

EBS/86/161  
Correction 1

CONFIDENTIAL

September 5, 1986

To: Members of the Executive Board  
From: The Secretary  
Subject: Mexico - Request for Stand-By Arrangement - Letter of Intent

The following corrections have been made in EBS/86/161 (7/23/86):

Page 12, para. No. 1, line 2: for "interest rates" read "interest rebates"  
para. No. 2, line 12: for "paragraph 9" read "paragraph 8"  
last 3 lines: for "provisions for..., as described"  
read "provisions described"  
para. No. 3, line 8: for "adjustment in...under paragraph 9"  
read "adjustment under paragraph 8"  
last 2 lines: for "changes in external financing under"  
read "changes under"

Page 13, para. No. 4, last line: for "paragraph 9" read "paragraphs 8 and 9"  
para. No. 5, line 5: for "January-December 1986. The limits for"  
read "January-December 1986. These limits  
will...of paragraph 8(c). The limits for"

Page 15, 1st full para., last line: for "remaining quarter"  
read "remaining quarters"

Page 17, column 1, line 4: for "-88" read "888"

Page 18, Table 2: add footnote "1/" to "Interest payments"

column 1, Mexican currency: for "7.23" read "8.37"  
Outside budget control: for "1.54" read "-1.54"  
penultimate line: for "5.24" read "4.14"  
last line: for "1.95" read "-0.85"

add footnote 1 "Includes exchange losses."

Corrected pages are attached.

Att: (5)

c. Upper-end scenario

If prices, as defined previously, move above US\$14 per barrel, external financing would be reduced in correspondence with the resulting additional revenues. The operational balance and other relevant targets would be adjusted accordingly.

21. The recovery of economic activity is considered by the Mexican Government to be an essential factor in ensuring the success of the stabilization effort on a durable basis and represents a main objectives of the policies envisaged. The program will feature a second special mechanism that would operate if the recovery fails to materialize despite appropriate policy implementation. This mechanism would trigger an increase in public investment in selected, high yielding projects identified as having a high domestic content and substantial spillover effects on the private sector. This mechanism will be of an automatic nature, defined on the basis of certain objective and predetermined indicators. For the funding of this mechanism, the Mexican Government will request the support of the international financial community; in this respect, the World Bank will be expected to play a major role, including the assessment of the investment projects being undertaken. The estimated amount of this potential release of funds would be US\$500 million for the program period, and the Mexican Government expects this amount to be considered as an additional segment of the overall financial package being requested; this funding would need to be committed in advance and not at the moment of the triggering of the mechanism in question.

22. The Mexican authorities believe that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take additional measures that may become appropriate for this purpose. During the period of the arrangement the authorities of Mexico and the Fund will consult periodically, in accordance with the policies on such consultations, to examine the progress being made in the program and the achievement of its objectives. In particular, the implementation of the economic program described herewith, exchange rate developments and management, as well as the evolution of economic activity during the second half of 1986 will be reviewed with the Fund before December 31, 1986. This review will also provide an opportunity for reaching policy understandings for 1987. A second review with the Fund will be completed before June 30, 1987, to assess the degree of recovery in economic activity and ensure the appropriateness of the policies for the achievement of the objectives of the program.

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Gustavo Petricioli  
Secretary of Finance and  
Public Credit of Mexico

Technical Memorandum of Understanding 1986-87

In accordance with the Economic Program that has been designed for 1986 and 1987 and which is described in the letter dated July 22, 1986:

I. Foreign financing

1. The public sector's net use of foreign credit, which (excluding interest rebates related to the 1984 external debt restructuring) amounted to US\$0.4 billion during 1985 and was a negative US\$0.5 billion during the first semester of 1986, will not exceed a negative US\$0.1 billion for the period January-September 1986 and will not exceed US\$5.0 billion in the period January-December 1986. For the period January-December 1987 the net use of foreign credit will not exceed US\$5.1 billion, but its phasing during the year will be agreed upon at the time of the first review under the stand-by program. These ceilings will be modified only in line with the provisions made under the oil price and/or the supplementary capital expenditure contingency mechanisms as described in paragraphs 8 and 9 below.

II. Public finance

2. The overall public sector borrowing requirement "PSBR" (i.e., the economic deficit of the nonfinancial public sector on a cash basis plus the financial intermediation conducted by the national development banks and official trust funds, excluding FICORCA) is expected to increase from an estimated 10.0 percent of GDP in 1985 to 16.9 percent of GDP in 1986. The overall PSBR, which amounted to Mex\$4,580 billion in 1985 and which is estimated to have reached Mex\$4,000 billion during the first six months of this year, will not exceed Mex\$8,350 billion in the nine-month period ending September 1986, and Mex\$13,640 billion in the period January-December 1986. The ceilings for 1986 will be modified to reflect increases or decreases in external public borrowing contemplated under paragraph 8 below. The yearly and quarterly ceilings for 1987 will be agreed upon at the time of the first review under the stand-by arrangement. These ceilings will be subject to adjustment in accordance with the provisions described in paragraphs 8 and 9 below.

3. The overall operational balance of the nonfinancial public sector, which amounted to a negative Mex\$888 billion (1.9 percent of GDP) in 1985, and which has been estimated at Mex\$186 billion in the period January-June 1986, has been programmed to register a deficit of no more than Mex\$340 billion in the period January-September, and a deficit of no more than Mex\$1,670 billion (2.1 percent of GDP) in the period January-December 1986. These ceilings shall be modified to reflect any adjustment under paragraph 8 below. The yearly and quarterly ceilings for 1987 will be agreed upon at the time of the first review under the stand-by arrangement. The 1987 ceilings shall be adjusted to reflect any changes under paragraphs 8 and 9 below.

### III. Banco de Mexico operations

4. The net foreign assets of the monetary authorities, which amounted to US\$3.1 billion on December 31, 1985, will increase by at least US\$0.5 billion during 1986, and by US\$0.9 billion during 1987. The net foreign assets of the monetary authorities will not decline by more than US\$3.8 billion in the period January-September 1986. The quarterly schedule for the net foreign asset accumulation for 1987 will be agreed upon at the time of the first review under the stand-by program. These targets will be adjusted according to the provisions of paragraphs 8 and 9 below.

The goals of the program regarding the accumulation of reserves have been formulated on the basis of assumptions regarding financing from various sources being available according to a specific calendar. If shortfalls or delays from the amounts or dates of financing envisaged were expected to be reversed, the management of the Fund would request early approval of a waiver by the Executive Board.

5. The net domestic assets of the Banco de Mexico, which in the period January-June 1986 increased by Mex\$1,108 billion, will not increase by more than Mex\$2,779 billion during the period January-September 1986, and not by more than Mex\$711 billion during the period January-December 1986. These limits will be adjusted in accordance with the provisions of paragraph 8(c). The limits for 1987 will be agreed upon at the time of the first review under the stand-by program.

6. The Banco de Mexico's net claims on the public sector, which amounted to Mex\$5,735 billion as of the end of December 1985, will not exceed Mex\$9,624 billion at the end of September 1986, and Mex\$8,206 billion at the end of December 1986. These ceilings shall be adjusted by an amount equivalent to the sum of commercial banks' lending to the nonfinancial public sector that would result exclusively from the implementation of mandatory portfolio requirements. Thus, the adjusted limit on the Banco de Mexico's net claims on the nonfinancial public sector will be subject to the following schedule in 1986: Mex\$13,133 billion at the end of September 1986, and Mex\$13,700 billion at the end of December 1986. However, if the unadjusted ceilings are exceeded, the commercial banks' lending to the public sector based on mandatory portfolio requirements will be reduced by an equivalent peso amount. The ceilings for 1987 will be agreed upon at the time of the first review under the stand-by program. These ceilings will be adjusted according to the provisions of paragraphs 8 and 9 below.

7. Financial intermediation conducted by the national development banks and all official trust funds (including those of the Banco de Mexico, but excluding FICORCA) will increase by no more than Mex\$898 billion in 1986, subject to the condition that it will not increase by more than Mex\$600 billion during the period January-September 1986.

#### IV. Contingency mechanisms

##### Oil price contingency mechanism

8. Depending on the evolution in the price of oil, the ceilings set forth above will be modified according to the following mechanism:

##### (a) Lower-end scenario

(i) If in any given calendar quarter within the first nine months of the program the mean price of oil of the representative Mexican crude oil mix falls below US\$9 per barrel, the corresponding quarterly target on Banco de Mexico's net international reserves will be lowered in full by the revenue loss that results from multiplying the quarterly reference volume of crude oil exports by the difference between the prevailing quarterly mean price and the price of US\$9 per barrel. In addition, the corresponding quarterly ceilings on the net credit from Banco de Mexico to the public sector, on the PSBR, and on the operational balance of the public sector will be raised by the peso equivalent of the adjustment to the net international reserves target. In the following quarter, the ceiling on the public sector's net use of foreign credit and the target on the Banco de Mexico's net international reserves for that quarter will be raised by the above-mentioned revenue loss.

(ii) During the second nine-month period of the program, the revenue shortfall in relation to the price of US\$9 per barrel will be computed as indicated in (a) above, but the adjustments to the relevant targets and ceilings will correspond to only 80 percent of the revenue loss in the first quarter, 60 percent in the second quarter, and 40 percent in the third quarter.

(iii) Because of its continuous nature, no adjustment to the ceiling on the net domestic assets of the Banco de Mexico will be effected, as it is assumed that the additional foreign financing will already have been disbursed by the scheduled date of purchase from the Fund following the quarter in which the price of oil falls below US\$9 per barrel.

##### (b) Upper-end scenario

If in any given calendar quarter the mean price of oil (as defined above) rises above US\$14 per barrel the corresponding quarterly target on the Banco de Mexico's net international reserves will be raised by the full amount of the excess revenue that results from multiplying the respective quarterly reference value of crude oil exports by the difference between the prevailing mean average price and the price of US\$14 per barrel. In addition, the corresponding quarterly ceilings on the net credit from the Banco de Mexico to the public sector, on the PSBR, and on the operational balance of the nonfinancial public sector

will be lowered. In the following quarter the ceiling on the public sector's net use of foreign credit and the target for the Banco de Mexico's net international reserves will be lowered by the above-mentioned revenue gain.

(c) Baseline scenario

If during the period of the program the mean price of oil (as defined above) in a given calendar quarter remains within a range of US\$9 to US\$14 per barrel, adjustments to ceilings and targets will be made with respect to the average price of oil exports assumed in the program (US\$9 per barrel in the third quarter of 1986, US\$11 per barrel in the fourth quarter of 1986, and US\$11 per barrel during 1987). The corresponding quarterly ceilings on Banco de Mexico's credit to the public sector, on the PSBR, and on the operational balance of the nonfinancial public sector will be adjusted fully for the revenue deviation resulting from the product between the respective quarterly reference volume of crude oil exports and the difference between the prevailing quarterly mean price and the price assumed in the projection. The target on the net international reserves and the ceiling on net domestic assets of Banco de Mexico for the corresponding quarter will be adjusted by 100 percent of the revenue deviation in the first quarter, by 75 percent of the revenue deviation in the second quarter, by 50 percent of the revenue deviation in the third quarter, and by 25 percent of the revenue deviation in the remaining quarters.

(d) For purposes of calculating the revenue deviations, the reference volume of crude oil will be 1.2 million barrels per day during the second half of 1986 and 1.3 million barrels per day during 1987. For purposes of adjusting the public finance and monetary authorities' ceilings and targets the adjustment contemplated in (a), (b), and (c) will be converted into pesos at the average exchange rate in the controlled market that prevailed in the respective quarter.

Supplementary capital expenditure contingency mechanism

9. In addition to the adjustments in 8a, b and c, in 1987 the ceilings on public sector's net use of foreign credit, on the PSBR, and on the operational balance of the nonfinancial public sector will be adjusted upwards by an amount not to exceed US\$500 million. The adjustment to the ceiling will become effective if, after March 31, 1987: (a) the 12-month rate of change in the index of manufacturing production ending in March 1987 has not reached a level agreed upon during the first review under the stand-by arrangement; (b) the investment projects to which the credit will be applied have already been identified and pre-appraised by the World Bank; and (c) all the targets and ceilings in the program for the quarter ending December 1986 and March 1987 have been observed. The amount of the adjustment shall be equal to the amount of financing disbursed from sources other than the Fund, pursuant to paragraph 21 of the accompanying letter.

For purposes of adjusting the public finance ceilings, the adjustment contemplated in this paragraph will be converted into pesos at the average exchange rate in the controlled market that prevailed in the respective quarter.

V. Other

10. During the period of the stand-by arrangement the financial authorities of Mexico and the Fund will consult periodically, in accordance with the Fund's policies on such consultations, to examine the progress being made in implementing the program and the achievement of its objectives. In particular, before the end of December 31, 1986 there will be a review of the implementation of the economic program described herewith, exchange rate developments and management, an assessment of the evolution of economic activity during the second half of 1986, and the establishment of the quarterly schedule of the targets and ceilings for 1987. A second review with the Fund will be scheduled for the second quarter of 1987. The above allowance for reviews and consultations does not preclude any further contacts that may arise in relation to the oil price and/or supplementary capital expenditure contingency mechanisms described in paragraphs 8 and 9 above.

Table 1. Mexico: Stand-By Arrangement--Quantitative Performance Criteria

	Actual Jan.-Dec. 1985	(Targets and Ceilings)				
		1986				
		Actual March	Prel. June	Sept.	Dec.	Jan.-Dec. 1987
<u>(In billions of Mexican pesos)</u>						
Cumulative overall public sector borrowing require- ments <u>1/ 2/</u>						
Unadjusted	4,580	1,074	4,000	8,350	13,640	... <u>3/</u>
Adjusted	--	--	--	<u>4/</u>	<u>4/</u>	<u>5/</u>
Cumulative changes in financial intermediation (effective flows)	389	-109	300	600	898	... <u>3/</u>
Cumulative nonfinancial public sector operational balance <u>6/</u>						
Unadjusted	-888	626	186	-340	-1,670	... <u>3/</u>
Adjusted	--	--	--	<u>4/</u>	<u>4/</u>	<u>5/</u>
Cumulative changes in net domestic assets of the monetary authorities (effective flow) <u>7/</u>	1,409	138	1,108	2,779	711	... <u>3/</u>
Net credit to the nonfinan- cial public sector by the monetary authorities <u>8/</u>						
Unadjusted	5,735 <u>9/</u>	6,492	7,978	9,624	8,206	... <u>3/</u>
Adjusted <u>10/</u>	--	--	--	13,133	13,700	<u>3/</u>
<u>(In millions of U.S. dollars)</u>						
Cumulative net foreign borrowing by the public sector <u>1/</u>						
Unadjusted	400	-430	-500	-100	5,000	5,100
Adjusted	--	--	--	<u>4/</u>	<u>4/</u>	<u>5/</u>
Cumulative change in net international reserves of the monetary authorities	-3,400	-342	-1,863	-3,763	500	900

Sources: Mexican authorities; and Fund staff estimates.

1/ Limit tested at the end of each period.

2/ Effective flows of financing measured on a cash basis.

3/ Limit to be agreed upon with the Fund before December 31, 1986.

4/ Adjustment for additional external financing authorized in line with provisions under oil price contingency mechanism.

5/ Adjustment for additional external financing authorized in line with provisions under oil price and supplementary capital expenditure mechanisms.

6/ Defined as the difference between the overall public sector borrowing requirements excluding cumulative charges in financial intermediation and the inflation component of the stock of domestic public sector debt denominated in local currency.

7/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the monetary authorities.

8/ Effective stocks calculated by adding effective flows to nominal stocks outstanding as of December 1985.

9/ Stock outstanding at the end of December 1985 unadjusted for changes in the exchange rate (used as base).

10/ Ceiling can be adjusted upwards by an amount equivalent to the sum of commercial banks' lending to the nonfinancial public sector that would result exclusively from implementing mandatory portfolio requirements. The counterpart of this adjustment would be an equivalent peso reduction of the commercial banks' lending to the nonfinancial public sector based on mandatory portfolio requirements.

Table 2. Mexico: Public Sector Operations

(In percent of GDP)

	1985	1986	1987
<u>PSBR</u>	<u>10.05</u>	<u>16.90</u>	<u>...</u>
Financial intermediation	0.85	1.11	1.11
Deficit outside budget	1.75	0.63	0.63
Of which: interest	0.20	0.43	0.43
<u>Economic balance under budgetary control</u> <u>(deficit -)</u>	<u>-7.44</u>	<u>-15.15</u>	<u>...</u>
Receipts	31.34	28.21	30.17
Petroleum receipts	13.86	10.68	11.13
Nonpetroleum receipts	17.48	17.52	19.04
Public enterprises	8.15	8.07	8.29
Federal Government	9.33	9.45	10.75
Expenditure	38.77	43.36	...
Programmable	22.27	21.78	21.28
Investment	3.93	3.90	4.40
Other	18.34	17.88	16.88
Nonprogrammable	16.51	21.58	...
Interest payments <sup>1/</sup>	12.27	18.51	...
Of which: inflationary component of interest payments on domestic debt denominated in Mexican currency	8.37	13.72	...
Other	4.23	3.07	3.07
<u>Primary balance (deficit -)</u>	<u>3.29</u>	<u>3.15</u>	<u>5.61</u>
Under budget control	4.83	3.35	5.81
Outside budget control	-1.54	-0.20	-0.20
Real interest payments on domestic debt denominated in Mexican currency and payments on debt denominated in foreign currency	4.14	5.22	...
<u>Operational balance</u> <u>(deficit -)</u>	<u>-0.85</u>	<u>-2.07</u>	<u>...</u>

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

<sup>1/</sup> Includes exchange losses.