December 2007
IMF Country Report No. 07/379

Mexico: 2007 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion 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 2007 Article IV consultation with Mexico, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 28, 2007, 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 November 9, 2007. 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 supplement of November 29, 2007, updating information on recent economic developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 3, 2007 discussion of the staff report that concluded the Article IV consultation.

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.

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INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Article IV Consultation with Mexico

Approved by Anoop Singh and Adnan Mazarei

November 9, 2007

Executive Summary

Background: Mexico has achieved macroeconomic stability—and weathered well the recent financial market turbulence—but it has not yet reached its economic potential. GDP and productivity growth have remained disappointingly low, and poverty and inequality are still high. The new government has made an impressive start in energizing the reform agenda, including the passage of the recent fiscal package, putting the central government pension scheme on a sustainable footing, and increasing competition in the financial sector.

Challenges: The recent deterioration of the U.S. economic outlook will spillover into Mexico, mainly via trade channels. Growth is expected to remain solid, but modestly below trend, and sharing the downside risks of the U.S. outlook. The risk of a sustained decline in oil production underscores a long-term vulnerability of the public finances. Mexico's fundamental challenge remains to put in place policies to achieve a sustained and substantial acceleration in GDP growth and reduction in poverty.

Staff's views: The modestly restrictive monetary policy stance reflects an appropriate balance between inflation risks. The recent tax and pension reforms are welcome steps towards addressing long-run fiscal challenges. For the medium term, the fiscal situation will tighten progressively, with much of the projected increase in taxes by 2012 being offset by the expected decline in oil revenues. It is critical to avoid increasing inertial expenditures, and to move ahead with plans to strengthen tax administration and expenditure management. A gradual but ongoing reduction of the large non-oil fiscal deficit would be prudent. Early implementation of reforms of the state-owned oil sector could reduce the risk of a sharp decline in oil production, and it will be important to improve competition in key sectors. It will be important to monitor rapidly growing credit to households, and to proceed carefully in stimulating financial development via development banks.

Authorities' views: The authorities broadly shared the staff's assessment. They were somewhat more optimistic on the near-term outlook for growth, while recognizing downside risks from the United States. They also emphasized the considerable upside potential for Mexico over the medium term, if envisaged structural reforms can be implemented. The authorities agreed that the oil production outlook was uncertain beyond the medium term, but emphasized that implementation of appropriate policies would greatly improve the chances of developing new oil resources.

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I. CONTEXT AND KEY ISSUES

1. **Since the 1994–95 crisis, Mexico has achieved broad domestic and external economic stability, and vulnerabilities have been sharply reduced.** Strengthened macroeconomic policies have brought sustained low inflation and a declining public debt ratio; a fully flexible exchange rate regime has been introduced; financial regulation and supervision have been greatly strengthened; and the public debt has been redeemed of "original sin" and its maturity extended. Given these improved fundamentals, as well as a decline in the current account deficit and external debt to low levels, Mexico has become increasingly resilient to external shocks, and has not been subject to disruptive episodes of capital flight or sharp exchange rate movements. Partly as a consequence, the economy has experienced its own "great moderation," with output now much less volatile, albeit closely linked to the U.S. cycle.

Selected Vulnerability Indicators, 2006
(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	151.5	150.4
Total gross external debt	20.1	41.7
Of which: External debt of domestic private sector	8.6	23.7
Current account balance	-0.2	-2.5
Gross external financing requirement 1/	7.2	16.2
Public sector 2/		
Overall balance	-0.7	-1.4
Gross public sector financing requirement 3/	11.6	7.5
Public sector gross debt	43.5	42.4
Of which: Exposed to exchange rate risk 4/	11.5	18.2
Exposed to rollover risk (ST debt, residual maturity) 5/	10.9	6.5
Financial system		
Capital adequacy ratio, in percent	16.0	13.7
Non-performing loans, in percent of total loans	1.7	4.1
Return on average assets, in percent	2.4	1.7
Change in credit-to-GDP ratio, in percentage points 6/	0.3	2.7

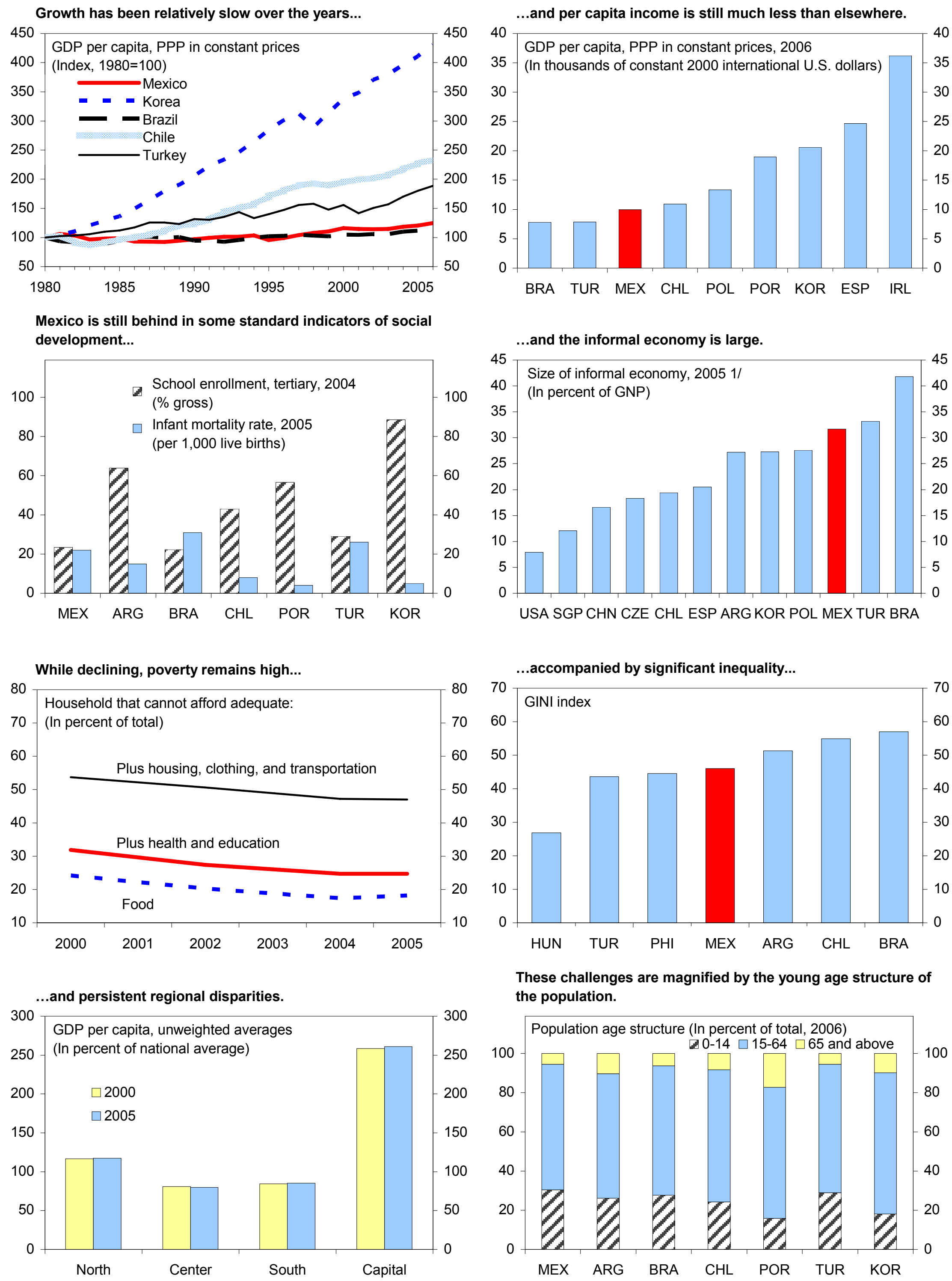
Source: IMF staff estimates.

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

2. **Despite these successes, Mexico is far from achieving its potential.** Notwithstanding the advantages of proximity to the United States, Mexico has not joined the league of fast-growing emerging markets, and there has been no sign of income convergence with the United States. Poverty and inequality remain high (Figures 1 and 2), accompanied by a substantial informal sector and large-scale emigration to the United States. Underlying this are a host of structural problems, including weak infrastructure and education; insufficient competition in key sectors and inflexible formal labor markets; still-limited financial intermediation; and weaknesses in the rule of law. At the same time, new challenges are emerging, most importantly—with oil accounting for more than a third of budget revenues—the fiscal implications of declining oil reserves.

Figure 1. Mexico: Social Indicators

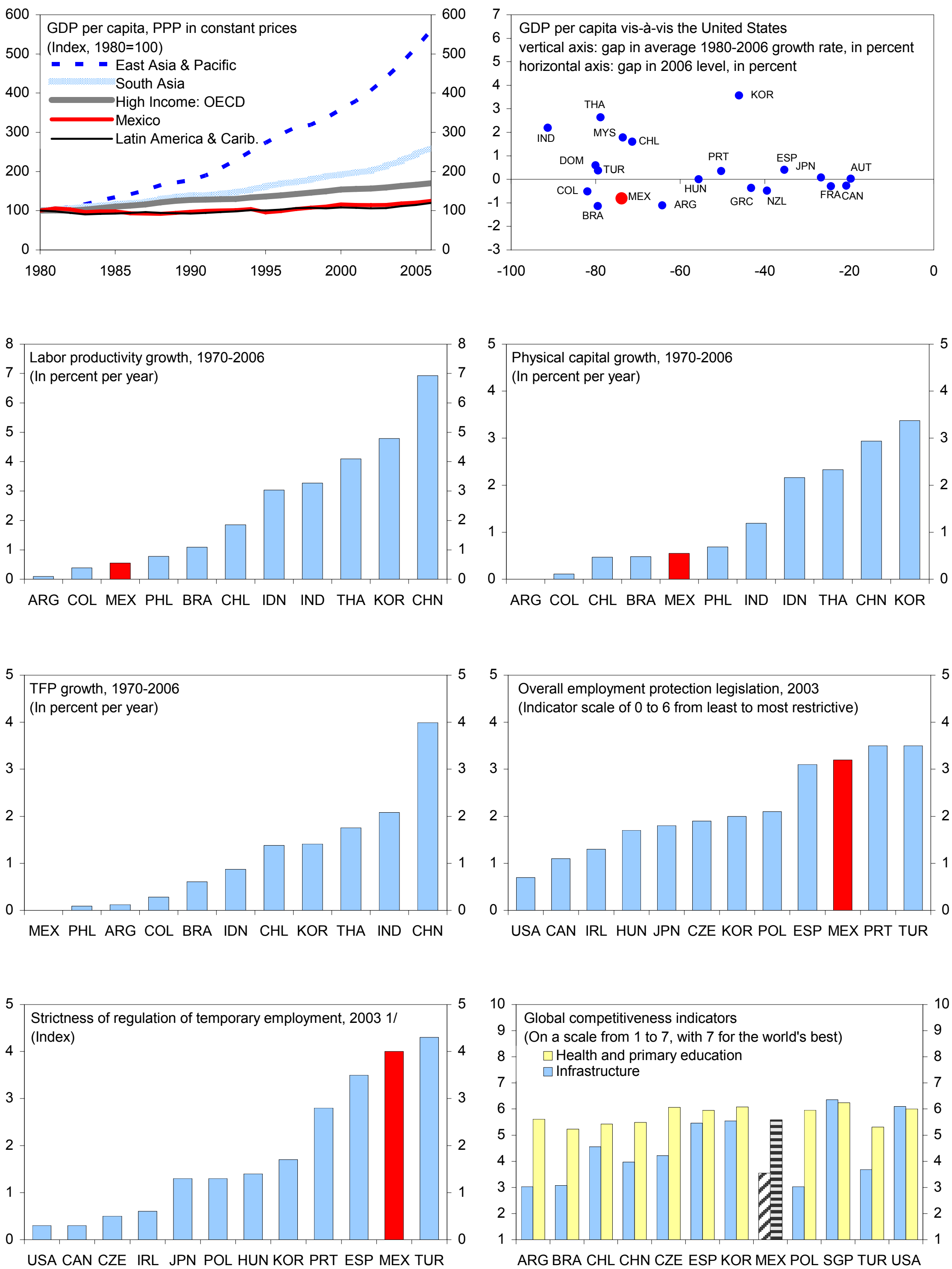
After 25 years of low growth, the Mexican economy faces important social and economic challenges–raising income per capita and reducing poverty, regional disparities, and inequalities.



Sources: EMED; Haver Analytics; INEGI; World Bank; and IMF staff calculations.
1/ Schneider, Friedrich. 2007. "Shadow Economies and Corruption all over the World: New Estimates for 145 Countries", University of Linz, Department of Economics.

Figure 2. Mexico: Economic Growth from an International Perspective

Economic growth remains insufficient to allow convergence in living standards. Low productivity, rigid markets, and insufficient infrastructure are holding up Mexico against global competition.



Sources: OECD Employment Outlook, 2006; World Economic Forum Global Competitiveness Report, 2007-2008; World Bank; IMF World Economic Outlook; and IMF staff calculations.

3. **The new government that took office last December has made an impressive start in addressing these challenges.** At the outset of his term, President Calderon set the goal of abolishing extreme poverty and raising GDP per-capita to US$29,000 by 2030. As a first step, in mid-2007, the National Development Plan, set out a wide ranging policy agenda, including ambitious plans to raise infrastructural expenditure and move ahead with structural reforms, with the aim of raising Mexico's potential growth from 3½ percent to 5 percent by 2012. Moreover, despite the administration's lack of a congressional majority, several major reforms have been enacted, including a comprehensive fiscal package to help offset declining oil revenues, a reform of civil service pensions, and measures to increase competition in the financial sector and expand access to finance.

4. **In this context, the discussions focused on four areas:**

- near-term implications of the recent deterioration in the global economic situation;
- making the most of recent fiscal reforms, and preparing to address medium- and longer-term fiscal challenges, including declining revenue from oil;
- catalyzing financial development while maintaining financial stability; and
- identifying immediate priorities within the long-structural reform agenda.

II. Recent Economic and Financial Developments

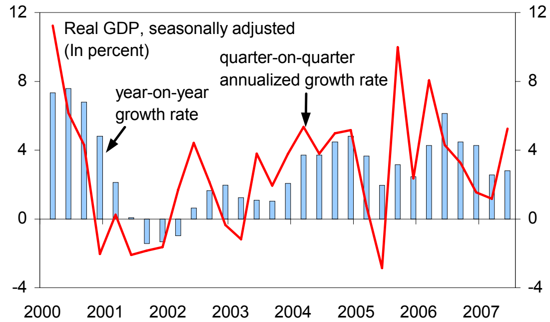
5. **The economic expansion has continued on a solid footing, albeit affected increasingly by developments in the United States.** After an unusually rapid increase through mid-2006, GDP growth has slowed in line with the United States (Figure 3), with solid consumption growth—aided by booming household credit—offset by slowing investment and exports. Despite some pickup in the second and third quarter, in part reflecting a rebound in the U.S. auto industry, growth is projected to average just under 3 percent for 2007 as a whole.

6. **With inflation—and inflation expectations—above target, the Bank of Mexico (Banxico) has tightened monetary policy this year.** After converging briefly to the 3 percent target, inflation has been closer to 4 percent since September 2006, boosted by a series of supply shocks to world food prices, especially corn, sugar and milk. Wage growth so far has not accelerated, and medium-term inflation expectations have been broadly stable—although remaining ½ point above the 3 percent target. In that context, Banxico acted to raise short-term interest rates to 7¼ percent in April, and further to 7½ percent in October, citing the need to avoid second-round effects and to guide downward inflation expectations.

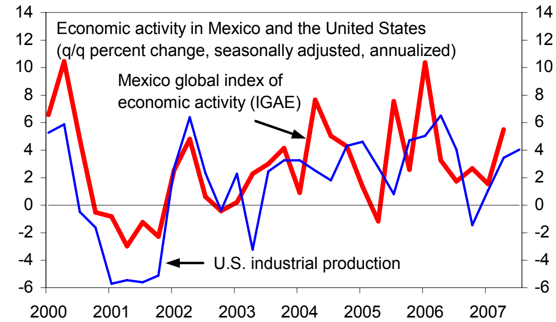
Figure 3. Mexico: Real Sector Developments

The economy has slowed, broadly in line with U.S. cyclical developments; so far confidence and domestic demand have held up well.

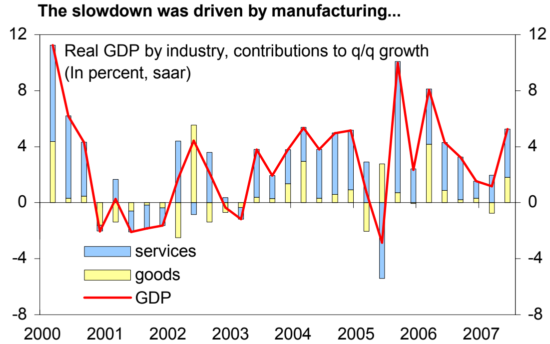
GDP growth slowed after mid-2006, but picked up in the second quarter of this year...



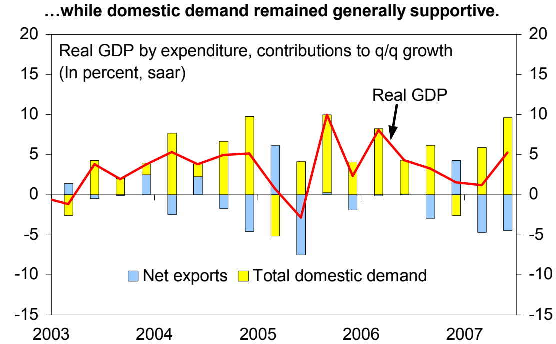
...broadly in line with U.S. industrial production.



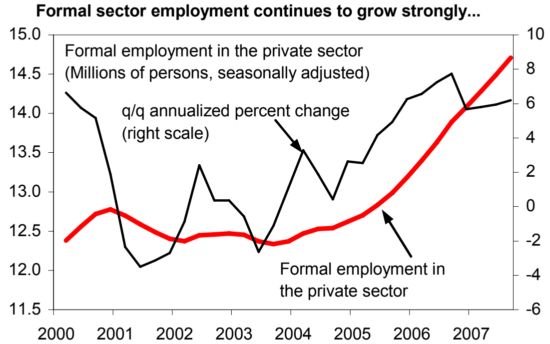
The slowdown was driven by manufacturing...



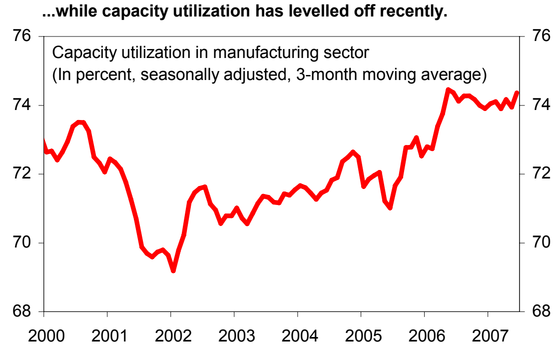
...while domestic demand remained generally supportive.



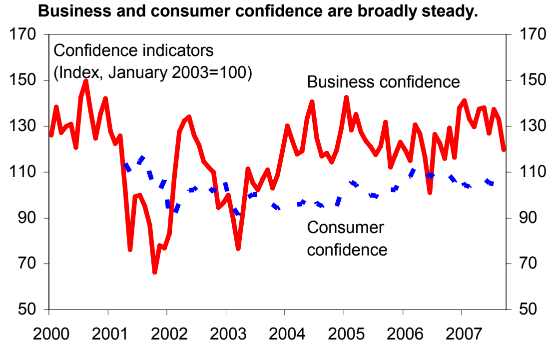
Formal sector employment continues to grow strongly...



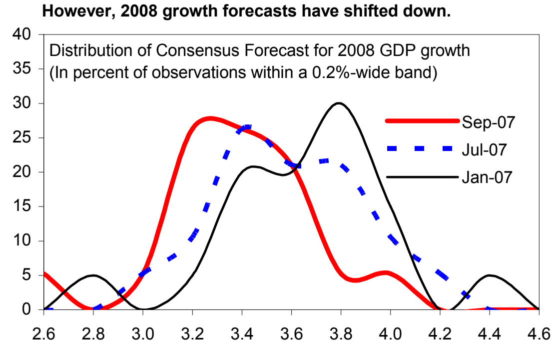
...while capacity utilization has levelled off recently.



Business and consumer confidence are broadly steady.



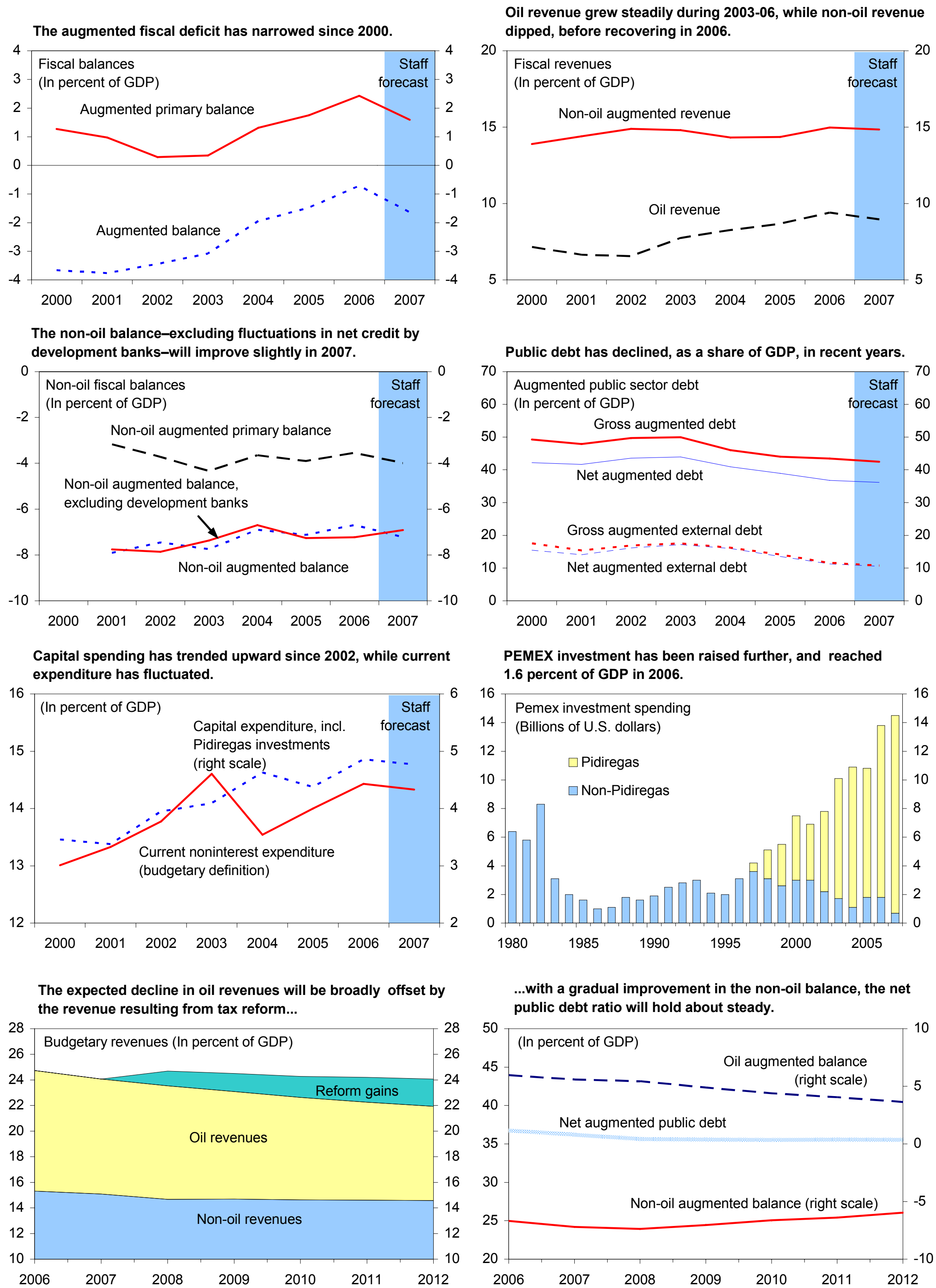
However, 2008 growth forecasts have shifted down.



Sources: Consensus Forecasts; EMED; Haver Analytics; and IMF staff calculations.

Figure 4. Mexico: Fiscal Issues

If the expected decline in oil revenues materializes, gradual improvement in non-oil revenues will be needed. The recent tax reform is an important step in the right direction.



Sources: EMED; Haver Analytics; Mexican authorities; and IMF staff calculations.

7. **Fiscal policy is on track to achieve balance for 2007, on the traditional budget measure, as required by the new Fiscal Responsibility Law** (Figure 4). The non-oil augmented fiscal deficit for 2007 is projected to be close to 7 percent of GDP, broadly similar to recent years level.[1] [2] Within this, a 0.4 percent of GDP decline in net oil revenues, reflecting declining oil production, is being offset by a reduction in operational outlays, while investment and social expenditures increase. Following longstanding policy, PEMEX' prices for domestic sales of gasoline and diesel were held essentially constant in real terms, now representing a subsidy (since international prices have risen above the Mexican level).

Mexico: Financial Operations of the Public Sector, 2002–2008
(in percent of GDP)

	2002	2003	2004	2005	2006	Budget 2007	Staff Proj. 2007	Draft Budget 2008	Staff Proj. 2008
Traditional balance	-1.2	-0.6	-0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Traditional balance excl.non-recurring revenue	-1.9	-1.3	-1.7	-0.4	-0.2	0.0	-0.2	-0.1	-0.1
Augmented balance 1/	-3.4	-3.1	-1.9	-1.5	-0.7	-1.7	-1.6	-2.1	-1.9
Augmented balance excl. development banks	-3.9	-2.7	-1.7	-1.6	-1.3		-1.3		-1.6
Non-oil augmented balance 2/	-7.5	-7.8	-6.9	-7.1	-6.7	...	-7.2	...	-7.4
Non-oil augmented balance excl. development banks	-7.9	-7.4	-6.7	-7.3	-7.2		-6.9		-7.1
Oil balance	4.0	4.7	5.0	5.7	6.0	...	5.6	...	5.4
Oil revenue 3/	6.5	7.7	8.3	8.7	9.4	8.3	9.0	8.2	8.9
Oil-related expenditure (incl. investment)	2.5	3.1	3.3	3.0	3.4	...	3.4	...	3.4
Gross augmented debt	49.7	50.0	46.0	44.0	43.5	...	42.5	...	41.5
Average crude oil export price (US$/barrel)	21.6	24.8	31.0	42.8	53.0	42.8	57.7	49.0	63.2

Sources: Mexican authorities; and IMF staff estimates.
1/ IMF staff definitions.
2/ Based on oil revenue, net of PEMEX operational expenditure and interest and of oil sector investment.
3/ Including fuel excise tax and net of PEMEX imports.

8. **Public debt trends remain generally favorable.** The public debt to GDP ratio has been steadily declining, and the average maturity of central government traded domestic debt has increased—with the government recently able to issue 30-year nominal fixed rate bonds, albeit in small amounts—although annual rollover of the augmented public debt is relatively high. That said, the net wealth of the public sector may be declining with the continued depletion of Mexico's proven oil reserves, now down to only 10 years' production.

9. **The external position remains solid, notwithstanding a decline in oil production and negative shocks from the United States** (Figure 5). Net oil exports contracted as production faltered, and auto exports to the United States weakened markedly after surging in 2006. Recorded remittances—previously on a strong upward trend—also slowed, seemingly

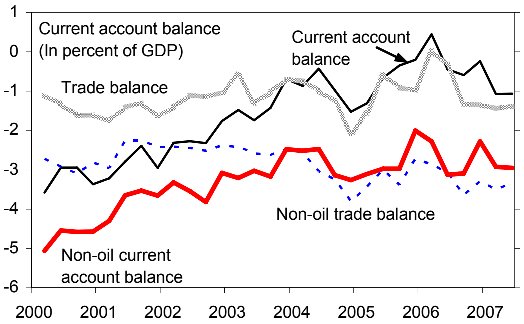
[1] The decline in the non-oil deficit in 2006 was mainly due to a development bank's sale of loans to FOVISSSTE, a publicly-authorized housing fund that as of 2006 is no longer included in the fiscal accounts.

[2] Looking over the last 5 years of rising oil revenues (see table), the non-oil augmented deficit did not expand—instead, the higher oil revenues helped reduce the overall augmented deficit and also pay for an increase in oil-related expenditures (including investment).

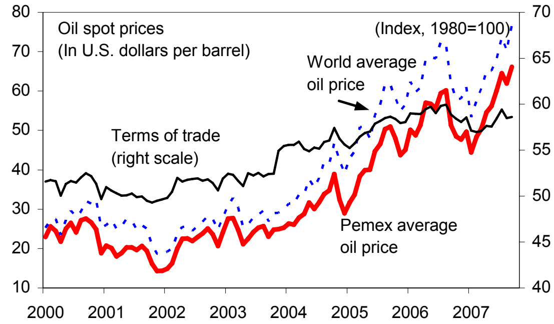
Figure 5. Mexico: External Sector - Trade and Current Account

Mexico's current account balance strengthened through 2006, helped by rising oil exports and fast-growing remittances. Going forward, these trends may not continue.

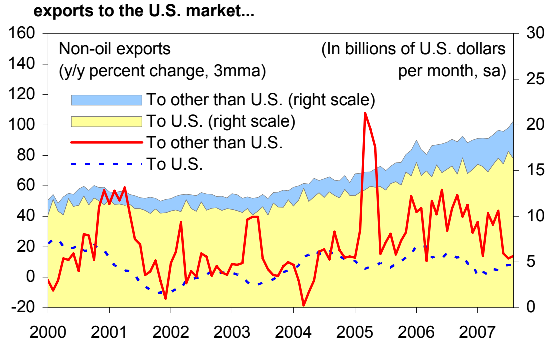
The current account balance improved considerably from 2000 to 2006...



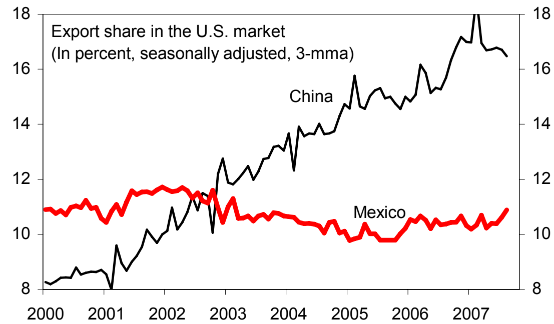
...as a result of rising oil export prices and terms of trade.



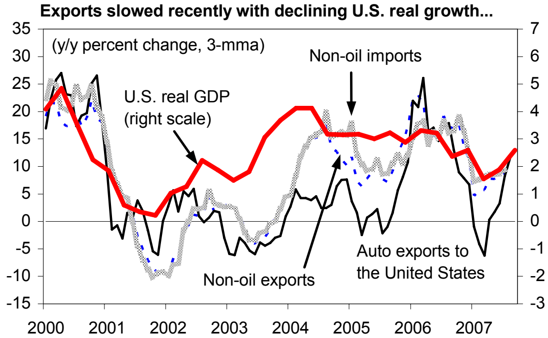
Exports to non-U.S. markets have been growing faster than exports to the U.S. market...



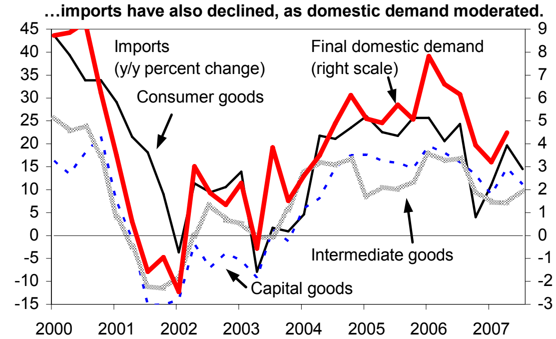
...while Mexico's export share in the U.S. market has stabilized (after its 2003-04 decline).



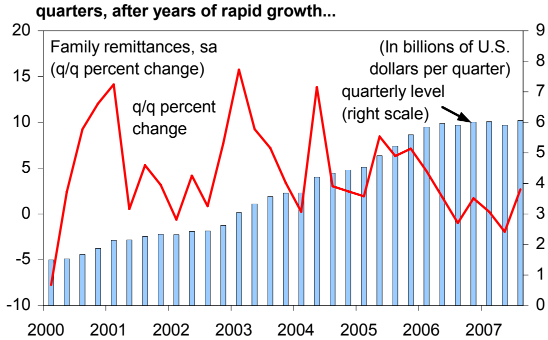
Going forward, external conditions may be less favorable: Exports slowed recently with declining U.S. real growth...



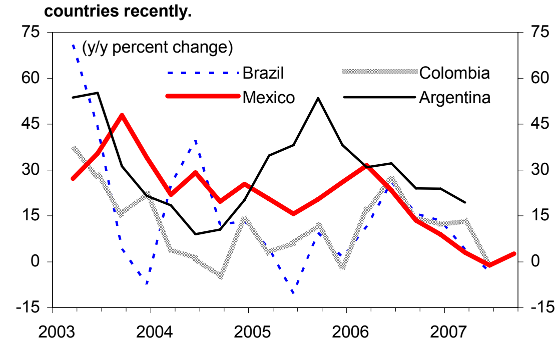
...imports have also declined, as domestic demand moderated.



Recorded inbound family remittances decelerated in recent quarters, after years of rapid growth...



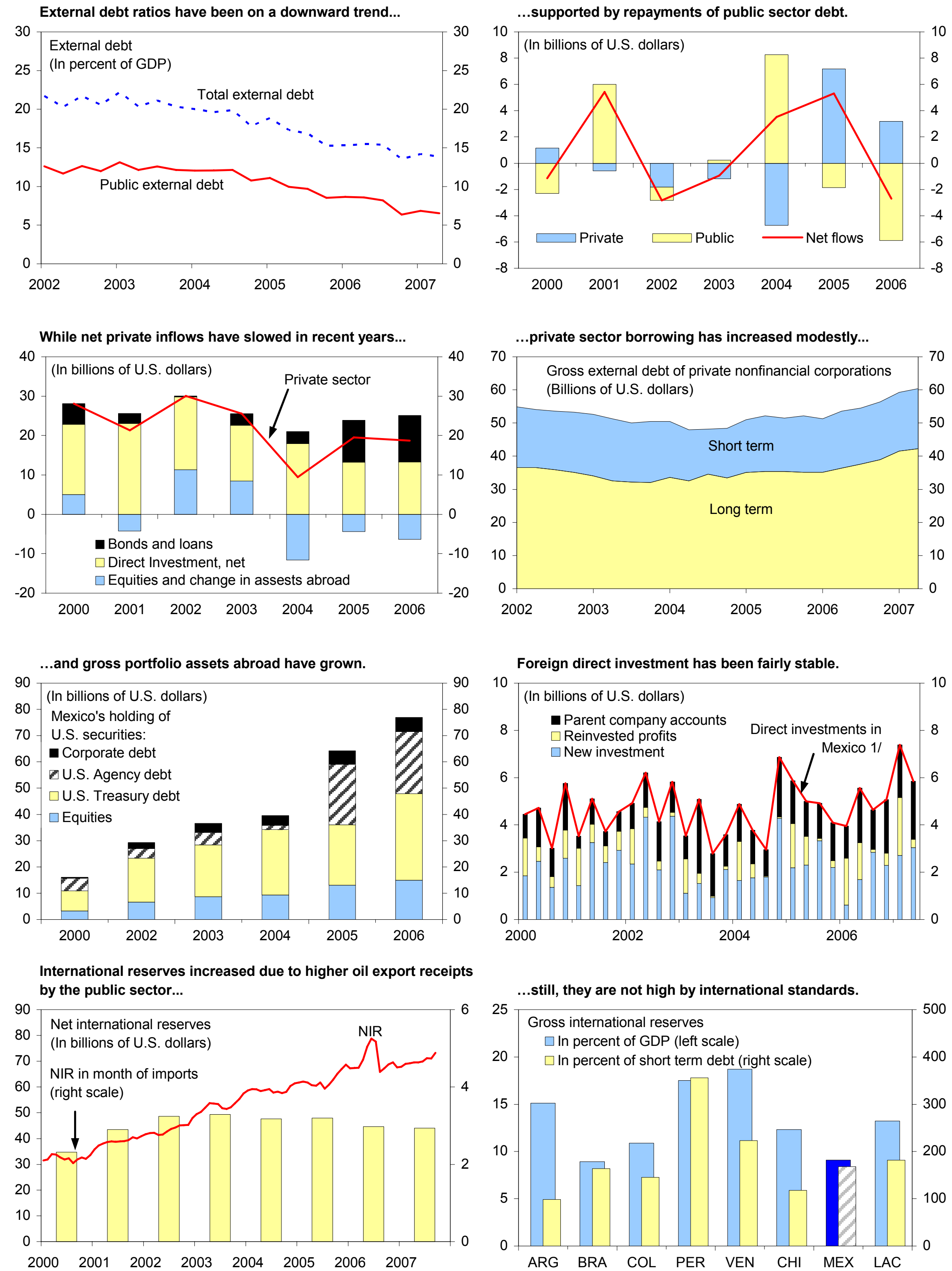
...a slowdown also seen in some other Latin American countries recently.



Sources: Mexican authorities; EMED; Haver Analytics; IFS; and IMF staff estimates.

Figure 6. Mexico: External Sector - Capital Account

Mexico's capital account has strengthened in recent years, with a reduction in external debt, consistent foreign direct investment, and despite declining private net inflows. International reserves have increased steadily.



Sources: Mexican authorities; Haver Analytics; U.S. Treasury TIC benchmark surveys; and IMF 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.

reflecting increased uncertainty over U.S. immigration policy and slowing U.S. activity.[3] As a result, the current account deficit rose modestly in the first half of 2007, and a deficit of ¾ percent of GDP is projected for the year as a whole. As in the past, net inflows of foreign direct investment have significantly exceeded the current account deficit this year. In contrast to 2006,[4] official reserves have risen this year, by US$5 ½ billion in the first three quarters of 2007; reserves are about 1½ times short-term total external debt on a residual maturity basis (Figure 6).

10. **Mexican financial markets have weathered recent global financial volatility well.** As in other emerging markets, the global repricing of risk resulted in a significant decline in equity markets, which shed most of their 2007 gains; a modest rise in sovereign bond and CDS spreads (Figure 7); and a modest depreciation of the peso. By October, all these movements had been largely reversed. With Mexican institutions reported to have little or no direct exposure to U.S. sub-prime assets, domestic financial markets have continued to function normally, without need for policy intervention by the authorities. There does not appear to have been significant contagion or withdrawal of liquidity through foreign-owned banks (which account for close to 80 percent of banking system assets).[5]

11. **The banking system appears sound although rapid consumer credit growth needs careful monitoring.** Commercial banks remain well capitalized, profitable and liquid, and nonperforming loans are low. The main potential concern remains rapid growth of bank credit to the private sector (31 percent annual growth through June), primarily to households; delinquent consumer loans have recently edged up, from a low base, although the risks are limited by households' relatively low debt service ratio (Figure 8).[6] Credit to enterprises has recently picked up, but remains very low; corporate financial indicators are relatively strong (Figure 9).

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[3] Some of the previous fast growth of recorded remittances was attributable to improvements in measurement.

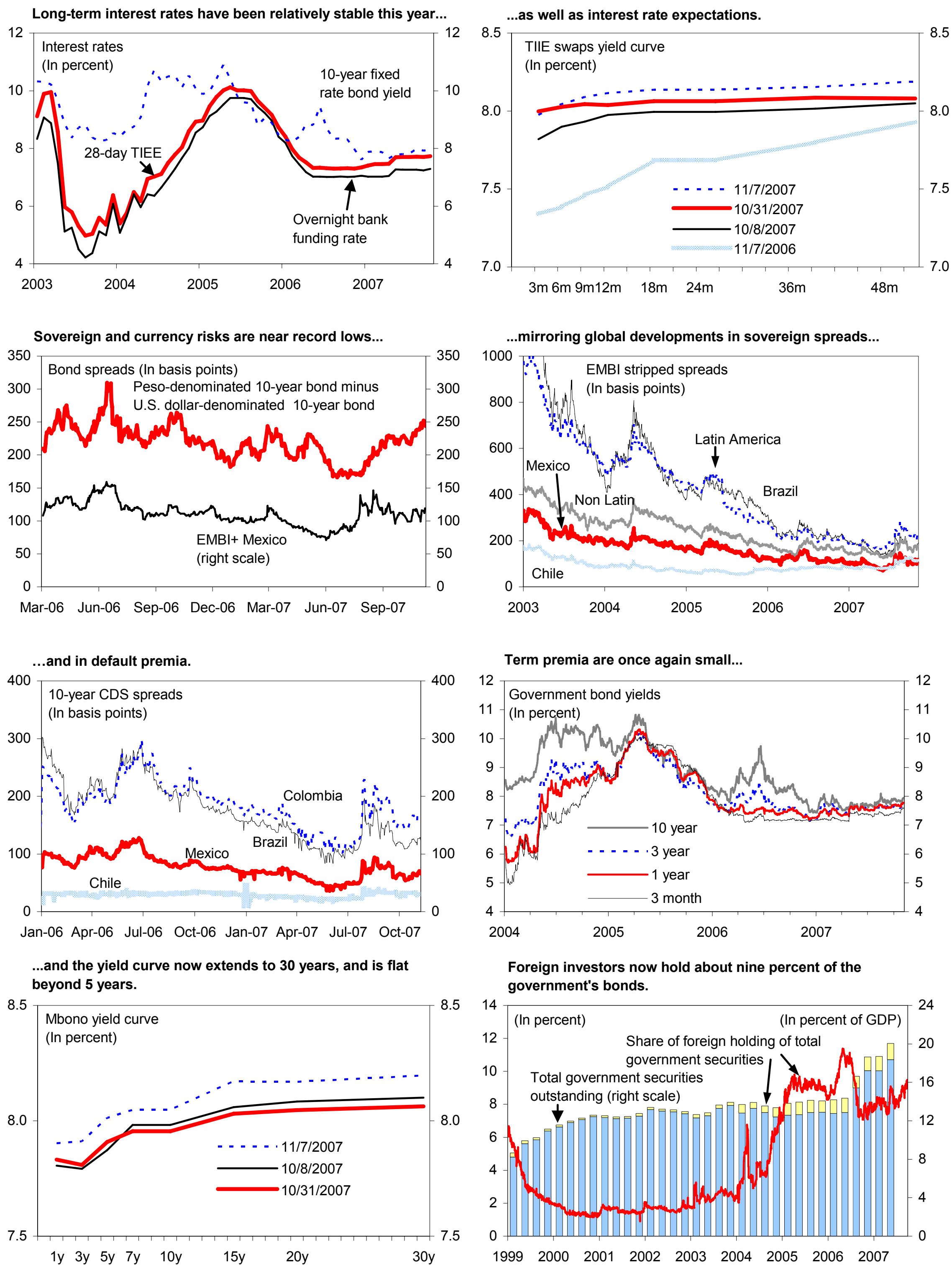
[4] The small decline in reserves in 2006 reflected a special operation, prepaying more than US$12 billion of public sector external debt.

[5] The authorities closely monitor all banks for related-party credit activity, while Memoranda of Understanding with foreign supervisory bodies complement the Mexican prudential regulations that put caps on interbank lending.

[6] International evidence finds that "credit booms" are more likely to be followed by financial distress episodes when they are associated with large current account deficits, appreciation of the real exchange rate, and high inflation. None of these conditions apply to Mexico.

Figure 7. Mexico: Bond Market Developments

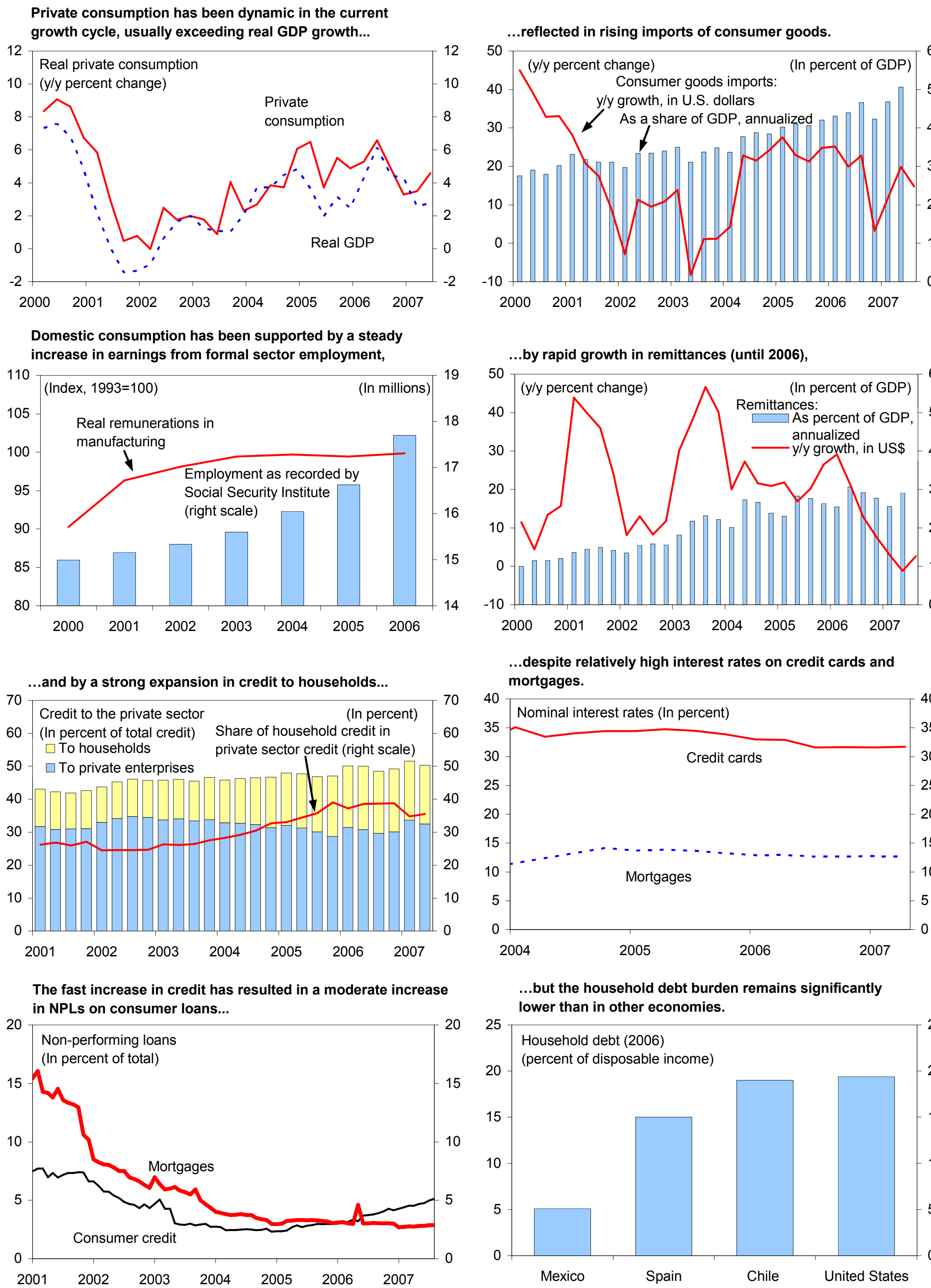
Bond market developments–stable interest rate expectations and low sovereign and currency risks–reflect benign global financial conditions and greater domestic macroeconomic stability.



Sources: Bloomberg L.P.; Consensus Forecasts; Datastream; Haver Analytics; IMF Information Notice System; and IMF staff calculations.

Figure 8. Mexico: Household Sector

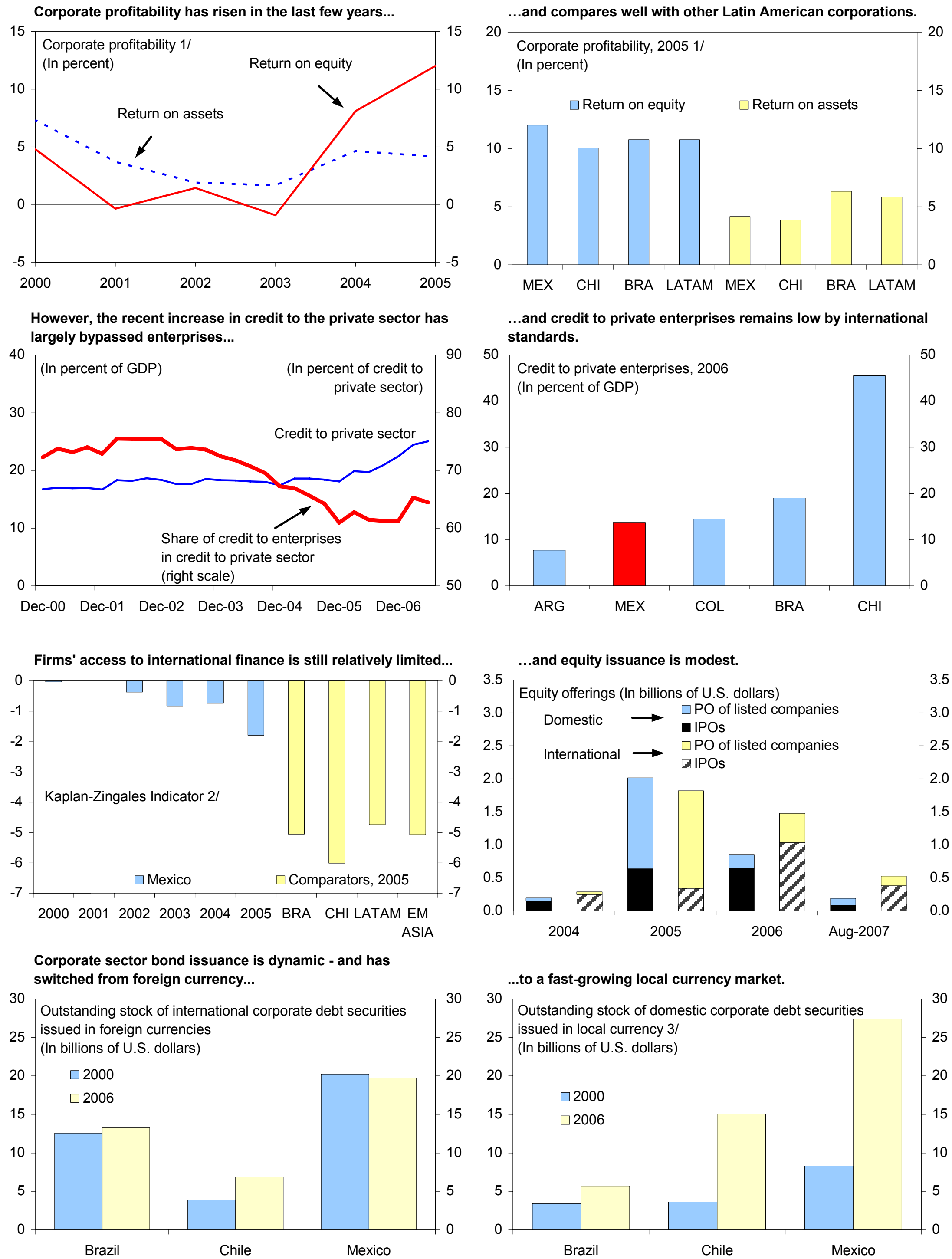
The household sector has played an important role in the current growth cycle, supported by rising income from wages and remittances and by greater access to bank credit.



Sources: Bank of Mexico; EMED; Haver Analytics; INEGI; and IMF staff calculations.

Figure 9. Mexico: Corporate Sector

Indicators of corporate profitability have been strong in recent years. Despite dynamic corporate bond issuance recently, access to finance remains a problem for many firms.

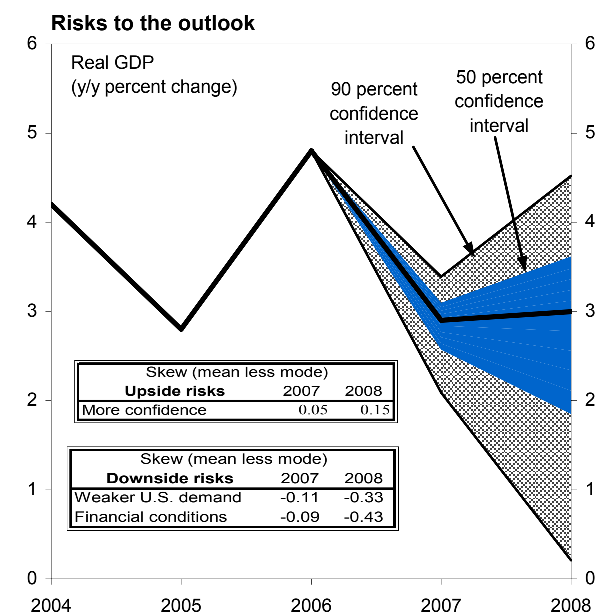


Sources: Bank for International Settlements; CNBV; and IMF staff calculations.
1/ Data from the IMF Corporate Vulnerability Utility, based on Worldscope database and covering publicly traded companies only (sample of about 105 corporations).
2/ The index is based on Kaplan and Zingales (1997) capturing the degree to which firms are constrained in their access to external financing. A more negative number indicates lesser constraints.
3/ Includes nonfinancial public corporations.

III. Outlook and Risks

12. **With the economy estimated now to be close to potential, external conditions are key to the near-term outlook** (Box 1). While Mexico will benefit from rising oil prices, it will be significantly affected by the weakening in the United States, with staff forecasts of U.S. growth in 2008 revised downward by almost 1 percentage point to 1.9 percent since July. Against this background, the staff project growth at close to 3 percent in both 2007 and 2008—below trend, and gradually reopening a modest output gap. The authorities saw the staff projections as somewhat pessimistic, noting that the staff's U.S. growth forecast was below Consensus Forecasts; they also thought the impact of the U.S. downturn would be smaller than previously since it was concentrated in housing, while industrial production—which affects Mexico more directly—had been less affected.

13. **There was agreement that near-term risks to growth were slanted to the downside.** While recent reforms would have a positive impact on confidence—reflected *inter alia* in sovereign rating upgrades by Fitch and S&P—Mexico would be vulnerable to a more rapid slowdown in the United States. In this event, given Mexico's much improved fundamentals, there could be room to ease monetary policy, consistent with the inflation targeting framework.



14. **Looking into the medium term, staff project that growth will pick up, first through cyclical recovery, but also reflecting faster growth of potential output.** The combination of greater infrastructure investment, enhanced efficiency of public investment, and lower long-term interest rates as a result of fiscal reforms should raise potential growth noticeably above the past trend (near 3½ percent). Looking forward, the authorities and staff saw significant upside risks as structural reforms are implemented, with the authorities targeting potential growth to reach 5 percent by 2012.

15. **A significant aspect of the medium-term baseline scenario is that—given the combination of slowing oil production and rising domestic fuel consumption—Mexico will lose its status as a net exporter of hydrocarbons.** On the fiscal side, lower production will result in a decline in the public sector's oil income to about 7 percent of GDP in 2012, so that a steady reduction of the non-oil fiscal deficit will be needed to comply with the zero budget balance target (as projected) and avoid a rising public debt ratio (see Section IV.B). On the external side, the combination of slowing exports and rising imports would essentially eliminate the

Box 1. Effects of the U.S. Deceleration on the Mexican Economy

Especially since the introduction of NAFTA, Mexico has exhibited strong sensitivity to the U.S. business cycle, which has continued recently. Real external linkages now seem more important for Mexico than financial linkages.

- Staff's analysis of the Mexican business cycle (Selected Issues, Chapter I) confirms that a close relationship with U.S. cycle continues. The co-movement between Mexican GDP and U.S. real activity is strong, with a close alignment of turning points.

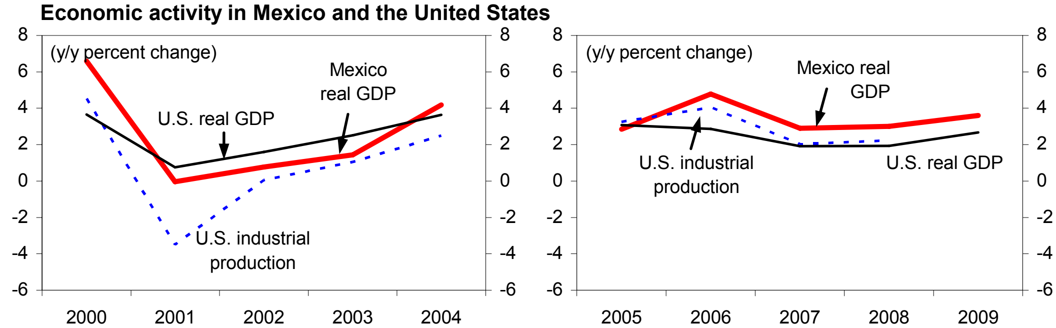
- Changes in U.S. real economic variables can account for as much as 45 percent of Mexican output fluctuations. This likely reflects the close trade integration with the United States; more than 85 percent of Mexico's exports destined to the U.S. market.

- Indicators of U.S. output—whether industrial production, or total GDP—seem more important than U.S. domestic demand, reflecting that much of Mexico's exports are intermediate goods, rather than final consumption goods. This export structure could work to Mexico's advantage if the U.S. external account deficit were to contract sharply (since U.S. final demand would then fall faster than U.S. output).

- Staff's analysis suggests that external financial conditions, and international oil prices, also influence Mexican GDP, but to a much lesser extent than real variables. This finding contrasts to some recent analyses for other emerging markets in Latin America (e.g., Zettelmeyer et al, 2007), where financial linkages seem more important. A possible explanation is that Mexican balance sheets are stronger (and so less vulnerable to tightening of international financial conditions). The smaller degree of financial intermediation in Mexico, and smaller external debt, may make Mexico less sensitive.

- Data limitations prevented quantifying the role of remittances in transmission of the U.S. business cycle, but other work suggests that U.S. downturns do lead to slower remittances. While remittances to Mexico are much less important (about 3 percent GDP, or 5 percent of private consumption) than elsewhere, a sharp slowdown could still have a non-negligible impact on domestic demand.

Economic activity in Mexico and the United States



Sources: IMF staff projections for GDP; U.S. industrial production projections from Consensus Forecasts.

Implications for the near-term outlook:

The current deceleration of U.S. activity is expected to have less impact on Mexico than in the past, as this time U.S. industrial production is expected by most analysts to fare better than U.S. GDP (in contrast to the 2001–02 cycle, with the opposite pattern).

oil trade surplus, shifting the current account into moderate deficit by 2012, and removing the main impulse to the accumulation of official reserves (Section IV.A).

Mexico: Medium-Term Staff Scenario: Main Elements
(In percent of GDP, unless otherwise indicated)

				Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012
External current account balance	-1.0	-0.6	-0.2	-0.8	-1.3	-1.6	-1.9	-2.0	-2.1
Oil trade balance	1.8	2.0	2.3	1.5	1.1	0.7	0.4	0.2	0.0
Exports	3.5	4.2	4.6	4.6	4.7	4.1	3.7	3.4	3.1
Imports	1.7	2.2	2.4	3.0	3.6	3.4	3.3	3.2	3.2
Augmented balance 1/	-1.9	-1.5	-0.7	-1.6	-1.9	-2.1	-2.2	-2.3	-2.3
Oil augmented balance	5.0	5.7	6.0	5.6	5.4	4.9	4.4	4.0	3.6
Non-oil augmented balance	-6.9	-7.1	-6.7	-7.2	-7.4	-7.0	-6.6	-6.4	-6.0
Net international reserves, end-year	9.0	8.9	8.1	8.4	8.4	8.4	8.2	7.9	7.6
Augmented public debt, gross	46.0	44.0	43.5	42.5	41.5	41.1	40.6	40.4	40.1
Augmented public debt, net	40.9	38.9	36.8	36.2	35.6	35.6	35.5	35.6	35.6
Real GDP, percent change	4.2	2.8	4.8	2.9	3.0	3.6	3.8	3.8	3.8
Crude oil production, percent change	0.4	-1.5	-2.3	-3.0	-1.0	-0.2	-0.2	-0.3	0.1

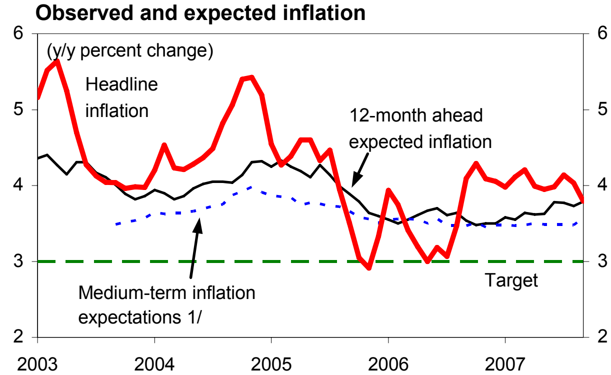
Sources: Mexican authorities; and IMF staff estimates.
1/ IMF staff definitions.

IV. Policy Discussions

A. Monetary Policy and Foreign Exchange Management

16. **Banxico has been generally successful in containing the impact of inflation shocks.** While inflation—as in other countries—recently has been pushed upward by a series of supply side shocks from international food prices, medium-term inflation expectations have remained anchored, albeit modestly above the 3 percent inflation target (Figure 10). Importantly, such expectations seem no longer to be backward looking, but consistently have looked beyond the effects of recent supply shocks, predicting that inflation will fall back, to around 3½ percent. Yet the situation is not fully satisfactory, since it leaves open the question of convergence of inflation to the 3 percent inflation target.

Observed and expected inflation



Sources: EMED; Haver Analytics; and IMF staff calculations.
1/ Expectations for 2003–2004 are annual average of 2005–2008. Expectations for 2005–2007 are annual average of 2006–2009.

17. **At the present juncture, Banxico faces the challenging task of weighing upside inflation risks from supply side shocks against downside risks from weakening external demand.**

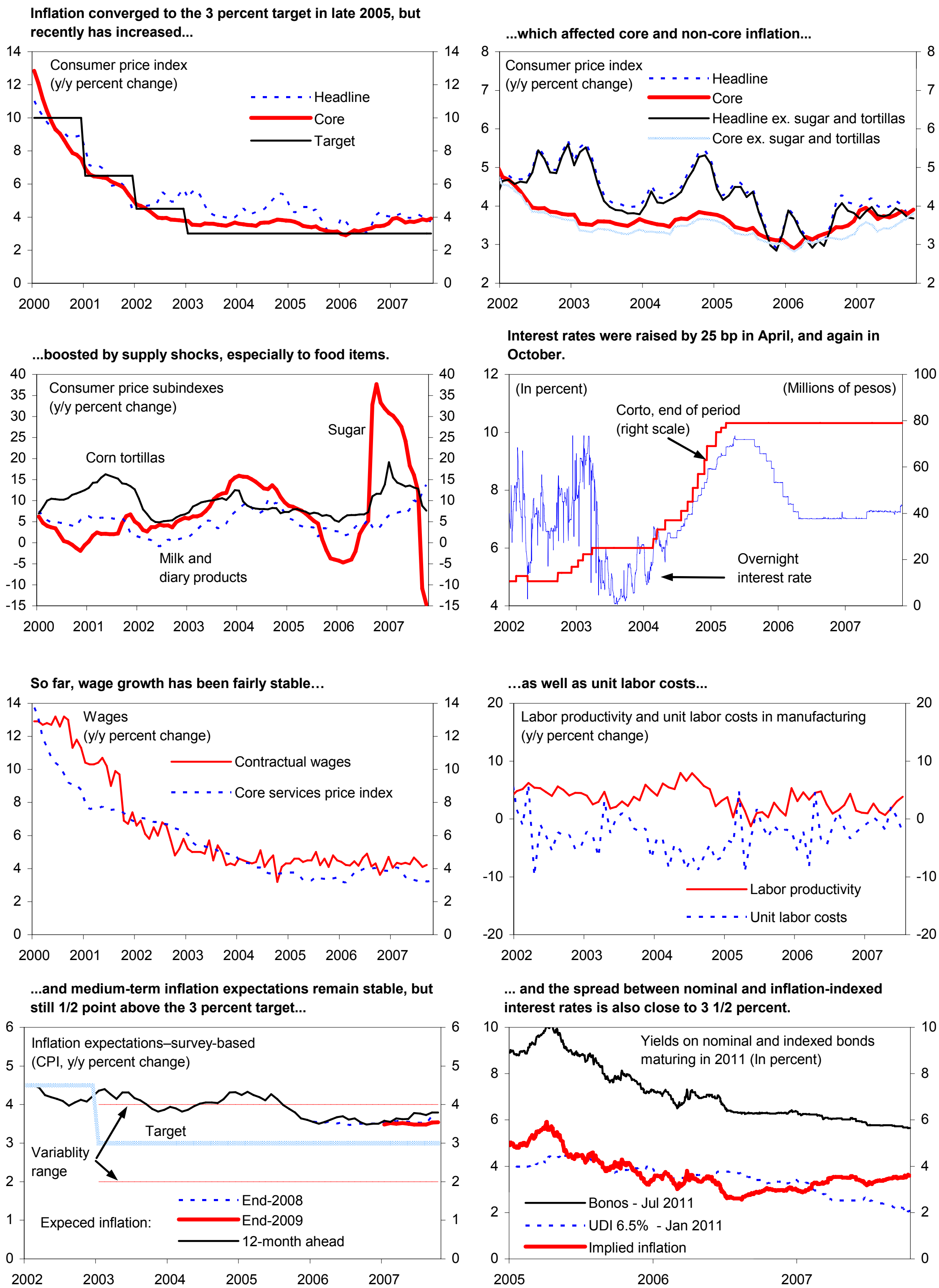
On the one hand, the authorities noted that external supply-side shocks—most recently, wheat prices—continued, while the recent tax reform would put upward pressures on prices in 2008, although the extent was difficult to estimate (partly reflecting concerns that these could adversely affect expectations, the introduction of the gasoline excise was delayed to January 2008). On the other hand, the 50bp reduction in the Fed Funds rate in September was a de facto tightening for Mexico; and looking forward, the weakening U.S. outlook could be expected to reduce demand pressures, and thereby the risk of second round effects. Overall, the team considered that the current policy stance—judged moderately restrictive—was appropriate for the time being, with the next move depending importantly on incoming data, including with respect to developments in the United States, as well as wage settlements and inflation expectations. The authorities emphasized that they would continuously evaluate the policy stance in light of the 3 percent inflation target; in October, Banxico raised rates by 25bp, to 7½ percent.

18. **The team welcomed the progress being made in enhancing Banxico communications.** In May 2007, Banxico for the first time published a conditional forecast that convergence to the inflation target would occur within a specified time horizon (in that case, about 18 months); the monthly monetary policy press releases were also revamped to focus more on factors affecting inflation beyond the short term. In October, Banxico took the further step of publishing a projected quarterly *path* for inflation over a 2-year horizon, indicating convergence to target near the end of 2009. The team observed that these measures, especially the communication of a projected inflation path, along with Banxico's rolling commitment to achieve the inflation target, would facilitate market adjustment to recent and future shocks, as well as convergence of inflation and inflation expectations to target. Looking forward, a further desirable step would be to publish Banxico's inflation model.

19. **Mexico operates an independently floating exchange rate system, and the team welcomed the continued observance of the transparent auction rule in place since early 2003 (Box 2).** Banxico passively accumulates part of the public sector's net foreign exchange cash flow, but abstains entirely from discretionary purchases or sales of foreign exchange, and thus the market-determined exchange rate remains fully flexible in both directions. This transparent regime—applied equally during times of peso appreciation and depreciation—has facilitated the inflation targeting framework, and by allowing continuous adjustment, it has avoided making Mexico a target of speculative inflows or outflows of capital.

Figure 10. Mexico: Inflation and Monetary Policy

Inflation has remained at about 4 percent in recent quarters; the central bank has twice tightened monetary policy in 2007, seeking convergence to the 3 percent inflation target.



Sources: Bloomberg L.P.; EMED; Haver Analytics; INEGI; and IMF staff calculations.

Box 2. The Foreign Exchange Policy Regime, and Accumulation of Reserves

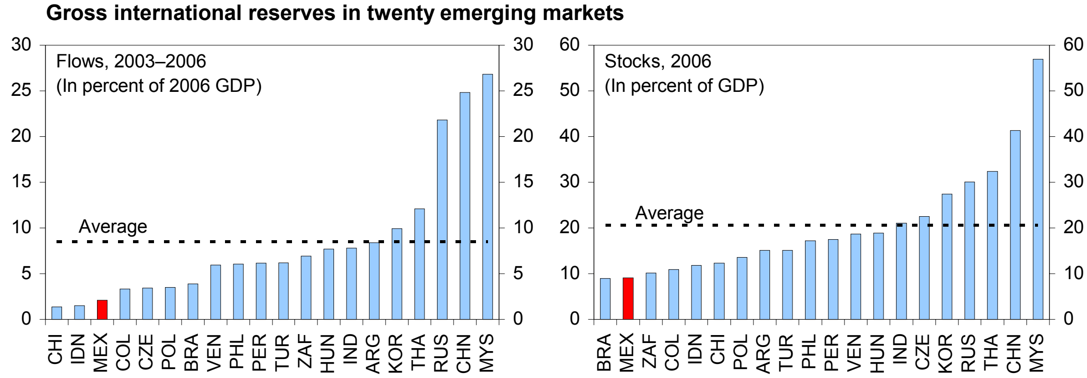
- The Bank of Mexico (Banxico) has not engaged in discretionary purchases or sales of foreign exchange in this decade.

- Still, Banxico accumulates reserves passively, partly from capitalization of interest earnings, but mainly by (net) purchases of the public sector's net foreign exchange cash flow (principally, proceeds from oil exports and from external borrowing, less amortization of external debt). Of these net inflows, Banxico sells 50 percent to the private market, via daily auctions, following a rule established in early 2003.

- The exchange rate is completely flexible on any given day, and in general is free to react fully to changes in fundamentals. At the same time, the pace of Banxico's passive reserve accumulation, via oil export revenue, can be influenced by fluctuations in oil export prices; this may dampen the sensitivity of the peso to such price fluctuations (relative to an alternative policy in which Banxico would auction 100 percent of the oil earnings it receives).

- Over the 2003–06 period, Mexico's reserves expanded by approximately US$17 billion, about 2 percent of 2006 GDP. Compared to other emerging markets during this period, Mexico's reserve accumulation was among the slowest.

Gross international reserves in twenty emerging markets



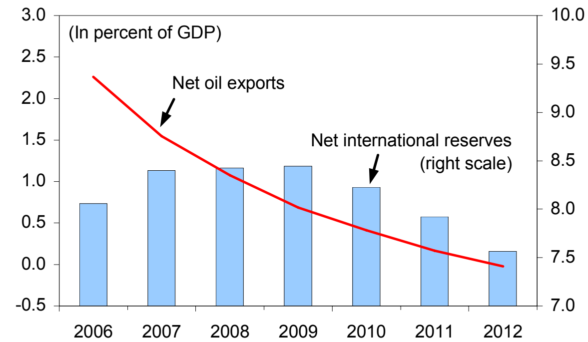
Source: IMF staff calculations.

- At end-2006, Mexico's reserves—again, viewed in relation to GDP—were second-smallest in this sample, at about 9 percent. Still, Mexico's reserves appear adequate by standard indicators, such as ratios to short-term external debt, imports, and M2 (Tables 3 and 6).

- The staff also applied the Jeanne-Ranciere (2006) model of "optimal reserves" to Mexico. While results from this approach are very sensitive to parameter assumptions, they tend to support the view that Mexico's reserves were too low some years ago, but have reached an adequate level.

20. **Still, Banxico's NIR have trended upwards, driven by rising public sector oil revenue, raising questions whether they are now too high.** While neither the level of—nor rate of increase in—reserves is high compared with other emerging markets, the team agreed that reserves have reached a comfortable level, and that it is no longer clear that the benefits of accumulating more reserves exceed the associated opportunity costs. That said, looking forward NIR accumulation would slow over the medium term as the public sector's net oil exports diminish, other things constant (and indeed the NIR/GDP ratio would begin to decline). Therefore, the team agreed with the authorities that there was no need for any change in Banxico's foreign exchange accumulation rule at this juncture, especially given the risks that this could send unintended signals to the market.

Net oil exports and net international reserves



Sources: Mexican authorities; and IMF staff estimates.

21. **The team judged the peso's real effective exchange rate (REER) to be broadly in line with medium-term fundamentals**. This assessment follows from several quantitative analyses, including the two cross-country estimation methods developed by the IMF's Consultative Group on Exchange Rates (CGER). Thus the REER that is estimated to be consistent with medium-term values of fundamentals turns out close to the current REER level.[7] In another approach, the estimated current account norm for Mexico is found to be a moderate deficit, one that is similar to the level projected 5 years ahead (on the basis of a constant REER).[8] Market assessments from Consensus Forecasts or from interest rate differentials also suggest little medium-term exchange rate movement, while options prices indicate only a very small probability of a large currency move (Figure 11). Moreover, external competitiveness seems adequate, with Mexico's share of the key U.S. market holding broadly steady (see Figure 5).

22. **The authorities expressed some skepticism about the usefulness of estimates of equilibrium real exchange rates, including the CGER exercise, given the large uncertainties involved.** Considering the depth,

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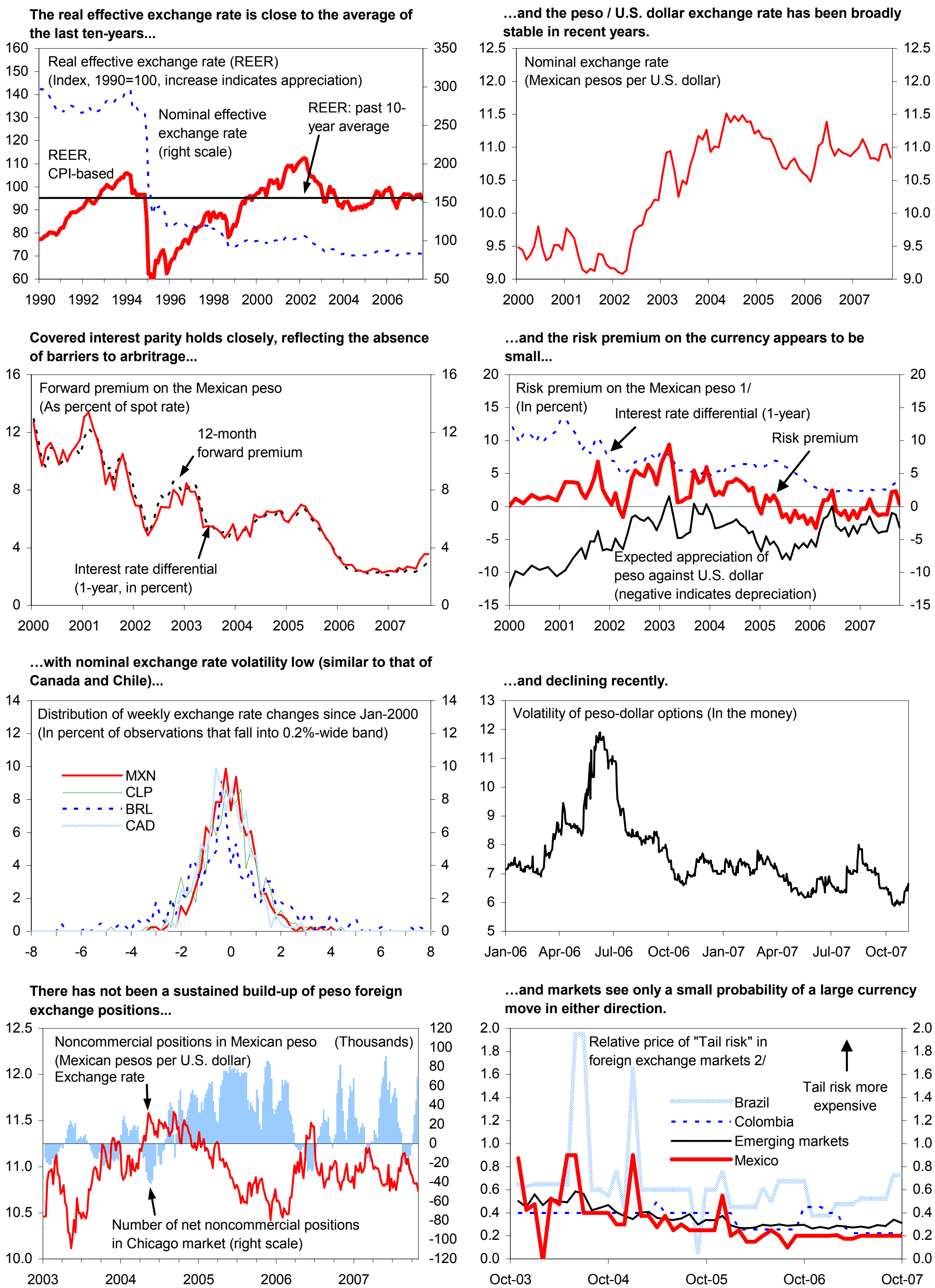
[7] The team also considered Mexico-specific models of the equilibrium REER, examining such factors as remittances and oil production volume, but these variants failed to improve on the CGER's modeling of the REER's historical behavior. The analysis did indicate that Mexico's equilibrium REER has been rather stable over the last 5 decades.

[8] Mexico's actual current account deficit is smaller than the norm estimated for 2012. However, this gap is projected to disappear over the next 5 years, as the actual current account deficit widens—primarily as a result of declining net exports of hydrocarbons. A third CGER approach, identifying the current account balance that would hold Mexico's net international investment position at its current level, also did not point to a need for eventual change in the REER.

Figure 11. Mexico: Exchange Rate Indicators

The floating exchange rate regime, in the context of inflation targeting, is serving Mexico well. With no sign of disequilibrium, markets expect continued stability of the Mexican peso.



Sources: Bloomberg L.P.; Consensus Forecasts; Haver Analytics; IMF Information Notice System; and IMF staff calculations.
1/ Risk premium is constructed as a difference between interest rate differential on 1-year CETES and 1-year U.S. T-bill rates and the Consensus Forecast expected 12-month-ahead depreciation of Mexican peso against the U.S. dollar.
2/ Excess implied volatility of deep out-of-the-money options, in percent.

sophistication, and forward-looking nature of the Mexican foreign exchange market, they expected the value of the peso would react quickly and continuously to remain in line with fundamentals. In their view, the broad stability of the real effective exchange rate of the peso in the last several years had reflected a balance of opposing tendencies, with the effect of trade competition (from Asian countries especially) being offset by an improving terms of trade and rising remittances inflows.

B. Fiscal Policy: Building on Recent Reforms and Ensuring Sustainability

23. **The team welcomed the major fiscal reforms approved in 2007, which are important steps in necessary directions (Boxes 3 and 4).** An innovative tax reform will effectively widen the tax base, narrowing loopholes and providing much-needed revenue, supported by tax administration efforts. Transfers to subnational governments—the basis for a large part of public expenditure—will be rationalized, and a range of measures will help improve accountability and efficiency of public expenditure. In addition, the system of pensions for federal government employees, which had been on a financially unsustainable basis, has been put on a sounder footing.

Box 3. The 2007 Reform of Federal Employee Pensions (ISSSTE)

- The ISSSTE reform, approved in March, transforms a defined benefit system into a defined-contribution system with individual accounts. Current workers will be offered a "recognition bond" for voluntary changing systems; they will have to decide whether to switch to the new system by mid-2008. The reform also guarantees a minimum pension and introduces fundamental parametric changes such as the increase in retirement ages.

- Although the implementation of the reform generates cash flow requirements over the medium term, the reform implies a major improvement in the long term: the authorities expect that the reform will reduce the projected actuarial deficit (estimated prior to the reform at about 60 percent of GDP) by about one third.

- Other public pension systems, including some at the subnational government level, and some state-owned enterprises, continue to face significant actuarial deficits.

Box 4. Fiscal Reforms Approved in 2007

The fiscal reform package approved in September has four pillars:

- **Tax policy reform:** A new single-rate tax, the *IETU*, will be introduced in 2008, with a rate of 16.5 percent, rising to 17.5 percent in 2010. Companies or persons with entrepreneurial activities will pay the *greater* of either the new IETU or the existing 28 percent income tax (ISR). While the new tax has a lower rate than the ISR, it allows far fewer exemptions. The reform also creates excises on gambling and lotteries, while eliminating the minimum tax on assets. A revenue gain of about 1 percent of GDP from these tax measures is expected in 2008, mostly from the IETU.

- **Tax administration:** Through a range of tax auditing and control efforts, such as better controls of tax refunds and promoting the use of an electronic signature, the authorities expect to raise tax collections by 0.2 percentage points of GDP a year over 2008–12 (broadly consistent with gains in tax efficiency during the previous administration). Efforts are ongoing to modernize customs administration, and introduce a fiscal career service. The reform also seeks to fight evasion of taxes by the informal sector, with a levy on cash deposits exceeding 25,000 pesos/month (creditable against any other federal tax liability).

- **Intergovernmental fiscal relations:** Increases in transferable federal revenues (relative to 2007 nominal levels) will be allocated to subnational governments using new formulas, which include tax collection incentives and some redistributive elements. The reform establishes a rule-based and transparent allocation process.

- **Public expenditure policy and management:** The reform aims to improve the effectiveness of spending through the establishment of a methodology to prioritize investment projects; cutting operating expenditures of the federal government, agencies and public enterprises; and starting “budgeting for results” in 2008. Measures that will strengthen accountability of subnational governments have been approved by the Senate and are pending approval by local legislatures. These measures include enabling the Superior Audit of the Federation to make audits of earmarked transfers and empowering congress to issue a law establishing a standard accounting framework across all levels of government.

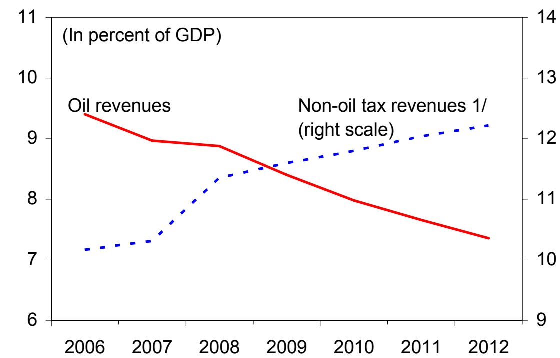
Other initiatives were approved jointly with the fiscal package. A new 5.5 percent tax will be applied gradually over 18 months to gasoline and diesel, with proceeds transferred to state governments (this tax will reduce, but not eliminate, the untargeted subsidies on these fuels). The tax regime for PEMEX was modified, reducing the ordinary royalty on hydrocarbons from 79 percent now to 71.5 percent in 2012 (budget revenue will be unaffected, as PEMEX is part of the budget).

Effects of the new tax (IETU): The IETU is likely to be paid by companies that had benefited from special tax regimes or had aggressively exploited the many loopholes of the existing income tax (ISR). The authorities estimate that the IETU will be paid by about 40 percent of companies, with the other 60 percent paying the ISR. Since the IETU replaces the assets tax and allows for immediate deduction of investment—in contrast to the gradual depreciation scheme in the ISR—its introduction can be expected to somewhat lower the relative cost of capital. (To avoid creating an incentive for firms to postpone investments until the IETU takes effect in January 2008, a transitory regime will allow deferred investment expenses to be credited against IETU.)

24. **The proposed 2008 budget again aims at a zero balance on the traditional budget measure (consistent with an augmented deficit of somewhat less than 2 percent of GDP).** Reflecting the tax reform, non-oil tax revenues are projected to increase by 1.1 percent of GDP, 30 percent of which will be transferred to the states, and the remainder used for infrastructure and social expenditures.[9] Net oil revenues are projected to decline slightly as a share of GDP, despite an expected rise in export prices, as oil production falls and fuel imports rise to keep up with domestic demand. Also in 2008, the pension reform will start to be implemented, inducing modest transition costs, and federal employees will choose whether to switch systems and accept "recognition bonds" from the government.[10]

25. **The team stressed that even with the tax reform, the fiscal situation would tighten progressively over the medium term.** The reform would produce an upfront jump in tax revenue, but subsequently the budget will have to cope with declining oil revenues as well as rising pension costs (notwithstanding the recent pension reform). In that context, it would be critical to move ahead rapidly with proposed strengthening of tax administration—which will ultimately generate over 40 percent of the revenue gains from the reform—as well as to achieve the targeted savings on operating and administrative expenditures in coming years. It would also be important to be cautious in taking on any new inertial or recurrent spending commitments, and to avoid increasing subsidies that are not targeted to the poor, such as those on household electricity, gasoline and diesel (ideally such subsidies should be reduced, including through targeting). The team welcomed the intention to emphasize infrastructure investment projects, though it would be important to control the share of these that will be financed through off-budget mechanisms or imply a stream of long-term expenditures.

Oil and non-oil tax revenues



Sources: Mexican authorities; and IMF staff estimates.
1/ Includes fiscal reform revenues.

26. **Social gains from this year's reforms will depend critically on implementation of much-needed steps to improve expenditure management.** The challenge is to improve efficiency and accountability at both federal and subnational levels. The team welcomed the authorities' plans to move toward performance budgeting, and steps to promote accountability in public expenditure executed at the state and local levels, funded by federal

[9] The revenue law for the 2008 budget was approved on October 30, but the corresponding expenditure budget was still in congress when this report was finalized (deadline for congressional approval is November 15).

[10] Exact financial implications of the pension reform cannot be gauged before mid-2008, when employees will have decided whether to accept the recognition bond option. The staff's medium-term fiscal projections assume that transition costs will peak at 0.2 percent of GDP in 2009, and decline gradually thereafter (these costs are reflected in the staff's projections of the augmented balance, but not of the traditional balance).

transfers. The proposal to empower congress to establish uniform accounting will be a critical step to enhancing subnational accountability, and the team suggested that a portion of federal transfers could be made contingent on meeting basic reporting standards. The authorities are now working to implement a Treasury Single Account to improve cash management and transparency in the use of public resources; they recognized that the federal government still lacks an effective financial management information system, and planned to move on this soon. The team noted that this would be necessary to track and "cost" the envisaged performance budgeting programs.

27. **This year's tax reform, while sufficient to meet needs over the next five years, is only a first step toward meeting Mexico's longer-run fiscal challenges**. Indeed, in presenting the government's tax reform proposal, the authorities suggested that the tax/GDP ratio would need to be raised by a total of some 10 points by 2020—partly to fund expenditure needs, but also to substitute for an uncertain oil revenue stream (Box 5). Thus a forward-looking policy orientation is critical to avoid the risk of a large and abrupt fiscal policy adjustment in the future. In this connection, the authorities noted that additional resources would be granted to PEMEX, which—in combination with more fundamental reforms (see below)—should allow more oil resources to be developed. In addition, the recent pension reform would generate important savings, to begin during the next administration, and some current oil revenue was flowing into special funds, another form of saving.[11]

28. **To complement these approaches, the team recommended an emphasis on a sustained gradual reduction of the *non-oil* augmented fiscal deficit, which remains a key underlying vulnerability**. Such a focus would raise awareness of the underlying fiscal position, considering oil as an exhaustible resource. An indicative limit on the non-oil deficit would be especially important if oil export prices were to rise further, creating a temporary abundance of oil revenue. In such a circumstance—which now seems relevant for 2008—avoiding a widening of the non-oil augmented deficit could mean aiming at a traditional budget balance above the minimum (zero) overall balance required by the Fiscal Responsibility Law. In a similar vein, the limits on the several funds for "excess" oil income, which are capped at modest levels, could be raised. If such approaches cannot be taken for 2008, it would be desirable to direct any additional oil-financed spending toward capital investment, including in the oil sector.

[11] Such inflows are counted as expenditure in the traditional budget balance (the augmented balance counts them as asset accumulation, or negative financing).

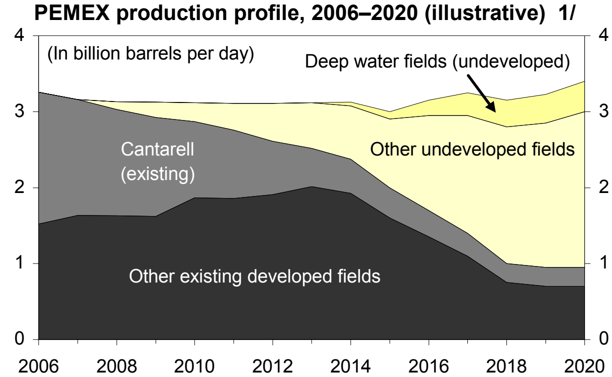
Box 5. The Sustainability of Oil Income

Mexico's proven reserves of oil have declined to the equivalent of about 10 years' of current production. The natural endowment is much larger, but there is great uncertainty about how much, and how quickly, other oil resources can be developed—and at what fiscal cost.

- **At least through the medium term, a significant stream of oil production is assured.** Although the Cantarell field, accounting for more than half of production, is now in decline, this is expected to be partially offset in the next few years by faster production at other fields.

- **Looking beyond the medium-term, the level of oil production is subject to wide uncertainty, depending mainly on the size and quality of new investments.** In the most pessimistic view—considering only the current level of proven reserves—production at current rates could be sustained for only about 10 more years. Realistically, however, ongoing and future investments will convert some part of Mexico's undeveloped resources into working wells. Such resources are sizable—according to PEMEX, "probable" reserves represent another 9 years of current production, and "possible" reserves another 9 years. Beyond this, if the necessary technology can be acquired to access deep water oil deposits in the Gulf of Mexico, the potential would be far greater. (In the oil industry, such technology and expertise is normally obtained through joint ventures with other oil companies—but PEMEX is not permitted to engage in these, or more broadly to share risk with other companies or investors.) The illustrative long-term scenario shown here (see chart) highlights the challenge of replacing production from existing, developed fields.

PEMEX production profile, 2006–2020 (illustrative) 1/



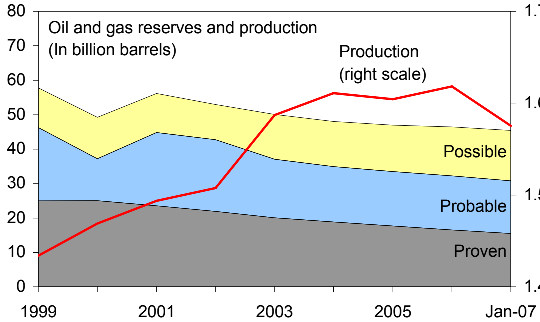
Source: Pemex, IMF staff calculations.
1/ Illustrative scenario, including undeveloped fields.

- **The possibility of still-higher world oil prices gives some upside risk to oil revenues—but the impact of world prices on revenues will diminish over time, along with the volume of net hydrocarbon exports.** Already, the moderate decline in oil production projected over the medium term implies that Mexico will cease to be a (net) exporter of hydrocarbons by about 2012. At that point, Mexico's external terms of trade will no longer benefit if international fuel prices rise, and net fiscal revenues from hydrocarbons will come entirely from sales to the domestic market, at administered prices. Under current policies, an important part of these domestic sales—gasoline and diesel fuels—are not linked to world prices.

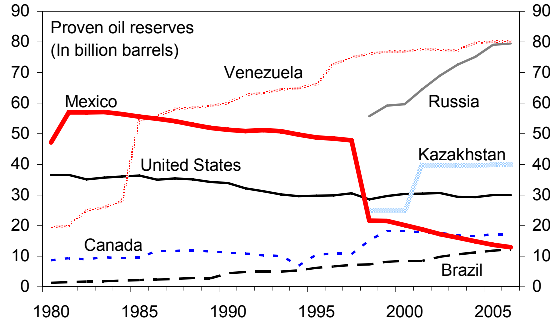
Figure 12. Mexico: Hydrocarbon Sector Issues

The oil sector outlook is uncertain, amid low and declining reserves. Over the coming 5 years, a projected decline in production will have important implications for the fiscal and external positions.

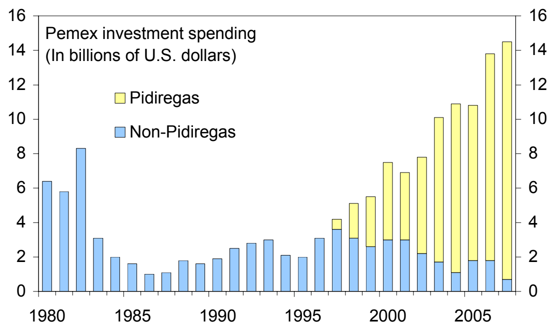
While energy production has been rising until recently, reserves have been been falling...



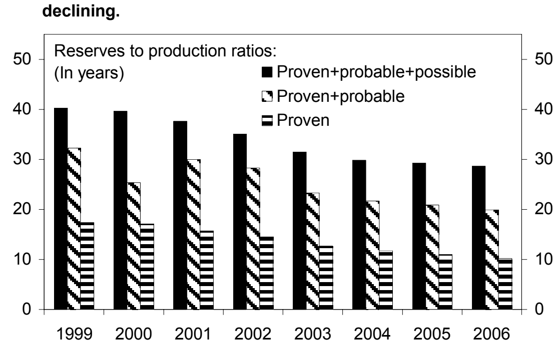
...in contrast to expansion of reserves elsewhere.



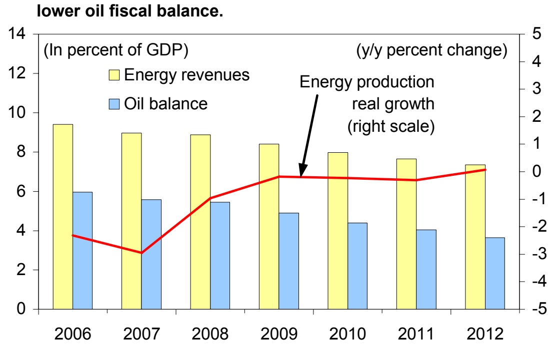
Despite higher investment rates, which reached 1.6 percent of GDP in 2006...



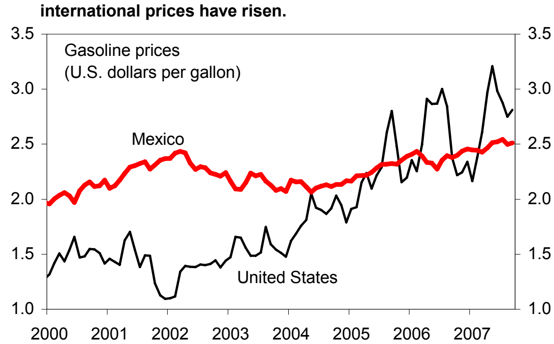
...the useful life of hydrocarbon reserves has been gradually declining.



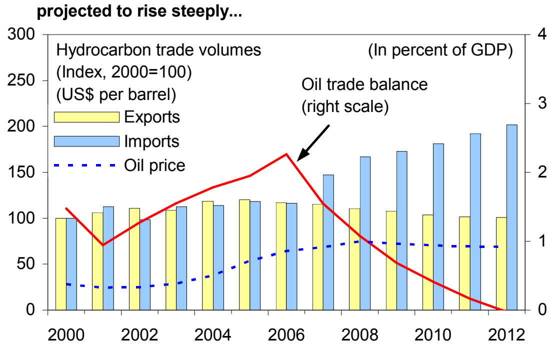
Declining oil production will imply lower energy revenues and a lower oil fiscal balance.



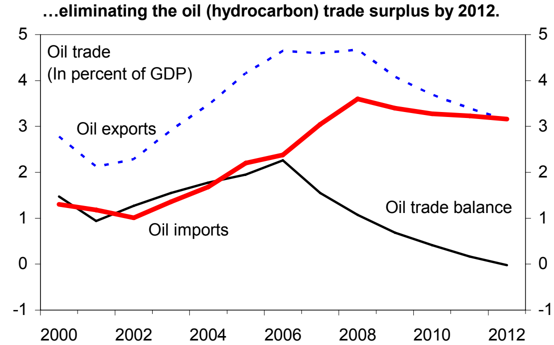
The pricing policy for gasoline now represents a subsidy, as international prices have risen.



While hydrocarbon export volumes stagnate, imports are projected to rise steeply...



...eliminating the oil (hydrocarbon) trade surplus by 2012.



Sources: BP statistical yearbook; Bank of Mexico; EMED; and IMF staff calculations.

29. **The team also recommended—and the authorities broadly agreed—that it would be desirable to develop a broader picture of the public finances to help assess longer term challenges and risks.** This could include a wide assessment of liabilities, such as remaining actuarial deficits of the public pension systems, non-debt liabilities associated with PPSs, developments in oil wealth and—to the extent possible—other public sector assets. It would also be desirable to track potential risks from contingent liabilities, including those related to minimum pension guarantees, financial guarantees extended by development banks, and PPPs (which are likely to expand in coming years). Presentation of longer-term budget scenarios in the annual budget documents would also be useful. There was also a case for consolidating management of all public debt in the Secretary of Finance and Public Credit, with a focus on reducing annual refinancing needs, and to develop consolidated monitoring of subnational governments' debt.

C. Maintaining Financial Stability Amid Financial Development

30. **Mexico's financial system has continued to develop and strengthen, increasing its resilience to shocks.** As discussed in Section II, the Mexican banking system remains sound (Figure 13), with the strong recovery in banks' financial positions contributing to the significant rebound in credit in recent years. Domestic capital markets—notably for government debt and derivatives markets—have also deepened, while the role of local investors, particularly the privately-managed pension funds (AFORES),[12] has grown markedly. The latter proved a stabilizing factor during the recent financial market turbulence, with purchases by local investors—who were more focused on Mexican fundamentals—offsetting sales by some foreign institutions.[13]

31. **The overall challenge now is to continue financial deepening—in terms of greater financial intermediation, as well as financial innovation—while maintaining stability.** Over the last year, the authorities have continued to promote banking competition, including through licensing eight new banks; launched significant reforms of AFORES by introducing a new investment regime and measures to promote competition (thereby raising net returns to contributors); and begun to use development banks to catalyze private sector lending to under-served sectors, including infrastructure. They have also introduced measures to strengthen the underdeveloped local repo market, and—with the Federal Competition Commission—are working on a strategy to strengthen contract enforcement and to provide better creditor rights' protection, including by strengthening the judicial system. The authorities have scheduled an AML/CFT assessment for 2008, to be conducted by the IMF's Legal Department.

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[12] Annual inflows to AFORES have doubled over the last five years, raising the stock to 9 percent of GDP.

[13] The opposite pattern has been observed in the past, e.g., during the run-up to the 2006 elections, downward price pressures from local investors were somewhat offset when foreigners stepped in.

32. **The team welcomed these developments, which build importantly on the progress made in recent years, but noted some areas needed careful monitoring**. In particular, as stressed in the recent FSAP Update,[14] it would be important to carefully monitor the ongoing rapid growth of credit to households, including through developing better data on households' balance sheets; in addition, the extension of banking licenses to subsidiaries of major corporations—while having the potential to significantly increase the banked population—carries risks, which the authorities are monitoring closely. While an expansion of development bank activity could help fill gaps in the market, the team underscored the potential risks, including contingent liabilities from guarantees. The proposed structured finance framework for public infrastructure also needed to be carefully considered, given the likely high degree of uncertainty on the potential returns, and the potential risks for local investors—or , if there are guarantees from the issuing development bank—the public sector itself.

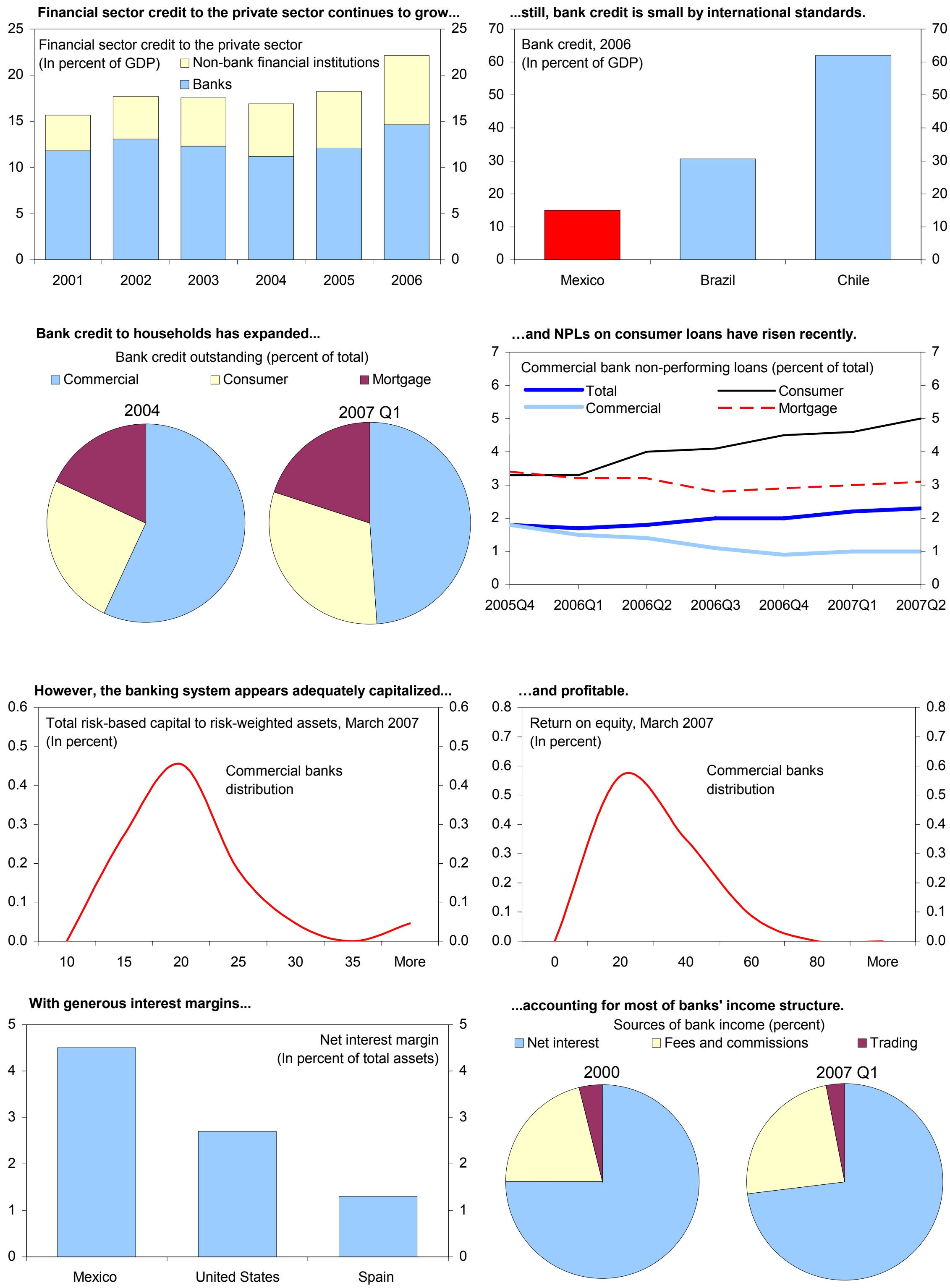
33. **Mexico has made considerable progress in strengthening tools to address systemic risks,** including in adopting a more expeditious bank resolution framework, the publication of the first financial stability report and the development of innovative analytical tools to assess contagion risk, and a "fire drill" exercise undertaken by Banxico. To build on this, it would be important to undertake interagency fire drills, and develop joint contingency plans, and to pass the bank bankruptcy law to complete the bank resolution framework. The team welcomed the authorities' intention to strengthen further the supervisory powers of the CNBV (the main banking supervisory body) as included in the proposed reform of the Banking Law as well as to consider consolidating regulatory functions under one roof. As recommended in the FSAP Update, greater independence for the regulator would also be desirable.

34. **The team took a close look at the mortgage-backed securities (RMBS) market in Mexico, which has been growing rapidly** (see Selected Issues, Chapter II and Figure 14). While small by developed country standards—the market is now the largest in Latin America, and the Mexican experience has attracted considerable interest in other emerging markets. Overall, the market is flourishing, with little risk of similar problems as in the U.S. sub-prime mortgage market, given that underlying loans are generally at fixed interest rates, have conservative loan to value ratios, and most have mortgage insurance (requiring a thorough review of the loan origination process). That said, pricing RMBS is more

[14] The 2006 FSAP Update report (October 2006) and background papers (May 2007) are available at http://www.imf.org/external/country/MEX/index.htm.

Figure 13. Mexico: Banking Indicators

High interest rate margins have contributed to bank profitability, while pent-up demand for credit has helped sustain strong household credit growth, with only a moderate increase in nonperforming loans.

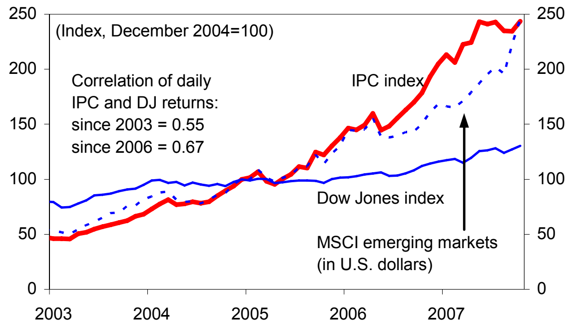


Sources: Banco de México; Comisión Nacional Bancaria y de Valores; and National Authorities.

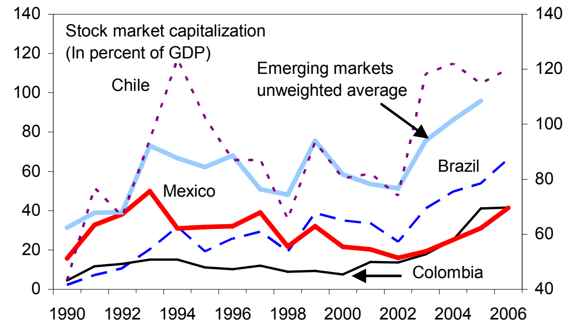
Figure 14. Mexico: Market Finance

Domestic financial markets have deepened through financial innovation–including the fast growth of the local corporate debt market and the expansion of structured finance products.

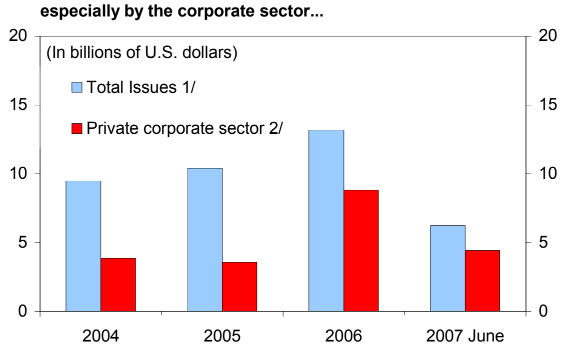
The stock market index has risen significantly...



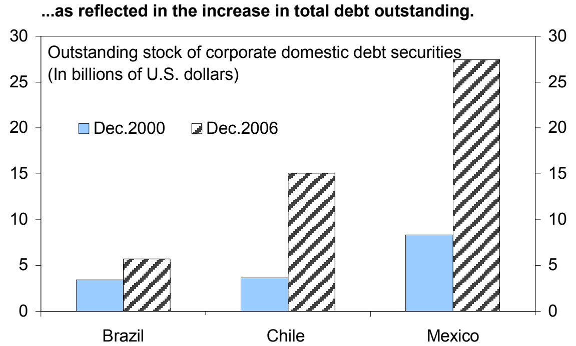
...but the stock market remains relatively shallow.



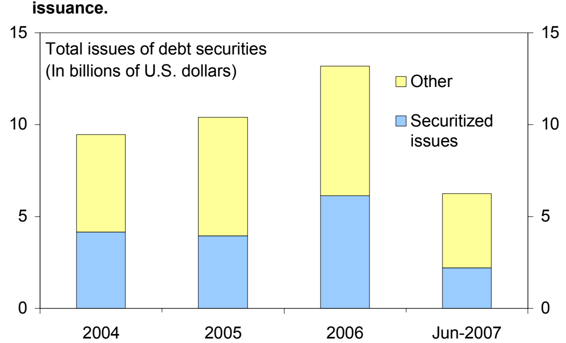
The local debt market has seen increased issuance, especially by the corporate sector...



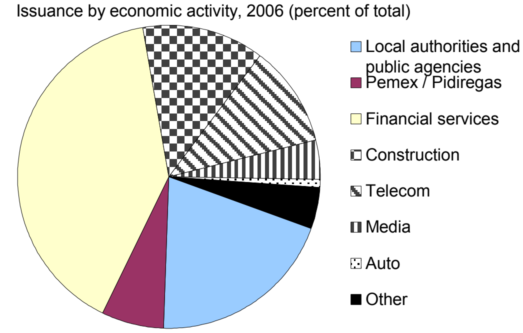
...as reflected in the increase in total debt outstanding.



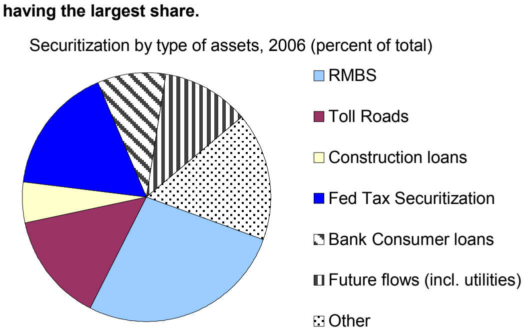
Securitized issues are a significant part of total domestic debt issuance.



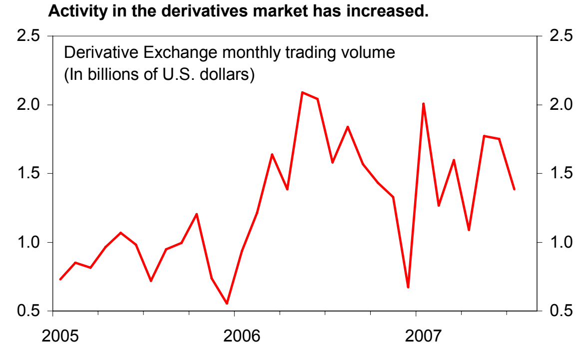
Domestic debt issuance came from a range of sectors in 2006, especially the financial services sector.



Securitized issues are of varied types, with residential mortgages having the largest share.



Activity in the derivatives market has increased.



Sources: Bank for International Settlements; Bloomberg L.P.; CNVB; Datastream; Dealogic; and Fitch.
1/ Total domestic medium and long-term debt issues excluding Central Government, IPAB and securitized IPAB loans, and FARAC /Banobras.
2/ Excluding public sector enterprises, agencies and local governments.

complicated than in some other countries, due to the absence of a performance history on prepayments and defaults, and much depends on local real estate appraisers, raising the risk of fraudulent reporting. The team and the authorities agreed that it would be desirable to develop fuller and more reliable real estate data (and to strengthen the obsolete property registry).

D. Structural Reforms to Promote Stability, Growth and Equity[15]

35. **The new government has rightly identified raising productivity growth as essential to reducing poverty and enhancing human development.** The key areas for action, which are well understood, include: improving infrastructure and education; boosting competition and flexibility in product and labor markets; deepening financial intermediation; and strengthening the rule of law to ensure a secure business environment, both in terms of physical security and contract enforcement.

36. **The National Development Plan sets out, in broad terms, the authorities' medium-term policy agenda in all these areas.** Some important elements of this plan already are in train, including the expansion of infrastructure investment and efforts to promote financial development and access to credit, as discussed above. In addition, President Calderon has made a priority of improving security by fighting crime. The authorities indicated that they would likely continue to take a step-by-step approach—which has worked very well so far—seeking to build a consensus for action and then move forward with implementation in one or two areas at a time.

37. **There was agreement that two key priorities were reform of the energy sector—especially given the long lags in developing oil resources—and stimulating competition.** President Calderon has initiated a national dialogue on energy sector reforms, and the recent fiscal package included some initial steps to put PEMEX on a sounder footing; the team argued that the challenge is to complement these with measures to address key governance problems and enhance operational flexibility, and allow a role for the private sector or other companies. The authorities also indicated that work on enhancing competition was already proceeding on several fronts, including the telecommunications sector. The team welcomed this, noting also that international experience suggests that improving product markets and competitiveness can facilitate reforms in other areas. In addition to stimulating efficiency, greater competition would directly improve equity. The team also noted that further liberalization of foreign trade and investment could play a role in stimulating competition and efficiency, and in reducing

[15] A comprehensive discussion of constraints to growth in Mexico—and associated reform needs—can be found in IMF Country Paper # 06/351, Chapter II, October 2006, available at http://www.imf.org.

poverty as well.[16] Recent and planned steps to liberalize certain food imports are steps in the right direction, and should help contain prices of basic food items.

38. **Mexico's large and relatively low productivity informal sector is a key constraint on growth.** The causes of informality are wide ranging, linked to many of the structural challenges noted above, and possibly also to interactions between tax and social security systems. Against this background, the team suggested that it would be useful to take an integrated look at the factors generating informality, and the scope for reducing them over time. The authorities broadly agreed, although they noted that some factors that had been suggested by some as creating disincentives to formal sector participation—such as universal benefit programs—also had important social benefits. They also noted that the new levy on large cash deposits will reduce the attractiveness of informality, by making tax evasion more difficult.

V. Staff Appraisal

39. **Over the last decade, Mexico has achieved macroeconomic stability, but still has a long way to go to reach its full economic potential.** Macroeconomic policies and frameworks have been markedly improved, and external and internal vulnerabilities reduced significantly. But despite these achievements, and the advantages of proximity to the United States, output and productivity growth have remained disappointingly low, and poverty and inequality high. In addition, new risks—notably of a sustained decline in oil production—have emerged.

40. **The new government has made an impressive start in addressing these challenges.** Major progress has been made in long-delayed public sector reforms, including the passage of the recent fiscal package, and putting the federal government pension scheme on a sustainable footing, and in increasing competition in the financial sector. More generally, the National Development Plan has set out a welcome longer-term vision to build a more inclusive society and bridge the gap with fast-growing economies, thereby reducing poverty while creating more and better job opportunities for the rapidly growing labor force.

41. **The macroeconomic outlook remains solid, although there are downside risks in the short term from the external environment.** Mexico has weathered the recent financial turbulence well, reflecting both limited exposure of domestic financial institutions to losses in the U.S. sub-prime market, as well as strong fundamentals. That said, given the strength of real sector linkages with the United States, GDP growth in both 2007 and 2008 is likely to

[16] Selected Issues Chapter III finds that Mexico's entry into NAFTA helped reduce "transactions costs" in external trade, but also that such costs still tend to be higher than in the Canada-U.S. trading relationship. This suggests that Mexico has some way to go in achieving full benefits of globalization, and points to the value of policies to lessen impediments to market integration, by removing obstacles to external trade, stimulating competitive behavior among firms within Mexico, and improving transportation and logistical infrastructure.

stay below potential, with risks slanted to the downside. Thereafter, staff projections suggest a solid rebound, with the pace depending at first on developments in the United States and—especially over the medium term—progress with structural reforms.

42. **Monetary policy has succeeded in anchoring inflation and inflationary expectations at a low level, although still somewhat above the 3 percent target.** In the short term, the Bank of Mexico will continue to face the challenging task of balancing upside risks to inflation from supply shocks against downside risks to inflation from the weakening external environment. For now, the present mildly restrictive policy stance appears broadly appropriate, with the next step depending critically on incoming data, including on the U.S. outlook. In this regard, recent actions to enhance central bank communications—including the publication of a forecasted inflation path—should help facilitate a smoother adjustment to current shocks, as well as to guide inflation expectations closer to the Bank of Mexico's target.

43. **Mexico continues to operate an independently floating exchange rate regime, allowing a continuous and generally smooth adjustment to shocks.** The real effective exchange rate has remained broadly stable in recent years, and—on several methodologies—appears broadly in line with fundamentals. International reserves have risen in recent years, to a healthy, but not excessive level; looking forward, staff projections suggest that the pace of increase will slow substantially as net oil export earnings decline. Correspondingly, the staff sees no immediate need for a change in the Bank of Mexico's non-discretionary rule governing the accumulation of reserves.

44. **The recent fiscal reform is a key step towards addressing the challenges from declining oil production;** the IETU in particular is an innovative way to strengthen non-oil tax revenues, and its broad base must be defended. But while the reform will allow for an increase in expenditures in the short run, the underlying situation will tighten progressively, with much of the projected increase in taxes being offset by the expected decline in oil revenues over 2008–12. It will be critical to resist pressures to increase inertial expenditures, and to press ahead with the measures necessary to strengthen tax administration and reduce operating expenditures; there is also room for fiscal savings by targeting energy subsidies to those most in need. More generally, the gains from the reform will depend critically on improved efficiency and accountability in public spending, at both the national and subnational levels. In this connection, the authorities' plans to strengthen expenditure management, including a planned move towards a performance budgeting system are welcome. This in turn will require early implementation of a modern integrated financial management information system, as well as the establishment of standardized—and high quality—accounting and reporting systems for the three levels of government.

45. **With proven oil reserves down to 10 years of current production, Mexico's fiscal policy will need—as the authorities have stressed—to look beyond the medium term.** Early implementation of long-discussed reforms of the state-owned oil sector could reduce

the fiscal risk of a sharp decline in oil production during the next administration, and potentially bring large economic returns. In the meantime, until the risk to future production can be substantially reduced, it would be prudent to gradually reduce the large non-oil fiscal deficit. To put greater focus on longer-term fiscal considerations, it would be useful to supplement the balanced budget target with an indicative limit for the non-oil augmented fiscal deficit, set to diminish over time, accompanied by presentation of longer-term budget scenarios during the annual budget discussions. It would also be desirable to develop more comprehensive measures of the public sector balance sheet, including oil wealth and contingent liabilities arising from government guarantees.

46. **As financial development proceeds, the authorities need to continue to strike a balance between steps to promote intermediation—still very low by international standards—and preserving stability.** The key priorities include continued close monitoring of rapidly rising consumer credit, which would be facilitated by improved data on consumer balance sheets and housing market developments; completion of outstanding measures to reduce systemic risks, including passage of the bank bankruptcy law; and further strengthening of creditor rights and contract enforcement. While the proposed expansion of development banks' activities could help fill gaps in the market, the authorities need to remain alert to potential risks, including from the use of structured instruments to finance infrastructure projects. More broadly, the recent progress in addressing issues identified in the 2006 FSAP is encouraging, and it will be important to continue in those directions.

47. **Mexico's fundamental challenge remains to put in place the policies needed to achieve a sustained and substantial acceleration in GDP growth.** Over the medium term, action will be needed on many fronts; the issue is how best to prioritize, not least because the authorities' step by step approach has succeeded in building the political consensus for action that was notably lacking in the past. In the near future, energy sector reform will be critical, including addressing key governance problems in PEMEX and allowing a greater role for the private sector. Strengthening competition, particularly in key network sectors such as telecommunications, should also have high priority, and—as international experience has shown—may also facilitate reform in other areas as well as helping equity. While there is still a long way to go, the progress with reform over the last year is an important step towards the goal of Mexico joining the ranks of the faster growing emerging market countries in the coming years.

48. **It is recommended that the next consultation occur on the standard 12-month cycle.**

Table 1. Mexico: Selected Economic, Financial, and Social Indicators, 2000–2008

I. Social and Demographic Indicators

GDP per capita (U.S. dollars, 2006)	8,066	Households below the poverty line (percent, 2002)	33.0
Population (millions, 2006)	104.1	Income share of highest 20 percent / lowest 20 percent	12.8
Life expectancy at birth (years, 2005)	75.4	Adult illiteracy rate (2005)	8.4
Under 5 mortality rate (per thousand, 2005)	27.0	Gross primary education enrollment rate (2005)	109.2

II. Economic Indicators

								Proj.	
	2000	2001	2002	2003	2004	2005	2006	2007	2008
(Annual percentage change, unless otherwise indicated)									
National accounts in constant prices									
Real GDP	6.6	0.0	0.8	1.4	4.2	2.8	4.8	2.9	3.0
Net exports (contribution)	-1.8	-0.7	0.0	0.7	-0.3	-0.8	-0.8	-0.7	-0.9
Total domestic demand	8.3	0.7	0.8	0.8	4.4	3.5	5.4	3.5	3.7
Private consumption	8.2	2.5	1.6	2.3	4.1	5.1	5.0	3.8	3.0
Public consumption	2.4	-2.0	-0.3	0.8	-0.4	0.4	6.0	2.9	2.7
Gross fixed private investment	9.0	-5.9	-4.1	-1.5	8.8	9.7	11.5	5.2	5.0
Gross fixed public investment	25.2	-4.2	17.0	8.5	2.5	-0.6	2.9	0.9	11.0
Change in business inventories (contribution)	0.3	0.4	-0.2	-1.0	0.2	-1.6	-0.6	-0.4	0.1
External sector									
Exports, f.o.b.	21.8	-4.4	1.4	2.3	14.1	14.0	16.7	10.4	9.3
Export volume	13.2	-2.2	-0.4	-3.0	2.1	5.3	8.5	5.1	5.7
Imports, f.o.b.	22.9	-3.5	0.2	1.1	15.4	12.7	15.5	11.7	10.8
Import volume	19.4	-4.1	0.7	-1.3	9.3	7.3	10.4	7.2	7.2
Petroleum exports (percent of total exports)	9.7	8.3	9.2	11.3	12.6	14.9	15.6	14.8	14.4
Terms of trade (deterioration -)	4.5	-2.9	2.4	3.0	5.8	3.0	2.9	0.8	0.0
Exchange rates									
Nominal exchange rate (US$/Mex$)									
(average, depreciation -)	1.1	1.2	-3.4	-11.7	-4.6	3.4	0.0	...	...
Real effective exchange rate (CPI based)									
(average, depreciation -)	8.3	6.4	0.0	-10.5	-3.8	4.1	0.5	...	...
Employment and inflation									
Consumer prices (end of year)	9.0	4.4	5.7	4.0	5.2	3.3	4.1	3.6	3.6
Formal sector employment (annual average)	5.9	-0.5	-0.8	-0.5	1.3	3.1	6.4	...	...
Formal sector unemployment rate (annual average)	2.2	2.8	3.0	3.4	3.9	3.6	3.4	3.3	3.2
Real manufacturing wages (annual average)	6.0	6.7	1.9	1.4	0.3	-0.2	0.4	...	...
Money and credit									
Broad money (M4a)	12.8	16.0	10.8	13.5	12.6	15.0	12.8	11.1	11.0
Treasury bill rate (28-day cetes, in percent, annual average)	15.3	11.2	7.1	6.2	6.8	9.2	7.2	7.2	…
(In percent of GDP)									
Nonfinancial public sector									
Augmented balance 1/	-3.7	-3.8	-3.4	-3.1	-1.9	-1.5	-0.7	-1.6	-1.9
Non-oil augmented balance	…	-7.9	-7.5	-7.8	-6.9	-7.1	-6.7	-7.2	-7.4
Augmented primary balance	1.3	1.0	0.3	0.3	1.3	1.8	2.4	1.6	1.3
Traditional balance	-1.1	-0.7	-1.2	-0.6	-0.2	-0.1	0.1	0.0	0.0
Gross public sector debt	49.3	47.9	49.7	50.0	46.0	44.0	43.5	42.5	41.5
Net public sector debt	42.2	41.7	43.6	44.0	40.9	38.9	36.8	36.2	35.6
o/w percent in foreign currency	38.0	34.2	37.2	39.1	39.1	34.8	28.9	27.4	25.9
Savings and investment									
Gross domestic investment	23.7	20.9	20.6	20.6	22.1	21.8	22.0	21.8	22.4
Public investment	3.6	3.6	4.2	4.5	4.6	4.3	4.4	4.3	4.6
Private investment	17.8	16.4	15.0	14.4	15.0	15.0	16.0	16.4	16.8
Change in inventories	2.3	0.9	1.4	1.6	2.5	2.5	1.6	1.1	1.0
Gross national saving	20.5	18.0	18.5	19.2	21.1	21.2	21.8	21.0	21.1
Public saving 2/	-0.1	-0.2	0.8	1.5	2.7	2.8	3.6	2.6	2.7
Private saving	20.6	18.2	17.7	17.7	18.4	18.4	18.1	18.4	18.4
External current account balance	-3.2	-2.8	-2.2	-1.3	-1.0	-0.6	-0.2	-0.8	-1.3
Non-oil external current account balance	-4.7	-3.8	-3.4	-2.9	-2.7	-2.6	-2.5	-2.4	-2.4
Net foreign direct investment	3.1	4.0	3.1	2.2	2.6	1.7	1.6	2.3	2.3
(In percent of exports of goods, nonfactor services, and transfers)									
Public external debt service 3/	21.6	17.2	14.1	14.3	11.8	10.2	13.9	7.1	5.9
(In billions of U.S. dollars, unless otherwise indicated)									
Net international reserves	33.6	40.9	48.0	57.4	61.5	68.7	67.7	74.4	78.4
Gross official reserves in percent of short-term debt 4/	65.5	90.9	109.4	135.8	155.1	125.3	151.5	151.3	146.3
Gross external debt (in percent of GDP, end of period)	28.7	26.4	25.0	25.4	24.3	22.6	20.1	19.9	19.8
Crude oil export price, Mexican mix (US$/bbl)	24.6	18.6	21.5	24.7	31.0	42.8	53.0	57.7	63.2

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

1/ Includes adjustments for development banks, Pidiregas, oil stabilization fund, IPAB.

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

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

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

Table 2. Mexico: Financial Operations of the Public Sector, 2003–2012
(In percent of GDP)

					Budget /1	Staff	Draft budget	Staff projections				
	2003	2004	2005	2006	2007	2007	2008	2008	2009	2010	2011	2012
Budgetary revenue, by entity	**23.2**	**23.0**	**23.3**	**24.7**	**22.8**	**24.1**	**24.1**	**24.7**	**24.5**	**24.3**	**24.2**	**24.1**
Federal government revenue	16.4	16.5	16.9	17.0	15.4	16.9	16.9	17.5	17.4	17.2	17.2	17.1
Tax revenue	11.1	10.0	9.7	9.7	10.2	9.9	11.6	10.9	11.2	11.4	11.7	11.9
Excise tax (including fuel)	1.7	1.1	0.6	-0.1	0.6	-0.1	0.6	0.0	0.0	0.0	0.1	0.1
Nontax revenue	5.3	6.5	7.2	7.3	5.2	7.1	5.3	6.6	6.2	5.8	5.5	5.2
Public enterprises	6.8	6.5	6.4	7.7	7.4	7.1	7.2	7.2	7.1	7.1	7.0	7.0
PEMEX	2.6	2.5	2.2	3.5	3.4	3.2	3.2	3.2	3.2	3.1	3.1	3.0
Other	4.2	4.0	4.2	4.2	4.0	4.0	3.9	4.0	4.0	4.0	4.0	4.0
Budgetary revenue, by type												
Oil revenue	7.7	8.3	8.7	9.4	8.3	9.0	8.2	8.9	8.4	8.0	7.7	7.4
Non-oil tax revenue 2/	9.9	9.3	9.5	10.2	10.1	10.3	11.4	11.4	11.6	11.8	12.0	12.2
Non-oil non-tax revenue	5.6	5.4	5.1	5.2	4.5	4.8	4.5	4.5	4.5	4.5	4.5	4.5
Budgetary expenditure	**23.9**	**23.2**	**23.4**	**24.6**	**22.8**	**24.1**	**24.1**	**24.7**	**24.5**	**24.3**	**24.2**	**24.1**
Primary	21.1	20.6	20.9	21.9	20.1	21.5	21.5	22.1	22.0	21.8	21.8	21.8
Programmable	17.6	17.1	17.4	18.1	16.7	17.9	17.6	18.0	17.9	17.8	17.9	17.8
Current	14.6	13.5	14.0	14.4	14.0	14.3	13.9	14.2	14.2	14.2	14.2	14.1
Wages	7.3	6.7	6.7	6.7	6.6	6.6	6.8	6.8	6.7	6.6	6.4	6.4
Pensions	2.1	1.9	2.1	2.2	2.2	2.2	2.2	2.2	2.3	2.4	2.6	2.8
Subsidies and transfers	2.3	2.3	2.4	2.4	2.5	2.6	2.5	2.6	2.6	2.6	2.6	2.6
Other	2.9	2.6	2.8	3.1	2.7	2.9	2.5	2.6	2.6	2.7	2.5	2.4
Capital	3.0	3.5	3.4	3.7	2.9	3.6	3.7	3.8	3.7	3.6	3.7	3.7
Physical capital	2.7	3.0	2.8	3.0	2.5	3.0	3.3	3.3	3.3	3.2	3.3	3.3
Financial capital	0.3	0.6	0.6	0.7	0.4	0.6	0.4	0.6	0.5	0.4	0.4	0.4
Nonprogrammable	3.5	3.5	3.5	3.8	3.4	3.5	3.9	4.1	4.1	4.0	3.9	4.0
Of which: revenue sharing	3.3	3.1	3.3	3.6	3.3	3.4	3.8	4.0	3.9	3.9	3.8	3.8
Interest payments 3/	2.8	2.7	2.5	2.7	2.7	2.6	2.6	2.6	2.5	2.5	2.4	2.3
Traditional balance	**-0.6**	**-0.2**	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Adjustments to the traditional balance	**2.5**	**1.7**	**1.4**	**0.8**	**1.6**	**1.6**	**2.1**	**1.9**	**2.1**	**2.2**	**2.3**	**2.3**
PIDIREGAS	1.1	1.1	0.9	1.2	1.1	1.2	1.3	1.3	1.3	1.3	1.3	1.3
IPAB	0.3	-0.7	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Budgetary adjustments	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.3	0.3	0.3	0.3
PEMEX and oil stabilization fund (-: net inflows)	-0.1	-0.5	-0.2	-0.5	...	-0.3	...	-0.2	-0.2	-0.2	-0.1	-0.1
FARAC	0.0	0.2	0.0	0.0	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Debtor support	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development banks	0.4	0.2	-0.1	-0.5	0.4	0.3	0.3	0.3	0.4	0.5	0.5	0.5
Nonrecurring revenue	0.7	1.5	0.2	0.3	0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Augmented balance 4/	**-3.1**	**-1.9**	**-1.5**	**-0.7**	**-1.7**	**-1.6**	**-2.1**	**-1.9**	**-2.1**	**-2.2**	**-2.3**	**-2.3**
Augmented interest expenditure	**3.4**	**3.3**	**3.2**	**3.1**	**3.2**	**3.2**	**3.1**	**3.2**	**3.3**	**3.3**	**3.1**	**3.1**
Augmented primary balance 5/	**0.3**	**1.3**	**1.8**	**2.4**	**1.5**	**1.6**	**1.0**	**1.3**	**1.1**	**1.1**	**0.8**	**0.8**
Memorandum items												
Crude oil export price, Mexican mix (US$/bbl)	24.7	31.0	42.8	53.0	42.8	57.7	49.0	63.2	60.9	59.4	58.6	57.9
Non-oil augmented balance 6/	-7.8	-6.9	-7.1	-6.7	...	-7.2	...	-7.4	-7.0	-6.6	-6.4	-6.0
Oil augmented balance	4.7	5.0	5.7	6.0	...	5.6	...	5.4	4.9	4.4	4.0	3.6
Oil-related expenditure	3.1	3.3	3.0	3.4	...	3.4	...	3.4	3.5	3.6	3.6	3.7
Transfers to state and local governments 7/	7.6	7.3	7.6	7.8	7.1	7.4	7.7	8.0	7.9	7.8	7.8	7.8
Augmented balance excluding development banks	-2.7	-1.7	-1.6	-1.3	-1.3	-1.3	-1.7	-1.6	-1.8	-1.8	-1.8	-1.8
Non-oil augmented balance excluding development	-7.4	-6.7	-7.3	-7.2		-6.9		-7.1	-6.7	-6.1	-5.9	-5.5
Gross public sector debt	50.0	46.0	44.0	43.5	...	42.5	...	41.5	41.1	40.6	40.4	40.1
Domestic (percentage of total debt)	64.9	64.8	67.9	73.5	...	74.6	...	75.8	77.0	78.3	79.5	80.7
External (percentage of total debt)	35.1	35.2	32.1	26.5	...	25.4	...	24.2	23.0	21.7	20.5	19.3
Net public sector debt	44.0	40.9	38.9	36.8	...	36.2	...	35.6	35.6	35.5	35.6	35.6
Nominal GDP (billions of Mexican pesos)	6,891	7,714	8,366	9,155	9,808	9,780	10,524	10,504	11,183	11,936	12,747	13,619

Sources: Mexican authorities; and IMF 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.
4/ PSBR excl. nonrecurrent revenue
5/ Treats transfers to IPAB as interest payments.
6/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, excise tax on gasoline) and PEMEX operational expenditure, interest payments, and capital expenditure.
7/ Transfers to subnational governments include revenue-sharing and earmarked transfers, but excludes decentralization agreements.

Table 3. Mexico: Summary Balance of Payments, 2003–2012

					Staff Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(In billions of U.S. dollars)									
Current account	-8.6	-6.6	-4.7	-1.7	-7.1	-12.0	-16.2	-19.5	-22.3	-25.0
Merchandise trade balance, f.o.b.	-5.8	-8.8	-7.6	-6.1	-10.1	-15.3	-19.3	-22.4	-25.2	-27.9
Exports	164.8	188.0	214.2	250.0	275.9	301.6	322.9	348.8	379.4	413.8
Of which:										
Petroleum and derivatives	18.6	23.7	31.9	39.0	40.7	43.5	40.2	38.5	37.6	36.8
Manufactures	140.6	157.7	175.2	202.8	225.7	249.1	274.7	303.1	335.0	370.3
Imports	-170.5	-196.8	-221.8	-256.1	-286.0	-317.0	-342.2	-371.1	-404.6	-441.7
Petroleum and derivatives	8.7	11.5	16.9	20.0	27.0	33.5	33.4	34.2	35.8	37.1
Factor income	-12.3	-10.3	-13.1	-14.0	-15.3	-15.3	-16.6	-17.9	-19.2	-20.5
Other services and transfers	9.5	12.6	16.0	18.4	18.2	18.7	19.7	20.9	22.1	23.4
of which Remittances	13.7	16.7	20.3	23.7	24.7	25.9	27.6	29.6	31.7	33.9
Financial account	21.9	12.0	12.9	-2.2	13.8	16.0	20.9	22.1	24.2	26.2
Public sector	-3.3	2.5	-6.7	-18.4	-6.4	-5.9	-5.5	-5.0	-4.7	-4.3
Medium- and long-term borrowing	-0.3	-2.8	-7.3	-20.5	-6.4	-5.9	-5.5	-5.0	-4.7	-4.3
Disbursements	15.6	13.4	6.8	9.8	7.5	6.9	6.4	5.9	5.4	5.0
Amortization 1/	15.9	16.1	14.1	30.3	13.9	12.8	11.8	10.9	10.0	9.3
Other, including short-term borrowing	-3.0	5.3	0.5	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	25.2	9.5	19.7	16.2	20.3	21.9	26.4	27.2	28.8	30.5
Direct investment	13.8	18.0	13.4	13.5	14.2	14.9	15.8	16.7	17.7	18.8
Bonds and loans 2/	3.0	3.1	10.6	11.8	13.7	13.7	16.3	15.3	15.1	15.0
Banking system	-0.5	-0.9	-2.3	0.1	-0.9	-0.6	-0.6	-0.6	-0.3	-0.4
Corporate sector	3.5	4.0	12.9	11.7	14.6	14.3	16.9	15.9	15.5	15.4
Equity investments and change in assets abroad	8.5	-11.6	-4.4	-9.1	-7.6	-6.7	-5.7	-4.8	-4.0	-3.3
Equity investments	-0.1	-2.5	3.4	2.8	3.1	2.9	3.0	3.0	3.0	3.0
Change in assets abroad	8.6	-9.1	-7.7	-11.9	-10.7	-9.6	-8.7	-7.8	-7.0	-6.3
Errors and omissions and valuation adjustments	-3.9	-1.4	-1.1	2.9	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-9.5	-4.1	-7.2	1.0	-6.7	-4.0	-4.7	-2.7	-1.8	-1.2
	(In percent of GDP, unless otherwise indicated)									
Memorandum items:										
Current account balance	-1.3	-1.0	-0.6	-0.2	-0.8	-1.3	-1.6	-1.9	-2.0	-2.1
Nonoil current account balance 3/	-2.9	-2.7	-2.6	-2.5	-2.4	-2.4	-2.3	-2.3	-2.2	-2.1
Nonoil trade balance 3/	-2.5	-3.1	-2.9	-3.0	-2.7	-2.7	-2.6	-2.6	-2.4	-2.4
Merchandise exports	25.8	27.5	27.9	29.8	31.2	32.4	32.8	33.4	34.3	35.2
Petroleum and derivatives exports	2.9	3.5	4.2	4.6	4.6	4.7	4.1	3.7	3.4	3.1
Merchandise imports	26.7	28.8	28.9	30.5	32.3	34.1	34.8	35.6	36.6	37.6
Petroleum and derivatives imports	1.4	1.7	2.2	2.4	3.0	3.6	3.4	3.3	3.2	3.2
Oil Trade balance	1.6	1.8	2.0	2.3	1.5	1.1	0.7	0.4	0.2	0.0
Gross financing needs (billions of US$) 4/	64.3	54.1	53.2	59.9	64.2	70.9	80.5	87.4	94.9	102.3
Gross international reserves 5/										
End-year (billions of US$)	59.0	64.2	74.1	76.4	83.1	87.1	91.8	94.5	96.3	97.5
Months of imports of goods and services	3.3	3.2	3.2	3.0	2.9	2.8	2.8	2.6	2.4	…
Months of imports plus interest payments	3.1	2.9	3.0	2.8	2.7	2.7	2.6	2.5	2.3	…
Percent of short-term debt (by residual maturity) 6/	135.8	155.1	125.3	151.5	151.3	146.3	140.6	133.6	126.5	…
Percent of gross financing requirement 7/	118.0	139.4	121.8	132.8	124.2	115.0	108.3	101.6	95.2	…
Crude oil export volume (millions of bbl/day)	1.84	1.87	1.82	1.79	1.74	1.74	1.73	1.72	1.71	1.70
Crude oil export price, Mexican mix (US$/bbl)	24.7	31.0	42.8	53.0	57.7	63.2	60.9	59.4	58.6	57.9
Gross total external debt	25.4	24.3	22.6	20.1	19.9	19.8	19.8	19.7	19.5	19.3
Of which: Public external debt	17.5	16.2	14.1	11.5	10.8	10.0	9.4	8.8	8.3	7.7
Gross total external debt (billions of US$)	162.4	166.2	173.1	169.0	176.3	184.1	194.9	205.1	215.6	226.3
Of which: Public external debt	109.9	109.2	104.0	89.2	87.9	85.9	85.2	84.6	84.0	83.4
Public external debt service (in percent of exports of goods, services, and transfers)	14.3	11.8	10.2	13.9	7.1	5.9	5.2	4.5	3.9	3.3
	(Annual percentage change)									
Export volume	-3.0	2.1	5.3	8.5	5.1	5.7	6.7	7.2	7.4	7.4
Non-oil exports	-4.4	2.2	6.8	10.6	6.9	7.2	8.5	8.5	8.4	8.3
Import volume	-1.3	9.3	7.3	10.4	7.2	7.2	7.0	7.3	7.4	7.4
Consumer goods	0.2	14.6	21.6	14.6	5.7	7.2	7.3	7.4	7.4	7.4
Intermediate goods	-0.2	10.5	5.3	11.5	5.4	6.6	7.3	7.5	7.5	7.6
Capital goods	-5.1	8.5	13.7	13.8	5.0	6.6	7.0	7.3	7.4	7.4

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

1/ Includes pre-payment of external debt.
2/ Includes financing of PIDIREGAS.
3/ Excluding oil exports and petroleum products imports.
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, 2000–2007 1/

	2000	2001	2002	2003	2004	2005	2006	2007 Q1	2007 Q2
	(In billions of Mexican pesos)								
Bank of Mexico									
Net international reserves 2/	322.5	374.8	500.9	645.4	685.7	730.3	731.7	763.4	755.0
In U.S. dollars (billions)	33.6	40.9	48.0	57.4	61.5	68.7	67.7	69.2	69.9
Net domestic assets	-113.5	-149.3	-237.0	-341.8	-345.5	-350.2	-281.9	-353.6	-346.2
Net credit to nonfinancial public sector	-428.4	-231.6	-152.6	-142.8	-144.4	-201.9	-429.8	-493.5	-621.0
Net credit to financial institutions	92.5	99.4	97.2	92.1	81.9	81.1	81.1	80.4	78.6
Other	222.5	-17.1	-181.6	-291.1	-283.0	-229.5	66.8	59.5	196.1
Monetary base	208.9	225.6	263.9	303.6	340.2	380.0	449.8	409.8	408.7
Financial system 1/									
Net foreign assets	296.0	453.9	599.1	543.7	498.2	567.1	339.7	477.0	602.7
Net domestic assets	1,889.1	1,888.5	2,217.7	2,467.2	2,699.0	2,893.4	3,452.9	3,616.3	3,715.9
Net credit to nonfinancial public sector	835.7	941.6	1,065.0	1,207.9	1,297.7	1,259.2	1,326.3	1,319.6	1,291.1
Net holdings of Bank of Mexico securities	21.0	125.6	130.7	112.6	154.9	168.6	73.3	84.1	58.3
Credit to private sector 3/	1,021.2	909.9	1,109.3	1,208.6	1,303.8	1,526.3	2,025.0	2,199.7	2,326.0
Liabilities to the private sector	2,571.0	2,982.7	3,304.6	3,750.7	4,222.0	4,857.2	5,480.4	5,566.7	5,682.8
Memorandum items:									
	(In annual percentage change)								
Growth of monetary base	10.7	8.0	17.0	15.0	12.0	11.7	18.4	16.1	10.7
Growth of liabilities to the private sector	12.9	16.0	10.8	13.5	12.6	15.0	12.8	10.7	11.0
Growth of credit to the private sector 3/	-2.0	-10.9	21.9	9.0	7.9	17.1	32.7	32.8	30.7
of which									
Banking Sector 3/	-4.6	-18.5	19.4	3.5	1.8	17.6	31.9	26.8	23.7
Nonbank financial institutions 3/	10.1	28.2	41.5	21.3	13.9	14.6	42.2	55.8	61.1
Consumer loans	-12.5	-10.5	3.9	65.5	3.9	12.4	44.3	46.9	42.9
Mortgages	451.0	-1.1	15.3	20.9	27.4	33.4	24.7	9.1	5.5
Business loans	-10.6	-12.5	27.3	-3.7	5.4	14.8	31.2	35.2	34.3
	(In percent of GDP)								
Monetary base	3.8	3.9	4.2	4.4	4.4	4.5	4.9	4.4	4.2
Liabilities to the private sector	46.8	51.3	52.8	54.4	54.7	58.1	59.9	59.1	58.9
Credit to the private sector 3/	18.6	15.7	17.7	17.5	16.9	18.2	22.1	23.4	24.1
of which									
Banking Sector 3/	15.3	11.8	13.1	12.3	11.2	12.1	14.6	14.6	15.1
Nonbank financial institutions 3/	1.3	1.5	2.0	2.2	2.3	2.4	3.1	4.3	4.5
Consumer loans	3.1	2.6	2.5	3.8	3.5	3.6	4.8	5.1	5.4
Mortgages	2.0	1.9	2.0	2.2	2.5	3.1	3.6	3.3	3.2
Business loans	13.5	11.1	13.2	11.5	10.8	11.5	13.8	15.0	15.6

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

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

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

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

Table 5. Mexico: Financial Soundness Indicators for Commercial Banks, 2000–2007 1/
(In percent)

	2000	2001	2002	2003	2004	2005	2006	Jun. 2007
Capital adequacy								
Regulatory capital to risk-weighted assets	13.22	13.90	15.49	14.18	14.07	14.32	16.09	15.92
Regulatory Tier 1 capital to risk-weighted assets	11.13	11.74	13.64	12.74	12.76	13.42	15.09	…
Capital to assets	9.55	9.42	11.34	11.44	11.20	12.54	13.55	…
Gross asset position in financial deriv. to capital	2.41	5.39	4.14	6.32	15.77	24.33	35.31	…
Gross liability position in financial deriv. to capital	0.63	2.84	3.04	4.46	14.12	21.48	33.78	…
Asset quality								
Nonperforming loans to total gross loans	5.81	5.14	4.56	3.15	2.51	1.82	1.99	2.33
Earnings and profitability								
Return on assets (before e.i. & taxes) 2/	0.94	1.20	1.08	2.16	2.28	3.31	3.67	2.47
Return on equity (before e.i. & taxes) 2/	9.86	12.42	10.47	18.46	19.77	27.53	28.97	17.99
Interest margin to gross income 2/	67.92	61.29	60.58	53.89	61.88	61.94	63.19	…
Trading income to total income 2/	4.99	10.29	6.71	11.61	3.58	6.63	6.63	…
Noninterest expenses to gross income 2/	77.28	71.43	73.22	64.78	65.64	57.97	53.95	…
Personnel expenses to noninterest expenses 2/	87.98	81.92	85.07	88.03	87.48	86.03	88.29	…
Liquidity								
Liquid assets to total assets	23.42	30.19	26.39	31.57	35.08	33.53	30.62	26.74
Liquid assets to short-term liabilities	91.17	97.85	76.20	88.21	101.90	89.86	85.74	80.36
Customer deposits to total (noninterbank) loans	75.71	97.00	98.85	116.99	119.07	120.10	107.45	…
Sensitivity to market risk								
Net open position in equities to capital	48.65	31.93	20.41	15.56	16.78	13.65	13.02	…

Source: CNBV.

1/ FSI compiled based on annual flow data and annual average of end-of-month stock data, except for 2000.

2/ From 2000–2006 with IMF methodology. Data for June 2007 with CNBV methodology, ROA and ROE are after taxes for 2007.

Table 6. Mexico: Indicators of External Vulnerability, 2001–2007

	2001	2002	2003	2004	2005	2006	2007				
	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Jul.	Aug.	Sep.
Financial Market indicators											
Exchange rate (per U.S. dollar, end-period)	9.16	10.44	11.24	11.15	10.63	10.81	11.03	10.79	10.93	11.04	10.93
(year-to-date percent change)	-4.7	14.0	7.6	-0.8	-4.6	1.7	2.0	-0.2	1.1	2.1	1.1
28-day treasury auction rate (percent; period average)	6.5	7.0	6.1	8.5	8.2	7.0	7.0	7.2	7.2	7.2	7.2
EMBI+ Mexico (basis points; period average)	313	312	205	166	125	105	108	83	100	123	112
Stock exchange index in U.S. dollar terms (year-to-date percent change)	18.3	-15.7	33.4	48.0	44.5	46.1	6.5	18.0	14.7	12.4	13.3
Financial system											
Bank of Mexico net international reserves (US$ billion)	40.9	48.0	57.4	61.5	68.7	67.7	69.2	69.9	71.1	71.1	73.2
Real credit to the private sector (12-month percent change) 1/	-14.7	15.3	4.8	2.5	13.3	27.5	27.5	25.7	26.4	...	...
Commercial banks' nonperforming loans (percent of total loans)	5.1	4.6	3.2	2.5	1.8	2.0	...	...	...	...	...
Commercial banks' loan loss provision (percent of nonperforming loans)	123.8	138.1	167.1	201.8	241.3	208.4	...	...	...	...	...
Exports and Imports											
Trade balance (US$ billion; year-to-date)	-9.6	-7.6	-5.8	-8.8	-7.6	-6.1	-2.5	-5.0	-5.8	-7.0	...
Exports (year to date, annual percentage change) 2/	-4.4	1.4	2.3	14.1	14.0	16.7	2.4	4.3	5.7	5.7	...
Of which											
Non-oil	-2.9	0.4	0.0	12.4	11.0	15.7	5.7	6.9	7.7	8.0	...
Imports (year to date, annual percentage change) 2/	-1.7	0.2	1.1	15.4	12.7	15.5	8.0	8.9	9.9	9.7	...
Of which											
Consumer goods	18.3	7.2	1.6	18.1	24.0	17.3	11.1	15.5	16.2	15.5	...
Capital goods	-6.8	-6.7	-3.7	11.8	16.0	16.4	8.9	11.9	12.6	12.6	...
Terms of trade (12-month percent change)	-2.9	2.4	3.0	5.8	3.0	2.9	-3.1	-1.0	-0.7	-2.4	...
Real effective exchange rate (CPI based; 12-month percent change) 3/	7.0	-8.6	-9.9	1.1	7.2	-1.8	-3.1	6.1	2.8	...	...
External Debt											
Nonfinancial public sector external debt (percent of GDP)	14.3	16.2	17.2	16.0	13.5	10.6	...	...	...	...	...
Nonfinancial public sector short-term external debt (percent of GDP) 4/	0.9	0.7	0.5	0.6	0.2	0.2	...	...	...	...	...
Private sector external debt (percent of GDP)	10.3	8.9	8.4	7.8	8.2	8.9	...	...	...	...	...
Private sector short-term external debt (percent of GDP)	2.0	1.5	1.5	1.2	1.2	1.2	...	...	...	...	...
Memorandum items:											
Gross international reserves to short-term debt (by residual maturity, percent) 4/	90.9	109.4	135.8	155.1	125.3	151.5	...	...	...	...	...
Monetary base to gross international reserves (percent)	55.0	49.9	45.8	47.5	48.2	54.5	49.0	48.6	47.7	46.8	45.9
Net international reserves to M2	13.7	16.5	18.9	18.2	16.8	14.8	15.4	15.0	15.3	15.2	15.5

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

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

Table 7. Mexico: Baseline Medium-Term Projections, 2002–2012

	2002	2003	2004	2005	2006	2007	Staff Projections 2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise indicated)										
National income and prices											
Real GDP	0.8	1.4	4.2	2.8	4.8	2.9	3.0	3.6	3.8	3.8	3.8
Consumer prices (end of year)	5.7	4.0	5.2	3.3	4.1	3.6	3.6	3.0	3.0	3.0	3.0
Consumer prices (average)	5.0	4.5	4.7	4.0	3.6	3.9	4.2	3.0	3.0	3.0	3.0
External sector											
Nonoil current account balance 1/	-3.4	-2.9	-2.7	-2.6	-2.5	-2.4	-2.4	-2.3	-2.3	-2.2	-2.1
Exports, f.o.b.	1.4	2.3	14.1	14.0	16.7	10.4	9.3	7.1	8.0	8.8	9.1
Imports, f.o.b.	0.2	1.1	15.4	12.7	15.5	11.7	10.8	8.0	8.5	9.0	9.2
Terms of trade (deterioration -)	2.4	3.0	5.8	3.0	2.9	0.8	0.0	-0.6	-0.4	-0.2	-0.1
Oil export price (US$ / bbl)	21.5	24.7	31.0	42.8	53.0	57.7	63.2	60.9	59.4	58.6	57.9
Interest rates											
Treasury bill rate (average 28-day cetes)	7.1	6.2	6.8	9.2	7.2	7.2	7.6	6.6	6.5	6.3	6.3
Real interest rate (28-day cetes)	2.0	1.6	2.0	5.0	3.4	3.1	3.3	3.5	3.4	3.2	3.2
	(In percent of GDP)										
Nonfinancial public sector											
Augmented balance	-3.4	-3.1	-1.9	-1.5	-0.7	-1.6	-1.9	-2.1	-2.2	-2.3	-2.3
Augmented primary balance	0.3	0.3	1.3	1.8	2.4	1.6	1.3	1.1	1.1	0.8	0.8
Augmented non-oil balance 2/	-7.5	-7.8	-6.9	-7.1	-6.7	-7.2	-7.4	-7.0	-6.6	-6.4	-6.0
Saving and investment											
Gross domestic investment	20.6	20.6	22.1	21.8	22.0	21.8	22.4	22.7	22.9	23.2	23.6
Fixed investment	19.3	18.9	19.6	19.3	20.4	20.7	21.4	21.5	21.6	21.9	22.1
Public	4.2	4.5	4.6	4.3	4.4	4.3	4.6	4.5	4.5	4.5	4.5
Private	15.0	14.4	15.0	15.0	16.0	16.4	16.8	17.0	17.2	17.4	17.6
Inventories	1.4	1.6	2.5	2.5	1.6	1.1	1.0	1.1	1.3	1.3	1.5
Gross national saving	18.5	19.2	21.1	21.2	21.8	21.0	21.1	21.0	21.0	21.0	21.0
Public sector	0.8	1.5	2.7	2.8	3.6	2.6	2.7	2.4	2.2	2.2	2.2
Private sector	17.7	17.7	18.4	18.4	18.1	18.4	18.4	18.6	18.7	18.8	18.9
Current account balance	**-2.2**	-1.3	-1.0	-0.6	-0.2	-0.8	-1.3	-1.6	-1.9	-2.0	-2.1

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

1/ Excluding oil exports and petroleum products imports.
2/ Excluding oil revenues, Pemex expenditures, and oil investments.

Table 8. Mexico: Public Sector Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	49.7	50.0	46.0	44.0	43.5	**42.5**	**41.5**	**41.1**	**40.6**	**40.4**	**40.1**	**0.5**
	o/w foreign-currency denominated	16.2	17.2	16.0	13.5	10.6	9.9	9.2	8.7	8.1	7.6	7.1	
2	Change in public sector debt	1.8	0.3	-3.9	-2.0	-0.6	-1.0	-1.0	-0.4	-0.4	-0.3	-0.3	
3	Identified debt-creating flows (4+7+12)	1.3	-0.9	-5.0	-3.1	-3.2	-1.4	-1.1	-0.5	-0.5	-0.3	-0.3	
4	Primary deficit	-0.3	-0.3	-1.3	-1.8	-2.4	-1.6	-1.3	-1.1	-1.1	-0.8	-0.8	
5	Revenue and grants	21.4	22.5	22.6	23.0	24.4	23.8	24.6	24.4	24.2	24.1	24.0	
6	Primary (noninterest) expenditure	21.2	22.2	21.3	21.3	22.0	22.2	23.3	23.3	23.1	23.3	23.2	
7	Automatic debt dynamics 2/	2.3	0.1	-2.2	-1.1	-0.4	0.5	0.3	0.7	0.7	0.6	0.5	
8	Contribution from interest rate/growth differential 3/	0.3	-1.1	-2.1	-0.4	-0.7	0.5	0.3	0.7	0.7	0.6	0.5	
9	Of which contribution from real interest rate	0.6	-0.5	-0.2	0.8	1.3	1.6	1.5	2.2	2.1	2.0	1.9	
10	Of which contribution from real GDP growth	-0.3	-0.6	-1.9	-1.2	-1.9	-1.2	-1.2	-1.4	-1.4	-1.4	-1.4	
11	Contribution from exchange rate depreciation 4/	2.0	1.2	-0.1	-0.7	0.2	...	...	...	...	...	...	
12	Other identified debt-creating flows	-0.7	-0.7	-1.5	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	
13	Privatization receipts (negative)	-0.7	-0.7	-1.5	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	0.5	1.2	1.1	1.1	2.6	0.4	0.1	0.1	0.1	0.1	0.0	
	Public sector debt-to-revenue ratio 1/	231.7	221.7	203.8	191.1	178.2	178.4	168.8	168.3	168.1	167.5	167.1	
	Gross financing need 6/	16.0	15.5	13.1	13.1	11.6	10.7	10.4	9.7	9.3	9.3	8.9	
	in billions of U.S. dollars	103.5	98.9	89.3	100.5	97.7	95.1	96.4	95.2	96.6	102.6	104.3	
	Scenario with key variables at their historical averages 7/						**42.5**	**40.3**	**38.1**	**35.9**	**33.8**	**31.7**	**-0.8**
	Scenario with no policy change (constant primary balance) in 2007-2012						**42.5**	**40.5**	**39.4**	**38.0**	**36.6**	**35.3**	**0.6**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	0.8	1.4	4.2	2.8	4.8	2.9	3.0	3.6	3.8	3.8	3.8	
	Average nominal interest rate on public debt (in percent) 8/	8.4	7.6	7.3	7.6	7.8	7.9	8.2	8.4	8.5	8.2	8.2	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.4	-0.9	-0.2	2.2	3.3	4.1	3.9	5.6	5.7	5.3	5.3	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.3	-7.1	0.8	4.8	-1.6	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	7.0	8.5	7.4	5.5	4.4	3.8	4.3	2.8	2.9	2.9	3.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	5.4	6.4	-0.1	2.9	8.1	4.1	7.8	3.6	3.1	4.6	3.3	
	Primary deficit	-0.3	-0.3	-1.3	-1.8	-2.4	-1.6	-1.3	-1.1	-1.1	-0.8	-0.8	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ 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).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 9. Mexico: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
I. Baseline Projections											
Gross financing need 1/	16.0	15.5	13.1	13.1	11.6	10.7	10.4	9.7	9.3	9.3	8.9
in billions of U.S. dollars	103.5	98.9	89.3	100.5	97.7	95.1	96.4	95.2	96.6	102.6	104.3
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-12 3/						10.7	9.2	7.4	6.6	6.1	5.4
A2. No policy change (constant primary balance) in 2008-12						10.4	9.6	8.4	7.7	7.4	6.8
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						10.7	10.8	10.2	9.9	10.0	9.7
B2. Real GDP growth is at baseline minus one-half standard deviations						10.7	10.8	10.6	10.7	11.4	11.6
B3. Primary balance is at baseline minus one-half standard deviations						10.7	10.9	10.3	10.0	10.1	9.8
B4. Combination of B1-B3 using 1/4 standard deviation shocks						10.7	10.9	10.4	10.1	10.3	10.1
B5. One time 30 percent real depreciation in 2008 5/						10.7	11.0	11.0	10.6	10.6	10.2
B6. 10 percent of GDP increase in other debt-creating flows in 2008						10.7	11.7	12.3	11.8	11.9	11.4
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-12 3/						95.1	86.1	73.3	69.1	68.0	63.9
A2. No policy change (constant primary balance) in 2008-12						92.3	87.9	81.6	79.3	80.3	78.3
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						95.1	100.4	100.2	102.8	110.3	113.4
B2. Real GDP growth is at baseline minus one-half standard deviations						95.1	99.3	101.9	108.1	120.3	129.1
B3. Primary balance is at baseline minus one-half standard deviations						95.1	101.3	101.4	104.3	112.1	115.5
B4. Combination of B1-B3 using 1/4 standard deviation shocks						95.1	100.9	101.0	103.8	111.5	114.8
B5. One time 30 percent real depreciation in 2008 5/						95.1	69.0	72.8	74.1	78.8	80.5
B6. 10 percent of GDP increase in other debt-creating flows in 2008						95.1	108.8	121.1	123.6	131.3	134.1

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 10. Mexico: External Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account 6/
Baseline: External debt	25.0	25.4	24.3	22.6	20.1	**19.9**	**19.8**	**19.8**	**19.7**	**19.6**	**19.7**	**-1.0**
Change in external debt	-1.4	0.5	-1.1	-1.8	-2.4	-0.2	-0.1	0.0	-0.1	0.0	0.1	
Identified external debt-creating flows (4+8+9)	-1.3	0.5	-2.6	-4.3	-3.4	-1.4	-0.9	-0.6	-0.4	-0.1	0.3	
Current account deficit, excluding interest payments	0.3	-0.5	-0.7	-1.0	-1.5	-0.9	-0.3	0.0	0.3	0.5	0.8	
Deficit in balance of goods and services	1.8	1.6	2.0	1.6	1.4	1.9	2.5	2.8	3.1	3.4	3.7	
Exports	26.8	27.8	29.5	30.0	31.7	33.0	34.2	34.6	35.1	35.8	36.6	
Imports	28.6	29.4	31.5	31.6	33.1	34.9	36.7	37.4	38.3	39.3	40.3	
Net non-debt creating capital inflows (negative)	-2.4	-1.2	-1.9	-2.2	-1.6	-1.7	-1.6	-1.6	-1.6	-1.6	-1.6	
Automatic debt dynamics 1/	0.8	2.2	0.0	-1.1	-0.3	1.1	1.0	1.0	1.0	1.0	1.0	
Contribution from nominal interest rate	1.8	1.8	1.6	1.6	1.7	1.7	1.6	1.6	1.7	1.7	1.7	
Contribution from real GDP growth	-0.2	-0.4	-1.0	-0.6	-1.0	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7	
Contribution from price and exchange rate changes 2/	-0.9	0.8	-0.7	-2.1	-1.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.1	-0.1	1.5	2.5	1.0	1.2	0.8	0.7	0.3	0.0	-0.2	
External debt-to-exports ratio (in percent)	93.2	91.6	82.3	75.2	63.5	60.3	57.7	57.2	56.0	54.8	53.8	
Gross external financing need (in billions of US dollars) 4/	63.4	54.9	50.0	46.1	60.9	57.5	66.9	75.8	85.6	95.6	106.6	
in percent of GDP	9.8	8.6	7.3	6.0	7.2	6.5	7.2	7.7	8.2	8.6	9.1	
Scenario with key variables at their historical averages 5/						**19.9**	**18.0**	**16.1**	**13.8**	**11.3**	**8.7**	**-2.6**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.8	1.4	4.2	2.8	4.8	2.9	3.0	3.6	3.8	3.8	3.8	
GDP deflator in US dollars (change in percent)	3.5	-2.9	2.7	9.2	4.4	2.5	2.0	2.1	2.2	2.2	2.3	
Nominal external interest rate (in percent)	7.3	7.2	6.9	7.4	8.1	8.9	8.2	8.8	9.0	9.1	9.1	
Growth of exports (US dollar terms, in percent)	1.3	2.0	13.9	14.0	15.6	9.9	9.0	6.9	7.6	8.2	8.4	
Growth of imports (US dollar terms, in percent)	0.4	1.2	14.8	12.6	14.6	11.3	10.4	7.8	8.3	8.8	9.0	
Current account balance, excluding interest payments	-0.3	0.5	0.7	1.0	1.5	0.9	0.3	0.0	-0.3	-0.5	-0.8	
Net non-debt creating capital inflows	2.4	1.2	1.9	2.2	1.6	1.7	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 deflat

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.

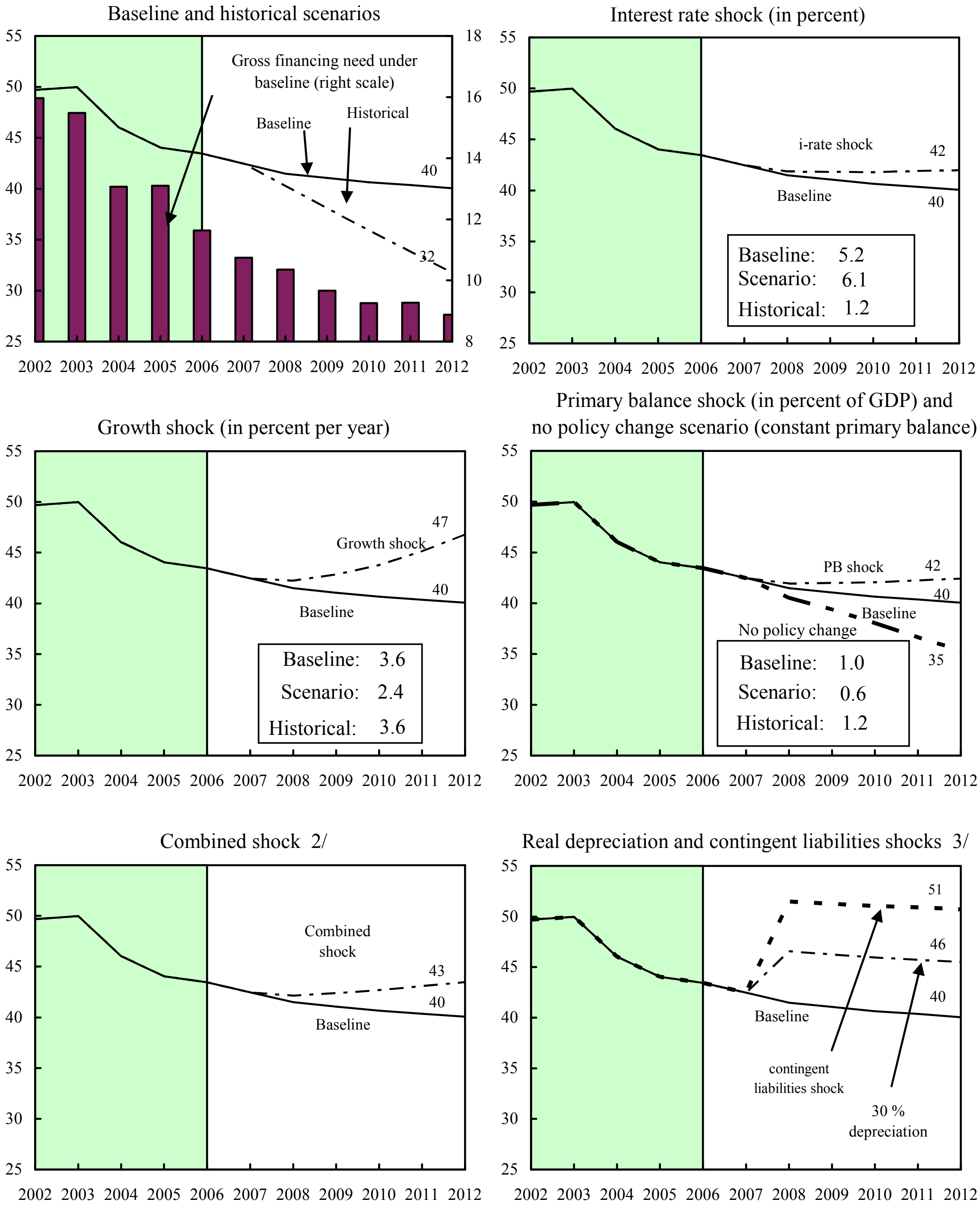
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 11. Mexico: External Sustainability Framework--Gross External Financing Need, 2002-2012

	Actual					Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/	63.4	54.9	50.0	46.1	60.9	57.5	66.9	75.8	85.6	95.6	106.6
in percent of GDP	9.8	8.6	7.3	6.0	7.2	6.5	7.2	7.7	8.2	8.6	9.1
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 2008-12 3/						57.5	64.7	65.0	64.0	59.6	52.3
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						57.5	67.3	76.4	86.4	96.6	107.9
B2. Real GDP growth is at baseline minus one-half standard deviations						57.5	66.9	75.8	85.5	95.2	105.7
B3. Non-interest current account is at baseline minus one-half standard deviations						57.5	72.0	83.0	95.2	108.1	122.4
B4. Combination of B1-B3 using 1/4 standard deviation shocks						57.5	69.7	79.7	90.7	102.1	114.6
B5. One time 30 percent nominal depreciation in 2008						57.5	67.9	76.1	84.9	93.1	101.7
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-12 3/						6.5	6.6	6.1	5.4	4.6	3.7
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						6.5	7.2	7.8	8.3	8.7	9.2
B2. Real GDP growth is at baseline minus one-half standard deviations						6.5	7.3	7.9	8.5	9.0	9.5
B3. Non-interest current account is at baseline minus one-half standard deviations						6.5	7.7	8.4	9.1	9.8	10.4
B4. Combination of B1-B4 using 1/4 standard deviation shocks						6.5	7.5	8.2	8.8	9.4	10.0
B5. One time 30 percent nominal depreciation in 2008						6.5	10.9	11.5	12.1	12.5	12.9

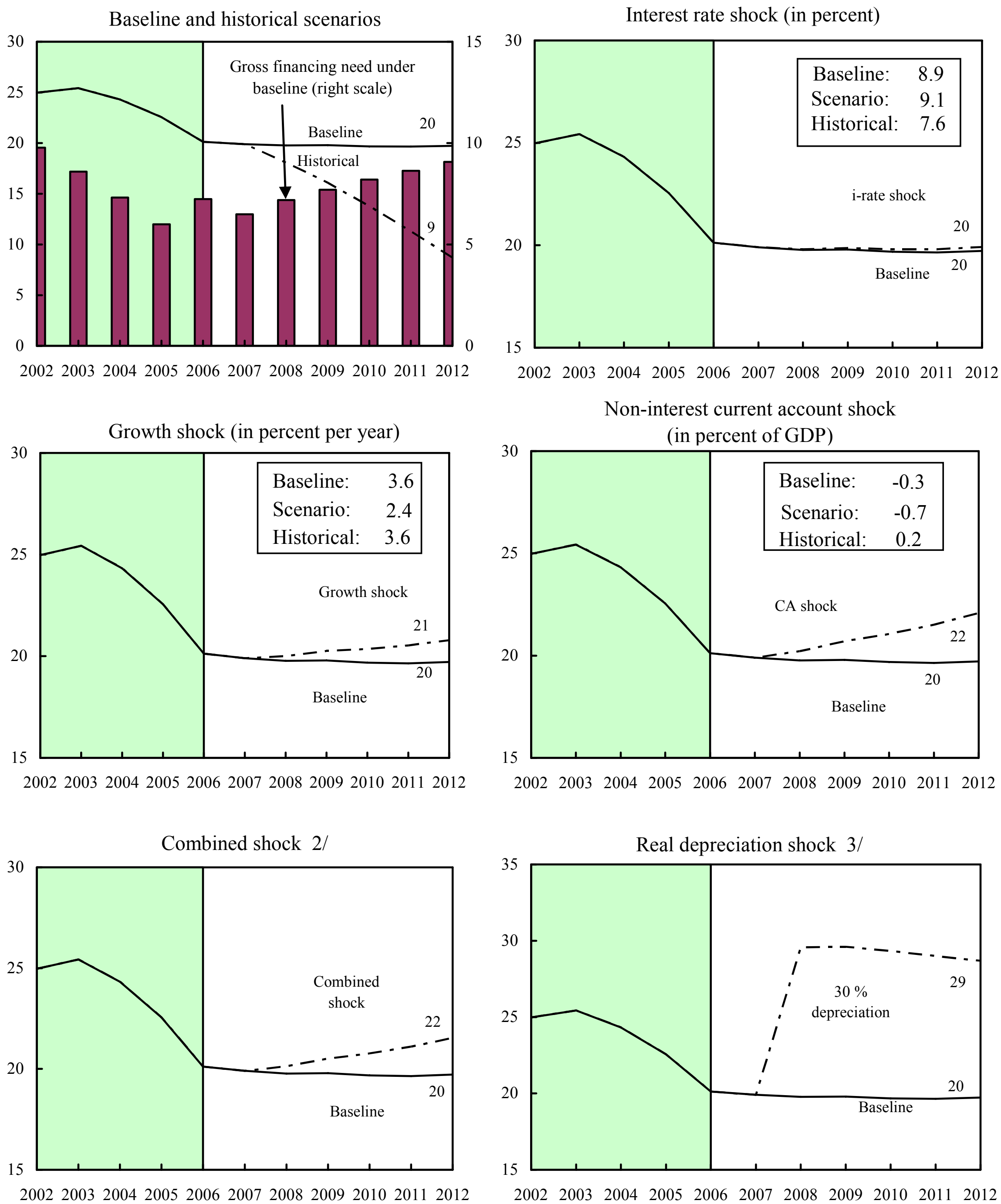
1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline 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 15. 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 2008, 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 16. 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 2008.

Appendix I. Background and Summary of Informational Annexes

Discussions. The 2007 Article IV consultation discussions were held in Mexico City during September 17–28, 2007. The mission met with the Minister of Finance, the Governor and the members of the Board of the Bank of Mexico, senior staff of several government ministries and agencies, representatives of regulatory agencies, the competition authority, representatives of labor unions, and banks. The staff team comprised D. Robinson (Head), S. Phillips, R. Garcia-Saltos, R. Blavy (all WHD); M. Garcia-Escribano (FAD); M. Espinosa and L. Zanforlin, (MCM); D. Velculescu (PDR); and S. Sosa (FIN). Mr. Singh joined the final days of the mission. Messrs. Guerra and Jimenez (OED) attended most meetings.

Exchange arrangement. Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4, and does not have restrictions on payments for current international transactions.
Mexico has a floating exchange rate regime since December 22, 1994.

Fund relations. Mexico has no outstanding purchases or loans.

Technical assistance. Since 2005, STA has provided assistance in national accounts. In 2007, FAD provided assistance in customs administration, intergovernmental fiscal relations and treasury.

Statistical Issues. Core data are adequate for surveillance. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). A data ROSC for Mexico was completed on May 23, 2003 and was subsequently published as IMF Country Report No. 03/150. In a number of cases, the periodicity and timeliness of disseminated data exceeded SDDS requirements. Still, there is room for improvement in a number or areas (see Informational Annex III), including subnational government fiscal and debt statistics.

Relations with the World Bank. As of July 31, 2007, Mexico was the Bank's ninth largest borrower with US$4.1 billion debt outstanding, representing 4 percent of the IBRD's total portfolio. A sharp decline in the Bank's exposure to Mexico occurred in 2006, when the government carried out a substantial prepayment (approximately US$9 billion) of multilateral bank (IBRD and IDB) debt, drawing on central bank foreign exchange reserves, which reduced IBRD debt outstanding by US$5.1 billion. The Bank's portfolio consists of 17 active projects with a total undisbursed balance of US$1 billion. Since the prepayment of external debt in 2006, new lending has been substantially lower than in previous years and the Bank and the government are in the process of redefining the level and forms of engagement that will be reflected in a Country Partnership Strategy that is expected to be discussed by the Bank's Board in the first quarter of CY 2008.

INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2007 Article IV Consultation—Informational Annexes

Prepared by the Western Hemisphere Department

November 9, 2007

Contents Page

Annexes

ANNEX I. MEXICO—FUND RELATIONS

(As of September 30, 2007)

The 2007 Article IV discussions were held in Mexico City during September 17–28, 2007. The staff team comprised D. Robinson (Head), S. Phillips, R. Garcia-Saltos, R. Blavy (all WHD); M. Garcia-Escribano (FAD); M. Espinosa and L. Zanforlin, (MCM); D. Velculescu (PDR); and S. Sosa (FIN). Mr. Singh (WHD) joined the final days of the mission. It met with the Minister of Finance, the Governor and the members of the Board of the Bank of Mexico, senior staff of several government ministries and agencies, representatives of regulatory agencies, the competition authority, representatives of labor unions, and banks. Messrs. Guerra and Jimenez (OED) attended most meetings.

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

Comprehensive economic data are available for Mexico on a timely basis. Mexico subscribes to the SDDS, and economic data are adequate to conduct surveillance (see also Annex III).

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	3,152.80	100.00
Fund holdings of currency	2,927.43	92.85
Reserve position in Fund	225.42	7.15

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	290.02	100.00
Holdings	293.40	101.17

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				
	2007	2008	2009	2010	2011
Principal					
Charges / Interest		0.01	0.01	0.01	0.01
Total		0.01	0.01	0.01	0.01

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 6, 2006. The relevant staff report was IMF country Report No. 06/532.

IX. Technical Assistance

Year	**Dept.**	**Purpose**
2007	FAD	Intergovernmental Fiscal Relations
2007	FAD	Customs Administration
2007	FAD	Treasury
2007	MCM	Accounting and Budgeting Functions, Bank of Mexico
2007	LEG	Pre-assessment on AML/CFT
2006	STA	National Accounts

X. Resident Representative: None

ANNEX II. MEXICO—RELATIONS WITH THE WORLD BANK

The Bank's relationship with Mexico in recent years provides a demonstration of the Bank's current role in middle income countries (MICs). On the demand side, as in the case of many other MICs, Mexico is interested in Bank support for addressing global priorities, including climate change, catastrophe risk management, and trade integration. The country also seeks to draw on the Bank's international experience through high-level technical assistance, and to maintain its relationship with the Bank as a fallback financing option should private credit markets fail to provide sufficient liquidity at some future point.

Mexico has been a leading consumer of many of the new or redesigned products and services that the Bank has developed. It was the first country to use local currency products, which have eliminated foreign currency risk to financial intermediaries in subnational loans. Mexico is also a leading implementer of Global Environment Facility (GEF) grants and other products that help to counter climate change and environmental degradation. Government officials have worked closely with Bank staff on efforts aiming to use existing fiduciary and safeguard systems within Bank projects, both to reduce the cost of doing business with the Bank and to facilitate the development of the country's institutions. Mexico has been open to the Bank's facilitation of dialogue on major development issues such as poverty and inequality, often through jointly sponsored conferences and workshops. Where Bank support could not be easily carried out through loan or grant-financed programs, various units of government have been willing to pay for the Bank's unique expertise through fee-based services arrangements.

As of July 31, 2007, Mexico was the Bank's ninth largest borrower with US$4.1 billion debt outstanding, representing 4 percent of the IBRD's total portfolio. A sharp decline in the Bank's exposure to Mexico occurred in the second half of 2006 when the government carried out a substantial prepayment (approximately US$9 billion) of multilateral bank (IBRD and IDB) debt, which reduced IBRD debt outstanding by US$5.1 billion. The prepayment reflects the government's interest to replace foreign currency debt with locally issued instruments and as such it suggests a reduced appetite for foreign borrowing in the future.

The Bank's portfolio consists of 17 active projects with a total undisbursed balance of US$1 billion. Ever since the 2006 prepayment of external debt, new lending has been substantially lower than in previous years and the Bank and the government are in the process of redefining the level and forms of engagement that will be reflected in a Country Partnership Strategy that is expected to be discussed by the Board in the first quarter of CY 2008.

ANNEX III. MEXICO—STATISTICAL ISSUES

Core data are adequate for surveillance. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). A data ROSC for Mexico was completed on May 23, 2003 and was subsequently published as IMF Country Report No. 03/150. 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. Several measures to improve **external debt statistics** have been carried out, including the compilation of data on external liabilities of publicly traded companies registered with the Mexican stock exchange (external debt outstanding, annual amortization schedule for the next four years broken down by maturity, and type of instrument), but a projection of the total external debt service of commercial banks is still not available. **International reserves** data are compiled according to the Operational Guidelines for the Data Template on International Reserves and Foreign Currency Liquidity of the IMF (2001). The authorities recently published **Financial Soundness Indicators** using the IMF's methodology for 2005 and 2006; it would be useful to update and publish such data on a regular basis.

A **national accounts** mission in 2005 found that the coverage 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. A follow-up mission, scheduled for early 2008, will include the analysis of the results of the input-output table, the new series of gross domestic product by the production and expenditure approaches at current and constant prices, and the complete set of national accounts series by institutional sector according to the *System of National Accounts 1993* for the period 2003–2005.

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 30-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.

In light of the large share of public expenditure that is executed at the state and local government levels, it would be useful to develop consistent and timely reporting of **subnational government operations and debt**, as well as consolidated general government statistics.

MEXICO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF OCTOBER 23, 2007)

	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	September 2007	October 2007	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	September 2007	October 2007	M	M	M		
Reserve/Base Money	August 2007	October 2007	M	D, M	W	LO, LO, O, O	LO, O, O, O, O
Broad Money	August 2007	October 2007	M	M	M		
Central Bank Balance Sheet	August 2007	October 2007	W	W	W		
Consolidated Balance Sheet of the Banking System	August 2007	October 2007					
Interest Rates[2]	September 2007	October 2007	D	D	D		
Consumer Price Index	September 2007	October 2007	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]			NA	NA	NA	LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	June 2007	August 2007	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2007	September 2007	M	M	M		
External Current Account Balance	Q2 2007	August 2007	Q	Q	Q	LO, LO, LO, LO	LO, O, O, O, LO
Exports and Imports of Goods and Services	June 2007	August 2007	M	M	Bi-W		
GDP/GNP	Q2 2007	August 2007	Q	Q	Q	O, O, LO, O	LO, LNO, O, LO, LO
Gross External Debt	August 2007	October 2007	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 on May 23, 2003 and based on the findings of the mission that took place during February 20 to March 7, 2002. For the dataset corresponding to the variable in each row, the assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[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.

INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 2007 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere Department

Approved by Anoop Singh and Adnan Mazarei

November 29, 2007

This supplement reports on economic and policy developments since the staff report was issued on November 12. The thrust of the staff's appraisal remains unchanged.

1. GDP growth for the third quarter reached 3.7 percent (y-o-y), somewhat above staff's projections. Growth was fueled by the service sector, which more than compensated for weaker performance in manufacturing sector. It is likely that growth for 2007 as a whole will modestly exceed the staff report's projection of 2.9 percent.

2. The Bank of Mexico decided, at its November 23 monetary policy meeting, to hold monetary conditions steady. The bank noted the economy's better performance in the third quarter, while pointing to an increased risk that weakening of the U.S. economy would negatively affect Mexican activity. The bank also observed that Mexican financial markets were continuing to function normally, amid renewed global financial turbulence.

3. Financial asset prices have weakened in the last few weeks, continuing to move broadly in line with global market developments. In November, Mexico's EMBI spread increased by about 45 basis points, while the EMBI global spread widened by about 65 basis points. The stock market declined about 7 percent (compared to 5 percent for the U.S. Dow Jones), and the peso lost about 2 percent against the U.S. dollar (all data as of November 28).

4. Congress approved the 2008 budget aiming at zero balance on the traditional budget measure, in line with the Fiscal Responsibility Law. Relative to the 2007 budget, the 2008 budget allocates significantly more resources to infrastructure investment and targets higher spending in social programs, i.e., education, housing and health.

5. The staff's projection of the oil export price has been revised upwards. For 2008, the price of the Mexican mix is now projected at about US$73 per barrel, compared to US$63.2 in the staff report (and US$49 in the budget). This revision raises staff's projection of fiscal revenues by about ½ percent of GDP. Under the Fiscal Responsibility Law, additional income resulting from higher oil prices will be split among several stabilization funds, the pension systems restructuring fund, and investment projects at the federal and state government levels.

6. The authorities made some adjustments on the IETU, the new income tax that will begin in 2008. These adjustments aim at a more uniform corporate tax treatment and include temporary tax credits for existing inventories, for investment-related losses incurred during 2005–07, and for the maquila sector. The authorities expect that these adjustments will not significantly affect revenues from the tax reform.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/140
FOR IMMEDIATE RELEASE
December 13, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Mexico

On December, 3, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.[1]

Background

The economic expansion has continued albeit slowed by developments in the United States. Despite some pickup in the second and third quarter, growth is projected to be close to 3 percent for 2007 as a whole. During the last 12 months inflation has been closer to 4 percent, boosted by a series of supply shocks to world food prices, than to the 3 percent target. Wage growth so far has not accelerated, and medium-term inflation expectations have been broadly stable—although remaining ½ point above the 3 percent target. In that context and citing the need to avoid second-round effects and to guide downward inflation expectations, the Bank of Mexico acted to raise short-term interest rates to 7¼ percent in April, and further to 7½ percent in October.

The external position remains solid, notwithstanding a decline in oil production and slower pace of growth in remittances. The current account deficit is projected to increase to ¾ percent of GDP for the year as a whole. The Bank of Mexico has continued to abstain from discretionary intervention in the foreign exchange market, following the rule for its foreign exchange sales announced in 2003. Mainly reflecting public sector oil

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[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.

export earnings, official reserves have risen by US$5 ½ billion in the first three quarters of 2007 and are about 1½ times short-term external debt on a residual maturity basis.

Fiscal policy is on track to achieve balance for 2007, on the traditional budget measure, as required by the new Fiscal Responsibility Law. The non-oil augmented fiscal deficit for 2007 is projected to be close to 7 percent of GDP, broadly similar to recent years' level. Within this, a 0.4 percent of GDP decline in net oil revenues, reflecting declining oil production, is being offset by a reduction in operational outlays, while investment and social expenditures increase. The public debt to GDP ratio has been steadily declining, and the average maturity of central government traded domestic debt has increased—with the government recently able to issue 30-year nominal fixed rate bonds, albeit in small amounts—although total public sector debt rollover needs are still relatively high.

Mexican financial markets have weathered recent global financial volatility well. As in other emerging markets, the global repricing of risk that began in late July led to a modest rise in bond spreads, as well as a decline in equity prices and some depreciation of the currency (although the latter two movements have now been largely reversed). Domestic financial markets have continued to function normally, without need for policy intervention by the authorities. Commercial banks remain well capitalized, profitable and liquid, and nonperforming loans are still low. The main potential concern remains rapid growth of bank credit to the private sector (29 percent annual growth through September), primarily to households. Credit to enterprises has recently picked up, but remains very low.

Executive Board Assessment

Executive Directors commended the improvements in macroeconomic and financial policies that have helped Mexico to reduce significantly external and internal vulnerabilities over the years—with sustained low inflation, a declining public debt ratio, and a reduction in external debt to low levels. They also welcomed the recent reform breakthroughs, including on tax policy and public pensions, as essential, forward-looking steps to addressing longer-term challenges.

At the same time, Directors noted that Mexico still has a long way to reach its full economic potential, emphasizing the need to accelerate output and productivity growth and to further reduce poverty and inequality. They therefore welcomed the National Development Plan's emphasis on building a more inclusive society that bridges the gap with fast-growing economies while creating more and better job opportunities.

Directors considered that Mexico's near-term outlook remains solid. They observed that Mexican markets have weathered the recent global volatility well, owing to Mexico's healthy fundamentals. Nevertheless, Directors expected that economic growth in the short run could remain somewhat below potential, as the recent deterioration of the U.S. economic outlook could spill over to Mexico.

Directors noted that monetary policy has succeeded in anchoring inflation and inflationary expectations at a low level, although still somewhat above the 3 percent target. In that context, they considered the current policy stance broadly appropriate, while noting that the Bank of Mexico now has the challenging task of weighing upside risks to inflation from supply shocks against downside risks to inflation from the weakening external environment. Directors welcomed the recent steps to enhance monetary policy communication—including the publication of a forecasted inflation path—which should facilitate adjustment to shocks, and guide inflation expectations closer to the target.

Directors considered the independently floating exchange rate regime as appropriate and serving Mexico well, and the real effective exchange rate as broadly in line with fundamentals. They noted that this transparent regime has facilitated continuous and smooth adjustment to shocks, thus contributing to internal and external stability. Directors also noted that the level of international reserves appears adequate, and saw no immediate need for a change in the non-discretionary rule governing the accumulation of reserves.

Directors welcomed the recent tax policy and public pension reforms as key to addressing long-term fiscal challenges. They recommended that the upfront revenue gains from the tax policy measures be used cautiously, including in light of the projected medium-term decline of oil production and associated fiscal revenue. In that context, Directors noted the importance of implementing the plan to strengthen tax administration, and resisting any pressures to increase inertial expenditures. They welcomed the authorities' focus on capital expenditures, while recommending the targeting of subsidies to those most in need.

Directors supported the recent and prospective steps to enhance efficiency and accountability in public spending, at both the national and subnational levels. They encouraged the early implementation of a modern integrated financial management information system and noted the importance of improving subnational fiscal and debt statistics.

While commending the recent steps to prevent medium-term fiscal difficulties, Directors noted the fiscal risks from a possible sharp decline of oil production during the next administration. In that context, they recommended giving a longer-term orientation to fiscal policymaking, developing comprehensive measures of the public sector balance sheet, and supplementing the balanced budget requirement with a focus on steadily reducing the large non-oil fiscal deficit. A number of Directors recommended establishing an indicative limit for the non-oil augmented fiscal balance over the medium term.

Directors observed that Mexico's financial system remains sound and well regulated. They commended the authorities' progress to address the issues identified in the 2006 FSAP Update and their intention to continue moving on that broad agenda. Directors noted the need to remain alert to potential risks, such as those arising from the use of structured instruments and the planned expansion of development banks' activities. They also recommended continued close monitoring of consumer credit growth, which would be facilitated by improved data on consumer balance sheets and housing market developments.

Directors commended the recent successes in building consensus in Mexico to re-energize the reform agenda, and hoped that this success would be extended to other areas. Directors noted the potential for Mexico to reap large gains—including in reducing fiscal risks—from an early implementation of reforms of the state-owned oil sector. Several Directors highlighted the importance of allowing investment partnerships with other oil companies and investors in the oil sector. Directors also emphasized the benefits of enhancing competition, especially in such key network sectors as telecommunications, to generate positive spillovers throughout the economy and to promote equity.

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 (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with Mexico is also available.

Mexico: Selected Economic and Financial Indicators 1/

	2002	2003	2004	2005	2006
(Annual percentage changes, unless otherwise indicated)					
Real GDP	0.8	1.4	4.2	2.8	4.8
Real GDP per capita 2/	-0.2	0.4	3.1	1.8	3.7
Gross domestic investment (in percent of GDP)	20.6	20.6	22.1	21.8	22.0
Gross national savings (in percent of GDP)	18.5	19.2	21.1	21.2	21.8
Consumer price index (end period)	5.7	4.0	5.2	3.3	4.1
External sector					
Exports, f.o.b.	1.4	2.3	14.1	14.0	16.7
Imports, f.o.b.	0.2	1.1	15.4	12.7	15.5
External current account balance (in percent of GDP)	-2.2	-1.3	-1.0	-0.6	-0.2
Change in net international reserves (end of period, billions of U.S. dollars)	7.1	9.5	4.1	7.2	-1.0
Outstanding external debt (in percent of GDP)	25.0	25.4	24.3	22.6	20.1
Total debt service ratio 3/ (in percent of exports of goods, services, and transfers)	24.6	24.6	20.8	18.0	23.4
Nonfinancial public sector (in percent of GDP)					
Augmented overall balance	-3.4	-3.1	-1.9	-1.5	-0.7
Non-oil augmented balance	-7.5	-7.8	-6.9	-7.1	-6.7
Traditional overall balance	-1.2	-0.6	-0.2	-0.1	0.1
Gross augmented public sector debt	49.7	50.0	46.0	44.0	43.5
Net augmented public sector debt	43.6	44.0	40.9	38.9	36.8
Money and credit					
Monetary base	17.0	15.0	12.0	11.7	18.4
Broad money (M4a)	10.8	13.5	12.6	15.0	12.8
Treasury bill rate (28-day cetes, in percent, annual average)	7.1	6.2	6.8	9.2	7.2

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/ Public and private sectors.