higher prices has either been avoided (by not passing price increases to consumers) or has been offset by a deterioration of the non-oil fiscal balance. The most relevant channel on growth is through higher oil prices' potential negative impact on the U.S. economy, in turn affecting Mexican exports.

Fiscal framework for oil income fluctuations

The fiscal framework for oil income has taken a year-at-a-time approach. The framework is centered on distributing the within-year oil windfall (that is, excess oil income defined relative to the budget's assumptions, rather than to a long-term oil price).

In practice, actual oil prices and revenue have exceeded budget assumptions in recent years. The advantage of having a conservative budget assumption lies in avoiding the need (in order to meet a deficit target) to cut budgeted expenditures if the oil price declines unexpectedly during the budget year. Such a budgeting approach may also help contain the growth of recurrent expenditure programs that would add inertia to government expenditure.

Each year's budget law then specifies a formula for distributing any oil windfall. However, the windfall for this purpose is measured after first compensating for shortfalls in budget revenues and financing overruns in certain non-discretionary spending (including for example spending arrears from the previous year, higher interest payments, and higher energy costs).

This approach to oil price fluctuations has been consistent with the achievement of annual targets for the traditional budget deficit. At the same time, saving of the incremental oil income since 2002, as measured by the narrowing of the augmented fiscal deficit, has been limited, for several reasons. First, in the budget adjustors, "excess" oil income is defined relative to an annual budget assumption that has been raised over time. Second, as noted, this excess income is defined net of certain negative developments elsewhere in the budget. Finally, the budget adjustors formulas agreed each year specifically assure that an important fraction of the remaining windfall will be spent. In short, the framework is not designed to achieve financial savings of temporary income from a multi-year oil price boom, but rather to support compliance with annual deficit targets.

determined according to a pre-set formula (rather than by annual negotiations with congress), thus smoothing expenditures over the oil cycle. The proposal would also reduce the range of potential "leakages" whereby unbudgeted windfall oil income during the year is measured net of certain negative developments elsewhere in the budget, before being distributed to spending or saving.

25. **The mission agreed that these changes would represent a step forward, while noting areas in which such a new framework could be enhanced.** First, it would be desirable to anchor fiscal policy by linking the framework to a medium-term debt objective. While focusing operationally on the fiscal balance, the framework could explicitly establish an objective for gradually reducing the public debt ratio. The authorities saw the point, but were concerned that proposing agreement on a specific debt target level at this stage would complicate and likely delay congressional approval. They also noted their expectation that the proposed deficit target would be consistent with a gradual decline in the public debt ratio. Second, the staff observed that the new approach—while it should support a greater saving of oil income than in the past—would put rather low upper limits on such saving. The proposal would establish three saving funds, but once these reached certain levels (about 1½ percent of GDP, for the combined funds), all subsequent oil windfall money would go to expenditure. The mission suggested easing, or eliminating, these limits on saving, but the authorities felt that a consensus for a greater saving of oil income was not yet established.[11] The saving funds would still provide an important cushion, and they emphasized that the proposed framework was symmetric: during times of low oil prices, dissaving would also be limited.

26. **With regard to the 2006 budget, the mission supported the authorities' intention to maintain consolidation efforts and increase saving of oil revenue.** To reduce the public debt further, the mission recommended reducing the augmented deficit to no more than 1½ percent of GDP in 2006, and in any case to avoid a weakening of the non-oil balance. In September, the authorities submitted a draft budget that was in line with the medium-term fiscal scenario set out by the government in its 2002 economic program. The budget thus aimed at a small surplus on the traditional balance, and an augmented deficit of 1½ percent of GDP, based on general expenditure restraint and an oil price assumption of US$31.5 per barrel (about one-third below prices for the Mexican oil mix prevailing in September 2005). Should oil prices turn out higher than the budget's assumption, the outcome for the underlying fiscal stance—as indicated by the non-oil augmented balance—would again depend on the budget's procedures for allocating unbudgeted oil income. Based on the proposed budget mechanisms, as well as consideration of potential leakages and pressures likely to emerge again in budget negotiations, staff project that the non-oil deficit would stay essentially constant in 2006 (this projection is based on a cut in the expenditure ratio from 2005, although not as large as the decline in the budget proposal).

[11] The Chilean fiscal framework, for example, requires saving the entire amount of the government revenue, from the state-owned copper company, that is associated with copper prices in excess of a medium-term forecast price.

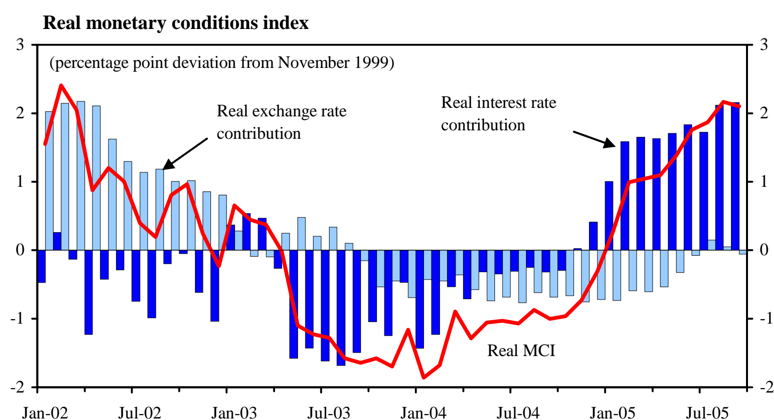
C. Monetary and Exchange Rate Policy

27. **The authorities explained that the tightening of monetary conditions in 2004 and 2005 had been necessary to contain, and then reduce, inflation.** Following a series of supply-side shocks that pushed up the headline inflation rate, the authorities had been concerned to see rising private inflation expectations in 2004 and moved quickly to avoid second-round effects and a potential de-anchoring of expectations. Beyond that goal, policy action had been required to take inflation down to the 3 percent target—the authorities emphasized that a settling of inflation in the upper part of the 2–4 percent "variability range" would not be acceptable.

28. **The mission agreed that the tightened stance had prevented spillovers of temporary price shocks, and helped to further the convergence of inflation to its target.** Wage increases had not accelerated, and inflation expectations had been revised downward. By mid-2005, both core inflation and inflation expectations had eased.

29. **Against this backdrop, the mission agreed that it had been appropriate to end the monetary tightening cycle in mid-2005.** The tightening had taken short-term real interest rates up to around 6 percent, and some of the effect of this tightening action on demand was likely still in the pipeline (subsequent to the mission, it became clearer that domestic demand was moderating). Barring unexpected new inflation pressures, the stance appeared to be sufficiently restrictive to support convergence to the inflation target—raising the issue of the timing and pace of phasing out the tight stance.

30. **The authorities emphasized that the policy stance was continually reassessed for consistency with the inflation target, noting several complexities and risks of the current setting.** Although the economy had grown rapidly in 2004, the authorities did not yet see generalized demand pressures on prices. With the recovery of credit, arising mainly from structural factors, the link from monetary policy to domestic demand was less certain, complicating assessment of the appropriate policy stance. The substantial interest rate differential with the U.S. also raised several considerations. Were this to lead to a significant short-term real appreciation of the peso (along with other underlying factors pushing up the real rate, such as rising oil exports and remittances), monetary conditions would effectively tighten further. The authorities also noted that the attractiveness of the Mexican capital market to foreigner investors, partly spurred by current global liquidity conditions, was difficult to predict.



Source: IMF staff calculations.

31. **The mission broadly shared this assessment, noting that the timing and pace of easing was linked also to the need to entrench recent credibility gains.** Moving too soon or too rapidly could risk being misread as a sign that the BoM was satisfied with inflation near the top end of the variability range (as currently suggested by indicators of market inflation expectations). However, given the restrictiveness of the policy stance, and taking account of monetary policy lags, it would be natural to begin relaxing the stance ahead of actually achieving the 3 percent target. The importance of solidly anchoring market expectations on the official target, in order to realize the full benefits of the inflation targeting regime, would argue for a gradual and cautious approach to easing until inflation expectations finally coincide with the target.

32. **The authorities explained the role that enhanced communication has played in the functioning of the inflation targeting framework, with a number of key operational changes since early 2004.** Importantly, policy announcements during that period have been shortened to a single page, have emphasized that the central bank's target is 3 percent (not the 2–4 percent variability range), and most fundamentally have guided more explicitly the evolution of short-term interest rates. It is clear to markets, the authorities noted, that monetary conditions and monetary policy are now increasingly conceived of in terms of the overnight interest rate. That said, the authorities were on the whole comfortable with the continued use of the corto as the official policy instrument, and did not see a clear case to shift now to an explicit interest rate target. In its August and September communiqués, the central bank signaled that interest rates could fall, but did not change the corto. Some analysts viewed this as a further shift toward using the interest rate as the policy tool, while others felt that the authorities wanted to send a more moderated signal to the market than might have been implied by a cut in the corto. Staff acknowledged that the current operational approach had proven workable so far, as the BoM had demonstrated effective control of the overnight interest rate; however, they also suggested that moving to a single instrument would provide more clarity to markets.[12]

33. **The persistence of private inflation expectations above the official inflation target—at all horizons—raises the question of what more could be done to enhance the policy framework.** The mission welcomed that the BoM has conveyed publicly its own projection of inflation over the near term (e.g., since January 2005, the BoM has stated its expectation that headline inflation would decline enough to end the year just inside the 2–4 percent variability range). The mission suggested that if the BoM were to go further—by publishing a forecast corresponding to a conventional monetary policy horizon, or by announcing a "convergence horizon" within which policy aims to achieve the 3 percent target—this could help manage private expectations, in turn making it easier to achieve the inflation target. The authorities saw the potential for such a benefit, but considered that it was still outweighed by the risks they had cited earlier of losing flexibility and credibility in a fast-changing economic environment, especially in the period before convergence with the target ("the final disinflation step") has been achieved.

[12] The use of the corto (a borrowed reserves objective) as a monetary policy instrument was a subject of much discussion in the past, when interest rates were fluctuating strongly. Many market analysts expect it to be eliminated at some stage.

34. **Finally, it was agreed that Mexico continues to be well-served by its floating exchange rate regime.** The mission commended the authorities' adherence to a floating exchange rate regime, accompanied by a rules-based reserve accumulation policy. The rule's formula for selling back reserves, although essentially a rule of thumb, has the key advantage of being transparent and avoiding the suggestion of an exchange rate target. The staff believed that the level of reserves was reasonably healthy, but further accumulation was not problematic, and in fact could provide some support to confidence in an election year context. The authorities noted that the "carrying" cost of reserves had climbed, with the widening Mexico-U.S. interest differential, but viewed this as a temporary phenomenon that was already being reversed.

D. Financial Sector Issues and Policies

35. **The mission noted continued improvement of a wide set of financial sector indicators (Table 5).** In particular, the mission noted the strong offsite supervision of the risk management practices of commercial banks and the largest nonbank financial intermediaries (the mortgage Sofoles[13]), increased reliance on market discipline mechanisms, and the growing participation of institutional investors with large assets under management. In addition, commercial banks are adequately capitalized, profitable, and appear to have sound risk management systems. Nonperforming bank loans (NPLs) are relatively low at less than 2½ percent of total loans, down from 5 percent at end 2001. Banks have also built sizeable provisions against NPLs, with coverage ratios around 200 percent. Recent stress tests by the authorities show that commercial banks would withstand severe market and private credit risk shocks. While credit growth has been partly supported by guarantee schemes (targeted to SMEs) through which development banks take on credit risk, these schemes are still limited in size (around 0.2 percent of GDP at mid-2005).

36. **Although potential risks to the financial system appear limited in the short-term, continued vigilance and increased efficiency in the allocation of credit to the private sector remain essential.** While Sofoles' non-performing loans remain low (about 2.7 percent of total loans), they have shown an upward trend this year, suggesting the need for Sofoles and their supervisors to closely monitor the quality of their credit (taking into account that non-performing loans are often a lagging indicator). The mission also noted that commercial banks' exposure to the public sector, although stable, remains high. In addition to making banks sensitive to potential changes in the value of government securities, these claims can crowd out the private sector, contributing to lower access to bank funding and potentially higher financing costs.

37. **The authorities explained that the near-term reform agenda included corporate governance, the bank resolution framework, and the optimal supervision of Sofoles.** A proposed new securities market law, which has been submitted to congress but has run into intense counter-lobbying, aims at raising corporate governance standards and encouraging

---

[13] Sofoles do not take deposits, are licensed by the Treasury to grant credit to specific segments of the economy and the bulk of their financing comes from the government through the state development banks, although they have started to tap the private market.

smaller firms to use equity finance by strengthening minority shareholder rights. The government is in the final stage of preparing new bank resolution legislation. Although there are already a series of procedures for prompt corrective actions in place, the passage of a new bankruptcy law would eliminate some loopholes that currently could complicate the resolution of financial institutions. Finally, the authorities plan to allow Sofoles to branch into leasing and factoring, de-regulating those Sofoles that do not take deposits from the public, and thus are not seen as representing a systemic risk.

38. **The authorities were also considering steps to promote more diversified investment strategies among private pension funds (Afores).** Although Afores' regulations have been changed to allow greater diversification and thus efficiency,[14] Afores continue to invest heavily in mostly short-duration government instruments. Most Afores invest in very similar portfolios, perhaps because they do not derive much of their income from the value of their assets under management. To lessen this investment concentration, each Afore has had to establish two mutual funds, one entirely in fixed-income securities, and another one in debt securities and equities. The authorities are in the process of fine-tuning this "benchmarking" in coordination with the industry.

39. **The mission welcomed Mexico's track record in financial reforms.** As documented in the two Selected Issues papers on the banking sector and domestic debt market, an impressive series of reforms has strengthened the stability of the banking sector, while promoting nonbank sources of financial intermediation. A number of the 2001 FSAP's key recommendations have been addressed, including in the area of the payments system, banking regulation, and offsite supervision of banks' risk management practices. In order to better assess the current strengths of the financial system and to serve as a reference for the next administration, the authorities plan to soon request an FSAP update.

E. Vulnerabilities and Measures to Boost Resilience

40. **The authorities underscored that economic fundamentals are solid and resilience to shocks has been fortified.** The level of gross public sector debt, at around 45 percent of GDP, does not raise concerns of sustainability, and the current fiscal stance is already adequate to avoid a rise in this debt ratio. Furthermore, the average maturity of domestic debt has increased in recent years. As the government has shunned dollar-indexed debt and shifted away from external debt, and as oil export prices have risen, there is no longer concern about the budget's net exposure to peso depreciation. External debt is mainly long-term, and the authorities consider that the federal government will not need to issue in the global bond market before 2007.

41. **Staff agreed that Mexico's economy has been considerably strengthened.** The exchange rate is flexible, the commitment to low inflation is credible, and exchange rate

[14] Afores' regulation had been characterized by strict investment limits with a strong bias toward liquid, inflation-indexed domestic government securities. However, recent legislation has enabled the Afores to invest in foreign securities, domestic equity, and derivatives. In time, regulation has de-emphasized the maturity, currency denomination and origination characteristics of the assets held by Afores, in favor of regulation emphasizing Afores' credit risk management.

pass-through to inflation has become low. Moreover, the public sector balance sheet especially is stronger than in the past, and compares favorably to other emerging markets' in terms of exposure to currency depreciation. Furthermore, external debt, and external financing needs, of both the public and private sectors are smaller in Mexico than in many other countries, and the modest current account deficit has been more than covered by FDI.

Selected Vulnerability Indicators, 2004
(In percent of GDP, unless otherwise indicated)

	Mexico	Median, sample of 48 emerging market countries
External sector		
Gross reserves in percent of short-term debt at remaining maturity	136.4	148.1
Total gross external debt	23.5	46.8
Of which: External debt of domestic private sector	8.5	22.9
Current account balance	-1.1	-0.9
Gross external financing requirement 1/	6.8	12.5
Public sector 2/		
Overall balance	-2.0	-2.2
Gross public sector financing requirement 3/	13.0	7.6
Public sector gross debt	46.5	46.7
Of which: Exposed to exchange rate risk 4/	16.3	25.7
Exposed to rollover risk (ST debt, residual maturity) 5/	10.6	4.4
MLT debt at variable interest rate	14.5	12.3
Memo items:		
EMBI + secondary market spread (bps, average)	187.0	...

Source: Staff estimates.

1/ Current account deficit plus amortization of external debt; 2005 estimate for Mexico.
2/ For Mexico, public sector includes public enterprises.
3/ Overall fiscal deficit plus debt amortization and rollover; 2005 estimate for Mexico.
4/ Debt in foreign currency or linked to the exchange rate, domestic and external.
5/ Short-term debt and maturing medium- and long-term debt, domestic and external, excluding external debt to official creditors.

42. **Still, the mission noted that further steps to bolster resilience continue to be important.** Annual public sector financing needs are estimated to exceed 10 percent of GDP, and the fiscal position could be affected significantly by an oil price decline (as a rough rule of thumb, a decline in the oil price of US$10/bl reduces government revenue by about 1 percent of GDP). While Mexico's public debt ratio is not out of line with other OECD or emerging market countries,[15] there is room to reduce public sector financing needs by reducing that ratio and also by further extending the average maturity of the public debt—especially of the domestically-issued debt, which was 3.1 years at mid-2005.[16] [17] In addition, an estimated 17¾ percent of GDP in public domestic debt carries a floating interest rate or is short-term. The authorities agreed that further extending the maturity of the public debt is

[15] Available data on public sector deficits and debt vary across countries. It should be noted in particular that the Mexican data have a very broad coverage, including both public enterprises (part of the budget) as well as several off-budget activities.

[16] Figure refers to domestic federal government securities only, as full information on the maturity of all components of the augmented public debt is not available.

[17] For comparison, this indicator recently has been about 2½ years in Brazil, 5 years in Malaysia, 5 ½ years in Colombia, 6 years in Israel, 6½ years in Canada, and almost 8 years in South Africa (as data definitions can vary across countries, such figures may not be strictly comparable).

important; they also noted that most of the public sector's financing need was in terms of pesos, and that account should also be taken of the public sector's liquid assets.[18]

43. **Staff observed that its analysis of various potential shocks (Annex V) illustrates the importance of continuing to extend the effective maturity of public debt.** While calculations show that a "confidence shock" episode[19] with a hike in interest rates and a sharp depreciation, along with weaker growth, could put the public debt on an upward path, the rise would be fairly limited. However, gross public sector financing needs could rise significantly if a shock were sustained and the authorities were forced to rely on short-term debt to finance amortization. The mission, therefore, underlined the importance of reducing rollover risk and continuing to seek an extension of debt maturity, even if interest rates were to become less favorable.

44. **Like other emerging markets, Mexico would be challenged by a scenario involving lower U.S. and world growth, especially if it were prompted by a significant loss of confidence in U.S. assets and rising foreign interest rates.** In such a setting, Mexico would be particularly affected through its important export links to the U.S. and by a demand-induced drop in world oil prices. Economic activity in Mexico would be strongly affected. Moreover, in the absence of new fiscal measures, the augmented fiscal deficit could widen by several percentage points of GDP (mainly from the oil price and interest rate effects). In such a scenario, it was agreed, an early and decisive fiscal policy response would be essential.

F. Structural Reforms and Competitiveness

45. **A political breakthrough on major structural reforms appears unlikely in the context of the run-up to the 2006 elections.** The mission noted that public awareness of the need for reforms had improved significantly over the past several years, as a result of the government's efforts. Still, full-fledged reforms critical for medium-term growth, including governance, labor market, energy and telecommunication sectors, and taxes, would probably have to wait. Some political analysts suggested that a window of opportunity for reform would come during the parliamentary session immediately after the elections (September–December 2006), before the new President takes office.

46. **In the meantime, the authorities emphasized they would continue to press for smaller-scale reforms aimed at improving structural competitiveness for specific sectors.** Already, a number of laws dealing with specific sectors (mining and farming) and public procurement had been approved so far in 2005 through a special working group on competitiveness in the Senate—established in 2005 with broad political, business, and public sector participation. Progress was also being made through administrative measures to reduce red tape at the local level and to enhance tax collections. The authorities will continue this

---

[18] They noted, for example, that IPAB, the public entity that accounts for an important share of the short-term domestic debt, held liquid assets of about 1.5 percent of GDP at mid-2005.

[19] The mission noted a consensus among private analysts that a sudden shock to confidence is unlikely, as neither economic fundamentals nor acceptance of the need to maintain macro policy discipline are likely to deteriorate quickly.

approach in 2006, through further addressing regulatory concerns identified by the private sector. Another area of progress was regional economic integration, which a recent security and prosperity partnership agreement with the U.S. and Canada is expected to promote.

47. **The mission welcomed these efforts, highlighting the need to move ahead with reforms of PEMEX corporate governance.** Higher oil prices, and higher resource flows to PEMEX, made it more important than ever to assure PEMEX's optimum performance. Administration proposals of governance reforms for PEMEX had not advanced in congress.

48. **The mission noted that progress on the structural reform agenda would help counter a loss of competitiveness in the face of intense competition from China and other markets with lower wages.** Conceptually, such competition was pulling against the tendency of the real exchange rate to appreciate as a result of higher oil export prices (and the spending of some of the additional oil income on domestic goods and services). For now, given the current external terms of trade, the real exchange rate is broadly in equilibrium. The real exchange rate has been fairly stable, and the current account deficit has remained small, implying declining external debt ratios. The mission observed also that the non-oil trade deficit had not greatly weakened, and that the growth of non-oil exports was continuing, at a respectable though not dynamic pace. On the other hand, the rate of FDI into Mexico was rather low by international comparison, and the mission and authorities agreed that Mexico's competitiveness will face ongoing risks, highlighting the need for structural reforms (Box 3). The authorities noted the relative lack of high productivity manufacturing in Mexico to which resources could shift as traditional maquila manufacturing was gradually moving to markets with lower wages. Looking forward, it would be important to encourage investment and enhance competitiveness by improving the supply of skilled labor and modern infrastructure, and by addressing high production costs (especially energy and telecommunication) and problems of public and corporate governance.

Mexico and Selected Countries: Foreign Direct Investment, in percent of GDP

	1995–2004	1995–1999	2000–2004	2003–2004
Mexico	2.9	3.0	2.9	2.2
Latin America (excl. Mexico) 1/	3.2	3.6	2.7	2.2
New EU member countries 2/	5.2	4.7	5.6	3.8
Selected Southern Europe 3/	3.5	1.4	5.6	4.0

Source: *World Economic Outlook.*

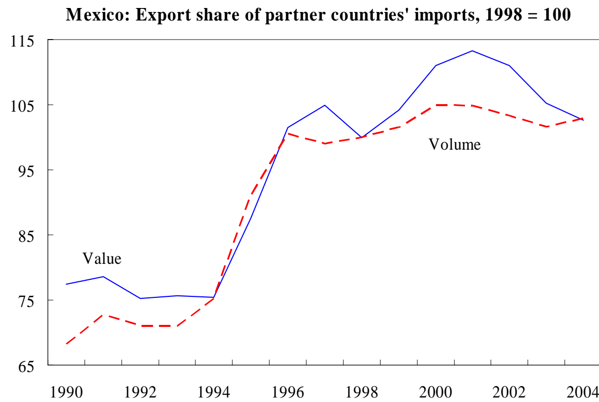
1/ Argentina, Brazil, Chile, Colombia, Venezuela.

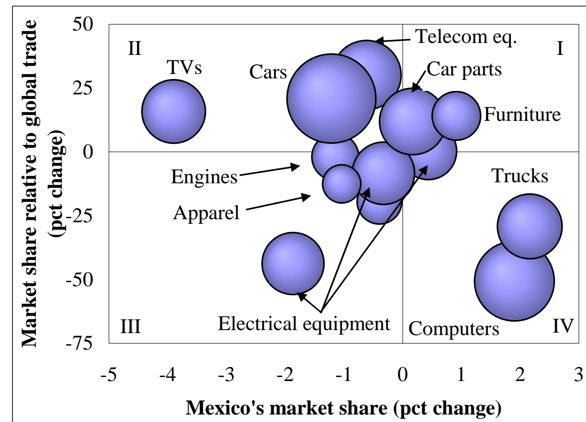
2/ The Czech Republic, Estonia, Hungary, Latvia, Poland, and Slovakia.

3/ Cyprus, Greece, and Portugal.

Box 3. Competitiveness of the Mexican Economy

Mexico's share of world export markets has returned to the levels it jumped to just after NAFTA a decade ago. The increase in the value of exports in the late 1990s seems to have been cyclical in nature and in 2004 the volume of exports was no higher than in 1996–98. The decline in world export market share—effectively a decline in Mexico's share of the U.S. market, to which Mexico exports almost 90 percent of its goods—appears related to increased competition from China. Recent data from the BoM suggest that Mexican and Chinese products compete head on in about one-half of commodities, the value of which is equivalent to three-quarters of their total exports to the United States.





An analysis of manufactured exports suggests that Mexico is not well-positioned in the major dynamic markets.[1] The figure above plots the changing world market share of Mexico's major manufacturing exports against the changing share of those products in world trade, with the size of each "bubble" representing the value of Mexico's exports in 2003. With the exception of car parts and furniture (quadrant I), most of Mexico's exports are either in commodities whose share in the world market is declining (quadrants III and IV) or Mexico's commodities are losing share in an expanding segment (quadrant II).

Mexico-China Competition on the U.S. Market

(January-April, 2005)

	Number of products exported to the U.S. 1/	Number of competing products 2/	Share of competing products 2/ 3/
Mexico	997	482	74.5
China	1084	482	73.3

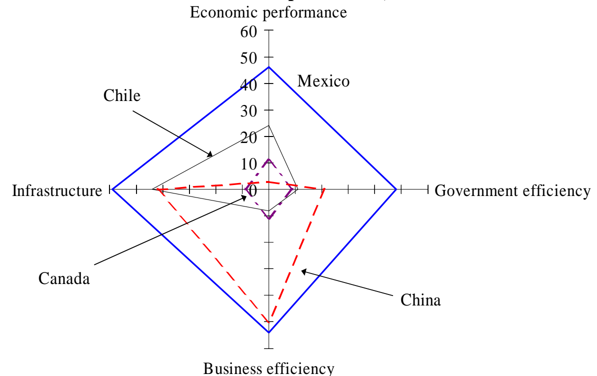
Source: Bank of Mexico.
1/ The United States imported a total of 1,237 commodities.
2/ Commodities where the value of Mexican (Chinese) exports is at least 5 percent of Chinese (Mexican) exports and where Mexico and China have at least a 5 percent share of the U.S. market.
3/ In percent of the value of the country's exports to the United States.

Survey-based indicators provide an alternative measurement of "structural" competitiveness. Both the International Institute for Management Development (IMD 2005 World Competitiveness Yearbook) and the World Economic Forum (WEF Global Competitiveness Report, 2004–05) rank Mexico below its main competitors (China and Canada) and at par with other Latin American countries. A more detailed breakdown of the IMD ranking suggests that Mexico scores much below Canada and Chile in all four categories and below China in all categories but business efficiency.

Survey-based indicators of competitiveness

	IMD	WEF
Mexico	**56**	**48**
Canada	5	15
Chile	19	22
China	31	46
Latin America 1/	47	60
New EU Accession 2/	44	43
Memorandum:		
Number of countries ranked	60	104

1/ Average of Argentina, Brazil, Chile, Colombia, and Venezuela.
2/ Average of Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.



[1] Comparison based on annual data of 15 major manufacturing exports (3-digit level) for 1998 and 2003.

IV. STAFF APPRAISAL

49. **Mexico's economy has come a long way in the decade since the 1994/95 crisis, with profound changes in economic policies, institutions and structure, although further challenges remain.** Confidence in the public finances has been achieved with declining fiscal deficits and improvement of the structure of the public sector debt. In the context of a floating exchange rate, monetary policy has brought inflation down to the low single-digits. A series of reforms has strengthened the financial sector and boosted its development, while NAFTA contributed to opening the economy further and integrating it in the world economy. Moreover, policies are now formed in a setting of a multi-party democracy, stronger institutions, and greater transparency of government. However, growth of per capita income has been lackluster in the last decade, with important parts of the structural reform agenda stalled. Looking ahead, the challenge to Mexico is to entrench the considerable progress on the macroeconomic policy front, and to launch a new round of structural reforms that will permit a transition to a rapid growth path.

50. **Fiscal policy has earned broad credibility with a track record of hitting annual deficit targets, albeit through reliance in recent years on rising oil revenue.** The reduced deficit on the traditional measure—together with restraint of the off-budget flows that are transparently reported in the augmented balance—has allowed some decline of the public debt ratio. This achievement, however, has been increasingly dependent on rising world oil prices. While the non-oil fiscal deficit narrowed somewhat in 2004, it appears to have weakened in 2005 (as in 2003). The gradual expansion of the non-oil deficit makes the budget potentially vulnerable to a reversal of these favorable conditions. So far, the government has absorbed much of the potential domestic impact of higher international oil prices through reducing fuel excise taxes, and by increasing subsidies to electricity consumption. The institutional and political environment has also made it difficult to save a high share of the additional oil income that does flow to the budget, but this remains an important goal.

51. **As the authorities recognize, Mexico would benefit from orienting fiscal policymaking more toward medium-term objectives, for which a revised fiscal policy process may be needed.** A proposed budget law now in congress would replace year-at-a-time decision-making on the fiscal stance and the use of oil income with a system centered on achieving a zero budget deficit over the medium-term, based on a medium-term reference oil price. A system along these lines would be a step in the right direction. It would be important also to press for a medium-term objective of further reducing the public debt that would promote the saving of an important share of revenue gains from oil price booms that may last several years. A medium-term fiscal framework for Mexico should also explicitly formulate policy in light of the size of oil reserves and oil-related investment needs. In the meantime, including in 2006, a further deterioration of the non-oil augmented balance should be avoided. The authorities have rightly emphasized the need to address medium-term fiscal pressures, including through their proposed reform of public sector pensions. Certainly, a reform to address the longstanding structural weaknesses of the tax system will be needed, and it is unfortunate that the authorities' earlier proposals in this direction have not found political consensus.

52. **Having firmly established a low inflation environment, monetary policy's challenge now is to achieve full credibility of the 3 percent inflation target.** The stabilizing advantages of the inflation targeting regime will be more fully realized when private expectations are aligned with the official target. The central bank acted appropriately to ensure that a rise in inflation and inflation expectations in 2004 would not become entrenched, and to push inflation down toward the 3 percent target. It is reassuring that both core inflation and inflation expectations have been moving downward in recent months. Barring strong new shocks, the focus in the near-term can be on gauging the appropriate pace for phasing out the restrictive policy stance. In continually assessing the balance of risks, the authorities will want to take into account the added importance of an anchor in an election year context as well as the remaining small but persistent gap between private inflation expectations and the inflation target.

53. **The effectiveness of monetary policy has been supported by important changes in the operational framework implemented since early 2004.** Together these have enhanced policy communication, including especially the shift towards defining policy changes in terms of an interest rate target. The central bank's indication of its inflation forecast for the current year is also helpful, and it is recommended that this important form of communication be extended to a somewhat longer forecast horizon, to further aid the private sector's understanding of the central bank's objectives.

54. **Mexico has made considerable progress in terms of strengthening the financial sector and its supervision.** Reforms in the financial and capital markets area have advanced considerably during the Fox administration, with a view not only to avoiding systemic vulnerabilities but also to providing a supportive financial environment for economic growth. An encouraging sign is that bank credit has begun to expand after many years of stagnation. The authorities recognize that financial reform and supervision must be an ongoing process, and their intention to request an FSAP update is welcome.

55. **In terms of reducing potential vulnerabilities, Mexico has applied well the lessons of the 1994/95 crisis, and the authorities' efforts to further solidify the macroeconomic framework are commendable.** Much has been achieved, of which staff would emphasize the strengthening of the public debt structure and of the financial system, and the anchoring of expectations on low inflation rather than an exchange rate objective. These and other policies are reflected in much-improved levels of a wide set of vulnerability indicators. As the authorities continue the process of building Mexico's resilience to shocks, it will be especially important to keep extending the maturity of all domestic debt and to reduce the level of interest rate-linked debt.

56. **Mexico is well-served by maintaining its floating exchange rate regime, including as an adjustment mechanism to external shocks.** Currently the country's real exchange rate is subject to opposing forces, as rising external competition would tend to induce a weaker rate, while the surging oil price—and the additional domestic demand it supports—would induce real appreciation. So far, non-oil exports are still growing, though only modestly. However, if signs were to emerge suggesting that price competitiveness were deteriorating excessively, fiscal policy could be called upon to reduce the public sector's contribution to demand.

57. **The near-term growth outlook for Mexico will continue to be closely linked to global and, in particular, U.S. developments, which are expected to remain relatively favorable.** With the passing of the mainly sector-specific factors that led to disappointing growth in the first half of this year, and barring important surprises in the global environment, Mexico's growth is likely to soon return to a moderate pace.

58. **Looking to the medium term, however, lifting Mexico's growth trend will depend mainly on the performance of the country's own economic policies.** Mexico's external competitiveness faces ongoing challenges, highlighting the need to move ahead with the pending structural reform agenda and thereby raise trend productivity and growth. As rising competition from China and other countries continues to gradually displace some Mexican production, the objective will be to move up the production ladder. As is widely acknowledged, progress on structural reforms has been disappointing, although there has been progress in some areas, especially the financial sector. Fortunately, there is by now a widened understanding of the pending structural reform agenda—including reforms in the energy and telecommunications sectors, the labor market, judicial system, tax system, and regulatory and business environments—partly the result of the Fox administration's efforts to advance such reforms. Without significant new breakthroughs on this agenda, the likelihood is that Mexico may achieve only lackluster economic growth.

59. **It is therefore to be hoped that the political system will soon find a way forward on reforms that so far have met gridlock.** Indeed, some analysts, seeing in recent years the growing pains of still relatively new multi-party democracy, expect that the natural development of new working relationships and rules of the game will improve prospects for consensus on new reforms.

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

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

I. Social and Demographic Indicators

GDP per capita (U.S. dollars, 2004)	6,506	Households below the poverty line (percent, 2002)	33.0
Population (millions, 2004)	102.4	Income share of highest 20 percent / lowest 20 percent	19.3
Life expectancy at birth (years, 2002)	73.6	Adult illiteracy rate (2000)	9.5
Under 5 mortality rate (per thousand, 2002)	29.0	Gross primary education enrollment rate (2000)	110.3

II. Economic Indicators

								Proj.	
	1998	1999	2000	2001	2002	2003	2004	2005	2006
(Annual percentage change, unless otherwise indicated)									
National accounts in constant prices									
Real GDP	5.0	3.8	6.6	0.0	0.8	1.4	4.4	*3.0*	*3.5*
Net exports (contribution)	-1.1	-0.5	-1.8	-0.7	0.0	0.7	0.2	*-0.3*	*-1.0*
Total domestic demand	6.2	4.3	8.3	0.7	0.8	0.8	4.0	*3.2*	*4.4*
Private consumption	5.4	4.3	8.2	2.5	1.6	2.3	5.5	*4.2*	*4.7*
Public consumption	2.3	4.7	2.4	-2.0	-0.3	0.8	-1.2	*-0.5*	*-0.8*
Gross fixed private investment	13.8	7.2	9.0	-5.9	-4.1	-1.5	8.5	*4.8*	*7.5*
Gross fixed public investment	-7.5	10.7	25.2	-4.2	17.0	8.5	3.6	*4.4*	*3.6*
Change in business inventories (contribution)	0.4	-0.6	0.3	0.4	-0.2	-1.0	-1.2	*-0.6*	*-0.3*
External sector									
Exports, f.o.b. 1/	1.2	14.6	21.5	-3.1	0.6	3.9	13.8	*13.1*	*8.4*
Export volume 1/	12.2	11.8	20.2	4.0	-3.4	-3.0	4.3	*2.9*	*4.4*
Imports, f.o.b. 1/	12.7	10.6	23.1	-1.7	-1.3	1.9	15.8	*13.6*	*6.8*
Import volume 1/	13.5	11.6	19.6	-2.3	-0.9	-0.5	3.7	*6.8*	*6.7*
Petroleum exports (percent of total exports)	9.7	11.6	15.5	13.0	14.6	17.6	19.7	*24.2*	*26.5*
Terms of trade (deterioration -)	-9.2	3.4	-1.8	-7.4	4.5	4.6	-2.3	*3.3*	*3.7*
Exchange rates									
Nominal exchange rate (US$/Mex$)									
(average, depreciation -)	-15.4	-4.7	1.1	1.2	-3.4	-11.7	-4.4	...	...
Real effective exchange rate (CPI based)									
(average, depreciation -)	1.9	9.0	10.0	8.3	-0.2	-12.8	-5.3	...	...
Employment and inflation									
Consumer prices (end of year)	18.6	12.3	9.0	4.4	5.7	4.0	5.2	*3.9*	*3.4*
Formal sector employment (annual average)	3.7	5.7	5.9	-0.5	-0.8	-0.5	1.3	...	...
Formal sector unemployment rate (annual average)	3.2	2.5	2.2	2.4	2.7	3.2	3.7	*3.6*	*3.5*
Real manufacturing wages (annual average)	2.8	1.5	6.0	6.7	1.9	1.4	0.0	...	...
Money and credit									
Broad money (M4a)	25.0	19.7	12.9	16.0	10.8	13.5	12.6	*8.4*	*8.2*
Treasury bill rate (28-day cetes, in percent, annual average)	24.6	21.4	15.3	11.2	7.1	6.2	6.8	*9.5*	*8.9*
(In percent of GDP)									
Nonfinancial public sector									
Augmented balance	-6.3	-6.3	-3.7	-3.6	-3.4	-3.1	-2.0	*-2.3*	*-1.4*
Non-oil augmented balance	-10.2	-10.5	-8.9	-9.0	-8.6	-9.2	-9.0	*-9.8*	*-9.8*
Augmented primary balance	0.5	1.3	1.2	1.1	0.3	0.4	1.3	*1.4*	*2.2*
Traditional balance	-1.2	-1.1	-1.1	-0.7	-1.2	-0.6	-0.3	*-0.2*	*0.2*
Gross public sector debt	52.6	55.8	49.3	47.9	49.7	50.0	46.5	*45.3*	*43.4*
Net public sector debt	45.0	46.8	42.2	41.7	43.6	44.0	41.2	*40.4*	*38.9*
o/w percent in foreign currency	52.0	46.9	38.2	35.5	37.6	39.2	39.5	*37.5*	*36.1*
Savings and investment									
Gross domestic investment	24.3	23.5	23.7	20.9	20.6	20.6	21.7	*22.3*	*22.4*
Public investment	2.8	3.0	3.6	3.6	4.2	4.5	4.8	*4.8*	*4.7*
Private investment	18.1	18.2	17.8	16.4	15.0	14.4	15.4	*15.5*	*15.8*
Change in inventories	3.4	2.3	2.3	0.9	1.4	1.6	1.6	*2.0*	*2.0*
Gross national saving	20.5	20.6	20.5	18.0	18.6	19.2	20.7	*21.2*	*21.7*
Public saving	-3.5	-3.3	-0.1	0.0	0.8	1.5	2.9	*2.5*	*3.3*
Private saving	24.1	23.9	20.6	18.0	17.8	17.7	17.8	*18.7*	*18.4*
External current account balance	-3.8	-2.9	-3.2	-2.8	-2.1	-1.3	-1.1	*-1.1*	*-0.7*
Non-oil external current account balance	-5.5	-5.0	-6.0	-5.0	-4.4	-4.3	-4.6	*-5.4*	*-5.5*
Foreign direct investment	2.9	2.8	2.9	4.5	2.4	1.9	2.6	*2.1*	*2.1*
(In percent of exports of goods, nonfactor services, and transfers)									
Public external debt service 2/	21.5	22.4	27.2	19.9	15.9	17.0	16.8	*16.4*	*16.0*
(In billions of U.S. dollars, unless otherwise indicated)									
Net international reserves	30.1	30.7	33.6	40.9	48.0	57.4	61.5	*67.6*	*74.5*
Gross official reserves in percent of short-term debt 3/	72.9	68.3	82.8	99.9	112.2	121.9	136.4	*146.5*	*158.0*
Gross external debt (in percent of GDP, end of period)	39.1	36.9	28.3	26.1	25.2	25.9	23.5	*21.2*	*19.9*

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

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

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

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

Table 2. Mexico: Financial Operations of the Public Sector, 2001–2006

(In percent of GDP)

	2001	2002	2003	2004	Budget 1/ 2005	Staff Projection 2005	Proposed Budget 2006	Staff Projection 2006
Budgetary revenue	**21.9**	**22.1**	**23.2**	**23.2**	**22.4**	**23.2**	**21.3**	**23.0**
Federal government revenue	16.2	15.8	16.4	16.6	16.1	16.7	14.7	16.2
Tax revenue	11.3	11.6	11.1	10.1	10.9	9.8	9.6	9.0
Excise tax (including fuel)	1.9	2.2	1.7	1.1	1.4	0.7	1.1	0.5
Nontax revenue	4.9	4.2	5.3	6.6	5.2	6.9	5.2	7.2
Public enterprises	5.7	6.4	6.8	6.6	6.3	6.5	6.6	6.8
PEMEX	1.8	2.4	2.6	2.5	2.3	2.3	2.6	2.8
Other	3.9	4.0	4.2	4.1	4.0	4.2	4.0	4.0
Budgetary revenue by type								
Oil revenue	6.7	6.5	7.7	8.3	7.8	8.9	8.0	9.7
Non-oil tax revenue 2/	9.8	9.8	9.9	9.4	9.9	9.6	8.9	8.9
Non-oil non-tax revenue	5.5	5.8	5.6	5.5	4.7	4.7	4.4	4.4
Budgetary expenditure	**22.6**	**23.3**	**23.9**	**23.5**	**22.7**	**23.4**	**21.1**	**22.8**
Primary	19.3	20.5	21.1	20.8	19.9	20.5	18.4	19.8
Programmable	15.9	17.0	17.6	17.2	16.6	17.3	15.0	16.9
Current	13.3	13.8	14.6	13.7	14.2	14.3	13.2	14.0
Wages	7.1	7.3	7.3	6.9	7.0	7.0	6.7	6.7
Pensions	1.9	2.0	2.1	1.9	2.2	2.1	2.2	2.2
Subsidies and transfers	2.1	2.2	2.3	2.3	2.5	2.4	2.1	2.1
Capital	2.6	3.2	3.0	3.6	2.4	3.0	1.8	2.9
Physical capital	2.4	2.3	2.7	3.0	2.4	2.9	1.8	2.7
Of which: subsidies and transfers	1.3	1.2	1.5	1.7	1.3	1.6	0.8	1.0
Of which: Pidiregas	0.1	0.2	0.3	0.5	0.3	0.5	0.4	0.4
Financial capital	0.2	0.8	0.3	0.6	0.0	0.1	0.0	0.2
Nonprogrammable	3.5	3.5	3.5	3.5	3.5	3.6	3.4	3.5
Of which: revenue sharing	3.4	3.4	3.3	3.1	3.4	3.4	3.2	3.4
Interest payments 3/	3.2	2.8	2.8	2.7	2.8	2.8	3.0	2.9
Traditional balance	**-0.7**	**-1.2**	**-0.6**	**-0.3**	**-0.2**	**-0.2**	**0.2**	**0.2**
Adjustments to the traditional balance	**2.9**	**2.2**	**2.4**	**1.7**	**2.2**	**2.1**	**1.7**	**1.6**
PIDIREGAS	0.8	0.8	1.1	1.1	1.0	1.0	0.9	0.9
IPAB	1.0	0.5	0.3	-0.7	0.3	0.3	0.2	0.2
Budgetary adjustments	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
PEMEX and oil stabilization fund	-0.1	0.1	-0.1	-0.5	0.0	0.0	0.0	-0.1
FARAC	0.1	0.4	0.0	0.2	0.0	0.0	0.0	0.0
Debtor support	0.0	-0.1	0.0	-0.2	0.1	0.1	0.1	0.1
Development banks	0.1	-0.4	0.4	0.2	0.5	0.4	0.4	0.4
Nonrecurring revenue	0.7	0.7	0.7	1.5	0.1	0.1	0.0	0.0
Augmented balance (PSBR excl. nonrecurrent revenue)	**-3.6**	**-3.4**	**-3.1**	**-2.0**	**-2.4**	**-2.3**	**-1.5**	**-1.4**
Augmented interest expenditure	**4.7**	**3.7**	**3.4**	**3.3**	**3.7**	**3.6**	**3.6**	**3.6**
Augmented primary balance 4/	**1.1**	**0.3**	**0.4**	**1.3**	**1.3**	**1.4**	**2.1**	**2.2**
Memorandum items								
Non-oil augmented balance 5/	-9.0	-8.6	-9.2	-9.0	-8.8	-9.8	-8.3	-9.8
Non-oil augmented primary balance	-4.2	-4.9	-5.8	-5.7	-5.1	-6.2	-4.7	-6.2
Gross public sector debt	47.9	49.7	50.0	46.5	...	45.3	...	43.4
Net public sector debt	41.7	43.6	44.0	41.2	...	40.4	...	38.9
Nominal GDP (billions of Mexican pesos)	5809.7	6263.1	6891.4	7634.9	7934.4	8275.0	8803.6	8951.7

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

1/ Based on version approved by Congress.
2/ Total tax revenue excluding excise tax on gasoline.
3/ Also includes transfers to IPAB and the debtor support programs (amounting to about 20 percent of total interest payments)
4/ Treats transfers to IPAB as interest payments.
5/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, IEPS on gasoline) and PEMEX operational expenditure and interest payments.

Table 3. Mexico: Summary Balance of Payments, 2002–2010

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Staff Projections					
	(In billions of U.S. dollars)								
Current account	-13.5	-8.6	-7.4	-8.0	-6.0	-9.9	-11.6	-13.1	-16.1
Merchandise trade balance, f.o.b.	-7.6	-5.8	-8.8	-10.7	-9.3	-14.6	-17.5	-20.7	-24.9
Exports 1/	101.7	105.7	120.3	136.0	147.4	150.7	155.8	161.2	166.4
Of which :									
Petroleum and derivatives	14.8	18.6	23.7	32.9	39.1	38.0	38.2	38.3	37.8
Manufactures	82.3	81.6	90.0	95.9	101.1	105.6	110.5	115.7	121.2
Imports 1/	-109.4	-111.5	-129.1	-146.7	-156.7	-165.3	-173.3	-181.8	-191.3
Factor income	-12.1	-12.1	-10.9	-11.3	-11.5	-11.2	-11.2	-10.9	-11.0
Other services and transfers	6.2	9.3	12.4	14.0	14.7	15.9	17.2	18.5	19.8
Financial account	17.8	14.6	16.4	14.1	12.9	16.6	18.2	19.7	22.6
Public sector	-3.0	-3.3	2.5	2.5	1.8	2.3	2.5	2.9	3.8
Medium- and long-term borrowing	-2.4	0.0	-2.1	-0.5	0.7	0.2	0.3	0.6	0.5
Disbursements	10.9	15.6	16.5	19.9	22.4	23.0	23.0	23.6	23.7
Amortization 2/	13.2	15.6	18.6	20.4	21.7	22.8	22.7	23.0	23.2
Other, including short-term borrowing	-0.6	-3.3	4.5	3.1	1.1	2.2	2.2	2.3	3.3
Private sector	20.8	15.7	4.7	11.6	11.1	14.2	15.7	16.8	18.8
Direct investment	15.5	12.3	17.4	15.7	16.9	17.7	18.5	19.4	20.3
Bonds and loans 3/	-5.0	-3.2	-2.6	2.0	2.4	3.4	3.4	3.4	3.4
Banking system	-3.0	-0.5	-0.6	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1
Corporate sector	-2.1	-2.7	-2.0	3.0	2.5	3.5	3.5	3.5	3.5
Equity investments and change in assets abroad	10.4	6.7	-0.8	-6.2	-8.2	-6.8	-6.3	-6.0	-4.9
Equity investments	-0.1	-0.1	-2.5	-3.4	-3.7	-3.9	-4.1	-4.3	-4.5
Change in assets abroad	10.5	6.8	1.7	-2.8	-4.5	-2.9	-2.2	-1.7	-0.4
Errors and omissions and valuation adjustments	2.8	3.5	-5.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-7.1	-9.5	-4.1	-6.1	-6.9	-6.7	-6.7	-6.6	-6.5
	(In percent of GDP, unless otherwise indicated)								
Memorandum items:									
Current account balance	-2.1	-1.3	-1.1	-1.1	-0.7	-1.1	-1.3	-1.4	-1.6
Nonoil current account balance	-4.4	-4.3	-4.6	-5.4	-5.5	-5.5	-5.4	-5.3	-5.3
Nonoil trade balance	-3.5	-3.8	-4.8	-5.7	-5.9	-6.0	-6.1	-6.1	-6.2
Merchandise exports	15.7	16.5	17.8	17.9	17.8	17.4	17.0	16.7	16.5
Merchandise imports	16.9	17.4	19.1	19.3	19.0	19.1	19.0	18.9	18.9
Gross financing needs (billions of US$) 4/	65.5	63.2	59.8	57.4	60.9	71.0	75.0	78.5	83.2
Gross international reserves 5/									
End-year (billions of US$)	50.7	59.0	64.2	70.3	77.2	83.8	90.5	97.1	103.6
Months of imports of goods and services	4.7	4.8	4.6	4.7	4.9	5.0	5.2	5.3	5.3
Months of imports plus interest payments	4.2	4.3	4.2	4.3	4.5	4.6	4.8	4.8	4.8
Percent of short-term debt (by residual maturity) 6/	112.2	121.9	136.4	146.5	158.0	151.2	156.8	162.5	168.3
Percent of gross financing requirement 7/	94.3	105.8	125.2	130.1	119.9	122.8	125.9	126.6	126.6
Crude oil export volume (millions of bbl/day)	1.7	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.0
Gross total external debt	25.2	25.9	23.5	21.2	19.9	19.4	18.9	18.4	18.0
Of which: Public external debt	16.1	17.2	16.3	15.2	14.0	13.3	12.6	11.9	11.3
Gross total external debt (billions of US$)	163.6	165.6	158.8	160.8	164.4	168.5	172.7	177.3	181.7
Of which: Public external debt	104.7	109.9	110.5	114.9	115.5	115.5	115.5	115.0	114.4
Public external debt service (in percent of exports of goods, services, and transfers)	15.9	17.0	16.8	16.4	16.0	16.1	15.5	15.2	14.8
	(Annual percentage change)								
Export volume	-3.4	-3.0	4.3	2.9	4.4	3.5	3.8	4.0	4.0
Non-oil exports	-3.5	-4.4	4.6	3.1	4.5	4.0	4.2	4.3	4.4
Import volume	-0.9	-0.5	3.7	6.8	6.7	5.2	4.6	4.3	4.2
Consumer goods	7.6	-0.8	11.4	15.0	7.6	5.8	5.1	4.6	4.1
Intermediate goods	-1.6	1.4	4.1	4.1	5.2	3.7	3.5	3.4	3.4
Capital goods	-6.3	-6.0	7.6	7.8	7.5	6.2	4.2	3.8	3.9

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/ Includes pre-payment of external debt.
3/ Includes financing of PIDIREGAS.
4/ Defined as the sum of the current account deficit, debt amortization (including short-term debt), and gross reserves accumulation.
5/ Excludes balances under bilateral payments accounts.
6/ In percent of short-term debt by residual maturity. Historical data include all prepayments.
7/ The financing requirement excludes pre-payments of public sector debt and reserve accumulation.

Table 4. Mexico: Summary Operations of the Financial System, 1999–2005 1/

	1999	2000	2001	2002	2003	2004	June 2005
	(In billions of Mexican pesos)						
Bank of Mexico							
Net international reserves 2/	291.9	322.5	374.8	500.9	645.4	685.7	665.6
In U.S. dollars	30.7	33.6	40.9	48.0	57.4	61.5	61.8
Net domestic assets 2/	-103.2	-113.5	-149.3	-237.0	-341.8	-345.5	-351.5
Net credit to nonfinancial public sector	-193.2	-287.5	-185.1	-116.8	-129.2	-141.4	-142.2
Net credit to financial institutions	34.4	69.6	10.5	-15.3	-68.9	-105.1	-152.1
Other	55.6	104.4	25.3	-104.9	-143.7	-99.0	-57.2
Monetary base	188.7	208.9	225.6	263.9	303.6	340.2	314.1
Financial system 1/							
Net foreign assets	366.7	484.2	612.1	709.9	711.1	648.7	689.4
Net domestic assets	1,777.8	1,533.1	1,438.7	1,764.8	1,891.4	2,179.2	2,128.3
Net credit to nonfinancial public sector	676.1	772.3	869.0	983.5	1,125.0	1,191.2	1,200.5
Net holdings of government securities	-93.8	-140.9	-46.4	-35.3	0.0	0.0	0.0
Net holdings of Bank of Mexico securities	0.0	20.3	43.4	48.8	37.0	36.9	59.9
Credit to private sector 3/	937.7	1,006.7	933.1	1,178.7	1,170.6	1,264.2	1,389.8
Medium and long term foreign obligations	290.1	278.5	246.4	264.0	274.6	248.7	224.4
Other net liabilities	-423.6	-832.1	-1,178.3	-1,093.9	-1,422.8	-1,642.8	-1,958.5
Liabilities to the private sector	2,278.0	2,571.0	2,982.7	3,304.6	3,750.7	4,222.0	4,551.8
	(In annual percentage change)						
Memorandum items:							
Growth of monetary base	43.5	10.7	8.0	17.0	15.0	12.0	12.7
Growth of liabilities to the private sector	19.7	12.9	16.0	10.8	13.5	12.6	15.6
Growth of credit to the private sector 3/	2.7	7.4	-7.3	26.3	-0.7	8.0	10.8
of which							
Banking Sector 3/	0.7	5.9	-14.1	25.2	-8.7	2.0	7.2
Nonbank financial institutions 3/	18.0	15.8	31.2	44.0	23.3	13.2	9.5
Consumer loans from banks	17.4	35.5	43.2	42.2	51.9	48.7	52.4
Business loans from banks	6.5	6.4	-3.7	1.4	-4.0	10.5	19.3

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

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

2/ NIR figures are as published by Banco de Mexico, which are defined net of foreign currency denominated liabilities to Mexico's government. NDA figures are different from those published by the BoM due to differences in the accounting of foreign assets other than international reserves.

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

Table 5. Mexico: Financial Soundness Indicators, 2001-2005

	2001	2002	2003	2004	2005 1/
Capital Adequacy					
Regulatory capital to risk-weighted assets	14.7	15.5	14.2	14.1	13.8
Capital (net worth) to assets	9.7	11.1	11.4	11.2	11.9
Asset Quality and Composition 2/					
Commercial banks' nonperforming loans (percent of total loans) 3/	5.1	4.6	3.2	2.5	2.4
Provisions to Capital	52.6	33.3	24.5	23.0	21.7
Govt. credit&securities + IPAB sec. to total assets 4/	62.0	62.4	62.4	62.6	62.4
Earnings and Profitability					
ROA	1.2	0.8	0.6	1.5	2.2
ROE	10.7	7.1	6.3	14.8	23.9
Interest margin to gross income	67.9	67.3	60.8	69.2	76.3
Noninterest expenses to gross income	61.5	66.0	61.1	60.2	60.4
Personnel expenses to noninterest income	44.6	46.5	45.8	44.2	44.0
Trading and fee income to total income	32.1	32.7	39.2	30.8	23.7
Spread between reference and deposit rates (TIIE – CPP) 5/	2.1	3.1	2.5	3.1	3.3

Source: National Banking and Securities Commission; and Fund staff estimates.
1/ March 2005.
2/ Covering all commercial banks.
3/ NPLs are loans overdue by 60 days or more
4/ Fund staff estimates.
5/ TIIE = Interbank rate, CPP = Cost of funding

Table 6. Mexico: Indicators of External Vulnerability, 2001–2005

	2001	2002	2003	2004	2005				
	Dec.	Dec.	Dec.	Dec.	Mar.	Apr.	May.	Jun.	Jul.
Financial Market indicators									
Exchange rate (per U.S. dollar, end-period)	9.16	10.39	11.23	11.15	11.17	11.05	10.87	10.78	10.60
(year-to-date percent change)	-4.8	13.4	8.1	-0.7	0.1	-0.9	-2.5	-3.4	-4.9
28-day treasury auction rate (percent; period average)	6.5	7.0	6.1	8.5	9.4	9.6	9.7	9.6	9.6
EMBI+ Mexico (basis points; period average)	313	312	205	166	166	186	181	172	159
Stock exchange index in U.S. dollar terms (year-to-date percent change)	24.2	-27.5	37.6	47.9	-2.0	-3.7	3.0	8.0	17.3
Financial system									
Bank of Mexico net international reserves (US$ billion)	40.9	48.0	57.4	61.5	61.7	60.7	60.5	61.8	59.3
Real credit to the private sector (12-month percent change) 1/	-11.2	19.5	-4.5	2.7	6.8	9.5	16.1	6.2	...
Commercial banks' nonperforming loans (percent of total loans)	5.1	4.6	3.2	2.5	2.4	...	...	2.3	...
Commercial banks' loan loss provision (percent of nonperforming loans)	123.8	138.1	167.1	201.8	199.6	...	...	198.4	...
Exports and Imports									
Trade balance (US$ billion; year-to-date)	-9.6	-7.6	-5.8	-8.8	-1.9	-2.6	-2.6	-2.6	-3.3
Exports (year to date, annual percentage change) 2/	-3.1	0.6	3.9	13.8	8.8	8.3	11.6	12.0	11.8
Of which									
Non-oil	-3.0	0.4	0.0	12.4	5.6	4.2	8.9	8.2	7.8
Imports (year to date, annual percentage change) 2/	-1.7	-1.3	1.9	15.8	13.6	13.0	14.4	13.3	12.5
Of which									
Consumer goods	18.3	7.2	1.6	18.1	26.0	24.9	25.1	24.2	24.0
Capital goods	-6.8	-6.7	-3.7	11.8	17.7	17.0	18.5	16.9	14.9
Terms of trade (12-month percent change)	-7.4	4.5	4.6	-2.3	0.7	...	...	1.7	...
Real effective exchange rate (CPI based; percent change year-to-date) 3/	8.3	-9.8	-12.9	-0.3	1.1	1.7	-0.4	0.6	1.7
External Debt									
Nonfinancial public sector external debt (percent of GDP)	14.8	16.1	17.2	16.3	...	...	...	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 4/	0.6	0.4	0.3	-0.1	...	...	...	...	...
Private sector external debt (percent of GDP)	10.3	9.5	9.6	8.5	...	...	...	...	...
Private sector short-term external debt (percent of GDP)	2.1	1.7	1.6	1.5	...	...	...	...	...
Memorandum items:									
Gross international reserves to short-term debt (by residual maturity, percent) 4	99.9	112.2	121.9	136.4	...	...	...	...	...
Monetary base to gross international reserves (percent)	55.0	50.1	45.8	47.5	43.6	44.2	45.7	44.4	44.7

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

1/ Does not include loans associated with FOBAPROA/IPAB debt-restructuring programs.
2/ In U.S. dollar terms net of maquila.
3/ Increase = appreciation.
4/ The short-term debt by residual maturity includes pre-payment of debt.

Table 7. Mexico: Baseline Medium-Term Projection

						Staff Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(Annual percentage change, unless otherwise indicated)										
National income and prices											
Real GDP	6.6	0.0	0.8	1.4	4.4	3.0	3.5	3.1	3.1	3.1	3.1
Consumer prices (end of year)	9.0	4.4	5.7	4.0	5.2	3.9	3.4	3.0	3.0	3.0	3.0
Consumer prices (average)	9.5	6.4	5.0	4.5	4.7	4.3	3.6	3.2	3.0	3.0	3.0
External sector											
Exports, f.o.b.	21.5	-3.1	0.6	3.9	13.8	13.1	8.4	2.3	3.3	3.5	3.3
Imports, f.o.b.	23.1	-1.7	-1.3	1.9	15.8	13.6	6.8	5.5	4.8	4.9	5.2
Terms of trade (deterioration -)	-1.8	-7.4	4.5	4.6	-2.3	3.3	3.7	-1.5	-0.6	-1.1	-1.6
Interest rates											
Treasury bill rate (average 28-day cetes)	15.3	11.2	7.1	6.2	6.8	9.5	8.9	7.7	7.2	7.2	7.2
Real interest rate (28-day cetes)	5.3	4.5	2.0	1.6	2.0	5.0	5.1	4.3	4.0	4.0	4.0
	(In percent of GDP)										
Nonfinancial public sector											
Augmented balance 1/	-3.7	-3.6	-3.3	-3.1	-2.0	-2.3	-1.4	-1.5	-1.4	-1.4	-1.4
Augmented primary balance	1.2	1.1	0.3	0.4	1.3	1.4	2.2	2.1	2.0	1.9	1.9
Saving and investment											
Gross domestic investment	23.7	20.9	20.6	20.6	21.7	22.3	22.4	22.4	22.3	22.3	22.4
Fixed investment	21.4	20.0	19.3	18.9	20.2	20.3	20.5	20.9	21.1	21.3	21.6
Public	3.6	3.6	4.2	4.5	4.8	4.8	4.7	4.7	4.8	4.8	4.9
Private	17.8	16.4	15.0	14.4	15.4	15.5	15.8	16.2	16.3	16.5	16.8
Inventories	2.3	0.9	1.4	1.6	1.6	2.0	2.0	1.5	1.2	1.0	0.8
Gross national saving	20.5	18.0	18.6	19.2	20.7	21.2	21.7	21.2	21.1	21.0	20.8
Public sector	-0.1	-0.1	0.9	1.4	2.3	2.6	3.3	3.3	3.4	3.4	3.5
Private sector	20.6	18.0	17.8	17.7	17.8	18.7	18.4	17.9	17.7	17.6	17.4
Current account balance	**-3.2**	**-2.8**	**-2.1**	**-1.3**	**-1.1**	**-1.1**	**-0.7**	**-1.1**	**-1.3**	**-1.4**	**-1.6**

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

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

Table 8. Mexico: Millenium Development Goals

	1990	1995	2000	2003
1. Eradicate extreme poverty and hunger	*2015 target = halve 1990 $1 a day poverty and malnutrition rates*			
Population below $1 a day (%)	..	..	9.9	..
Poverty gap at $1 a day (%)	..	..	3.7	..
Percentage share of income or consumption held by poorest 20%	..	..	3.1	..
Prevalence of child malnutrition (% of children under 5)	16.6	16.9	7.5	..
Population below minimum level of dietary energy consumption (%)	5.0	5.0	5.0	5.0
2. Achieve universal primary education	*2015 target = net enrollment to 100*			
Net primary enrollment ratio (% of relevant age group)	95.6	99.5	99.4	..
Percentage of cohort reaching grade 5 (%)	79.5	89.0	90.5	..
Youth literacy rate (% ages 15-24)	95.2	96.2	96.6	..
3. Promote gender equality	*2005 target = education ratio to 100*			
Ratio of girls to boys in primary and secondary education (%)	98.4	98.2	101.3	..
Ratio of young literate females to males (% ages 15-24)	94.7	98.9	99.7	97.4
Share of women employed in the nonagricultural sector (%)	35.4	35.9	37.3	37.1
Proportion of seats held by women in national parliament (%)	12.0	14.0	18.0	16.0
4. Reduce child mortality	*2015 target = reduce 1990 under 5 mortality by two-thirds*			
Under 5 mortality rate (per 1,000)	44	36	30	25
Infant mortality rate (per 1,000 live births)	37	30	25	23
Immunization, measles (% of children under 12 months)	75	90	96	96
5. Improve maternal health	*2015 target = reduce 1990 maternal mortality by three-fourths*			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	89	..	83	65
Births attended by skilled health staff (% of total)	..	85.7	..	..
6. Combat HIV/AIDS, malaria and other diseases	*2015 target = halt, and begin to reverse, AIDS, etc.*			
Prevalence of HIV, female (% ages 15-24)	..	..	0.1	..
Contraceptive prevalence rate (% of women ages 15-49)	..	65	70	..
Number of children orphaned by HIV/AIDS	..	..	27,000	..
Incidence of tuberculosis (per 100,000 people)	49.0	43.6	36.5	33.5
Tuberculosis cases detected under DOTS (%)	..	15.2	68.2	80.9
7. Ensure environmental sustainability	*2015 target = various (see notes)*			
Forest area (% of total land area)	32.2	..	28.9	..
Nationally protected areas (% of total land area)	2.9	3.7	3.5	9.1
GDP per unit of energy use (PPP $ per kg oil equivalent)	5.1	5.3	5.8	5.6
CO2 emissions (metric tons per capita)	3.7	4.3	4.3	..
Access to an improved water source (% of population)	80	..	88	91
Access to improved sanitation (% of population)	66	..	74	77
Access to secure tenure (% of population)	..	..	..	..
8. Develop a Global Partnership for Development	*2015 target = various (see notes)*			
Youth unemployment rate (% of total labor force ages 15-24)	5.4	7.1	4.4	4.9
Fixed line and mobile telephones (per 1,000 people)	65.6	101.2	267.1	448.8
Personal computers (per 1,000 people)	8.2	25.6	57.6	82

Sources: Mexican authorities; and World Development Indicators databas

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

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

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

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

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

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

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

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

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

MEXICO—FUND RELATIONS
(As of August 31, 2005)

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	2,585.80	100.00
Fund holdings of currency	1,954.89	75.60
Reserve position in Fund	630.96	24.40

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	290.02	100.00
Holdings	308.04	106.21

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

V. Latest Financial Arrangements:

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

VI. Projected Payments to the Fund:

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges / Interest		0.02	0.02	0.02	0.02
Total		0.02	0.02	0.02	0.02

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

VIII. Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on September 27, 2004. The relevant staff report was IMF Country Report No. 04/419.

IX. Technical Assistance

National Accounts Mission	STA	May 2005
Payments Systems	MFD	December 2004

X. Resident Representative: None.

MEXICO: STATISTICAL ISSUES

Comprehensive economic data are available for Mexico on a timely basis, and are adequate to conduct surveillance. Core statistical data are published on a timely basis and are of good quality (Annex IV). Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). Following a data ROSC mission to Mexico in February/March 2002, the report was published in June 2003 as IMF Country Report No. 03/150. Its main conclusion was that the overall quality of Mexican statistics is good. In a number of cases, the periodicity and timeliness of disseminated data exceeded SDDS requirements However, there are various areas where improvements could be made. The authorities are aware of this situation and are continuing work in this regard.

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

A follow-up national accounts mission conducted in May 2005 found that the capture of non-observed (informal, illegal, and underground) activities is incomplete and that outdated coefficients from the use matrix of the base year 1993 are extensively used. Technical assistance might be needed for implementing the work plan proposed by the mission, covering changing the base year, compiling an input-output table for 2003, and completing the implementation of the *1993 SNA*.

In the fiscal area, the authorities have reported since 2001 a comprehensive measure of the fiscal balance—the Public Sector Borrowing Requirement—that encompasses the direct net cost of public investment projects with deferred recording in the fiscal accounts (PIDIREGAS) as well as the interest cost on a number of government liabilities that had not been previously recorded. Both the preliminary (available with a 45-day lag following the end of each quarter) and the final (available mid-year of the subsequent year) data are published and submitted to congress, ensuring that revisions are transparent and subject to public scrutiny.

MEXICO—RELATIONS WITH THE WORLD BANK

The World Bank Group maintains a substantial program of lending operations, analytical work and policy dialogue with Mexico. The Bank's Country Partnership Strategy (CPS) with Mexico, as discussed by its Board in April 2004, proposes a selective program of IBRD and IFC operations and a strategic program of analytical and learning services built upon four strategic pillars: (1) reduce poverty and inequality; (2) increase competitiveness; (3) strengthen institutions; and (4) promote environmental sustainability. The CPS envisages a greater focus on the role that the Bank can play as a knowledge institution, while continuing to deliver a program of lending operations consistent with Mexico's development needs.

Over a four-year period, FY05–FY08, the Bank expects to make more of a difference in areas where it already maintains productive relationships with government counterparts, where challenges are multisectoral in nature and where there remain difficult unresolved matters. It also proposes to be an honest broker among government institutions and civil society in their efforts to deal with development issues. It will seek a sustained programmatic analytical engagement in selected areas where the Bank can have the greatest impact, such as poverty, competitiveness, education quality, decentralization of public finances, and sustainable water management. Analytical and learning services in these areas will be supported by lending at the request of the government. In addition, given the importance of supporting local governments in Mexico's development strategy, opportunities to increase lending and non-lending assistance to the states and municipalities will be explored.

As of July 31, 2005, the IBRD exposure in Mexico was US$9.1 billion, representing 8.5 percent of the IBRD's total portfolio, making Mexico the second largest borrower. The portfolio under implementation comprises 17 lending operations for US$2.9 billion in commitments of which US$1.6 billion are still available for disbursements. The Bank also manages 6 full-size GEF/PCF operations, the largest GEF portfolio in the Bank.

Within the framework of the CPS, a lending program has been agreed that best addresses Mexico's development needs (as a creditworthy middle-income country) and allows the Bank to respond quickly to changing circumstances. A lending range of US$0.8 to US$1.7 billion a year is available to promote the country's key development objectives. This lending range is consistent with careful risk management, in view of the government's sound macroeconomic policies and its prudent debt management strategy as well as the projected evolution of IBRD exposure.

The main focus of IFC's strategy in Mexico is to support the country's efforts to improve its business environment by assisting companies that seek to position themselves better vis-à-vis local, regional or global competitors. This support will be provided through investment and advisory assistance and can cover a wide spectrum of firms, from SMEs to 2nd and top tier companies as well as the public sector. On the latter, the IFC stands ready to provide reimbursable advisory services to the authorities to complement and support ongoing IBRD work in this area.

MEXICO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of September 15, 2005

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	9/14/05	9/15/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July 2005	Aug. 2005	M	M	M		
Reserve/Base Money	Aug. 2005	Sep. 2005	M	D, M	W	LO, LO, O, O	LO, O, O, O, O
Broad Money	July 2005	Aug. 2005	M	M	M		
Central Bank Balance Sheet	Sep. 2005	Sep. 2005	W	W	W		
Consolidated Balance Sheet of the Banking System	July 2005	Aug. 2005	M	M	M		
Interest Rates[2]	9/14/05	9/15/05	D	D	D		
Consumer Price Index	July 2005	Aug. 2005	Bi-W	Bi-W	Bi-W	O, O, LNO, O	LO, LNO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	July 2005	Sep. 2005	M	M	M	LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	July 2005	Sep. 2005	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2005	Aug. 2005	Q	Q	Q		
External Current Account Balance	Q2 2005	Aug. 2005	Q	Q	Q	LO, LO, LO, LO	LO, O, O, O, LO
Exports and Imports of Goods and Services	July 2005	Aug. 2005	M	M	Bi-W		
GDP/GNP	Q2 2005	Aug. 2005	Q	Q	Q	O, O, LO, O	LO, LNO, O, LO, LO
Gross External Debt	June 2005	Aug. 2005	M	M	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[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] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in June 2003 and based on the findings of the mission that took place during February-March 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

MEXICO: DEBT SUSTAINABILITY ANALYSIS, 2005–2010

1. Standardized bound tests

Stress tests conducted using the standard IMF Debt Sustainability Analysis (DSA) framework suggest Mexico's overall resilience to plausible shocks.

Standardized stress tests, based on the historical volatility of key macroeconomic variables for the past 10 years, indicate that the level of public debt would not increase substantially over the medium-term if macro conditions turned out significantly worse than projected. In the worst cases, involving real GDP growth of 1.2 percent or real interest rates of 8 percent on average in the next four years, public debt as a share of GDP would still remain in the 48-50 percent range (Figure 1). Importantly, currency depreciation does not pose a serious risk to the fiscal accounts, which would in fact improve if the peso were to weaken. While this suggests debt sustainability is not likely to be a concern, a broad range of shocks would result in a rise in the public sector financing requirement, reflecting the still relatively short average maturity of the domestic debt. The worst projected case would occur in the event of an economic stagnation, with annual public sector financing requirements reaching 16½ percent of GDP, compared to about 13 percent in 2005.

Standardized tests also illustrate Mexico's strong external position. The deterioration of the growth outlook, or the primary external current account, would have only limited effects on the trajectory of the country's external debt and external financing requirements. The most significant shock would come from a large exchange rate depreciation vis-à-vis the US dollar, but even in this case, the overall external debt would remain below 30 percent of GDP by 2010 (Figure 2). This projected increase would also be significantly offset by the revaluation of net international reserves.

2. Other stress scenarios

Mexico's fiscal and external debt position could show greater deterioration under alternative scenarios involving combined shocks or shocks of greater magnitudes. Staff estimations indicate that the main challenge would be to provide for a higher liquidity financing need.

One prominent risk scenario would be an inability to adjust fiscal spending as a result of a sudden permanent decline in oil prices (US$ 40 per barrel for the world average petroleum price from 2006 onwards, implying less than US$30 per barrel for the Mexican oil mix). Assuming only limited spending cuts, the primary balance is estimated to deteriorate by about 1 percent of GDP every year, keeping gross public debt above 45 percent of GDP and financing requirements around 13 percent of GDP throughout the medium-term. (The actual fiscal impact would depend importantly on the administered pricing of the domestic energy provided by state enterprises, including gasoline and electricity: if lower international fuel prices were transmitted to domestic consumers, then their effect on the fiscal accounts would be accordingly greater.) On the external side, the main effect would be a reduction in the pace of reserve accumulation rather than a significant jump in the level of debt or financing requirements.

A second prominent risk scenario simply assumes an arbitrary shock to market confidence in Mexican assets, implying a financial liquidity test, with a rapid deterioration of the exchange rate, a hike in interest rates, and a return to short-term or interest-rate indexed debt as the principal means to finance the fiscal deficit and public debt falling due. Using magnitudes observed in recent crisis episodes (outside Mexico), staff finds that the fiscal deficit would not show a marked deterioration. However, there would be a substantial rise in short-term financing requirements, which in principle could be a cause for a further deterioration of confidence and further financial pressures on the public sector. The external position, on the other hand, would not deteriorate significantly.

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

Table 1. Mexico: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	49.3	47.9	49.5	50.0	46.5	**45.3**	**43.4**	**42.5**	**41.6**	**40.8**	**40.1**	**1.2**
	o/w foreign-currency denominated	16.1	14.8	16.4	17.2	16.3	15.2	14.0	13.3	12.6	11.9	11.3	
2	Change in public sector debt	-6.6	-1.4	1.5	0.5	-3.5	-1.2	-1.9	-0.9	-0.9	-0.8	-0.7	
3	Identified debt-creating flows (4+7+12)	-5.8	-0.1	0.6	-0.4	-3.7	-1.5	-2.1	-0.9	-1.0	-0.8	-0.8	
4	Primary deficit 2/	-1.2	-1.0	-0.5	-0.3	-0.8	-1.5	-2.3	-2.1	-2.0	-1.9	-1.9	
5	Revenue and grants	21.0	21.1	21.4	22.5	21.7	23.1	23.0	23.1	22.9	22.5	22.2	
6	Primary (noninterest) expenditure	19.8	20.0	20.9	22.3	20.9	21.6	20.8	21.0	20.8	20.6	20.3	
7	Automatic debt dynamics 3/	-4.2	1.6	1.7	0.5	-1.4	0.0	0.2	1.1	1.1	1.1	1.1	
8	Contribution from interest rate/growth differential 4/	-4.2	2.0	0.3	-1.1	-1.6	0.0	0.2	1.1	1.1	1.1	1.1	
9	Of which contribution from real interest rate	-1.2	2.0	0.6	-0.4	0.3	1.3	1.6	2.4	2.3	2.3	2.3	
10	Of which contribution from real GDP growth	-3.1	0.0	-0.3	-0.6	-1.9	-1.3	-1.5	-1.3	-1.2	-1.2	-1.2	
11	Contribution from exchange rate depreciation 5/	0.1	-0.4	1.5	1.6	0.2	...	...	...	...	...	...	
12	Other identified debt-creating flows	-0.4	-0.7	-0.7	-0.7	-1.5	-0.1	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts and other non-recurring revenues (negative)	-0.4	-0.7	-0.7	-0.7	-1.5	-0.1	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 6/	-0.8	-1.2	1.0	1.0	0.2	0.3	0.2	0.1	0.1	0.1	0.1	
	Public sector debt-to-revenue ratio 1/	234.0	227.5	231.3	221.7	214.7	196.3	188.4	184.0	181.9	181.2	180.2	
	Gross financing need 7/	11.7	16.6	15.8	17.1	15.4	13.0	12.5	12.4	11.9	11.7	11.4	
	in billions of U.S. dollars	67.9	103.5	102.4	109.4	104.2	98.6	103.2	107.5	108.9	112.8	116.1	
	Scenario with key variables at their historical averages 8/						**45.3**	**41.8**	**38.4**	**35.2**	**32.0**	**29.0**	**-1.2**
	Scenario with no policy change (constant primary balance) in 2006-2010						**45.3**	**44.1**	**43.8**	**43.5**	**43.3**	**43.0**	**1.3**
	Scenario with international oil prices at US$40 from 2006 onwards						**45.3**	**45.0**	**45.4**	**45.7**	**45.8**	**45.9**	
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	6.6	0.0	0.8	1.4	4.4	3.0	3.5	3.1	3.1	3.1	3.1	
	Average nominal interest rate on public debt (in percent) 9/	10.5	10.2	8.4	7.6	7.2	8.5	8.6	8.6	8.6	8.6	8.6	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.7	4.3	1.4	-0.9	0.9	3.3	4.1	5.9	5.9	6.0	6.1	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.4	2.6	-9.0	-9.1	-1.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	12.1	5.8	7.0	8.5	6.3	5.2	4.5	2.7	2.7	2.6	2.5	
	Growth of real primary spending (deflated by GDP deflator, in percent)	10.5	1.1	5.2	8.0	-2.3	6.5	-0.4	4.4	2.1	1.9	1.8	
	Primary deficit	-1.2	-1.0	-0.5	-0.3	-0.8	-1.5	-2.3	-2.1	-2.0	-1.9	-1.9	

1/ Gross debt of the federal government, social security, nonfinancial enterprises, public development banks, IPAB, FARAC, and direct PIDIREGAS projects.
2/ Includes privatization and other non-recurring revenues.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ 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 (2010).

Table 2. Mexico: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross financing need 1/	11.7	16.6	15.8	17.1	15.4	13.0	12.5	12.4	11.9	11.7	11.4
in billions of U.S. dollars	67.9	103.5	102.4	109.4	104.1	98.5	103.4	107.5	108.9	112.8	116.1
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						13.0	10.5	8.9	7.8	6.9	6.1
A2. No policy change (constant primary balance) in 2006-10						13.0	13.4	13.3	13.0	12.9	12.8
A3. International oil prices at US$40 per barrel						13.0	14.2	13.9	13.5	13.2	12.9
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						13.0	14.5	14.9	15.0	15.5	15.9
B2. Real GDP growth is at baseline minus one-half standard deviations						13.0	13.3	14.1	14.6	15.7	16.8
B3. Primary balance is at baseline minus one-half standard deviations						13.0	13.4	13.5	13.2	13.3	13.3
B4. Combination of B1-B3 using 1/4 standard deviation shocks						13.0	14.1	14.5	14.6	15.0	15.4
B5. One time 30 percent real depreciation in 2006 5/						13.0	13.8	15.1	14.7	14.6	14.4
B6. 10 percent of GDP increase in other debt-creating flows in 2006						13.0	14.1	15.8	15.3	15.2	15.1
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						98.5	86.0	76.2	70.5	65.7	60.5
A2. No policy change (constant primary balance) in 2006-10						98.5	110.8	115.6	118.8	124.2	129.5
A3. International oil prices at US$40 per barrel						98.5	116.7	120.5	123.1	127.4	130.9
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						98.5	119.4	129.6	137.6	149.4	161.5
B2. Real GDP growth is at baseline minus one-half standard deviations						98.5	107.6	117.6	126.4	139.8	154.7
B3. Primary balance is at baseline minus one-half standard deviations						98.5	110.5	117.2	121.2	128.4	135.1
B4. Combination of B1-B3 using 1/4 standard deviation shocks						98.5	115.1	123.7	129.9	139.5	149.1
B5. One time 30 percent real depreciation in 2006 5/						98.5	74.2	85.5	87.4	91.3	94.9
B6. 10 percent of GDP increase in other debt-creating flows in 2006						98.5	116.8	137.2	140.4	147.0	153.0

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
4/ The implied change in other key variables under this scenario is discussed in the text.
5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 3. Mexico: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	28.3	26.2	25.2	25.9	23.4	**21.2**	**19.9**	**19.4**	**18.9**	**18.4**	**17.9**	**-1.1**
2	Change in external debt	-8.7	-2.2	-0.9	0.7	-2.5	-2.2	-1.3	-0.6	-0.5	-0.5	-0.5	
3	Identified external debt-creating flows (4+8+9)	-6.2	-3.5	-1.4	-0.2	-2.6	-1.2	-1.6	-1.0	-0.9	-0.8	-0.5	
4	Current account deficit, excluding interest payments	0.8	0.8	0.6	-0.2	-0.5	-0.6	-0.8	-0.3	-0.2	0.0	0.2	
5	Deficit in balance of goods and services	1.8	2.1	1.8	1.6	2.0	2.1	1.9	2.4	2.7	2.9	3.2	
6	Exports	20.3	18.3	17.6	18.5	19.8	20.0	19.9	19.4	19.1	18.8	18.6	
7	Imports	22.2	20.4	19.4	20.1	21.8	22.1	21.8	21.8	21.8	21.7	21.8	
8	Net non-debt creating capital inflows (negative)	-3.0	-4.5	-2.4	-1.9	-2.2	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	
9	Automatic debt dynamics 1/	-4.0	0.2	0.4	1.9	0.1	1.0	0.8	0.9	0.9	0.8	0.8	
10	Contribution from nominal interest rate	2.4	2.0	1.4	1.5	1.6	1.7	1.5	1.5	1.4	1.4	1.3	
11	Contribution from real GDP growth	-2.0	0.0	-0.2	-0.4	-1.1	-0.6	-0.7	-0.6	-0.6	-0.6	-0.5	
12	Contribution from price and exchange rate changes 2/	-4.4	-1.9	-0.9	0.8	-0.5	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	-2.5	1.3	0.4	0.9	0.1	-1.0	0.3	0.5	0.4	0.3	0.1	
	External debt-to-exports ratio (in percent)	139.2	142.9	142.9	140.1	118.4	106.1	100.2	99.9	98.8	97.6	96.5	
	Gross external financing need (in billions of US dollars) 4/	76.2	70.5	58.4	53.8	55.8	51.3	54.0	64.4	68.3	71.9	76.7	
	in percent of GDP	13.1	11.3	9.0	8.4	8.2	6.8	6.6	7.4	7.5	7.5	7.6	
	Scenario with key variables at their historical averages 5/						**21.2**	**19.2**	**16.7**	**14.1**	**11.2**	**8.1**	**-3.0**
	Scenario with falling international oil prices						**21.2**	**20.6**	**20.8**	**21.0**	**21.3**	**21.6**	
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	6.6	0.0	0.8	1.4	4.4	3.0	3.5	3.1	3.1	3.1	3.1	
	GDP deflator in US dollars (change in percent)	13.4	7.1	3.5	-2.9	1.8	8.6	5.1	2.3	2.2	2.1	2.0	
	Nominal external interest rate (in percent)	7.7	7.7	5.7	5.9	6.7	7.9	7.7	7.8	7.8	7.6	7.7	
	Growth of exports (US dollar terms, in percent)	21.0	-3.6	0.5	3.3	13.5	13.0	8.2	2.7	3.7	3.8	3.7	
	Growth of imports (US dollar terms, in percent)	22.6	-1.4	-0.7	2.0	14.8	13.6	7.0	5.7	5.1	5.2	5.4	
	Current account balance, excluding interest payments	-0.8	-0.8	-0.6	0.2	0.5	0.6	0.8	0.3	0.2	0.0	-0.2	
	Net non-debt creating capital inflows	3.0	4.5	2.4	1.9	2.2	1.6	1.6	1.6	1.6	1.6	1.6	

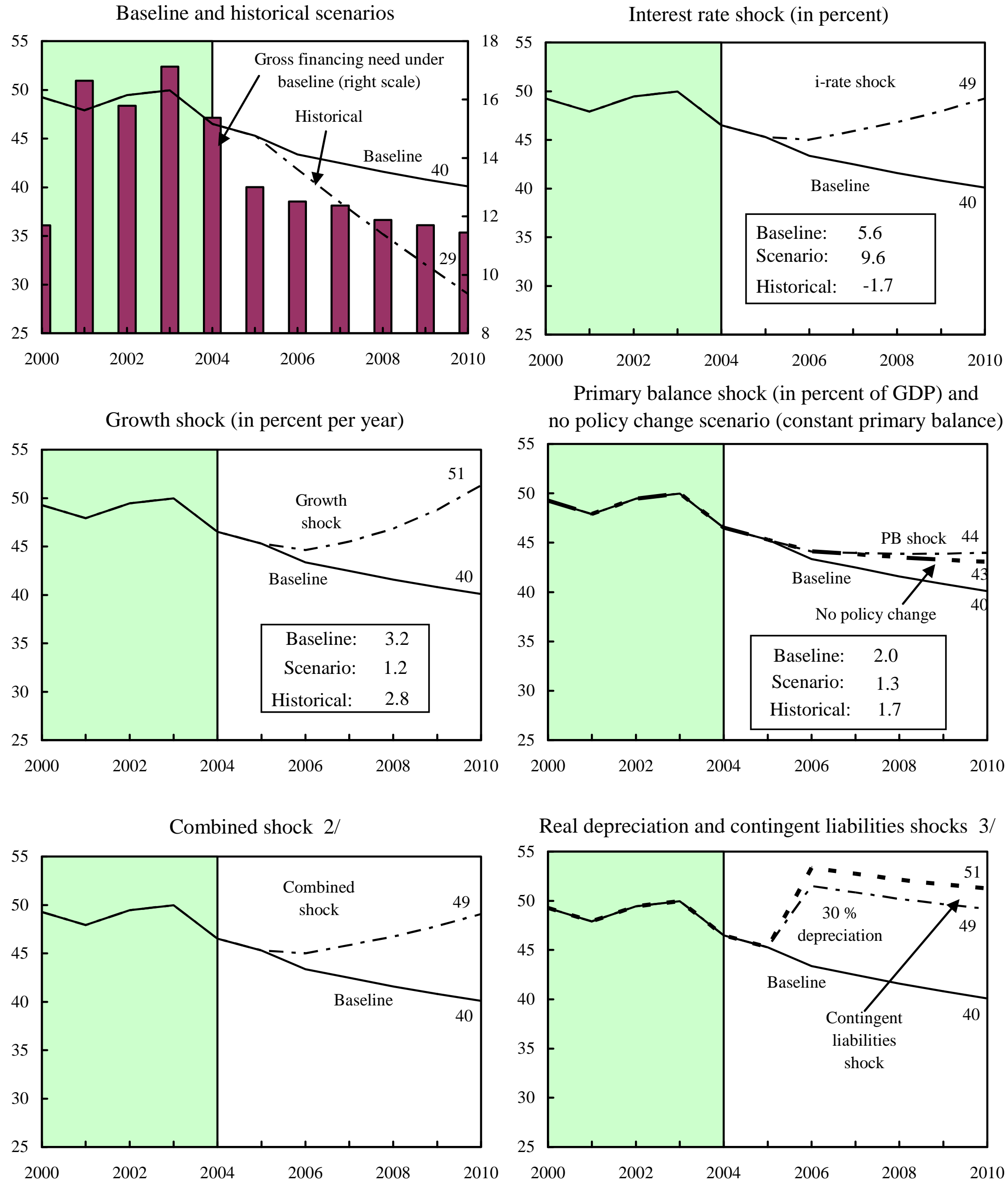
1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP defla
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Table 4. Mexico: External Sustainability Framework--Gross External Financing Need, 2000-2010

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/	76.2	70.5	58.4	53.8	55.8	51.3	54.0	64.4	68.3	71.9	76.7
in percent of GDP	13.1	11.3	9.0	8.4	8.2	6.8	6.6	7.4	7.5	7.5	7.6
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						51.3	52.9	53.3	48.0	40.8	31.2
A2. Falling international oil prices						51.3	61.1	74.5	81.7	88.8	97.7
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						51.3	55.2	66.0	70.5	74.6	80.0
B2. Real GDP growth is at baseline minus one-half standard deviations						51.3	54.2	64.6	68.5	72.0	76.6
B3. Non-interest current account is at baseline minus one-half standard deviations						51.3	63.1	77.3	85.4	93.6	103.5
B4. Combination of B1-B3 using 1/4 standard deviation shocks						51.3	59.2	71.7	77.9	83.9	91.3
B5. One time 30 percent nominal depreciation in 2006						51.3	56.4	66.0	69.8	73.0	76.8
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						6.8	6.6	6.3	5.4	4.3	3.1
A2. Falling international oil prices						6.8	7.4	8.6	8.9	9.2	9.6
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						6.8	6.7	7.6	7.7	7.7	7.9
B2. Real GDP growth is at baseline minus one-half standard deviations						6.8	6.7	7.7	7.9	8.1	8.3
B3. Non-interest current account is at baseline minus one-half standard deviations						6.8	7.7	8.9	9.3	9.7	10.2
B4. Combination of B1-B4 using 1/4 standard deviation shocks						6.8	7.3	8.4	8.7	9.0	9.4
B5. One time 30 percent nominal depreciation in 2006						6.8	10.5	11.7	11.7	11.6	11.6

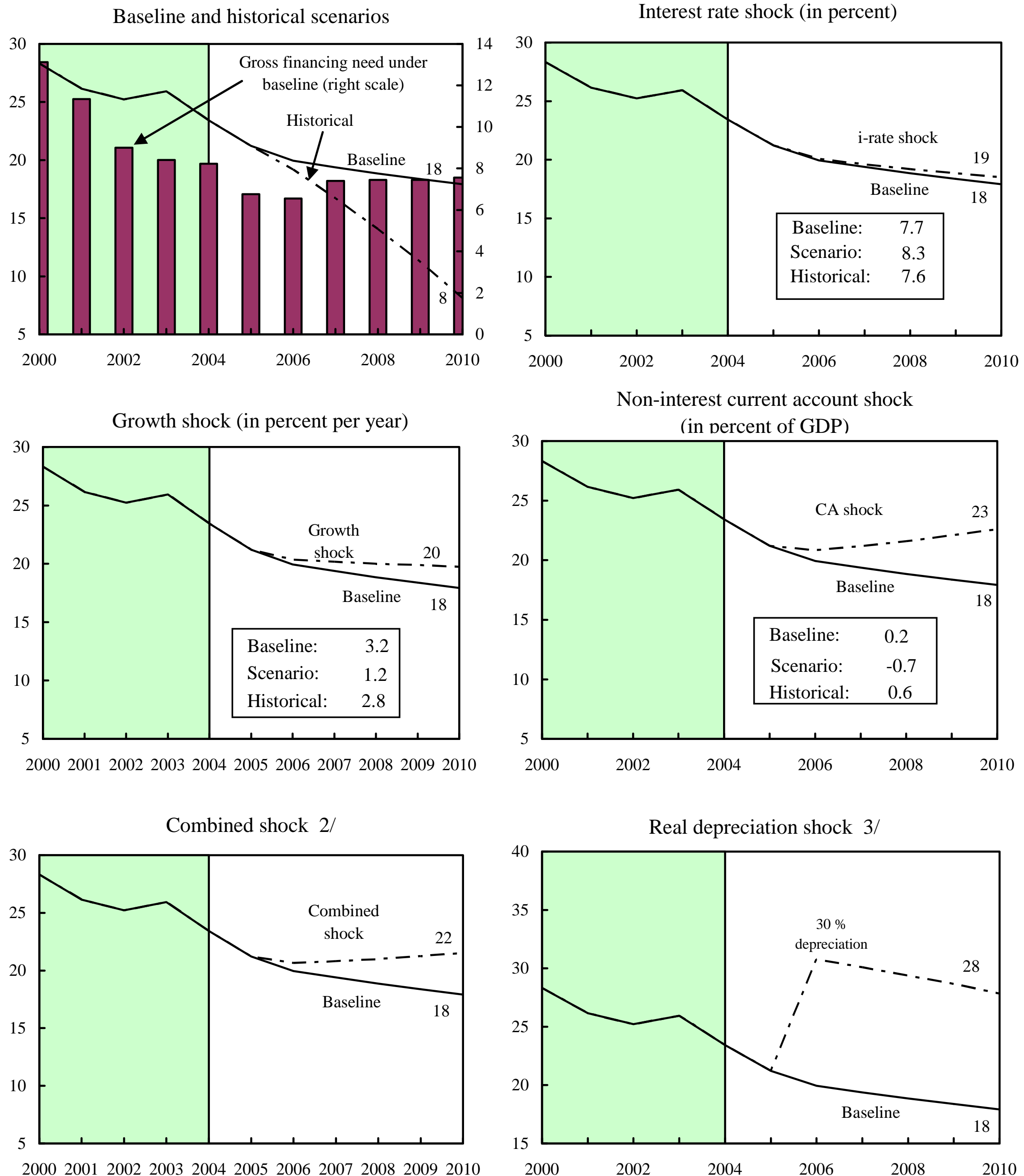
1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
4/ The implied change in other key variables under this scenario is discussed in the text.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Statement by the IMF Staff Representative
November 9, 2005

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

1. **Recent indicators suggest that, as expected, economic activity recovered somewhat in the third quarter, although recent hurricanes could impact growth at the end of the year.** The Bank of Mexico (BoM) now projects growth of 2¾ to 3¼ percent for 2005. The staff projection of 3 percent assumed a pickup in growth in the second half of the year. The index of overall economic activity rose by 4.5 percent in August over the previous year, faster than in recent months, while retail sales grew by 4.4 percent in real terms. September industrial production, on the other hand, showed almost no growth from a year earlier. Hurricanes Stan and Wilma struck parts of southern Mexico hard, but the BoM expects that their effect on GDP growth will be small.

2. **Inflation has come down more than expected.** Core inflation has continued to edge down, to 3.2 percent in the first half of October, while headline inflation has declined markedly, from just under 4 percent in August to 3.5 percent in September and 3.1 percent in the first half of October (12-month basis). September data show that increases in contractual wages remain around 4½ percent, as they have for some time. Notwithstanding some risk of agricultural price shocks from the recent hurricanes, recent developments suggest that headline inflation at end-2005 is likely to turn out below the staff report's projection of 3.9 percent. Last week, the Bank of Mexico revised downward its end-2005 inflation projection, from just under 4 percent to about 3½ percent.

3. **On October 28, the (BoM) announced that it would permit another 25 basis point easing of monetary conditions; the overnight interbank rate subsequently declined from 9¼ to 9 percent.** This announcement was the third such move since monetary easing began at end-August, again with no change in the corto. The BoM also announced that it will shift to monthly, rather than twice monthly, policy meetings, linking this move to the fact that inflation has become more stable and predictable than in the past.

4. **Third quarter trade data indicate somewhat faster export growth than in the first half of 2005.** The value of total exports in U.S. dollars grew 13½ percent in the third quarter, compared to 11 percent in the first semester (for non-oil exports, the figures were 9½ percent and 8¼ percent, respectively). The value of imports continued to grow at an annual rate of about 12 percent, about the same rate as in the first six months of the year.

5. **The 2005 budget dispute was finally resolved, and discussions on the 2006 budget are expected to be completed by November 15.** The remaining dispute over parts of the 2005 budget was resolved in late October, when deputies and the executive reached agreement on the composition of spending for the year. On the 2006 budget, the house of deputies has approved a revenue law which would allow budgeted spending to be about

1 percent of GDP higher than in the government's proposal, as the deputies: raised the budget's oil price assumption from $31.5 to $36.5 per barrel; raised projected non-oil revenue; and lowered the fiscal balance target from a small surplus to balance (traditional definition). The changes do not imply a significant revision of the staff report's projections of the overall fiscal balance in 2006, and staff continue to expect that the non-oil augmented balance will be broadly unchanged from 2005.

6. The Mexican authorities have now officially requested an FSAP update, with the work to begin early next year.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/160
FOR IMMEDIATE RELEASE
December 1, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Mexico

On November 9, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

The economic recovery that began in mid-2003 has continued, though at a slower pace in 2005. A broad-based expansion of economic activity in 2004, driven by a rebound of private consumption and private investment, took growth up to 4.4 percent. The economic recovery was accompanied by a boost to confidence, capacity utilization, and formal employment. In the first semester of 2005, growth slowed to 2.8 percent, reflecting several sector-specific developments, including a soft patch in U.S. industrial production. The most recent indicators point to a strengthening of activity in the third quarter of this year.

After rising through November 2004, inflation has come down significantly in 2005, approaching the Bank of Mexico's 3 percent inflation target. The 12-month headline inflation rate peaked at 5.4 percent in November 2004, but has declined thereafter, to 3.1 percent in the first half of October 2005. Core inflation also has come down, to 3.2 percent.

After tightening monetary policy since early 2004, the Bank of Mexico (BoM) signaled an end to its monetary tightening cycle in June 2005, and began to reverse that tightening in August.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The firming of monetary conditions in this cycle was substantial—with the overnight interbank interest rate rising from less than 5 percent in early 2004 to 9 ¾ percent by spring 2005. Since August, rates have come down to 9 percent, as the BoM has signaled 25 basis point cuts in the desired floor interest rate, in each of August, September, and October. From early 2004, the BoM has taken a number of steps to enhance its communication with markets, including signaling a desired minimum level of interest rates– yet maintaining the *corto* instrument (the borrowed reserves objective).

The fiscal accounts improved in 2004 on the strength of rising oil revenues and restraint of current expenditures. The authorities achieved their target for the traditional deficit, 0.3 percent of GDP, and the broadly-defined deficit (the augmented deficit) narrowed to 2 percent of GDP, from 3.1 percent in 2003. Rising oil revenue helped finance an increase in capital expenditure, particularly in the oil sector. Gross public debt declined to 46.5 percent of GDP, in part through the write-off of some of the bank restructuring debt.

In 2005, oil revenues are rising again, but their impact on the broader deficit is being more than offset by a deterioration in the non-oil fiscal balance. Staff project that the traditional deficit will narrow slightly, to 0.2 percent of GDP in 2005, while the augmented deficit widens to 2.3 percent of GDP. Oil income for the year is projected to be up by about ½ percentage point of GDP from 2004 (and about 1 percentage point over budget projections). It is expected that almost all of this unbudgeted revenue will go to compensate for shortfalls in non-oil revenue, and toward transfers for additional investment spending by PEMEX and the states, as implied by the budget law, with a small part going to the oil stabilization fund and reduction of the traditional budget deficit.

The external current account deficit has remained modest, with a continued rise in oil exports and household remittances compensating for some widening of the non-oil trade deficit. With the recovery of economic activity in 2004 and 2005, imports of investment and especially consumer goods grew strongly, while weak auto exports to the U.S., and enhanced competition from China and other countries, slowed non-oil exports.

Mexican financial markets have recently performed strongly, as have other emerging markets. Sovereign bond spreads have continued to decline, recently to less than 150 basis points. At end-October, the stock market was up more than 75 percent (in domestic currency terms) since end-2003, with much of that gain coming since April of this year. The peso also has tended to strengthen this year though giving up some of its gains since August. The BoM has continued to abstain from market purchases of foreign exchange, but rising foreign exchange receipts from the state-owned oil company have pushed NIR upward. NIR reached US$61 billion by end 2004, about 4½ months of Mexico's imports and 1.6 times its short-term external liabilities; at October 28, 2005, NIR was US$62.3 billion.

The authorities have taken further steps to strengthen the public finances. The average maturity of the domestic debt of the federal government was extended to 3.1 years by June 2005, up from 2.6 years in early 2004. Exposure to currency depreciation has declined further as the public sector's annual foreign exchange earnings from oil now exceed US$30 billion, against interest payments on its foreign debt of US$9 billion. Furthermore, at mid-year the authorities announced that the federal government had accumulated enough foreign currency liquidity to allow it to forego any external bond issues through 2007.

Executive Board Assessment

Executive Directors commended the Mexican authorities for the improvements they had made in economic policies, institutions and structures over the last decade, which have contributed to greater macroeconomic stability and reduced financial vulnerability. Fiscal policy has earned broad credibility, with a track record of achieving the annual deficit targets, and a prudent monetary policy has established a low-inflation environment. A series of reforms has strengthened the financial sector and boosted its development. Directors welcomed that economic policy making is taking place in a setting of greater inclusiveness and transparency in government. The challenge ahead will be to launch a new round of structural reforms that will enhance the economy's efficiency and competitiveness and ensure the transition to a more rapid growth path, while entrenching the considerable progress that has already been made in economic policy design and implementation.

Concerning fiscal policy, Directors commended the authorities for achieving declining annual targets for the fiscal deficit, reducing the public debt ratio, and improving the debt structure, and they encouraged them to continue their efforts. At the same time, Directors noted that the overall fiscal balance has been benefiting increasingly from rising world oil prices, and that a reversal of oil prices could complicate fiscal policy if expenditures could not be reduced quickly. Most Directors urged the authorities to avoid a further widening of the non-oil fiscal deficit in 2006. A few Directors recommended monitoring closely the increase in spending by the state governments.

Directors supported Mexico's intention to implement a medium-term budget framework, with the objectives of reducing public debt further, strengthening the public finances, limiting vulnerability to oil revenue fluctuations, and allocating resources efficiently to essential investments, especially in the oil and social sectors. Noting the important share of oil revenues in total government revenues, Directors also encouraged the authorities to take measures over the medium term to strengthen the tax system and broaden its base, including by bringing more of the economy into the formal sector. Directors considered that the current high oil prices make it more important than ever to ensure that the operations and investments of the state-owned oil company (PEMEX) are effective.

Directors agreed that the monetary tightening of 2004 and early 2005 had been necessary to contain the rise in inflation and reverse inflation expectations. They were reassured that headline and core inflation are now close to the 3 percent target. With inflation expectations also moving down in recent months, the improved inflation outlook has allowed the Bank of Mexico to begin gradually loosening its policy stance. Directors recommended that the Bank continue to proceed cautiously in this direction, noting that inflation expectations have not yet converged to the 3 percent inflation target.

Directors welcomed the changes in the operational framework of monetary policy since early 2004. The Bank of Mexico's steps to refocus and sharpen its policy statements, provide an indication of its estimate of inflation for the current year, and shift toward defining policy changes through signalling a minimum level of interest rates have enhanced communication and the market's understanding of monetary policy objectives. Some Directors suggested that the authorities make public inflation forecasts for both the current year and a somewhat longer horizon, and adopt fully and explicitly an interest rate policy instrument.

Directors considered that Mexico has been well served by its floating exchange rate regime. External competitiveness appears to be broadly adequate at present, as reflected in the sustainable balance of payments position.

Directors welcomed the considerable progress made in strengthening and reforming the financial sector and capital markets and reducing potential vulnerabilities, setting the stage for an environment conducive to economic growth. Commercial banks appear to be well capitalized, profitable, and provisioned against nonperforming loans. Directors were encouraged that bank credit has begun to expand after a long period of stagnation. They noted the efforts to further enhance financial sector supervision.

Directors expressed disappointment with the slow pace of structural reforms in recent years in spite of the authorities' commitment to move forward in this area. At the same time, they supported the authorities' emphasis on implementing small-scale reforms to improve structural competitiveness in specific sectors. Nevertheless, Directors emphasized that to confront Mexico's external competitiveness, productivity, and growth challenges effectively in the future, more thoroughgoing structural reforms will be indispensable, including in the energy and telecommunications sectors, the labor market, the judicial system, the tax system, and the regulatory and business environment. In that light, Directors were encouraged that there is a growing popular understanding of the need to implement an ambitious structural reform agenda. They advised the authorities to continue to stand ready to move ahead quickly to implement these reforms at the appropriate juncture.

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

Mexico: Selected Economic and Financial Indicators 1/

	2000	2001	2002	2003	2004
(Annual percentage changes, unless otherwise indicated)					
National accounts and prices					
Real GDP	6.6	0.0	0.8	1.4	4.4
Real GDP per capita 2/	5.1	-1.5	-0.7	0.0	2.9
Gross domestic investment (in percent of GDP)	23.7	20.9	20.6	20.6	21.7
Gross national savings (in percent of GDP)	20.5	18.0	18.6	19.2	20.7
Consumer price index (end period)	9.0	4.4	5.7	4.0	5.2
External sector					
Exports, f.o.b. 3/	21.5	-3.1	0.6	3.9	13.8
Imports, f.o.b. 4/	23.1	-1.7	-1.3	1.9	15.8
External current account balance (in percent of GDP)	-3.2	-2.8	-2.1	-1.3	-1.1
Change in net international reserves (end of period, billions of U.S. dollars)	2.8	7.3	7.1	9.5	4.1
Outstanding external debt (in percent of GDP)	28.3	26.1	25.2	25.9	23.5
Total debt service ratio 5/ (in percent of exports of goods, services, and transfers)	44.8	38.3	29.9	31.1	31.5
Nonfinancial public sector (in percent of GDP)					
Augmented overall balance	-3.7	-3.6	-3.4	-3.1	-2.0
Traditional overall balance	-1.1	-0.7	-1.2	-0.6	-0.3
Gross augmented public sector debt	49.3	47.9	49.7	50.0	46.5
Net augmented public sector debt	42.2	41.7	43.6	44.0	41.2
Money and credit					
Monetary base	10.7	8.0	17.0	15.0	12.0
Broad money (M4a)	12.9	16.0	10.8	13.5	12.6
Treasury bill rate (28-day cetes, in percent, annual average)	15.3	11.2	7.1	6.2	6.8

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

1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.
2/ Fund staff estimates.
3/ Exports net of maquila sector imports.
4/ Excludes maquila sector imports.
5/ Public and private sectors.

Statement by Moises Schwartz, Executive Director for Mexico
November 9, 2005

Supported by prudent fiscal and monetary policies and by a sound financial system, the Mexican economy has continued along its path of stability. Growth has recovered, inflation is within the variability range of the target and the medium-term outlook is favorable. Given the close integration with the US economy, the slowdown observed in the latter during the first half of the year resulted in a transitory deceleration of the Mexican economy in the same period. Notwithstanding, the economy has managed to continue growing during 13 consecutive quarters and recovery is well underway, with private consumption and investment as the main contributors to growth. Economic activity has fostered employment, which, in turn, has continued to strengthen domestic demand. The outlook is favorable and it is expected that industrial production will increase its pace with an important expansion in 2006.

Fiscal Policy

My authorities are convinced on the contribution that public finances consolidation can add to growth, basically through the reduction of the debt's financial cost, increasing the availability of resources that can be oriented to social expenditure or investment; and the support that economic stability provides to financial markets and, hence, to private sector activity. As it has been the case during the current administration, fiscal targets have been met, even when no additional oil-related resources were present. During the current administration, the traditional balance has been reduced from 1.1 percent of GDP in 2000 to an expected 0.2 percent of GDP in 2005 and to an equilibrium or even a surplus in 2006, while the augmented deficit (broadly defined) will decrease from 3.7 percent of GDP to 2.4 percent in 2005 and to 1.5 percent in 2006. As the fiscal consolidation process advances, the public sector internal absorption of resources (public sector borrowing requirements as a share of domestic financial savings) has decreased, from 66 percent in 2000 to an estimated 14 percent in 2005, liberating resources and actually creating a "crowding-in" effect in the financial system.

My authorities are pursuing an adequate mix of external and domestic debt, reducing the weight of external liabilities. As a result, the fiscal deficit is totally financed by domestic debt while external debt reduction has been carried out. It is expected that the net external debt will be equivalent to 6.8 percent of GDP at end 2006, the lowest in the country's recent economic history. Moreover, currently the government has at its disposal the foreign exchange necessary to meet all 2006 and 2007 external debt payments. It is expected that the average net financing cost of the federal government will be near 2.5 percent of GDP for the period 2001-2006, 0.8 percentage points lower than the one observed during the previous administration. At the same time, the average maturity of domestic debt has increased from 291 days in 1993, to 539 in 2000, to 1,161 in September 2005, while the amortization profile is now comfortable. In addition, 37 percent of total debt is currently short term, compared to 65 percent in 2001.

Public finances have been supported by high oil prices, which have resulted in higher than budgeted oil income. Nonetheless, oil income has been managed in a prudent and transparent way. Excess resources are distributed according to a previously-determined formula that allocates them to investment in the oil sector, infrastructure projects in the states, to improve the public balance and to the oil stabilization fund. My authorities understand the potential benefit of allocating a higher share of excess revenue to saving, but they also recognize that Mexico has an important lag in infrastructure that merits to be addressed in order to equip the economy for continuous and sustained growth in the future. As it has been acknowledged, there is also an important need for oil producing countries to assign resources for investment in the energy sector. The availability of additional resources has allowed for higher expenditure where there have been historical lags. Well-designed social programs and productive infrastructure investment have received priority. Nonetheless, a conservative budgeting approach and the existence of formulas and mechanisms to allocate excess resources have resulted in an orderly and responsible process.

Although future oil prices indicate some persistence at high levels, my authorities acknowledge that these are not permanent. In this sense, a prudent approach is called for. This is one of the reasons why a conservative budget including a 0.2 percent of GDP surplus has been presented for 2006. In addition, an initiative to reform the Budget Process, including a Fiscal Responsibility Law, has been submitted to Congress. Salient features include rules to set the oil price in the budget, the oil stabilization fund and other important considerations that are still negotiated on a yearly basis.

Monetary Policy and the Financial System

Improvement in monetary policy has come a long way. Thanks to a significant consolidation in public finances, monetary policy has been focused on the fight against inflation. The central bank is autonomous since 1994 and in 1999 it began a gradual transition towards an inflation target regime, by announcing a target for the medium term. In 2000 the central bank began the publication of inflation reports and the concept of core inflation was introduced. A formal inflation targeting framework was adopted in 2001, while in 2002 the long-term target of 3 percent, including a variability range of +- 1 percentage point, was announced. Since 2003 monetary policy announcements take place on previously scheduled dates.

Macroeconomic stability and fiscal discipline have promoted financial deepening, thus been paramount in fostering financial savings. From 2000 to 2005 domestic financial savings increased from 42.4 percent of GDP to 51.0 percent. The increase in savings allowed to increase the financing to the private sector from 17.9 percent of GDP in 2000, to 22.7 percent in March 2005. In addition, between 2001 and 2004 more than 20 initiatives oriented to develop the financial system and improve its efficiency were approved. Improvements to the legal framework and restructuring process have led to a well capitalized and adequately supervised banking system. These measures have allowed a healthy increase in bank and non-bank credit. The authorities are well aware of the risks that such increase could pose and hence have committed to follow developments closely. It should be noted, however, that balance sheets are in their best position in years and that credit is starting from a low base. Looking forward, the authorities are working closely with Congress on an initiative for a new

Securities Market Law, which would allow for new corporate figures and improve the legal framework for companies in the stock market.

My authorities value the Fund's advice and consider that they should continue their efforts to ensure that the financial system is consolidated as a sustainable element of support for economic growth. In this sense, they have requested the Bank and the Fund to undertake a FSAP update that could not only help assess the impact of reforms already implemented, but that would also provide valuable information on additional opportunities for enhancing the efficiency of the financial sector.

Structural reforms

Notwithstanding the proximity of political times, my authorities will focus on reaching consensus to approve structural reforms and further consolidate macroeconomic stability. The authorities acknowledge that structural reforms are the mechanism through which productivity can receive a sustained impulse, and that countries that have achieved sustained growth are those that have engaged in reforms in the financial, labor and fiscal areas and that have reduced regulation in the economy, as well as fought monopolies and opened up to competition in sectors as energy and telecommunications. Reaching consensus is a difficult but rewarding exercise, and they are committed to expedite this process.