

EBS/85/123  
Correction 1

CONFIDENTIAL

June 5, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Mexico - Staff Report for the 1985 Article IV Consultation  
and Use of Fund Resources Under the Extended Arrangement -  
Program for the Third Year

The following corrections have been made in EBS/85/123 (5/13/85):

Page 2, line 3: for "SDR 200,625 million" read "SDR 200.625 million"  
line 4: for "SDR 3,410,625 million" read "SDR 3,410.625 million"

Page 5, Table 2: revised

Page 9, 2nd full para., line 11: for "26 percent--" read "21 percent--"

Page 10, line 7: for "less that 17 percent" read "less than 17 percent"

Page 11, Table 4: revised

Page 12, line 6: for "US\$560 million" read "US\$480 million"

Page 37, column 1, line 13: for "-7.4" read "-7.9"  
line 15: for "10.2" read "9.7"  
line 21: for "(10.2)" read "(9.7)"  
line 22: for "(9.7)" read "(11.5)"  
line 24: for "(-7.4)" read "(-7.9)"  
line 25: for "(25.2)" read "(25.7)"

column 2, line 13: for "-0.9" read "-0.6"  
line 15: for "7.1" read "7.4"  
line 21: for "(7.1)" read "(7.4)"  
line 22: for "(13.2)" read "(12.9)"  
line 24: for "(-0.9)" read "(-0.6)"  
line 25: for "(24.8)" read "(24.5)"

Page 43, penultimate line: for "SDR 1,203.7 million"  
read "SDR 1,203.745 million"

Pages 49 and 50, Basic Data: revised

Page 51, column 1, line 21: for "-7.4" read "-7.9"  
column 2, line 21: for "-0.9" read "-0.6"  
column 3, line 21: for "2.5" read "2.6"  
column 5, line 21: for "2.8" read "2.9"

Corrected pages are attached.

Att: (11)

## I. Introduction

The 1985 Article IV consultation discussions with Mexico and negotiations for the third year of the current extended arrangement were held in Mexico City and Washington in the period extending from October 30, 1984 to March 21, 1985.<sup>1/</sup> In the course of these discussions the staff reviewed with the authorities the performance during the second year of the program. In the letter of intent dated March 25, 1985 and the attached Technical Memorandum of Understanding (EBS/85/70, 3/25/85), the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico assess the performance during the second year of the arrangement and describe the economic policies of the Government of Mexico for 1985.

The Mexican representatives in the consultation discussions included the Secretary of Finance and Public Credit; the Secretary of Budget and Planning; the Director General of the Bank of Mexico; the Under Secretary of Finance and Public Credit; the Under Secretary of Planning; the Under Secretary of External Trade; the Under Secretary of National Banking; the Under Secretary of Budget Control; and senior officials of various ministries, the Bank of Mexico, public enterprises, and other government agencies.

The extended arrangement with Mexico was approved by the Fund's Executive Board on December 23, 1982 (EBM/82/168). At that time, macroeconomic targets for the three-year period 1983-85 and performance criteria for the first program year were established (see EBS/82/208, 11/12/82, and its supplements); Mexico also undertook to hold consultations with the Fund before the beginning of the second and third program years in order to establish suitable performance clauses for each of these periods. The program for the second year of the arrangement was approved by the Fund's Executive Board on March 2, 1984 (EBM/84/35) and was described in EBS/84/1 (1/3/84) and its supplements. The arrangement

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<sup>1/</sup> Mexico has accepted the obligations of Article VIII, Sections 2, 3, and 4. A staff mission consisting of Messrs. Pujol (Head-WHD), Gil Diaz (WHD), Katz (FAD), Leite (CBD), Neuhaus (ETR), Valdivieso (WHD), and Ms. Toso (Secretary-WHD) visited Mexico City from October 30 to November 16, 1984 to start the discussions which provided the basis for this paper. The discussions were continued in Mexico on December 6-7, 1984 by Mr. Beza and Mr. Pujol (both WHD). In mid-December 1984 a Mexican team visited Washington, D.C., and this was followed by another visit to Washington in mid-January 1985. Mr. Pujol and Mr. Valdivieso (both WHD) visited Mexico City January 22-25, 1985. The full staff mission returned to Mexico City February 11, through March 8, 1985 and a Mexican team visited Washington, D.C., March 11-13, 1985. The consultation discussions were continued by the Fund mission on March 15-20, 1985 in Mexico City and concluded on March 21 in Washington, D.C. Mr. Pedro Perez, Executive Director for Mexico, and Mr. Guillermo Ortiz, Alternate Executive Director for Mexico, participated in the main policy discussions.

provided for Mexico's access to Fund resources for the equivalent of SDR 3,611.25 million over the three year period (450 percent of the SDR 802.5 million quota in effect at that time), of which SDR 200.625 million was under the first credit tranche and SDR 3,410.625 million was under an extended arrangement.

Mexico made all scheduled purchases under the EFF during 1983 and 1984 and as of April 30, 1985 the Fund's total credit outstanding to Mexico stood at 206.6 percent of Mexico's present quota of SDR 1,165.5 million, of which SDR 1,304.1 million (111.9 percent of quota) was financed from ordinary resources and the remainder from borrowed resources under the policy of enlarged access. The extended arrangement for Mexico provides for purchases of up to SDR 1,203.7 million for the third year of the program; it is proposed that the purchases be phased evenly in four installments with the first purchase to take place shortly after Board approval of this year's program, the next two purchases to take place by the end of August and November 1985, and the last one in early 1986 (Table 1). It is intended that the first purchase be contingent upon Board approval and the observance of the performance criteria established for the end of March 1985, that the second purchase be contingent on the performance criteria established for the end of June, that purchases after September 30, 1985 be contingent upon compliance with the corresponding performance criteria and the conclusion of the review clause mentioned in paragraph 8 of the Technical Memorandum of Understanding attached to the letter of intent, and that the purchase to take place in early 1986 be contingent upon the observance of the December 1985 performance criteria. Full utilization of the extended arrangement would raise the Fund's credit to Mexico to 309.8 percent of Mexico's quota. Further information on Mexico's relations with the Fund is presented in Appendix I.

The last Article IV consultation with Mexico was held in the period May 2-23, 1984 in Mexico City. The resulting reports (SM/84/155, 7/2/84, and SM/84/165, 7/16/84) were considered by the Executive Board at EBM/84/177 on July 30, 1984. In that meeting, Executive Directors commended the authorities for the implementation of adjustment policies that had made possible a major turnaround from the economic crisis that had affected Mexico in 1982. The balance of payments had been strengthened significantly, price performance had improved, and economic activity was showing signs of recovery. Instrumental to these achievements had been the pursuit of appropriate fiscal, monetary, and wage policies. Directors noted the gains in competitiveness that had been attained through a major currency depreciation in the early stages of the program and recognized the positive impact that such a measure had had on the balance of payments, but they expressed concern about the rate of depreciation of the peso lagging behind the inflation differential between Mexico and its main trading partners; they also encouraged the authorities to seek a prompt unification of the dual exchange market. Concern was indicated by some Directors over the limited progress in liberalizing imports and emphasis was placed on the need to accelerate the process of liberalization. Directors welcomed the advances made in restructuring the public and

Table 2. Mexico: Summary Accounts of the Public Sector

(In percent of GDP)

	1981	1982	1983	1984		1985
				Program	Actual	Original Budget 1/
<u>Public sector revenue</u>	17.4	19.3	22.2	20.8	20.4	21.4
Taxes on petroleum sector	4.0	4.9	6.8	6.2	5.8	6.2
Other federal government taxes	11.0	10.3	10.7	10.2	10.2	10.9
Other federal government revenue	0.9	1.1	1.1	0.6	0.8	0.8
Social security contributions	2.8	3.0	2.5	1.9	2.3	1.9
Federal District	0.3	0.3	0.2	0.2	0.2	0.2
Operating surplus of public enterprises (net)	2.3	4.6	7.7	7.9	7.0	7.5
PEMEX	(4.2)	(6.5)	(10.9)	(9.9)	(9.2)	(8.8)
Electricity	(-0.3)	(-0.6)	(-1.1)	(-0.8)	(-0.7)	(-0.7)
CONASUPO	(-1.4)	(-0.8)	(-1.4)	(-0.9)	(-1.3)	(-0.5)
Railways	(-0.3)	(-0.2)	(-0.3)	(-)	(-0.1)	(-)
Other	(0.1)	(-0.2)	(-0.4)	(-0.3)	(-0.2)	(-0.1)
Less: taxes paid by public enterprises	-4.0	-4.9	-6.9	-6.2	-5.9	-6.2
Capital revenue of public enterprises	0.1	0.1	0.1	--	--	--
<u>Public sector expenditure 2/</u>	32.0	37.1	30.7	26.3	26.6	25.9
Government consumption	10.2	11.3	9.4	8.7	9.7	9.1
Wages and salaries	(5.4)	(6.0)	(4.9)	(3.9)	(4.6)	(4.3)
Goods and services	(2.8)	(3.1)	(2.3)	(2.5)	(3.0)	(2.5)
Transfers to local governments	(2.0)	(2.2)	(2.2)	(2.3)	(2.2)	(2.2)
Current transfers and subsidies	3.0	2.6	2.9	2.1	1.9	1.9
Interest payments	3.1	5.6	8.7	6.4	6.7	6.7
Exchange losses	--	4.0	0.6	0.3	0.7	0.3
Financing requirements, rest of public sector (net) 3/	1.1	2.6	0.8	0.4	0.7	0.2
Of which: local government	/0.2/	/0.2/	/0.1/	/.../	/0.2/	/.../
Unclassified (Ajenas)	1.2	0.9	0.2	0.2	0.4	0.1
Capital expenditures	13.3	10.1	8.1	8.2	6.4	7.5
Fixed investment	(13.0)	(9.7)	(7.4)	(8.1)	(6.1)	(7.5)
Of which: PEMEX	/3.9/	/3.0/	/2.0/	/2.0/	/1.6/	/1.7/
Financial investment and other 4/	(0.3)	(0.4)	(0.6)	(0.1)	(0.2)	(0.1)
<u>Overall balance</u>	-14.6	-17.8	-8.5	-5.5	-6.2	-4.5
Foreign financing (net)	7.4	3.7	3.5	2.4	1.3	0.1
Domestic financing (net) 5/	7.2	14.1	5.0	3.1	4.9	4.4
<u>Memorandum items</u>						
Petroleum exports	5.5	8.6	11.3	10.1	9.4	8.1
Current balance of public sector	-1.4	-7.9	-0.6	-2.6	0.1	2.9
Current balance excluding PEMEX	-5.6	-14.4	-11.5	-7.3	-9.1	-5.9
Operating expenditure of public enterprises	10.6	11.0	12.2	11.7	11.6	10.3
GDP in billions of Mexican pesos	5,874	9,417	17,142	27,700	29,438	43,000

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

1/ The original budget for 1985 has been revised for purposes of the program on the basis of measures adopted in February and March 1985. The details of these revisions are presented in Table 8.

2/ Exclusive of operating expenditure of public enterprises. Net operating surplus of public enterprises is shown under public sector revenue.

3/ Includes residual financing of the nonconsolidated public sector.

4/ Includes acquisition of property.

5/ Differs from the domestic financing appearing in Table 10 because banking system credit to the public sector funded with foreign resources is classified here as foreign financing.

return of confidence and the resumption of sustained growth. The program sought to assure external competitiveness through an immediate sharp devaluation of the Mexican peso and the adoption of a flexible exchange rate policy. Liberalization of the exchange and trade system also was planned. These policies were reinforced by major efforts to eliminate external payments arrears and to restructure both the public and private external debt.

1. Developments in 1983

The successful implementation of the program during 1983 resulted in a major turnaround in economic conditions. The fiscal deficit declined from the equivalent of about 18 percent of GDP in 1982 to 8 1/2 percent in 1983. This strengthening of the fiscal situation facilitated an appreciable deceleration in the growth of the monetary and credit aggregates which, supported by a moderate wage policy and appropriate exchange rate and interest rate adjustments, served to reduce existing imbalances and move Mexico away from the crisis atmosphere that had prevailed in 1981-82.

Domestic inflation declined sharply in 1983--particularly in the second half of the year. Contributing to this result was not only the tightening of demand management policies but also the pursuit of a moderate wage policy. Minimum wages rose by just under 45 percent, well below the 81 percent rate of inflation experienced in 1983; it should be noted that approximately one third of the inflation recorded in 1983 was accounted for by corrective price increases in public sector goods and services or in items subject to price controls (Chart 2). With regard to output, the contraction that occurred in late 1982 and early 1983 resulted in a fall of more than 5 percent in real GDP for 1983 as a whole. However, by the last quarter of 1983 there were signs of a recovery, including a rise in total employment (Chart 3).

The impact of the adjustment program during 1983 was particularly evident in the balance of payments. The current account shifted from a deficit of US\$5 1/2 billion in 1982 to a surplus of over US\$5 billion in 1983, and the overall balance moved from a deficit of nearly US\$7 billion to a surplus of US\$5 1/2 billion (Table 3). This swing in the balance of payments was to a large extent the result of a very sharp cutback of imports and the virtual cessation of capital flight. The strength of the current account and the availability of some US\$4.7 billion in net official capital permitted Mexico to rebuild its international reserves and repay a large part of the external arrears that had accumulated in 1982.

A key element in the turnaround of the balance of payments and fiscal situation in 1983 was the sharp devaluation that took place in December 1982. In that month the Mexican authorities announced the replacement of the generalized system of exchange controls that had prevailed since September 1982 by the introduction, on a temporary basis, of a new dual exchange system consisting of a controlled market

US\$1 billion of private debt guaranteed by official creditors abroad; developments with respect to the signing of individual bilateral agreements are described below.

2. The program for 1984 and developments in the second program year

The program for 1984 envisaged the continuation of the policy approach adopted in late 1982, with a further strengthening of the public finances complemented by restrained financial and incomes policies and a further liberalization of controls over domestic prices and external transactions. The overall public sector deficit was to be reduced by an additional 3 percentage points of GDP, to 5 1/2 percent of GDP. The program targeted a further increase of US\$2 billion in net international reserves in 1984 and full settlement of remaining external payments arrears, with public sector net external borrowing being limited to US\$4 billion. On the basis of the policies being implemented, economic activity was expected to recover gradually, with real GDP rising by 1 percent, while inflation was expected to decline to a 12-month rate of about 40 percent by December 1984.

Despite some slippages, Mexico's performance under the adjustment program during 1984 continued to be positive. Economic activity strengthened significantly in response to the growth of non-oil exports and a recovery of private investment. Preliminary official estimates indicate that real GDP rose by 3 1/2 percent in 1984, compared with the 1 percent rise envisaged in the program. The balance of payments remained strong, with the trade account registering a positive balance of almost US\$14 billion and the current account a surplus of more than US\$4 billion. In contrast to 1983 when imports fell sharply, the strength of the trade account in 1984 reflected in large part the rise in nonpetroleum exports--they went up by 21 percent--rather than a very low level of imports. In addition, there was an improvement in the behavior of the private capital account (including errors and omissions). Net international reserves rose by about US\$3 billion (compared with the US\$2 billion contemplated in the program), notwithstanding a lower than programmed utilization of net official external borrowing (US\$2.2 billion, compared with the US\$4 billion that had been planned). All remaining external payments arrears, scheduled to be eliminated before year-end, were fully settled by the end of the first quarter of 1984.

The program's aim with respect to the reduction in inflation during 1984 was not met. Although the inflation rate came down by some 22 percentage points, the 12-month rate of inflation in the period ended December 31, 1984 was 59 percent, substantially in excess of the 40 percent sought under the program. A combination of factors contributed to this result, including large adjustments in controlled prices in the early months of 1984, a slower pace of import liberalization than had been envisaged, a higher minimum wage award than had been implicit in the program, and a somewhat looser demand management policy--particularly in the latter part of the year.

The general liberalization of domestic prices and adjustment of public sector prices started in 1983 was continued during 1984, and adjustments in controlled prices continued to exceed the rise in prices not subject to government control during 1984. However, the process of freeing imports from prior licensing and other administrative barriers did not proceed at the speed originally expected, and by the end of 1984 less than 17 percent of total imports had been freed from import permits. The maintenance of the trade barriers gave many domestic producers a monopolistic or an oligopolistic position at a time when controls over domestic prices were being relaxed.

Minimum wages were raised by 30 percent on January 1, 1984 (compared with the 25 percent granted at the beginning of 1983) and then by a further 20 percent in June 1984 (compared with 15.5 percent in mid-1983). The cumulative increase of minimum wages was 57 percent during 1984, compared with just under 45 percent during 1983. These wage increases seem to have contributed to a downward rigidity in inflationary expectations during 1984.

Demand policies became somewhat relaxed toward the second half of the year. In August 1984, the contingency expenditure reserve provided for in the budget was released. Credit policy also became somewhat looser toward the end of the year at the same time that the demand for private credit, which had remained depressed in the early part of the year, began to pick up.

The public sector's economic deficit <sup>1/</sup> for 1984 reached Mex\$1,826 billion on a cash basis (the equivalent of 6.2 percent of GDP), which was lower in proportion to GDP than the one registered in 1983, but in excess of the limit of Mex\$1,524 billion (5.5 percent of GDP) envisaged in the program for the year as a whole (Table 4). In addition, the payment of some Mex\$200 billion of interest due by the Government to the Bank of Mexico at the end of 1984 was postponed to 1985; if these interest payments due but not paid were taken into account, the public sector deficit on a commitment basis would be close to 7 percent of GDP. The deviation of the public sector deficit from the limits established in the program occurred in the latter part of the year and was largely due to higher current expenditures. While in nominal terms revenues of the public sector exceeded the original yearly target and disbursements for investment were slower than budgeted, outlays for interest payments and for goods and services were higher than their original appropriations. The rise in these payments reflected not only the higher than programmed inflation, which affected the level of domestic interest rates, but also some apparent relaxation of expenditure controls.

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<sup>1/</sup> The public sector economic deficit as defined in the program excludes the net lending operations undertaken by the development banks and official trust funds (which are estimated to have amounted to about 1.4 percent of GDP in 1984). These credit operations are covered in the program under the financial intermediation ceiling.

Table 4. Mexico: Summary Public Sector Operations, 1982-85

	1982	1983	1984		1985	
			Program	Actual	Budget	Program
(In billions of Mexican pesos)						
<u>Overall deficit</u>	-1,679	-1,464	-1,524	-1,826	-1,922	-1,785
<u>Public sector receipts</u> 1/	2,851	5,895	8,993	9,419	13,615	13,745
Petroleum exports	812	1,939	2,784	2,780	3,477	3,541
Other PEMEX receipts	156	605	1 090	997	1,552	1,577
Other public enterprises	506	884	1,563	1,700	2,632	2,632
Federal Government	1,070	2,002	2,992	3,218	5,033	4,922
Social security	281	425	522	666	836	988
Federal District	26	41	42	59	85	85
<u>Public sector outlays</u> 1/	4,530	7,359	10,517	11,245	15,537	15,530
<u>Operating expenditure</u> 2/	1,619	2,652	3,975	4,504	6,050	6,070
Interest payments	813	2,182	2,819	3,098	4,195	4,468
Current transfers	477	870	1,213	1,212	1,772	1,656
Other current outlays 3/	667	272	233	540	278	279
Capital expenditure	954	1,383	2,277	1,892	3,243	3,087
<u>Memorandum item</u>						
Current account	-742	-102	730	42	1,255	1,236
Change in GDP Share						
	1982	1983	Actual 1984	Program 1985	1984 1982	1985 1984
(In percent of GDP)						
<u>Overall deficit</u>	-17.8	-8.5	-6.2	-4.1	11.6	2.1
<u>Public sector receipts</u> 1/	30.3	34.4	32.0	31.6	1.7	-0.4
Petroleum exports	8.6	11.3	9.4	8.1	0.8	-1.3
Other PEMEX receipts	1.7	3.5	3.4	3.6	1.7	0.2
Other public enterprises	5.4	5.2	5.8	6.0	0.4	0.3
Federal Government	11.4	11.7	10.9	11.3	-0.4	0.4
Social security	3.0	2.5	2.3	2.3	-0.7	--
Federal District	0.3	0.2	0.2	0.2	-0.1	--
<u>Public sector outlays</u> 1/	48.1	42.9	38.2	35.7	-9.9	-2.5
<u>Operating expenditure</u> 2/	17.2	15.5	15.3	13.8	-1.9	-1.5
Interest payments	8.6	12.7	10.5	10.3	1.9	-0.3
Current transfers	5.1	5.1	4.1	3.8	-0.9	-0.4
Other current outlays 3/	7.1	1.6	1.8	0.7	-5.2	-1.2
Capital expenditure	10.1	8.1	6.4	7.1	-3.7	0.7
<u>Memorandum item</u>						
Current account	-7.9	-0.6	0.1	2.9	8.0	2.8

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

1/ Differs from Table 2 because public sector receipts and outlays are inclusive of public enterprises operating revenue and expenditure, respectively.

2/ Includes wages, goods and services, and Adefas.

3/ Includes exchange losses, net financing requirements of the rest of the public sector, unclassified (Ajenas), and other residual operations.

The public sector deficit in 1984 was financed largely from domestic resources as net foreign financing, at US\$2.2 billion, was well below the US\$4 billion contemplated under the program. The lower use of foreign financing came about partly because of the decision taken in the second half of 1984 to reduce the size of Pemex's acceptance facility with foreign commercial banks (by some US\$480 million) and to postpone until March 1985 the last drawing (for US\$950 million) of the US\$3.8 billion commercial bank loan obtained in 1984.

During 1984 monetary and credit policies continued to be relatively restrained. The net domestic assets of the Bank of Mexico declined by Mex\$53 billion in 1984, whereas the program had envisaged a contraction of Mex\$43 billion, and, as noted above, the accumulation of net international reserves--at US\$3 billion--exceeded by a significant margin the original aim. An active program of auctions of central bank deposits was pursued during the year to mop up liquidity, and interest rates were managed flexibly. In general the policy was to lower nominal interest rates gradually as inflation decelerated, while maintaining--on average--positive real rates on short-term financial savings instruments and a competitive edge vis-a-vis foreign financial assets (Chart 4). Lending rates also followed a general downward trend and the spread between deposits and lending rates narrowed significantly. However, in May 1984, interest rates on deposits were raised to contain speculative pressures induced by rising foreign interest rates.

The adoption of these policies resulted in an acceleration in the growth of financial savings which gained a strong momentum in the third quarter of 1984. The flow of deposits into the banking system, which had declined in real terms in 1982 and 1983, registered strong growth in 1984. However, in December 1984 and January 1985 the growing borrowing requirements of both the public and private sectors significantly outstripped the growth of financial resources. Interest rates remained unchanged from November 1984 to mid-March 1985, when they experienced a substantial upward adjustment. The sharp increase in credit demand in late 1984 and the first two months of 1985 contributed to pressure domestic prices and the reserve position of the Central Bank.

As a result of heavy loan demand in the latter part of 1984, credit to the private sector by development banks and official trust funds (financial intermediation) also exceeded the program limit <sup>1/</sup> that had been established for the year as a whole. The accommodation of this larger demand for credit was facilitated by a stronger growth of deposits in development banks than had been anticipated under the program. This credit, a portion of which is granted at preferential

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<sup>1/</sup> The limit established by the program on these operations of financial intermediation could be adjusted upward by up to Mex\$200 billion to the extent that there was still room under the ceiling for the overall public sector economic deficit, but by December 1984 there was no longer any room under that ceiling.

Table 14. Mexico: Macroeconomic Projections

	1982	1983	1984	Projections	
				1985	1986-90 1/
(Annual percentage changes)					
<u>Production and prices</u>					
Real GDP	-0.5	-5.3	3.5	3.5	4.5 to 6.0
GDP deflator	61.1	94.2	66.0	43.0-48.0	11.0 to 25.8
Consumer price index (end of period)	98.9	80.8	59.2	35.0-45.0	10.0 to 20.0
(As percent of GDP)					
<u>Balance of payments</u>					
Trade balance	4.7	10.2	7.9	6.2	3.1 to 5.3
Net factor payments abroad	-7.1	-6.7	-5.7	-4.9	-3.0 to -4.1
Of which: interest payments on public external debt 2/	(-4.8)	(-5.2)	(-4.8)	(-4.0)	(-2.2 to -3.3)
Other services and transfers	-1.0	0.1	0.1	-0.2	-- to -0.3
Current account excluding factor services	3.7	10.4	8.0	6.0	2.8 to 5.0
Current account	-3.4	3.6	2.3	1.1	-0.2 to 0.9
Net official capital	4.1	3.3	1.3	--	0.3 to 0.5
Private capital (including errors and omissions)	-4.9	-3.1	-1.9	-0.9	-0.5 to 0.2
Net international reserves (surplus -)	4.1	-3.9	-1.7	-0.3	-0.4 to -0.8
<u>Public sector</u>					
Savings	-7.9	-0.6	0.1	2.8	3.7 to 5.3
Capital revenue	0.2	0.1	0.1	0.2	0.1
Investment	9.7	7.4	6.2	7.0	7.5 to 8.6
Other capital expenditure	0.4	0.6	0.2	0.1	0.2 to 0.3
Overall deficit	17.8	8.5	6.2	4.1	3.5 to 3.9
Domestic financing	(14.1)	(5.0)	(4.9)	(4.1)	(3.1) to (3.6)
External financing	(3.7)	(3.5)	(1.3)	(--)	(0.3) to (0.5)
<u>Savings and investment</u>					
Gross national investment	21.2	20.3	19.9	22.0	23.2 to 24.0
Public sector	(9.7)	(7.4)	(6.2)	(7.0)	(7.5) to (8.6)
Private sector 3/	(11.5)	(12.9)	(13.7)	(15.0)	(15.4) to (15.7)
Gross national savings	17.8	23.9	22.2	23.1	23.2 to 24.1
Public sector	(-7.9)	(-0.6)	(0.1)	(2.8)	(3.7) to (5.3)
Private sector	(25.7)	(24.5)	(22.1)	(20.3)	(18.5) to (20.4)
<u>External debt</u>					
Public sector external debt less gross international reserves of the Bank of Mexico 4/	29.3	30.9	28.7	26.9	16.7 to 24.3
(In billions of US dollars)					
<u>External financing and reserves</u>					
Net external financing of the public sector	6.1	5.0	2.2	--	0.6 to 1.5
Change in net international reserves of the Bank of Mexico (increase -)	6.8	-5.5	-3.0	-0.5	-1.0 to -1.8

Sources: Mexican authorities; and Fund staff estimates.

1/ Where a range of values is given, it should not be inferred that the lower number necessarily pertains to 1986 and the higher to 1990; in some cases the opposite is true.

2/ Excludes interest payments on the external debt of the nationalized banking system.

3/ Includes inventory changes.

4/ Excludes the external debt of the nationalized banking system.

The GDP growth contemplated in these projections for the second half of the 1980s is in line with Mexico's historical record in the 1950s and the 1960s--a period when Mexico experienced steady growth without inflation--and it is consistent with a significant growth of per capita GDP. The ratio of total investment to GDP is expected to rise from about 20 percent in 1984 to 22 percent of GDP in 1985 and to the range of 23 to 24 percent of GDP in the 1986-90 period, a level similar to the one prevailing in the early 1970s but significantly lower than the exceptionally high levels achieved in 1980-81 when large investments in energy-related projects were being undertaken. The overall savings ratio, which declined to a low of 18 percent of GDP in 1982, has already moved up somewhat in 1983 and 1984 and is expected to be in the range of 23 to 24 percent of GDP in the 1986-90 period, reflecting mostly an improvement in public sector savings.

A continued decline of the rate of inflation is expected throughout the 1986-90 period on the basis of the pursuit of a prudent demand policy and the improvement of confidence. Most of the corrective price measures that were needed at the beginning of the program period will have been implemented by the end of 1985 and distortions in the price system should have been eliminated. The liberalization of the commercial policies that is contemplated should contribute to an increase in the overall efficiency of the economy and thus help to improve price performance.

#### V. Exchange Arrangements Subject to Fund Approval

The exchange system currently in effect in Mexico involves multiple currency practices subject to Fund approval under Article VIII, Sections 2 and 3 of the Articles of Agreement. These were most recently described in SM/84/155, and Correction 1 (7/2/84). The changes in the system that have taken place since that time have been discussed in the earlier sections of this paper and in the accompanying paper on recent economic developments.

Multiple currency practices arise from the operation of:

- (i) an exchange market comprising a controlled market rate for specified transactions; and
- (ii) a free market rate for all other transactions.

VII. Proposed Decision

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. The Fund and Mexico have held consultations pursuant to paragraph 4(d) of the extended arrangement for Mexico (EBS/82/203, Sup. 4) and as contemplated in paragraph 29 of the letter dated November 10, 1982 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico attached thereto, in order to review the implementation of the measures described in that letter, to reach understandings on the policies and measures that Mexico will pursue over the remainder of the program period, and to establish suitable performance clauses for the year 1985.
2. The letter dated March 24, 1985 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico, together with the Technical Memorandum of Understanding attached thereto (EBS/85/70, 3/25/85), shall be attached to the extended arrangement for Mexico. The letter dated November 10, 1982, together with the Technical Memorandum attached thereto, and the letter dated January 3, 1984 together with the Technical Memorandum attached thereto (EBS/84/1, 1/3/84), shall be read as modified and supplemented by the letter dated March 24, 1985 and the attached Technical Memorandum.
3. Beginning on the effective date of this decision, Mexico will have the right to make purchases under the extended arrangement up to a total amount equivalent to SDR 1,203.745 million, provided that the amount of such purchases shall not, without the consent of the

Fund, exceed (i) the equivalent SDR 295.8 million before August 20, 1985, (ii) the equivalent of SDR 598.4 million before November 20, 1985 or (iii) the equivalent of SDR 901.0 million before December 31, 1985. After December 30, 1985, a purchase may be made if the request for the purchase is submitted on or before December 31, 1985 to be effective on that date, the data for that date are received on or before February 20, 1986 and those data show that the performance criteria were observed as of December 31, 1985.

4. Purchases under the arrangement in accordance with paragraph 3 of this decision may not be made:

(a) during any period in which:

- (i) the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 1 of the attached Technical Memorandum, has not been observed; or
- (ii) the data at the end of the preceding period indicate that the limit on the overall public sector deficit, as specified in paragraph 3 of the attached Technical Memorandum, has not been observed; or
- (iii) the data at the end of the preceding period indicate that the limit on the unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector, as specified in paragraph 4 of the attached Technical Memorandum, has not been observed; or
- (iv) the data at the end of the preceding period indicate that the target for the net international reserves

Mexico--Basic Data

Area and population

Area	1,958,201 sq. kilometers
Population (mid-1984)	76.9 million
Annual rate of population increase (1977-84)	2.7 percent

GDP (1984)

SDR 171 billion
US\$175 billion
Mex\$29,438 billion

GDP per capita (1984)

SDR 2,225

<u>Origin of GDP</u>	<u>1982</u>	<u>1983</u>	<u>Prel.</u> <u>1984</u>
		(percent)	
Agriculture, livestock, and fishing	8.8	9.6	9.5
Mining (including petroleum)	3.8	3.9	3.8
Manufacturing	24.1	23.6	23.9
Construction	5.5	4.7	4.7
Electricity	1.6	1.7	1.8
Commerce	25.4	24.2	24.0
Transport and communications	7.5	7.5	7.6
Financial services	9.8	10.6	10.5
Other services	13.5	14.2	14.2

Ratios to GDP

Exports of goods and services <u>1/</u>	13.5	14.5	15.1
Imports of goods and services <u>1/</u>	16.1	11.9	13.2
Current account of the balance of payments <u>1/</u>	-2.6	2.6	1.9
Central government revenues	16.3	18.6	16.8
Central government expenditures	24.8	26.2	21.9
Public sector savings	-7.9	-0.6	0.1
Public sector overall balance (deficit -) <u>2/</u>	-17.8	-8.5	-6.2
External public debt (end of year)	29.3	31.9	31.0
Gross national savings	17.8	23.9	22.2
Gross aggregate investment	21.2	20.3	19.9
Money and quasi-money (end of year)	34.3	30.0	29.9

Annual changes in selected economic indicators

Real GDP per capita	-3.2	-7.6	0.9
Real GDP (at 1970 prices)	-0.5	-5.3	3.5
GDP at current prices	60.3	82.0	71.7
Domestic expenditures (at current prices)	51.7	69.5	76.2
Investment	(17.5)	(73.5)	(68.4)
Consumption	(65.3)	(68.4)	(78.5)
GDP deflator	61.1	92.2	66.0
Wholesale prices (annual averages)	56.1	107.3	70.3
Consumer prices (annual averages)	58.9	101.9	65.5
Central government revenues	63.9	107.6	55.4
Central government expenditures	69.8	92.4	44.0
Money and quasi-money	70.1	59.2	71.1
Money	(61.9)	(41.5)	(58.4)
Quasi-money	(74.0)	(67.0)	(75.9)
Net domestic credit <u>3/</u>	58.9	47.2	64.0
Credit to public sector (net)	(62.7)	(28.2)	(19.8)
Credit to private sector	(-5.3)	(23.2)	(37.8)
Merchandise exports (f.o.b., in U.S. dollars)	5.7	4.5	9.1
Merchandise imports (f.o.b., in U.S. dollars)	-40.0	-41.0	32.9

<u>Federal government finances</u>	<u>1982</u>	<u>1983</u>	<u>Prel. 1984</u>	
	(In billions of Mexican pesos)			
Revenue	1,532	3,181	4,943	
Expenditure	2,331	4,485	6,459	
Current account surplus or deficit (-)	-331	-557	-662	
Overall deficit (-)	-799	-1,304	-1,516	
<u>Public sector finances</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	
Current account surplus or deficit (-)	-742	-102	42	
Overall deficit (-)	-1,679	-1,464	-1,826	
<u>Balance of payments</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	
	(In billions of U.S. dollars)			
Merchandise exports (f.o.b.)	22.1	23.1	25.2	
Merchandise imports (f.o.b.)	-14.4	-8.5	-11.3	
Travel and border transactions (net)	0.6	1.2	1.4	
Interest on public debt	-7.9	-7.4	-8.5	
Other interest payments	-3.4	-2.9	-2.9	
Other services and transfers (net)	-2.6	-0.3	0.2	
Balance on current and transfer accounts	-5.6	5.2	4.1	
Official capital (net)	6.8	4.7	2.2	
Private capital and errors and omissions (net)	-8.0	-4.4	-3.3	
SDR allocations and gold revaluation	--	--	--	
Change in official net reserves	-6.8	5.5	3.0	
	<u>December 31</u>			
<u>International reserve position</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
	(In millions of SDRs)			
Monetary authorities (net)	4,188.6	-1,779.9	4/ 3,353.3	6,638.6
Monetary authorities (gross)	4,305.0	1,509.6	4/ 4,908.4	9,162.9

1/ In relation to GDP in U.S. dollars at 1979 exchange rate.

2/ Includes net deficit of public sector outside budget control.

3/ Changes are effective flows in relation to the unadjusted stock of liabilities to private sector at the beginning of the period.

4/ Includes as liabilities disbursements under a BIS loan and arrears on interest payments on private debt with foreign commercial banks.

Mexico: Selected Economic and Financial Indicators

	1982	1983	1984		1985 Prog.
			Prog. <sup>1/</sup>	Prel.	
(Annual percentage changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	-0.5	-5.3	1.0	3.5	3.5
GDP deflator	61.1	92.2	50.0	66.0	43.0-48.0
Consumer prices (end of period)	98.9	80.8	40.0	59.2	35.0-45.0
Overall public sector					
Receipts	73.1	106.8	59.0	59.8	44.5
Outlays	80.9	62.5	47.0	52.8	38.2
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	5.7	4.5	8.1	9.1	2.4
Export volume	(19.6)	(5.7)	(6.0)	(7.4)	(4.6)
Imports, f.o.b.	-40.0	-41.0	64.7	32.9	23.9
Import volume	(-43.7)	(-44.6)	(56.1)	(32.5)	(21.5)
Terms of trade (deterioration -)	-17.0	-1.3	-3.4	1.3	-4.0
Nominal effective exchange rate (appreciation -) <sup>2/</sup>					
Average	101.3	138.4	...	37.2	...
End of period	261.6	46.9	...	31.5	...
Real effective exchange rate (appreciation -) <sup>2/</sup>					
Average	30.5	19.4	—	-14.9	—
End of period	86.3	-17.3	...	-16.0	...
Money and credit					
Domestic credit (net) <sup>3/</sup>	58.9	47.2	36.3	64.0	50.8
Public sector <sup>3/</sup>	(62.7)	(28.2)	(16.6)	(19.8)	(22.0)
Private sector <sup>3/</sup>	(-5.3)	(23.2)	(21.9)	(37.8)	(28.8)
Money and quasi-money (M3)	70.1	59.2	43.3	71.1	46.7
Velocity (GDP relative to M3)	2.7	3.1	3.8	3.2	3.3
Interest rate (annual rate, one-year term deposits) <sup>4/</sup>	50.0	47.4	44.0	39.6	40.0
(In percent of GDP)					
Overall public sector savings	-7.9	-0.6	2.6	0.1	2.9
Overall public sector deficit (-)	-17.8	-8.5	-5.5	-6.2	-4.1
Domestic financing	(14.1)	(5.0)	(3.1)	(4.9)	(4.1)
Foreign financing	(3.7)	(3.5)	(2.4)	(1.3)	(-)
Gross domestic investment	21.2	20.3	19.0	19.9	22.0
Gross national savings	17.8	23.9	18.4	22.2	23.1
BOP-current account (deficit -)	-3.4	3.6	-0.6	2.3	1.1
At 1979 exchange rate	(-2.3)	(2.6)	(-0.5)	(1.9)	(0.9)
External public debt <sup>5/</sup>					
Inclusive of Fund credit	38.3	43.6	38.9	35.1	31.5
At 1979 exchange rate	(29.3)	(30.9)	(30.0)	(28.7)	(26.9)
Interest payments on external public debt <sup>6/</sup>	4.7	5.0	4.7	4.5	3.5
At 1979 exchange rate	(3.6)	(3.6)	(3.6)	(3.7)	(3.0)
(In percent of export of goods and services)					
Debt service <sup>7/</sup>					
Before rescheduling	44.6	50.2	42.8	45.4	54.6
After rescheduling	40.1	33.2	32.2	33.6	44.5
(In billions of U.S. dollars)					
Overall balance of payments	-6.8	5.5	2.0	3.0	0.5
Gross official reserves					
(months of merchandise imports) <sup>8/</sup>	0.1	4.9	4.7	7.8	7.5

Sources: Bank of Mexico; Secretariat of Programming and Budget; and Fund staff estimates.

<sup>1/</sup> Annual changes and ratios to GDP in column "Prog. 1984" are those projected at the time of program inception.

<sup>2/</sup> Indices of effective exchange rate measured in terms of local currency per unit of foreign exchange.

<sup>3/</sup> Changes are effective flows adjusted for exchange rate changes in relation to total liabilities to the private sector at the beginning of the period.

<sup>4/</sup> Maximum authorized rate at the end of the period net of withholding tax; excludes compounding.

<sup>5/</sup> Includes short term debt, but net of gross international reserves.

<sup>6/</sup> Interest paid on external public debt, net of interest earned on gross international reserves.

<sup>7/</sup> Includes debt service on Fund credit.

<sup>8/</sup> Excluding gold and payments agreements.

Mexico: Summary of the Financial Program for 1985

I. Targets

1. Real GDP growth is expected to reach 3.5 percent in 1985, the same rate of growth as in 1984. Private sector investment is expected to continue growing at a fast pace. The public sector's relative importance in total expenditure is expected to continue declining, although public sector investment will be increasing in real terms this year.
2. The inflation rate is expected to decline over the program period. The 12-month rate of increase in prices is projected at about 40 percent by the end of 1985 compared with about 59 percent by the end of 1984 and 81 percent by the end of 1983. The year on year price increase is expected to be about 48 percent in 1985.
3. The overall balance of payments surplus is expected to be US\$500 million in 1985 in light of a smaller current account surplus and a negligible net flow of foreign borrowing by the public sector.

II. Assumptions

1. The rate of inflation of Mexico's trading partners is expected to be about 4 1/2 percent in 1985. Crude oil exports are expected to average 1.525 million barrels a day, a small decline in relation to 1984, whereas the prices of crude oil are expected to remain constant at their February levels (i.e., US\$27.75 per barrel for light crude (Ithsmus) and US\$25.50 per barrel for heavy crude (Maya)); nonpetroleum exports are expected to grow at about 16 percent, following an increase of 28 percent in 1984. Import volumes are estimated to grow at a rate of 21 percent reflecting the continued expansion of economic activity and the intensification of the liberalization of commercial policy. The terms of trade are expected to deteriorate by 4 percent in 1984, as export unit values will decline following the fall in the price of oil at the beginning of the year.
2. Public sector net foreign borrowing is projected at less than US\$0.1 billion in 1985 compared with US\$2.2 billion in 1984 and US\$4.7 billion in 1983. Concomitantly with this moderate reliance on foreign borrowing and a projected decline in interest rates, net factor payments are expected to decline from 5.7 percent of GDP in 1984 to 4.9 percent of GDP in 1985.
3. The effective interest rate on Mexico's external debt is projected to decline from 12 1/2 percent in 1984 to 11 percent in 1985.
4. Based on the behavior of financial savings, velocity--which is measured as the ratio of nominal GDP to average financial liabilities to the private sector (including holdings of Federal Government Securities)--is projected to decline from 4.1 in 1984 to 3.8 in 1985.