FOR AGENDA

SM/98/181
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

September 3, 1998

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Mexico—Staff Report for the 1998 Article IV Consultation**

The attached supplement to the staff report for the 1998 Article IV consultation with Mexico (SM/98/181, 7/14/98) has been prepared on the basis of additional information.

Mr. P. Young (ext. 38481) or Mr. Mandeng (ext. 38605) is available to answer technical or factual questions relating to this paper prior to the Board discussion scheduled for tomorrow, Friday, September 4, 1998.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Monday, September 14, 1998; and to the European Commission (EC), the European Investment Bank (EIB), the Inter-American Development Bank (IDB), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 1998 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere and
Policy Development and Review Departments

Approved by Claudio M. Loser and Joaquín Pujol

September 3, 1998

I. Overview

1. This supplement covers economic developments since the staff report (SM/98/181, 7/14/98) was issued. Through July and August, as with all other emerging markets, Mexico has faced continued peso and asset price volatility related to the lingering economic crisis in Asia and growing uncertainties about Russia and about emerging markets in general. Following the sharp deterioration of economic conditions in Russia, financial market pressures intensified in the last two weeks of August, resulting in a sharp depreciation of the peso and a significant increase in interest rates. The government's policy response to the weaker-than-expected international oil prices and the financial turbulence has been broadly as anticipated in the staff report. Specifically, government expenditures have been curtailed, monetary policy has been tightened, and the peso has been allowed to adjust. In the financial turbulence of March–April, moderate increases in interest rates were sufficient to stabilize the markets and contain the depreciation of the peso. However, the recent depreciation has been sharper, notwithstanding a substantial rise in interest rates.

2. The rate of inflation is currently faster than envisaged in the staff report, but so far the market turbulence has not had a major impact on the pace of economic activity. There are signs of a slowdown in portfolio capital inflows and borrowing spreads have increased, but foreign direct investment has been even stronger than envisaged. In summary, there is as yet no strong evidence that Mexico's economic prospects have changed to an extent that would warrant a modification in the thrust of the staff appraisal. Nonetheless, the staff acknowledges that prolonged market turbulence of the intensity of the past two weeks, could have a serious impact on Mexico's economic prospects. Thus, if the financial markets do not rebound in the near future, it may become necessary to re-evaluate the policy mix. In this regard, a staff visit is being planned for late-October, and these issues will be revisited at that time. In the meanwhile, the staff feels that the timely response of the authorities in tightening monetary and fiscal policies has been appropriate, and encourages them to maintain the tightened stance

as long as markets are in turmoil and to take the necessary steps to accelerate the restructuring of the banking system.

II. Financial Market Developments

3. During July and August, the peso depreciated by a further 11 percent with respect to the U.S. dollar, bringing the cumulative depreciation for the year to 23 percent. Over the same period, the stock market index fell by 30 percent, raising the cumulative decline in the first eight months of the year to 43 percent. Short-term interest rates (based on 28-day *cetes* sold at the primary auction), have increased by 700 basis points since end-June and 840 basis points for the year, reaching 27.2 percent on August 25.[1] In the two months to end-August, stripped spreads on the Mexican Brady bonds widened by 500 basis points (raising the stripped spread yield to about 1,100 basis points), compared with an average of almost 700 basis points for all Latin American Bradies.

III. Real GDP and Inflation

4. Recent production indicators confirm a slowdown in economic activity in 1998 compared with 1997. Real GDP growth in the first half of 1998 was 5.4 percent (in relation to the corresponding period of 1997), compared with 7 percent for 1997 as a whole. The growth performance in the first semester remains broadly consistent with the Fund staff projection of 4.7 percent contained in the staff report. The deceleration in real GDP growth in the first half of the year has been largely due to slower growth in agriculture, manufacturing, and commerce. Indicators of private consumption are mixed—growth of output in the commerce sector and of imports of consumer goods declined in the second quarter, but retail sales continued to expand at a strong pace. The annual growth rate of real wages in the manufacturing slowed to 1.8 percent in May–June compared with an annual average of 3½ percent in the first quarter of 1998. Employment growth in the manufacturing sector has remained stable at around 3½ percent during the first half of 1998.

5. The sharp depreciation of the peso has led to higher-than-expected inflation, notwithstanding the tightening of monetary policy by the Bank of Mexico. Cumulative inflation in January–July 1998 reached 9.3 percent, compared with the Bank of Mexico (BOM) target of 12 percent for the year as a whole. The staff expects that, even with a continued tight monetary stance in the remainder of the year, monthly inflation is likely to average about 1 percent, bringing the end-year inflation rate to around 14–15 percent, at the low end of market expectations.

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[1]There was no primary auction on August 31.

IV. Public Finances

6. In early 1998, the government revised the oil price assumption underlying the 1998 fiscal operations (from US$15.5 per barrel to US$12.5 per barrel) and announced expenditure cuts to compensate for a projected decline in oil revenues of about 0.7 percent of GDP. In the first half of 1998, notwithstanding an average oil price of US$10.5 per barrel, (roughly the same level projected at the time of the consultation discussions), the consolidated public sector registered a small surplus (0.1 percent of GDP), compared with an overall deficit (0.6 percent of GDP) previously projected by the mission. While revenues have been in line with staff estimates made at the time of the consultation discussion, government expenditure was substantially below projected levels amid lower interest payments and a sharper-than-expected compression of noninterest current expenditure.

7. In early July, the government announced additional expenditure cuts (of about 0.1 percent of GDP) to compensate—along with higher-than-budgeted non-oil revenues— for a further downward revision in international oil prices to an average price of US$11.5 per barrel for the year. Based on the latest WEO projections for the second half of the year, the average oil price for the Mexican export mix may be around US$10.5 per barrel for the year as a whole. The staff estimates that even at this lower oil price, the overall budget deficit target could be achieved if the expenditure margins accumulated in the first semester are maintained. Recent significant increases in interest rates could put additional pressure on the expenditure margin (on the order of 0.2 percent of GDP), in which case, additional cuts in noninterest expenditure may be needed.[2] The authorities have reaffirmed their intention to achieve the fiscal deficit of 1.25 percent of GDP.

V. Monetary Developments

8. In response to the persistent depreciation pressure on the exchange rate, the BOM has repeatedly tightened monetary policy. There has been a marked increase in the slope of the *cetes* yield curve as long-term rates increased by more than short-term rates. According to the BOM, the slower rise in short-term interest rates was, in part, related to interest rate collusion in the interbank market. In an attempt to increase the effectiveness of monetary policy, the BOM, on August 18, restricted the use of interbank credit lines for meeting liquidity requirements, to 95 percent of the level outstanding as at August 14. In addition as from early September, commercial banks will be required to maintain at the BOM a remunerated reserve deposit (of Mex$25 billion for the system as a whole to be accumulated over time), which will be used in the daily money market auctions. The reserve requirement will allow the BOM to maintain a net creditor position in its open market operations. Through these measures the BOM hopes to increase its ability to influence short-term interest rates. Market participants

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[2]In general, each 10 percentage point increase in domestic interest rates is estimated to increase annual expenditures by 0.6 percent of GDP.

have expressed some concern regarding the transparency of the measures. To allow banks to reduce their interest rate exposure and facilitate the implementation of the monetary policy measures, the Bank of Mexico offered interest rate swaps whereby commercial banks can exchange short-term floating rate payments for fixed rate payments.

9. The measures appear to have achieved their immediate desired objective—short-term interest rates have risen markedly. However, monetary policy will remain constrained by the fragility of the banking system. Sharp increases in interest rates over the past few weeks are likely to put downward pressure on bank profits. A related issue is that the net foreign currency exposure of some of the banks' main debtors could increase credit risks.

10. As of August 31, net international reserves of the BOM had declined by over US$600 million since end-June (standing at US$21.2 billion), largely due to redemptions of government external debt and two consecutive interventions in the foreign exchange market (US$200 million each), in accordance with the automatic intervention mechanism introduced last year.[3]

VI. External Sector

11. Preliminary data put the trade deficit for the first seven months of the year at US$3.6 billion, which was somewhat lower than projected at the time of the consultation discussions. However, as oil prices are expected to be weaker than originally envisaged, there is no basis for revising the staff's projection for the external current account deficit for 1998 (US$16 billion, 3.6 percent of GDP). The lower trade deficit compared with staff projections is largely explained by a larger-than-expected deceleration of import growth (mainly consumer imports) in the last four months, in particular that of consumer imports. Non-oil exports have continued to expand rapidly, increasing by 11½ percent in the first seven months of 1998 compared with the corresponding period of 1997, despite a sharp slowdown in automobile exports in July, due to the General Motors strike.

VII. The Financial Sector Reform Package

12. The package of financial sector reforms sent to Congress in March is still being studied by a congressional commission, but its major component—the assumption by the federal government of some US$65 billion of liabilities now on the books of FOBAPROA—has been a subject of widespread public debate. The controversy has centered on the need to complete a full audit of past transactions of FOBAPROA. Alternative proposals, made by the political

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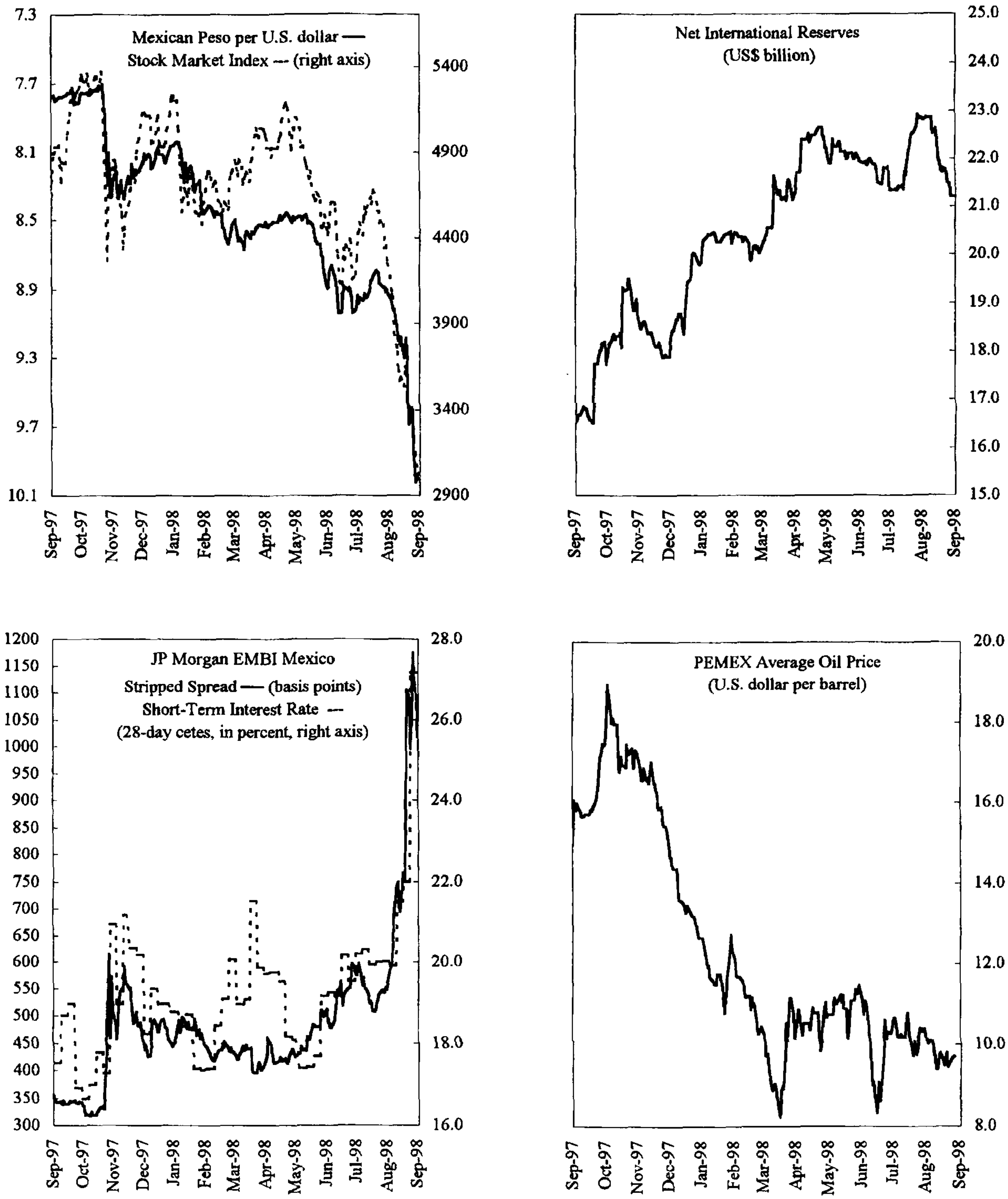
[3] The automatic intervention mechanism, introduced in February 1997, provides for the sale of up to US$200 million per day based on the interday exchange rate depreciation. The mechanism was instituted to help reduce volatility of the exchange rate.

opposition parties, and are now being examined.[4] These proposals include plans for shareholders to bear a greater portion of the cost of the bank bailout. There are also pressures to provide additional support for small debtors. The package is expected to be taken up by the full Congress at the forthcoming session, scheduled to begin in early September.

[4]The assumption by the government of FOBAPROA's liabilities would simply make *explicit* the existing de facto guarantee.

Figure 1. Mexico: Selected Market Indicators



Sources: Bank of Mexico; PEMEX; and JP Morgan.