EBS/10/49
Correction 2

CONFIDENTIAL

March 25, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Mexico—Arrangement Under the Flexible Credit Line and Cancellation of the Current Arrangement**

The attached corrections to EBS/10/49 (3/17/10) have been provided by the staff:

Correction to Remove Evident Ambiguity

Page 9, para. 15, line 2, for "policy framework comprising successful inflation targeting", read, "policy framework, elements of which in Mexico's case include successful inflation targeting"

Page 11, 3rd bullet, line 1, for "Reserve position."
read, "Relatively comfortable reserve position."

Questions may be referred to Mr. Haksar (ext. 37157) and Ms. Vladkova Hollar (ext. 39695) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

Other Distribution:
Department Heads

14. **The access being requested under the FCL arrangement is not out of line compared with other recent high access cases**. The table below compares the access level being requested by Mexico under the FCL to the broader experience of other high access cases in the Fund, across an array of metrics. Access for Mexico at the 1,000 percent level is at or below the median of high access cases on many measures, including as a share of GDP (5 percent), trade (<20 percent of exports or imports), and broad money (8 percent).

Mexico: Proposed Access, 2010

	Proposed Arrangement	Mexico FCL April 17, 2009	Poland FCL May 6, 2009	Colombia FCL May 11, 2009	High-Access Cases 1/ Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Median
Access								
In millions of SDRs	31,528	31,528	13,690	6,966	100	1,169	12,903	5,276
Average annual access (percent of total)	1,000	1,000	1,000	900	100	165	525	244
Total access in percent of: 2/								
Actual quota	1,000	1,000	1,000	900	83	300	941	559
Gross domestic product	5	6	5	5	38	3	9	6
Gross international reserves	44	49	34	44	39	27	84	49
Exports of goods and nonfactor services	17	19	11	33	34	11	39	23
Imports of goods and nonfactor services	16	17	11	29	36	10	33	20
Total debt stock								
Public	12	10	10	15	42	9	33	15
External	24	24	8	22	89	7	20	12
Short-term external 3/	105	77	21	84	84	20	102	36
M2	8	10	11	34	21	8	30	15

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include available data at approval and on augmentation for all the requests to the Board since 1997 which involved the use of the exceptional circumstances clause or SRF resources and arrangements under the FCL. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables

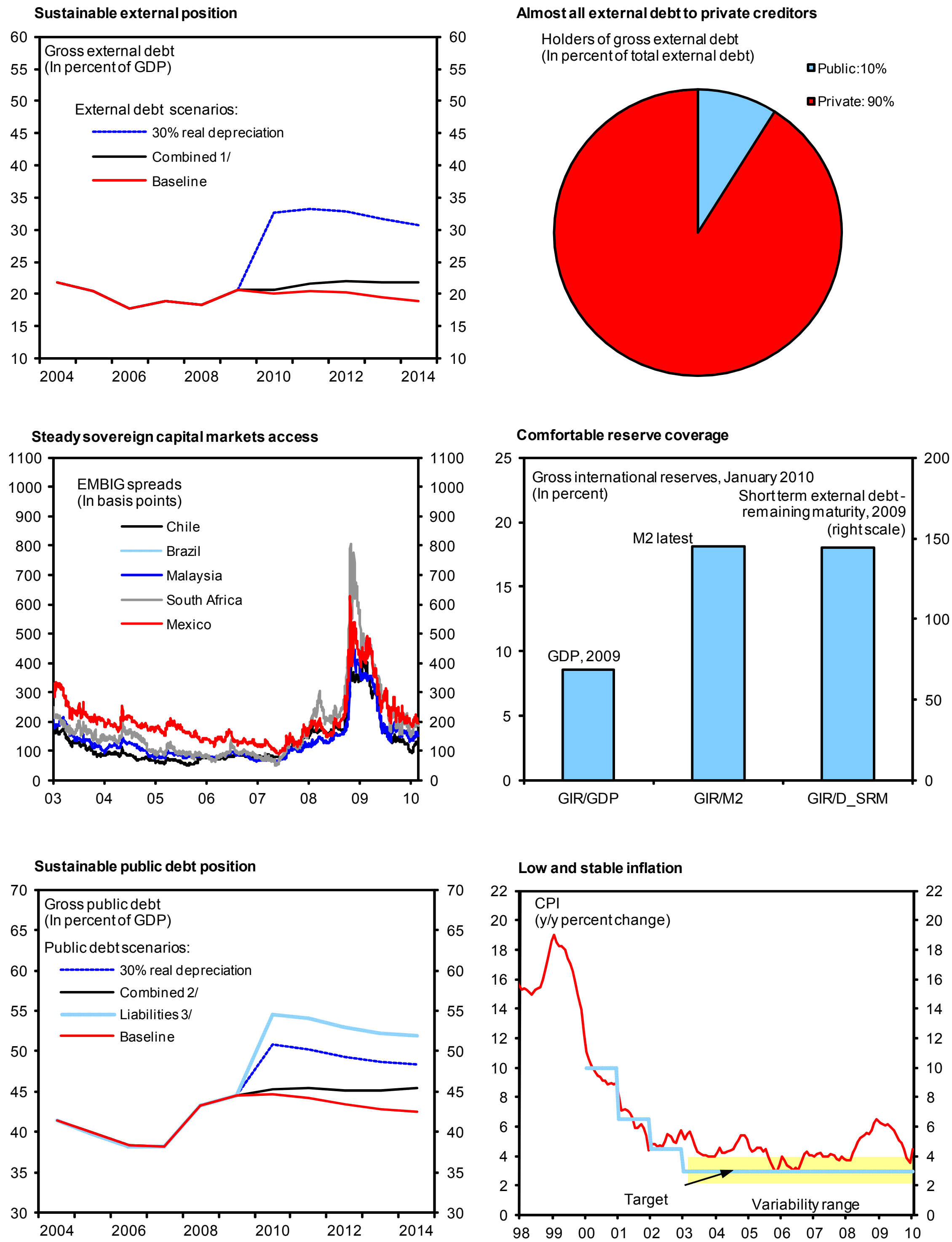
3/ Refers to residual maturity.

Qualification criteria

15. ***The staff believe that Mexico qualifies for an arrangement under the FCL*** (Figure 2). The authorities continue to have in place a very strong ~~policy framework comprising successful inflation targeting~~ policy framework, elements of which in Mexico's case include successful inflation targeting, a credible fiscal rule, and strong bank regulation and supervision. The important tax measures approved in the 2010 budget again demonstrates the authorities' commitment to maintain very strong policies, as acknowledged by the Board during the recent 2010 Article IV consultation.

- **Sustainable external position**. External debt levels are projected to decline from current moderate levels of around 24 percent of GDP to around 20 percent of GDP over the medium term, with public external debt remaining low as well. Among other factors, this reflects the projected external current account deficit being contained at about 1½ percent of GDP. These findings are generally robust to a range of shocks as discussed in the DSA analysis in SM/10/50.

Figure 2. Mexico: Qualification Criteria



Sources: Bloomberg L.P.; Datastream; EMED; Haver Analytics; and IMF staff calculations.
1/ Combined permanent 1/4 standard deviation shocks applied to interest rate, growth, and primary current account balance.
2/ Combined permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time 10 percent of GDP increase in debt-creating flows.

- **Capital account position dominated by private flows**. The overwhelming majority of debt financing in Mexico's balance of payments is from private creditors—debt to official creditor's accounts for about 10 percent of the total external debt stock, and 7 percent of gross flows in 2009.

- **Steady sovereign external access at favorable terms**. Mexico is among the highest-rated emerging markets—notwithstanding last year's rating downgrades by Fitch and S&P's—reflected in a track record of low sovereign external borrowing spreads, including during periods of stress such as during the 2001 recession. While external sovereign spreads have increased since the outbreak of the crisis—as in the case of other highly rated emerging markets—Mexico has retained access at reasonable terms, as demonstrated by the successful placement of US$1 billion in a 10-year bond deal in January 2010 at a yield of 5¼ percent.

- **~~Reserve position~~Relatively comfortable reserve position**. Mexico's reserves more than cover short-term debt falling due and were viewed as comfortable for normal times before the crisis. Moreover, reserves have been rebuilt to pre-crisis levels of over US$90 billion. However, since the crisis investors have drawn attention to lower coverage on balance sheet exposures relative to peers and, as discussed in ¶12, it is now believed prudent for reserves to be increased going forward.

- **Sustainable public debt and sound finances**. Fiscal policy is underpinned by the balanced budget rule as well as the authorities' commitment to keep the augmented public sector deficit (including development banks and other levels of government) at a level that stabilizes the overall public debt. Reflecting this, post-crisis projections for public debt and deficits are only somewhat higher (about 2½ and ½ percentage points of GDP, respectively, on average during 2011–13), further supported by the expected stabilization in oil production levels. The staff's DSA analysis discussed in SM/10/50 shows public debt in Mexico remaining manageable, with public sector gross financing requirements set to continue their trend decline as a share of GDP. No significant contingent liabilities have been incurred thus far in the crisis, with credit guarantees extended by public banks amounting to only about 1 percent of GDP. The authorities' stated medium term agenda includes further efforts to compensate for the projected decline in oil revenues as a share of GDP and to prevent compression of public investment. The authorities have clearly demonstrated their ability to deliver on difficult reforms, passing two major tax reforms since 2007 to begin the process of fiscal consolidation and bringing debt levels down gradually.

- **Low and stable inflation**. Inflation has fallen on a sustained basis in Mexico, including since the introduction of the inflation targeting framework, in the context of a floating exchange rate regime. While headline inflation is rising in 2010, due to the effect of one-off increases in taxes and domestic fuel prices, medium-term inflation expectations have remained well anchored.

- **Absence of systemic bank insolvencies**. The banking system remains liquid and well capitalized. The authorities have moved quickly to address emerging problems in some small institutions, and there are no bank solvency problems that pose an imminent systemic threat. Analysis by Banxico in its 2009 *Financial Stability Report*, and stress tests conducted by staff, show that the system remains well placed to cope with a range of further shocks to credit and market risk.

- **Effective financial sector supervision**. The 2006 FSAP update noted the underlying strength of the regulatory framework and supervisory authorities in Mexico, as well as the substantial progress made since the original FSAP in 2002. Successive Article IV consultations since have echoed these views. The authorities have taken further steps to strengthen the framework for bank resolution and planned to establish a permanent financial stability committee with representatives from the SHCP, Banxico and CNBV. They are also considering tightening the limit on lending by bank subsidiaries based in Mexico to parents abroad, and the disclosure requirement regarding corporates' derivative exposures has also been substantially strengthened.

- **Data transparency and integrity**. The overall quality of Mexican statistics is good, as acknowledged by the 2003 data ROSC. A data ROSC update was conducted in February 2010, and the draft report is being reviewed by the authorities. Mexico has been a subscriber to the SDDS since 1996 and the authorities provide a wealth of data to the public over the internet, with periodicity and timeliness exceeding SDDS requirements in a number of cases. Further measures have been taken to increase the transparency of corporate sector data.

16. ***The authorities' letter (Attachment) highlights their continued commitment to implementing very strong economic policies***. The authorities note that their policy priorities are to support the ongoing recovery, maintain macroeconomic and financial stability, and continue to lay the basis for strong and sustainable medium term growth. In broad terms, fiscal policy remains anchored by the balanced budget rule and medium term budgetary framework, while monetary policy will remain guided by the inflation targeting framework which has effectively anchored medium-term inflation expectations.

17. ***The policy strategy for the period ahead encompasses the following, as discussed during the 2010 Article IV consultation***.

- **Fiscal policy**. The 2010 budget includes the implementation of a major tax reform to offset the permanent revenue losses from the fall in oil production, along with a temporary easing of the balanced budget rule by ¾ percentage point of GDP to cover the cyclical deterioration in tax revenues. As the economy recovers, the authorities plan to return to a balanced budget under the rule by 2012. The authorities are continuing with efforts to restrain and rationalize current expenditure and further