

EBS/89/91

CONFIDENTIAL

May 9, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Mexico - Staff Report for the 1989 Article IV Consultation  
and Request for Extended Fund Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with Mexico and its request for an extended arrangement in an amount equivalent to SDR 2,797.2 million. The letter from the Mexican authorities, together with a technical memorandum of understanding was circulated as EBS/89/66 on April 12, 1989. The text of the proposed extended arrangement and a draft decision will be circulated in a supplement to this paper following the discussions on May 10 and May 19 of the papers on issues relating to debt (EBS/89/77, 4/19/89; EBS/89/78, 4/19/89; and EBS/89/79, 4/20/89).

It is understood that the Executive Director for Mexico will be requesting the Board for a waiver of the circulation period, to enable this subject to be brought to the agenda for discussion at an early date to be announced.

Mr. Loser (ext. 8373) or Mr. Kalter (ext. 8481) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)



INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 1989 Article IV Consultation  
and Request for Extended Fund Arrangement

Prepared by the Western Hemisphere and the Exchange  
and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, Research,  
and Treasurer's Departments)

Approved by S.T. Beza and Eduard Brau

May 9, 1989

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## I. Introduction

The 1989 Article IV consultation discussions with Mexico and negotiations on a program under the Extended Fund Facility were conducted in Mexico City during the period February 13-March 3, 1989 and in Washington during the period March 27-April 7, 1989. The Mexican representatives in the discussions included the Secretary of Finance and Public Credit, the Director General of the Bank of Mexico, the Secretary of Planning and Budget, the Secretary of Labor, the Under-Secretaries of Finance and Public Credit, External Commerce, Planning and Budget, Foreign Investment, Industry and Foreign Trade, and Labor, and senior officials of various ministries, the Bank of Mexico, public enterprises, and other government agencies. <sup>1/</sup> The staff team consisted of Messrs. Loser (Head), Bonvicini, Kalter, Khor (all WHD), and Sheehy (ETR), Ms. Rojas-Suarez (RES), and Mrs. Puri (Secretary--WHD).

In a letter dated April 11, 1989 (with an attached Technical Memorandum of Understanding) the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico describe the economic policies of the Government of Mexico for the period 1989-92 and request use of the Fund's general resources equivalent to SDR 2,797.2 million (an annual access rate of 80 percent of Mexico's quota) under an extended arrangement from the Fund. A copy of the letter of intent together with the Technical Memorandum of Understanding was circulated to the Executive Directors on April 12, 1989 (EBS/89/66). This report describes recent developments in the Mexican economy and the program in support of which the request for Fund resources is being made.

An amount equivalent to 30 percent of total resources made available by the Fund to Mexico would be set aside for the purpose of debt reduction operations. Because the policies on the modalities of these operations are currently being discussed by the Executive Board, the features of the set aside for the specific case of Mexico will be presented in a supplement to this paper. A request for a purchase related to a shortfall in exports and an increase in costs of cereal imports under Section IV of the CCFF Decision is presented in an accompanying paper.

The last Article IV consultation with Mexico was concluded by the Executive Board on March 10, 1988 (EBS/88/23 and Supplement and Correction 1, and SM/88/47) when the second review under the 1986-87 stand-by arrangement was also conducted. That stand-by arrangement, for the equivalent of SDR 1.4 billion (120 percent of Mexico's quota or at an annual access rate of 80 percent), became effective on November 19, 1986 (EBM/86/185) for the period through March 31, 1988. Mexico made all scheduled purchases under the arrangement.

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<sup>1/</sup> Mexico has accepted the obligations of Article VIII, Sections 2, 3, and 4.

As of March 31, 1989 Fund holdings of Mexican pesos subject to repurchase amounted to SDR 3,465.8 million (297.4 percent of Mexico's quota of SDR 1,165.5 million), of which SDR 1,630.5 million was financed from ordinary resources and the remainder from borrowed resources under the policy of enlarged access (Table 1). 1/

On the assumption that purchases and repurchases are made on schedule, full use of the requested extended arrangement would raise the Fund's holdings of Mexican pesos to SDR 3,747.4 million (or about 321.5 percent of quota). In addition, full purchases related to a shortfall in exports and an increase in costs of cereal imports under the CCFE would raise the Fund's holdings of Mexican pesos to SDR 4,213.6 million (or about 361.5 percent of quota).

## II. Recent Developments

### 1. Background

In response to severe economic difficulties experienced in 1981-82, in late 1982 Mexico adopted a comprehensive adjustment program that was supported by the Fund in the form of an extended arrangement covering 1983-85; concurrently, the international financial community extended additional financial resources and agreement was reached on the restructuring of Mexico's external debt. The program's achievements were considerable but by 1985 the adjustment effort had weakened. The situation was made more difficult by a major earthquake in September 1985 and by the effects of a sharp drop in international petroleum prices in early 1986, which led to a decline in export receipts and public sector revenues equivalent to some 6 percent of GDP in 1986.

The Mexican authorities adopted in mid-1986 a program of macroeconomic and structural adjustment. This effort was supported by the Fund and the World Bank, as well as by official creditors and commercial banks. Aided by a reflow of capital, the domestic policy stance led to an improvement in the external payments position in the latter months of 1986. The 12-month rate of increase in consumer prices, however, picked up markedly and the pace of economic activity continued to weaken (Table 2 and Charts 1 and 2).

During 1987 there was a further strengthening of the balance of payments as the external current account shifted from a deficit of about US\$1 billion in 1986 to a surplus of US\$4 billion in 1987 aided by higher oil prices. The capital account also strengthened and there was a build up of some US\$6 1/2 billion in net official international reserves. Real GDP rose by about 1 1/2 percent, but the increase in consumer prices accelerated from 106 percent during 1986 to nearly 160 percent during 1987.

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1/ Additional information on Mexico's relations with the Fund is shown in Appendix I.

Table 1. Mexico: IMF Position (January 1, 1986-June 30, 1992)

	1986	1987	1988	Jan. 1- March 31 1989	Apr. 1- Dec. 31 1989	1990	1991	Jan. 1- June 30 1992
(In millions of SDRs)								
<u>Purchases</u>	<u>741.4</u>	<u>600.0</u>	<u>350.0</u>	<u>—</u>	<u>1,165.5</u>	<u>932.4</u>	<u>932.4</u>	<u>233.1</u>
Ordinary resources	516.4	157.9	—	—	845.4	—	—	—
Credit tranches	516.4	157.9	—	—	—	—	—	—
Extended arrangement	—	—	—	—	379.2	—	—	—
CCFF	—	—	—	—	466.2 <sup>1/</sup>	—	—	—
Borrowed resources	225.0	442.0	350.0	—	320.1	932.4	932.4	233.1
<u>Repurchases</u>	<u>125.4</u>	<u>280.0</u>	<u>419.1</u>	<u>104.5</u>	<u>535.1</u>	<u>877.1</u>	<u>807.4</u>	<u>296.0</u>
Total credit outstanding (end of period)	3,319.4	3,639.4	3,570.3	3,465.8	4,096.2	4,151.5	4,276.5	4,213.6
(In percent of quota)								
Purchases	63.6	51.5	30.0	—	100.0	80.0	80.0	20.0
Total credit outstanding (end of period)	284.8	312.1	306.3	294.2	357.5	356.2	366.9	361.5

Source: International Monetary Fund.

<sup>1/</sup> Provisional.

Table 2. Mexico: Key Economic Indicators

(Percentage change)

	1984	1985	1986	1987	Prel. 1988	Proj. 1989
Real GDP	3.6	2.6	-3.8	1.5	1.1	1.5
Real aggregate domestic expenditure	4.0	4.8	-5.6	-0.1	3.2	1.4
Real private consumption	2.9	4.2	-1.2	-2.2	1.2	1.6
Real fixed investment	6.4	8.1	-12.0	-0.7	3.1	4.6
Import volume	27.1	17.2	-11.7	4.3	43.2	5.6
Export volume	8.0	-4.6	7.4	13.4	1.4	4.7
Terms of trade	-1.9	-5.3	-28.2	10.4	-5.6	--
Consumer price index (end-of-year)	59.2	63.7	105.7	159.2	51.7	18.0
Nominal exchange rate (end-of-year) <u>1/</u>	33.8	92.9	148.5	138.2	2.8	9.3 <u>2/</u>
Real effective exchange rate index (end-of-year) <u>3/</u>	18.5	-20.6	-23.5	3.3	28.7	...
Real minimum wage index	-6.8	-1.7	-9.0	-4.8	-13.1	-11.4
Unemployment (percent of labor force)	6.5	4.7	4.3	3.9	3.6	...

Sources: Mexican authorities; and Fund staff estimates.

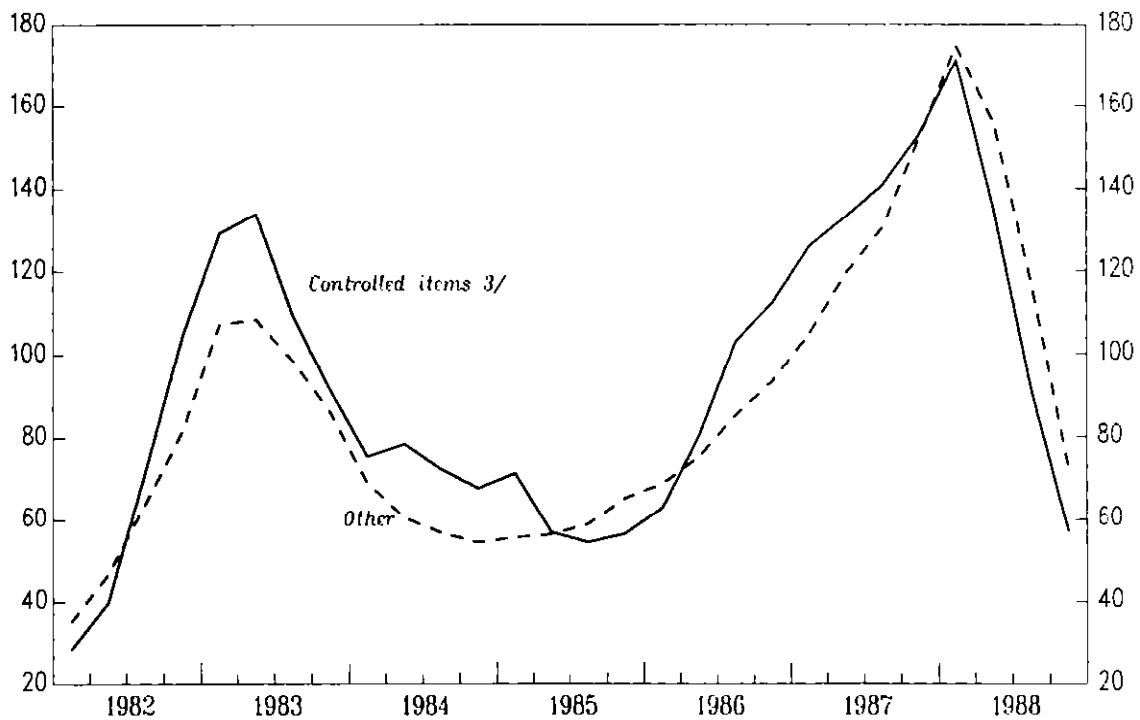
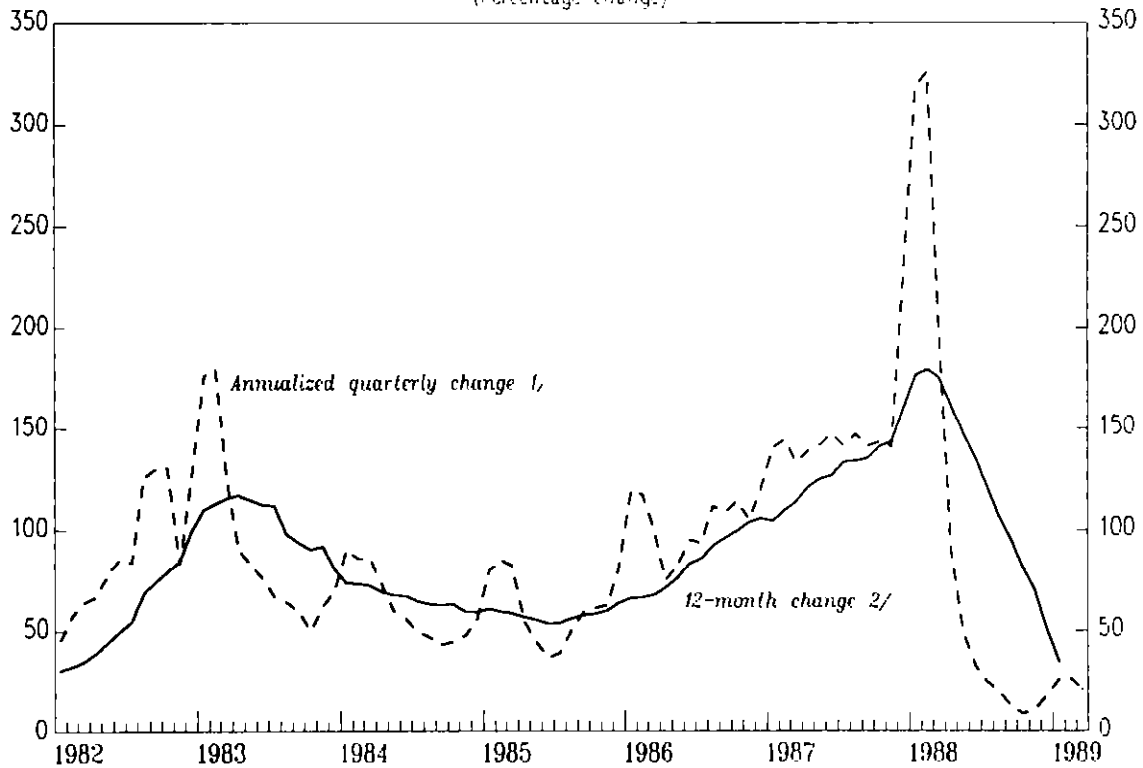
1/ Expressed in Mexican pesos per U.S. dollar.2/ Through July 31, 1989.3/ Increase reflects appreciation.



CHART 1  
MEXICO

CHANGES IN CONSUMER PRICE INDEX

(Percentage change)



Sources: Mexican authorities; and Fund staff estimates.

1/ Change over a three month period, annualized

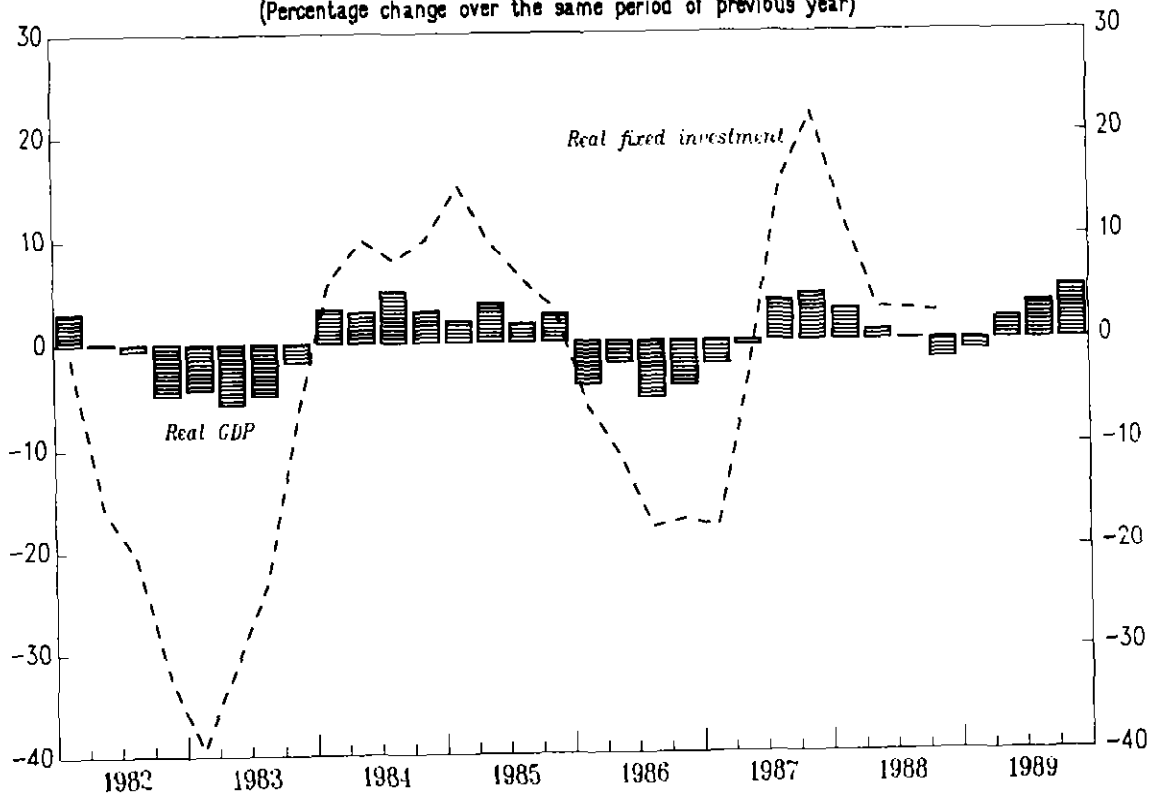
2/ Change over the same month of the previous period

3/ Items under price control



CHART 2  
MEXICO

**CHANGES IN REAL GDP AND FIXED INVESTMENT**  
(Percentage change over the same period of previous year)



Sources: Mexican authorities; and Fund staff estimates.



## 2. Developments in 1988 and 1989

The acceleration of inflation in 1987 reflected to an important extent an increased degree of indexation and more frequent adjustments of wages. In December 1987 the authorities introduced a comprehensive economic program based on a pact with labor and business (the Pact for Economic Solidarity or PACTO), which was aimed at correcting prevailing imbalances and, in particular, at bringing down the rate of inflation. Major adjustments to the exchange rate, minimum wages, and public sector prices and tariffs were put in effect in December 1987, accompanied by further trade liberalization measures and a tightening of credit. A wide-ranging wage-price-exchange rate freeze through March 1988 also was announced at that time.

In 1988 the Mexican authorities took significant policy actions that resulted in an increase in the primary fiscal surplus. Also, in the context of an extension of the PACTO and a major trade liberalization effort, the rate of price increase during the year fell to 52 percent (see Table 2). Domestic real interest rates rose, however, and thus the operational fiscal outcome weakened markedly. The fiscal imbalance led to lower public sector savings, only partly offset by higher private savings. In conjunction with a higher level of investment (including significant inventory accumulation) and a real appreciation of the peso, this resulted in a deterioration of the external current account. The overall balance of payments registered a deficit of US\$6.9 billion, more than offsetting the net reserve gain of 1987. Real GDP increased by 1.1 percent led by a continued growth in exports and higher investment by the private sector (see Chart 2).

The monthly rate of inflation (measured by consumer prices) was 15 1/2 percent in January 1988, following the initial adjustments of prices under the PACTO; however, the rate of price increase decelerated to a monthly average of 2 1/2 percent in the second quarter of the year and 1 percent in the third, before accelerating to 1 1/2 percent in the fourth. After an initial sharp adjustment in early 1988, the previous de facto indexation of wages was broken, and by early 1989 wages were rising at an annual rate of some 12 percent. In real terms, minimum wages declined by over 12 percent on average in 1988 and by almost 20 percent during the year.

The primary fiscal surplus rose from 5.0 percent of GDP in 1987 to an estimated 5.9 percent in 1988, as a consequence of a strong performance in revenues other than petroleum export receipts and tight control over expenditures (Tables 3 and 4 and Chart 3). Because of the major adjustments in public sector prices (notably, gasoline prices and electricity tariffs for nonagricultural use) at the end of 1987, receipts from domestic sales of public sector goods and services remained unchanged in relation to GDP from 1987 to 1988, notwithstanding the freeze in these prices during 1988. At the same time, stepped-up efforts to improve income tax collections and reforms to the income tax system resulted in increased revenue from this source equivalent to

Table 3. Mexico: Macroeconomic Flows  
(Percent of GDP)

	1984	1985	1986	1987	Prel. 1988	Proj. 1989
<b>I. Balance of Payments</b>						
Current account	2.4	0.4	-0.9	2.9	-1.6	-2.4
Trade balance	8.0	5.3	4.5	7.1	2.3	2.1
Exports	14.4	12.4	13.3	15.7	13.0	12.4
Imports	-6.4	-7.2	-8.8	-8.7	-10.7	-10.3
Interest payments	-6.7	-5.5	-6.4	-5.7	-5.0	-5.3
Other	1.1	0.6	0.8	1.6	1.1	0.8
Capital account	-0.7	-2.2	--	1.8	-2.3	3.2
Nonfinancial public sector	1.3	0.2	-0.4	1.8	-0.7	3.1
Private sector	-2.0	-2.4	0.4	--	-1.6	0.1
Net official reserves (increase -)	-1.7	1.9	0.8	-4.7	3.9	-0.7
<b>II. Aggregate Expenditure, Savings, and Investment</b>						
Aggregate domestic expenditure	92.1	95.0	95.7	92.6	97.7	98.0
Consumption	72.2	73.9	77.6	74.0	77.2	76.7
Capital formation	19.9	21.2	18.1	18.6	20.5	21.3
Public sector	6.4	5.7	5.2	5.3	5.1	4.8
Private sector	13.5	15.5	12.9	13.3	15.3	16.4
External savings	-2.4	-0.4	0.9	-2.9	1.6	2.4
National savings	22.3	21.6	17.2	21.4	18.9	18.9
Public sector (adjusted) 1/	6.9	4.9	3.7	7.4	0.9	2.6
Private sector	15.4	16.6	13.5	14.0	18.0	16.3
Domestic savings	28.0	26.4	23.2	26.5	23.1	23.6
<b>III. Nonfinancial Public Sector</b>						
Public sector savings	0.3	-2.7	-9.3	-9.6	-6.0	-0.7
Public sector savings (adjusted) 1/	6.9	4.9	3.7	7.4	0.9	2.6
Fixed investment	6.4	5.7	5.2	5.3	5.1	4.8
Other capital expenditures	0.3	0.2	0.3	0.2	0.2	0.2
Primary balance	4.8	3.3	2.3	5.0	5.9	7.3
Operational balance	0.3	-1.0	-1.8	2.0	-4.4	-2.5
Overall deficit (-)	-7.1	-8.6	-14.8	-15.0	-11.3	-5.8
Public sector borrowing requirement	8.4	9.5	15.6	15.9	12.9	7.0
<b>IV. Financial System Flows</b>						
Liabilities to private sector (M-2)	11.9	7.8	12.1	16.3	6.4	2.7
Net domestic credit	11.0	10.8	14.3	14.5	10.8	2.5
Public sector (net)	4.7	8.4	13.0	9.1	4.2	0.7
Private sector	6.3	4.4	4.7	7.6	5.6	1.9
Other (net)	--	-1.9	-3.4	-2.2	0.9	0.1
Net foreign assets	1.4	-2.3	-1.6	2.7	-3.5	0.5
Net official reserves	1.7	-1.9	-0.8	4.7	-3.9	0.7
Banking system, n.i.e.	-0.3	-0.4	-0.8	-2.0	0.4	-0.3
<b>Memorandum items</b>						
Nominal GDP (in trillions of Mexican pesos)	29.5	47.4	79.4	192.9	197.6	484.2
Nominal GDP (in billions of U.S. dollars)	175.7	184.4	129.9	141.2	176.6	201.1

Sources: Mexican authorities; and Fund staff estimates.

1/ Adjusted for the inflationary component of interest payments on the domestic debt of the nonfinancial public sector.

Table 4. Mexico: Public Sector Operations  
(In percent of GDP)

	1984	1985	1986	1987	Prel. 1988	Prog. 1989
<u>Total financing requirements</u>	8.4	9.5	15.6	15.9	12.9	7.0
Foreign financing	1.3	0.1	-0.2	2.6	0.2	3.1
Domestic financing <u>1/</u>	7.1	9.4	15.8	13.3	12.7	3.9
<u>Financial intermediation <u>2/</u></u>	1.4	0.8	0.9	0.9	1.6	1.2
<u>Overall economic balance on cash basis</u>	-7.1	-8.6	-14.8	-15.0	-11.3	-5.8
<u>Overall balance under budget control</u>	-5.0	-7.2	-13.3	-14.1	-9.8	-5.2
<u>Receipts under budget control</u>	31.3	30.4	29.3	29.6	28.5	27.3
<u>Petroleum receipts <u>3/</u></u>	15.1	13.3	11.3	12.0	9.9	8.5
PEMEX exports	9.4	8.1	4.9	6.0	3.4	2.8
Domestic receipts	5.7	5.2	6.4	6.0	6.5	5.7
<u>Nonpetroleum receipts</u>	16.2	17.1	17.9	17.6	18.6	18.8
Federal government	9.0	9.2	9.8	9.6	10.7	12.1
Public enterprises <u>3/</u>	5.1	5.5	5.9	5.8	5.6	4.6
Social security	2.1	2.3	2.2	2.2	2.3	2.1
<u>Outlays under budget control <u>4/</u></u>	36.3	37.6	42.5	43.7	38.3	32.5
<u>Programmable outlays</u>	20.8	21.5	21.6	20.5	17.9	16.2
Wages and salaries	6.2	6.2	6.1	6.0	5.3	4.8
Total transfers	2.9	3.1	3.2	3.3	2.5	2.4
Other capital expenditure <u>5/</u>	4.2	3.8	3.8	3.7	3.0	2.7
Other current expenditure <u>6/</u>	7.6	8.3	9.1	7.9	6.5	6.3
<u>Nonprogrammable outlays</u>	15.4	15.7	20.1	22.9	20.2	16.3
Interest payments	10.3	11.3	16.3	19.6	16.4	12.8
Exchange losses	0.7	0.4	0.5	0.3	0.4	--
Revenue sharing	2.9	2.7	2.7	2.6	2.8	3.0
Floating debt <u>7/</u>	1.5	1.3	0.6	0.4	0.5	0.5
<u>Unclassified outlays</u>	0.1	0.4	0.8	0.3	0.2	--
<u>Overall balance outside budget control <u>8/</u></u>	-2.1	-1.5	-1.5	-0.9	-1.6	-0.6
Of which: interest payments	-0.2	-0.2	-0.2	-0.3	-0.2	-0.3
<u>Primary balance</u>	4.8	3.3	2.3	5.0	5.9	7.3
Under budget control	6.0	4.5	3.6	5.8	7.1	7.6
Outside budget control	-1.9	-1.3	-1.3	-0.7	-1.2	-0.3
Primary balance less oil exports	-4.6	-4.9	-2.6	-1.0	2.5	4.5
Operational balance	0.3	-1.0	-1.8	2.0	-4.4	-2.5

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

1/ Differs from the domestic financing to the public sector from the financial system appearing in Table 5 because banking system credit to the public sector funded with external resources is classified here as foreign financing. Excludes interest accrued but not paid to the Bank of Mexico.

2/ Includes net lending to the private sector by development banks and official trust funds. Credit extended by these institutions to public sector enterprises is included in "domestic financing". Transfers from the federal government to the development banks and trust funds are included under "transfers."

3/ Includes gross receipts from sales.

4/ Entities under budgetary control include the federal government, the social security system, PEMEX, and 25 other public enterprises. Outlays include public enterprises' costs of producing goods and services.

5/ Includes real and financial investment and acquisition of used capital goods.

6/ Includes operating expenditure other than wages and salaries.

7/ Net carryover of expenditure from previous year's budget.

8/ Entities outside budgetary control include the federal district, the Mexico City Metro, the telephone company, the state and local governments, and many enterprises owned by governments at the federal, state, and local levels. Net financial results for these entities are derived from financing flows.

almost 1 percentage point of GDP. This improvement was offset, however, by the effect of lower oil prices. Hence, total public sector revenue declined from 29 1/2 percent of GDP in 1987 to 28 1/2 percent in 1988. This decrease was more than compensated by a reduction in noninterest expenditures from the equivalent of 23 1/2 percent of GDP in 1987 to under 21 percent in 1988, mainly due to significant declines in expenditures on wages and salaries, transfers, and investment.

As a result of the improved primary balance outcome and lower domestic nominal interest rates, the public sector borrowing requirement (PSBR) declined by 3 percentage points of GDP in 1988 to 13 percent of GDP. However, because of sharply higher real domestic interest rates (Chart 4), the operational fiscal balance moved from a surplus of 2 percent of GDP in 1987 to a deficit of around 4 1/2 percent of GDP in 1988.

Because external financing of the public sector declined significantly in 1988, most of the public sector deficit was financed domestically. Early in 1988, in part reflecting a tightening of monetary policy, bank credit to the private sector contracted sharply. In this period, the financing needs of the public sector were covered by the commercial banks and securities placed with the public. Subsequently, as credit to the private sector expanded sharply, the Bank of Mexico absorbed the financing requirements of the public sector. For the year as a whole, commercial bank credit to the private sector increased by 18 percent in real terms (Tables 5 and 6).

Notwithstanding high real interest rates, the performance of private sector financial savings in the formal banking system was sluggish during much of 1988, reflecting a process of disintermediation in the presence of financial restrictions (Chart 5). In November 1988 the Bank of Mexico brought these operations into the formal banking system by deregulating restrictions on bankers' acceptances and replacing the former reserve requirement regime for these instruments with a liquidity coefficient of 30 percent. This action resulted in a significant reflow of resources into the banking system and for the year as a whole private sector financial assets rose by over 6 percent in real terms (see Table 6). This was still short of the expansion in domestic credit and the net international reserves declined as noted.

The exchange rate for the peso remained unchanged vis-a-vis the U.S. dollar in 1988 except for a small adjustment in February, and the peso appreciated in real effective terms by 29 percent during the year; in terms of unit labor costs the appreciation was around 10 percent (Chart 6). In December 1987 the maximum import duty rate was reduced from 35 percent to 20 percent (except for automobiles) and a number of quantitative import restrictions were eliminated, as part of a major process of trade liberalization.

The external current account shifted from a surplus of about US\$4 billion in 1987 to a deficit of US\$2.8 billion in 1988 (Table 7 and

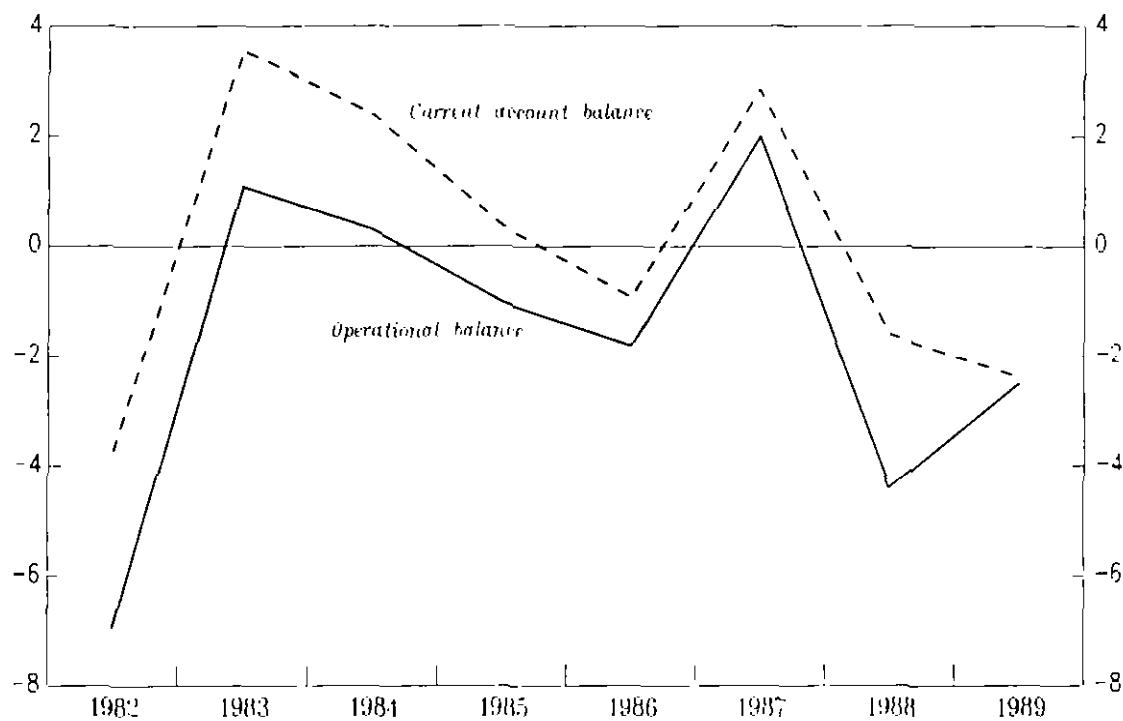
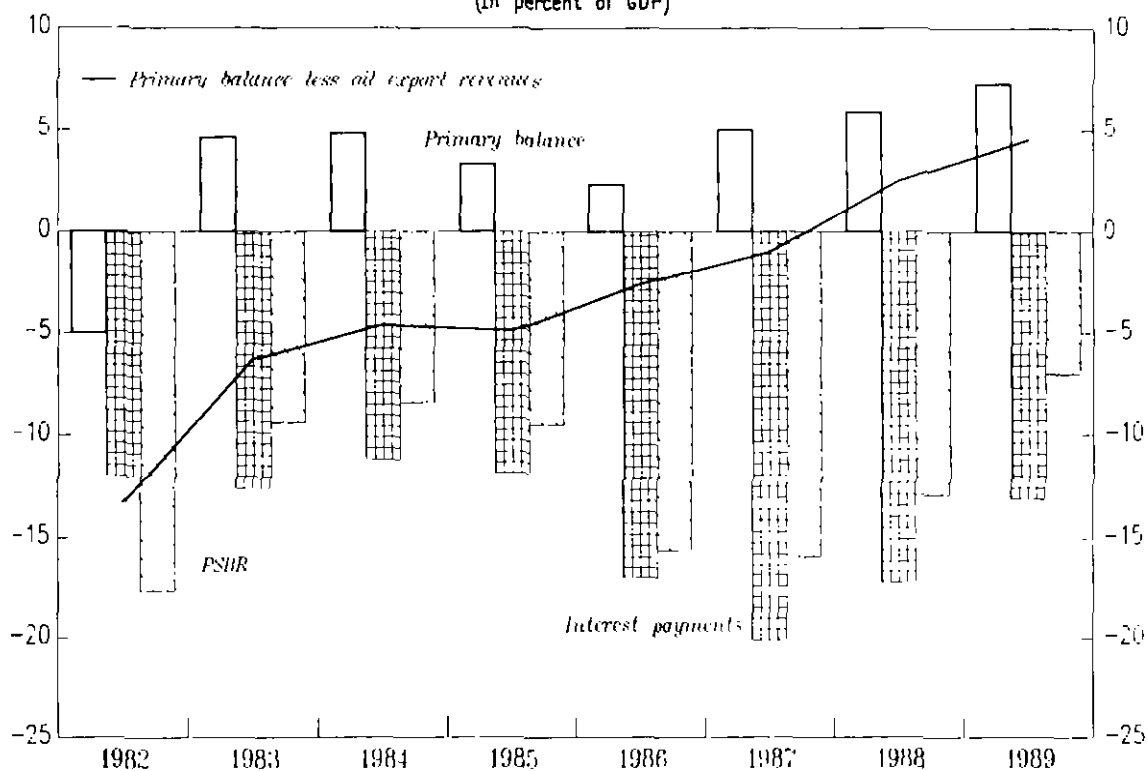


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CHART 3  
MEXICO

FISCAL AND EXTERNAL DEVELOPMENTS

(In percent of GDP)

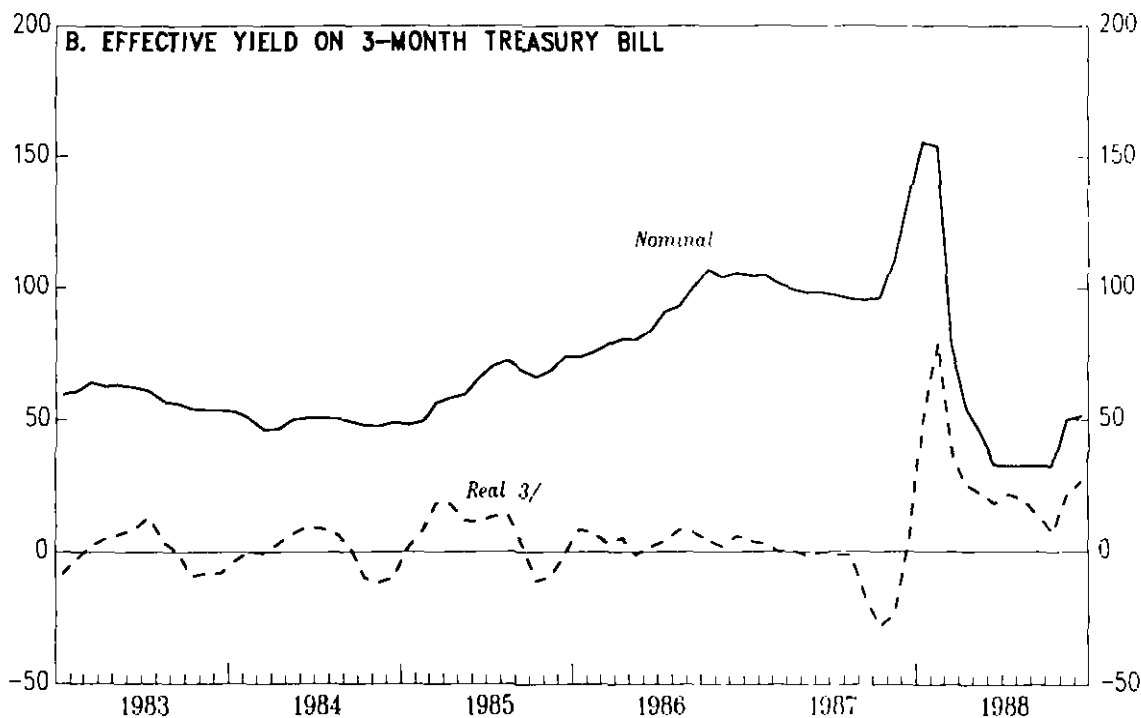
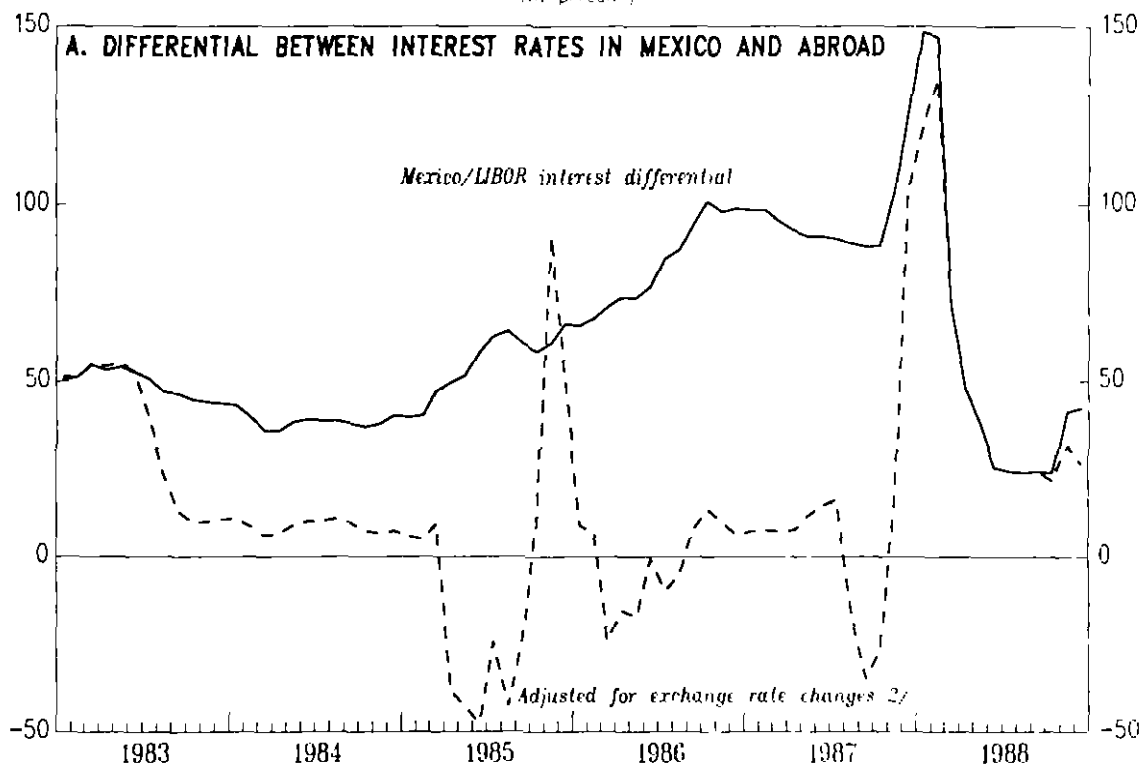


Sources: Mexican authorities; and Fund staff estimates.



CHART 4  
MEXICO

INTEREST RATES ON PESO DENOMINATED INSTRUMENTS 1/  
(in percent)



Sources: Mexican authorities; and Fund staff estimates

1/ Based on 3-month Treasury bill rate

2/ Adjusted for 3-month change in the nominal exchange rate

3/ Adjusted for 3-month change in consumer prices.



Table 5. Mexico: Summary Operations of the Financial System

	Actual Stocks Dec. 1987	Effective Flows				Prel.	Proj.
		1984	1985	1986	1987	1988	1989
(In billions of Mexican pesos)							
I. Bank of Mexico							
Net international reserves	18,865	501	-788	-177	6,792	-15,075	3,781
Net domestic assets	-11,547	-60	1,401	1,503	-2,532	21,257	-977
Net credit to the public sector	9,867	752	1,900	3,411	1,745	17,500	3,600
Credit to private sector	587	6	11	27	27	2	--
Other (net)	-1,093	-818	-510	-2,035	-4,304	3,419	-4,577
Note issue	7,318	441	613	1,326	4,260	5,846	2,804
II. Financial System							
Net foreign assets	20,771	442	-761	-202	6,903	-15,075	3,781
Net domestic credit	121,930	3,250	5,111	11,370	28,329	44,103	12,706
Net credit to public sector	106,774	1,372	3,964	10,325	17,852	17,200	3,600
Net credit to private sector	38,521	1,865	2,077	3,733	14,800	23,000	9,400
Other (net)	-23,365	13	-930	-2,688	-4,323	3,903	-299
Medium-and long-term foreign obligations	79,230	21	312	1,104	1,720	-1,150	1,500
Liabilities to nonbank public financial intermediaries	4,811	163	350	446	1,537	4,100	1,500
Liabilities to private sector (M-2)	58,660	3,508	3,688	9,618	31,975	26,078	13,487
(Percentage change in relation to note issue at the beginning of the period)							
Bank of Mexico's net domestic assets	...	-8.6	127.4	88.4	-81.7	286.6	-7.5
Bank of Mexico's net credit to the public sector	...	107.4	172.7	206.5	56.3	239.7	27.5
Note issue	...	63.0	55.7	78.0	137.4	80.1	21.4
(Percentage change in relation to liabilities to private sector at the beginning of the period) 1/							
Net domestic asset	...	53.3	49.6	72.9	89.1	53.7	9.2
Net credit to public sector	...	22.5	38.5	66.2	56.1	21.0	2.6
Credit to the private sector	...	30.6	20.2	23.9	46.5	28.0	6.8
Liabilities to private sector (M-2)	...	57.5	35.8	61.7	100.6	31.8	9.7
(In percent of GDP)							
Net domestic credit	62.3	11.0	10.8	14.3	14.5	10.8	2.5
Net credit to public sector	54.6	4.7	8.4	13.0	9.1	4.2	0.7
Credit to private sector	19.7	6.3	4.4	4.7	7.6	5.6	1.9
Liabilities to private sector (M-2)	30.0	11.9	7.8	12.1	16.3	6.4	2.7

Sources: Mexican authorities; and Fund staff estimates.

1/ In respect to total liabilities to the private sector (M-4).

Table 6. Mexico: Financial Flows

(In trillions of Mexican pesos, unless otherwise indicated)

	1986	1987	Prel. 1988	Proj. 1989
<u>Total sources of funds</u>	<u>15.1</u>	<u>53.0</u>	<u>52.8</u>	<u>46.6</u>
Growth of M-4	16.2	50.3	50.9	31.0
(percentage real annual growth)	(-0.9)	(-0.4)	(6.8)	(4.5)
Foreign borrowing by public sector	-0.1	5.1	0.9	15.6
(billions of U.S. dollars)	(-0.2)	(3.7)	(0.4)	(6.3)
Other deposits (net)	-1.1	-2.3	1.0	--
<u>Total use of funds</u>	<u>15.1</u>	<u>53.0</u>	<u>52.8</u>	<u>46.6</u>
International reserve accumulation	-0.7	9.0	-15.6	3.7
(billions of U.S. dollars)	(-1.1)	(6.6)	(-6.9)	(1.5)
Public sector borrowing requirement	12.4	30.6	51.2	33.9
(percent of GDP)	(15.6)	(15.9)	(12.9)	(7.0)
Financial intermediation	0.7	1.7	6.3	5.9
Economic deficit	11.7	28.9	44.9	28.0
External	-0.1	5.1	0.9	15.6
Domestic	11.8	23.8	44.0	12.4
Commercial bank credit to private sector	3.4	13.4	17.2	9.0
(percent real annual growth)	(-18.9)	(-0.6)	(17.7)	(4.2)

Sources: Mexican authorities; and Fund staff estimates.

Table 7. Mexico: Summary Balance of Payments  
(In billions of U.S. dollars)

	1984	1985	1986	1987	Prel. 1988	Prog. 1989
<u>Current account 1/</u>	4.2	0.7	-1.2	4.0	-2.8	-4.8
Merchandise trade, f.o.b.	14.1	9.7	5.9	10.0	4.1	4.3
Exports	25.4	22.9	17.3	22.2	23.0	25.0
Petroleum and derivatives	16.6	14.8	6.3	8.6	6.7	6.5
Other	8.8	8.2	11.0	13.6	16.3	18.5
Imports	-11.3	-13.2	-11.4	-12.2	-18.9	-20.8
Public sector	-4.8	-4.4	-3.3	-2.8	-3.6	-3.8
Private sector	-6.5	-8.8	-8.1	-9.4	-15.4	-16.9
Factor income	-10.1	-8.9	-7.7	-7.2	-7.4	-9.5
Interest on public debt	-8.3	-7.5	-6.1	-6.0	-6.9	-8.0
Other interest payments	-3.4	-2.7	-2.2	-2.1	-2.0	-1.7
Other	1.7	1.3	0.6	0.9	1.4	1.1
Other services and transfers	0.2	-0.1	0.7	1.2	0.6	0.4
Travel	1.3	1.1	1.2	1.5	1.4	1.6
Border transactions	-0.2	-0.4	-0.4	-0.4	-0.6	-0.6
Other	-0.9	-0.7	-0.2	0.1	-0.2	-0.6
<u>Capital account</u>	-1.2	-4.1	0.1	2.5	-4.1	6.3
Official capital	2.1	0.3	-0.5	2.6	-1.2	6.1
Commercial banks	2.4	0.2	-0.4	4.4	-1.5	4.3
Multilaterals	0.6	0.7	0.9	0.4	0.8	1.4
Bilaterals and suppliers 2/	-0.5	-0.1	0.2	1.4	1.0	1.2
Other (including short term)	-0.4	-0.5	-1.2	-3.6	-1.5	-0.8
Private capital	-3.4	-4.4	0.5	---	-2.8	0.2
Interest earnings abroad	-1.5	-1.4	-1.1	-1.2	-1.3	-1.5
Direct investment	0.4	0.5	1.5	3.2	1.7	2.1
Net external credits	0.4	-1.0	-0.8	-2.6	-3.0	-0.9
Other payments and errors and omissions	-2.6	-2.6	0.9	0.5	-0.2	0.5
<u>Net international reserves</u> (increase -)	-3.0	3.4	1.1	-6.6	6.9	-1.5
Of which: arrears	-0.3	--	--	--	--	--
<u>Memorandum items</u>						
As percent of GDP						
Nonpetroleum exports	5.0	4.4	8.5	9.6	9.2	9.2
Merchandise imports	6.4	7.2	8.8	8.7	10.7	10.3
Current account balance	2.4	0.4	-0.9	2.9	-1.6	-2.4
Gross international reserves 3/						
In months of:						
Merchandise imports	7.8	4.3	5.8	12.1	3.3	4.2
Imports plus interest payments	3.8	2.4	3.4	7.2	2.2	2.8
Crude oil export volume ('000 bpd)	1,525	1,438	1,288	1,345	1,307	1,300
Average crude oil price (US\$/bbl)	26.8	25.4	11.9	16.0	12.3	12.0

Sources: Mexican authorities; and Fund staff estimates.

1/ Interest rebate is included as a receipt in transfers within the current account in all years.

2/ Including CCC.

3/ Excluding gold and payments agreements.

Chart 7). The merchandise trade surplus declined from US\$10 billion in 1987 to US\$4.1 billion in 1988. Exports increased marginally as a 20 percent increase in nonpetroleum exports was mostly offset by a decline in petroleum exports caused by a drop in average oil prices from US\$16 a barrel in 1987 to US\$12 a barrel in 1988 (Chart 8). At the same time, imports rose by almost 55 percent, reflecting the strong growth in domestic demand, the real appreciation of the peso and the liberalization of the trade system.

The capital account was in deficit by over US\$4.1 billion in 1988. The official capital account shifted from a surplus of US\$2.6 billion in 1987 to a deficit of US\$1.2 billion in 1988 as net inflows from commercial banks of US\$4.4 billion in 1987 gave way to net outflows of US\$1.5 billion in the following year (see Table 7). Direct foreign investment remained at around US\$1 3/4 billion in 1988. However, there was a large outflow of private capital, largely associated with private sector debt reduction operations for a total of US\$3 billion. As noted, net international reserves declined by US\$6.9 billion (see Chart 7). By end-December 1988, the gross international reserves were equivalent to about three months of imports of goods and interest payments.

In December 1988, a new pact for economic growth and stability (PECE) was announced for 1989. The PECE has specific guidelines through end-July. The peso is being depreciated at a rate of 1 peso per dollar a day (initially equivalent to 1.3 percent a month). Minimum wages were increased by 8 percent and public sector prices and tariffs were raised, except for gasoline, diesel, and electricity and gas for residential use.

The monthly rate of inflation was 2.4 percent, 1.4 percent and 1.1 percent in January, February, and March 1989, respectively, and has resulted in some depreciation of the peso in real effective terms. Interest rates have remained at about 4 percent a month, implying a real rate of about 3 percent a month in March. Preliminary indications are that the fiscal accounts strengthened considerably in the first quarter of 1989, with the primary surplus reaching 8 1/2 percent of GDP, reflecting a strong effort to restrain expenditures. With the average cost of funds for the Government at around 4 percent a month, the PSBR is estimated at around 7 percent of GDP during this period. While the external current account is estimated to have been in deficit, net private sector inflows were sufficient for net international reserves to remain broadly unchanged for the quarter.

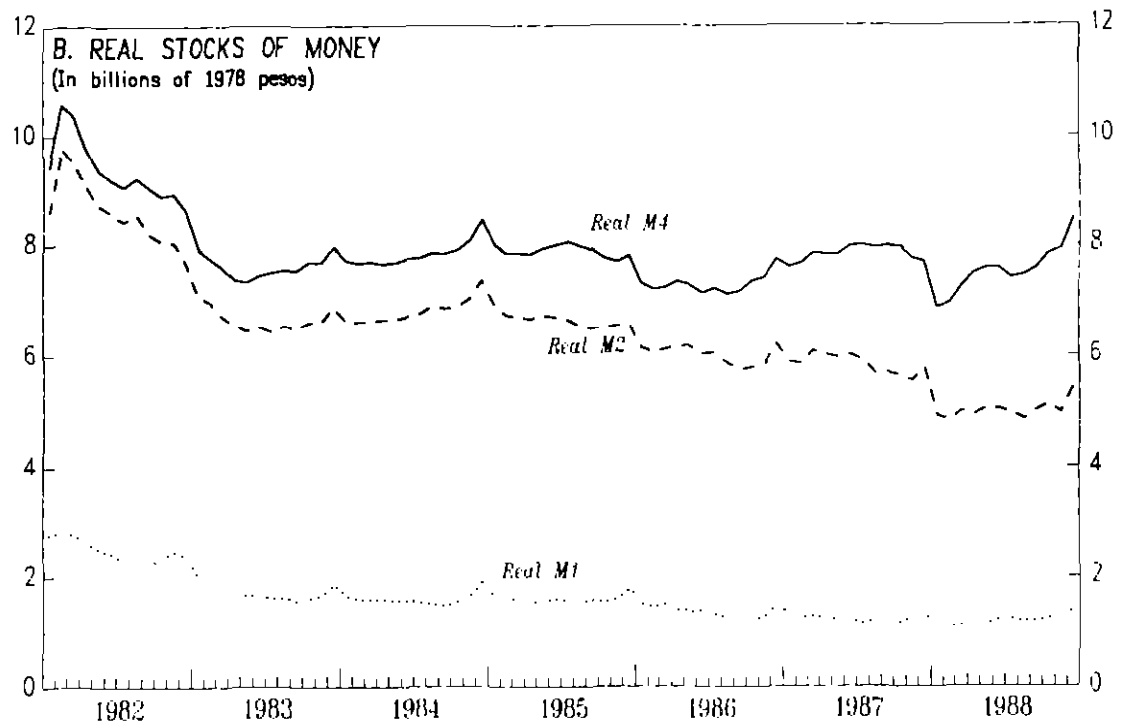
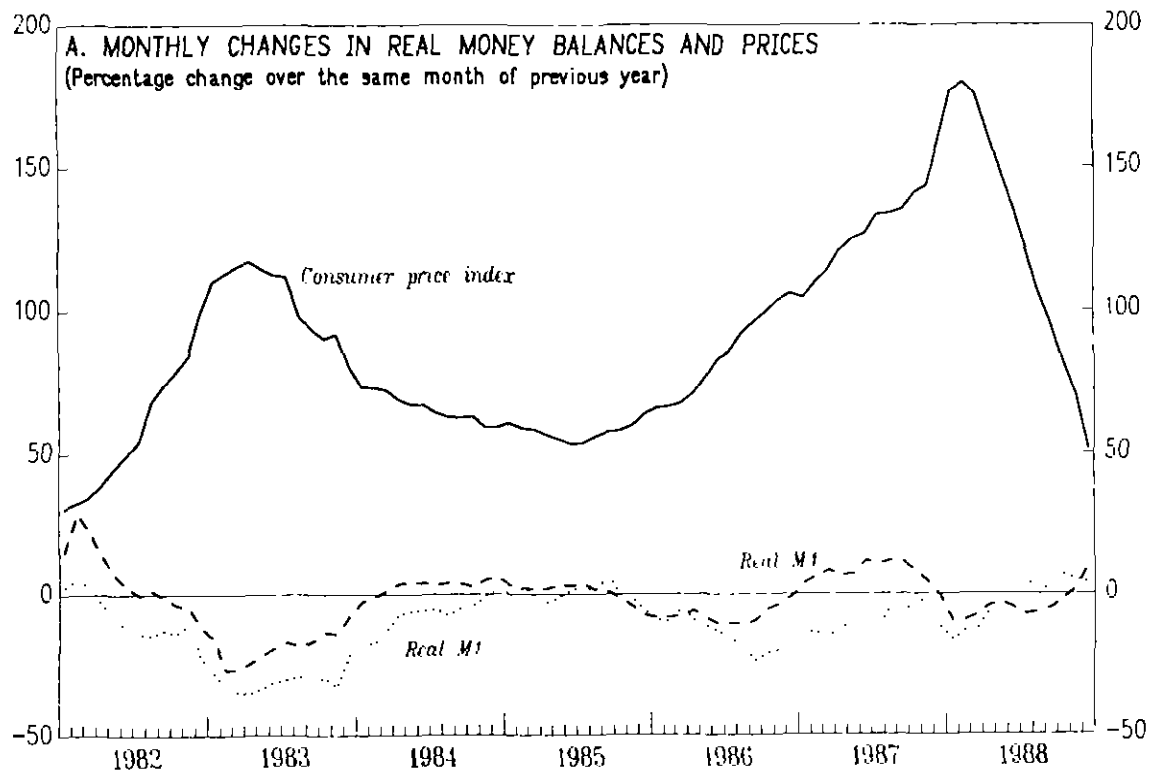
### III. The Medium-Term Policy Framework

The authorities' economic strategy seeks to consolidate the progress made in reducing inflation and to lay the basis for sustained economic growth, including the creation of conditions for increases in real wages. To achieve these objectives, the program for 1989 has been



CHART 5  
MEXICO

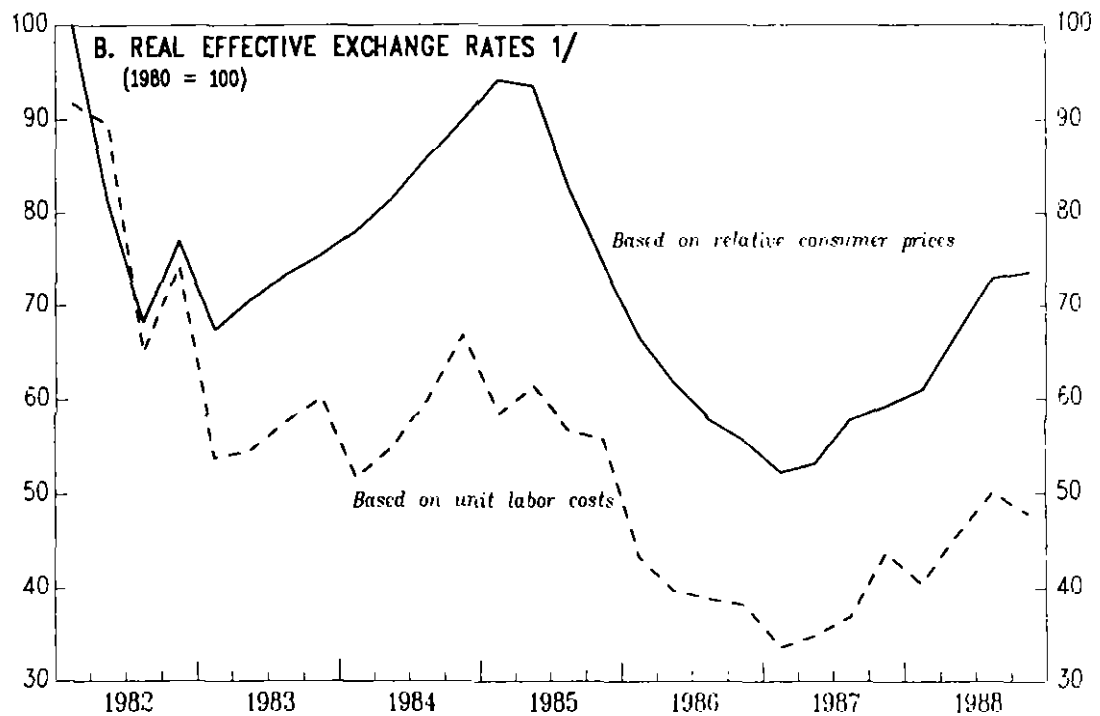
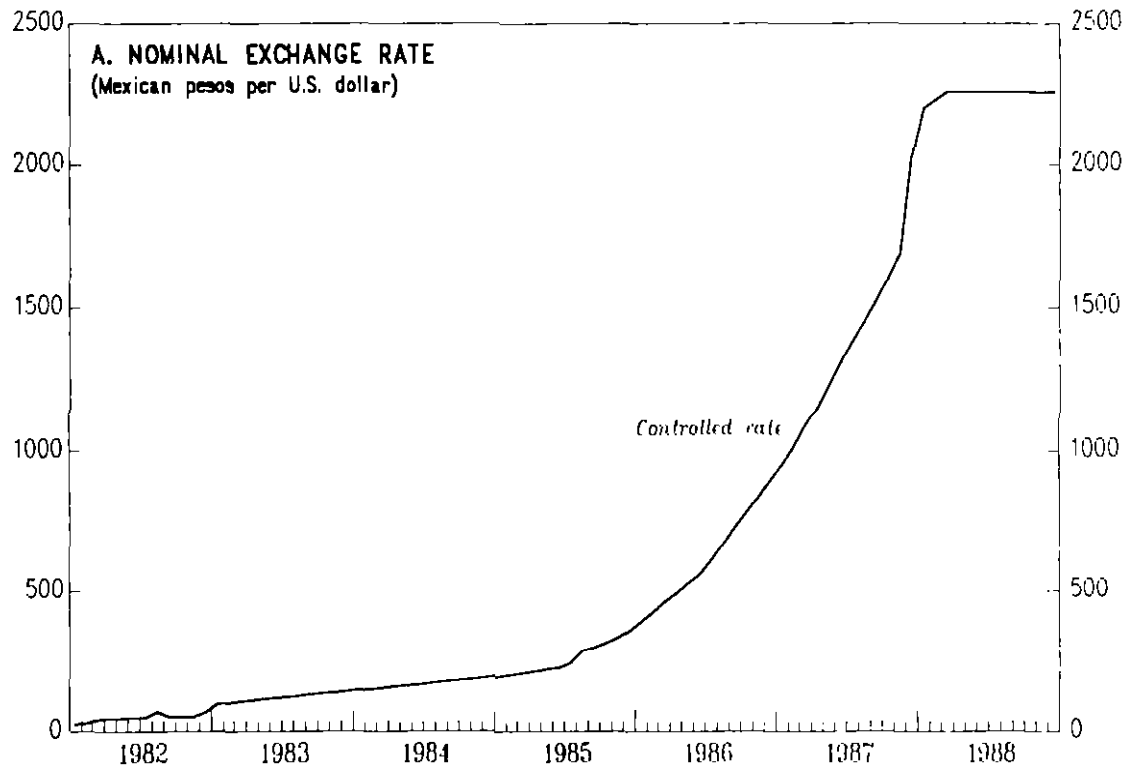
INDICATORS OF REAL MONEY BALANCES



Sources: Bank of Mexico; and Fund staff estimates.



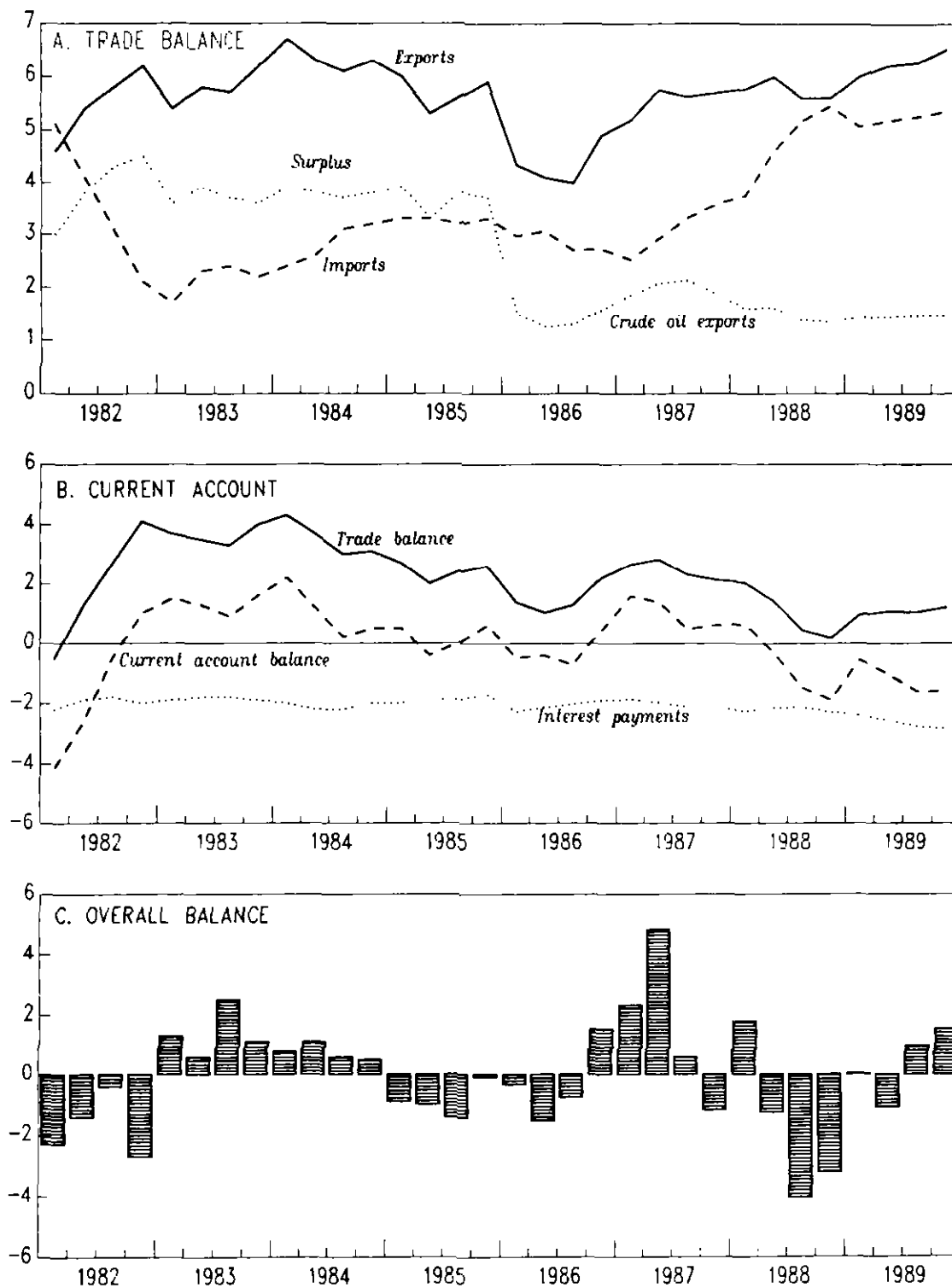
CHART 6  
MEXICO  
EXCHANGE RATE INDICES



Sources: Mexican authorities; and Fund staff estimates.  
1/ Based on controlled market rate. Decline reflects depreciation.



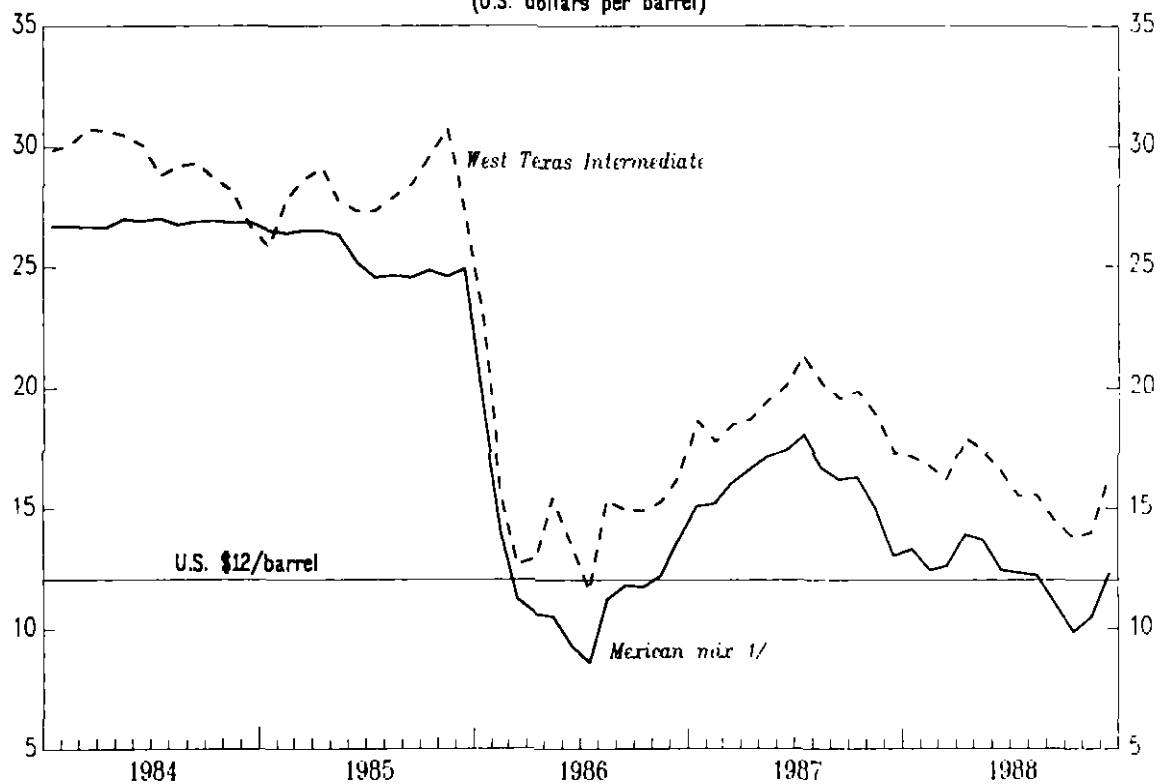
CHART 7  
MEXICO  
**QUARTERLY BALANCE OF PAYMENTS**  
(In billions of US dollars)



Sources: Mexican authorities; and Fund staff estimates



CHART 8  
MEXICO  
**CRUDE OIL PRICES**  
(U.S. dollars per barrel)



Sources: PEMEX; and Fund staff estimates.

1/ Average price of Mexican exports of Maya, Isthmus, and Olmeca crudes.





formulated in a medium-term framework, and includes financial and structural policies needed to foster economic efficiency and increase investment. The aim is to attain an increase in both public and private sector savings, an outward-looking orientation of the economy, an increase in foreign direct investment and capital reflows, and a reduction in the debt service burden, including operations that would result in significant reductions in both external debt and debt-service.

The Mexican program is based on a significant reduction in the net resource transfer of Mexico to its creditors from previous high levels. To this end, Mexico has embarked on wide-ranging negotiations on financing from its commercial creditors while continuing to seek access to new resources from official bilateral and multilateral creditors.

While financial support from the international financial community is essential to the Mexican program, the authorities recognize that the success of the program will depend crucially on their internal efforts. Therefore, they are committed to continue to deepen the structural reforms introduced in earlier years, while preserving the gains made with regard to relative prices and inflation. They consider that only under these conditions will growth be sustainable and the general welfare of the Mexican population improve. The Mexican authorities will be monitoring their economic program closely and are determined to introduce in a timely fashion all necessary corrections to their policies. In their view, an essential ingredient for the success of their policies would be an open trade system abroad, and an environment conducive to a reduction of the debt burden in a lasting fashion.

#### 1. Medium-term scenarios

##### a. General trends

On the basis of the authorities' quantitative objectives the staff has prepared a baseline medium-term scenario (Table 8 and Chart 9), based on the assumption that all financing will be provided through a traditional new money approach and that appropriate financial and structural policies are in place, as described in Section III.2 below. This baseline scenario assumes optimal conditions, namely that all needed new financing is available and that there are no adverse repercussions from the resulting debt burden on investment and capital flows. In fact, it is likely that if the domestic package were to be supported with new money only, investment and GDP growth would be lower than in the baseline scenarios as illustrated by a low growth scenario developed by the staff (see Chart 9). Under these circumstances, the rate of GDP growth expected under the program would be likely to materialize only if significant debt reduction operations were present. While the staff has not made a judgement regarding the amount of debt reduction that may be necessary to enable Mexico to achieve its

Table 8. Mexico: Medium-Term Scenario

	Prel. 1988	Projection					
		1989	1990	1991	1992	1993	1994
(Annual percentage change)							
Real GDP	1.1	1.5	3.5	4.5	5.5	6.0	6.0
Consumer prices (average)	114.2	21.9	15.0	7.0	6.0	6.0	6.0
Consumer prices (end of year)	51.7	18.0	12.0	6.0	6.0	6.0	6.0
(In percent of GDP)							
<u>External sector</u>							
Current account (deficit -)	-1.6	-2.4	-2.0	-2.0	-2.0	-2.0	-2.0
Of which: exports (fob)	13.0	12.4	12.5	12.3	12.2	12.0	11.9
imports (fob)	-10.7	-10.3	-10.3	-10.3	-10.5	-10.5	-10.6
interest payments	-5.0	-5.3	-5.1	-4.9	-4.7	-4.5	-4.3
Official capital (net)	-0.7	3.0	2.2	2.3	1.8	1.8	1.7
Private capital (net)	-1.6	0.1	0.2	0.3	0.5	0.5	0.5
Net reserve movement (increase -)	3.9	-0.7	-0.4	-0.5	-0.3	-0.3	-0.3
<u>Nonfinancial public sector</u>							
Primary balance	5.9	7.3	6.1	5.5	5.2	4.9	4.4
Operational balance	-4.4	-2.5	-0.9	-0.9	-0.9	-0.8	-0.9
Public sector borrowing requirement	12.9	7.0	5.0	3.3	3.0	2.7	2.7
<u>Savings and investment</u>							
Gross domestic investment	20.5	21.3	23.6	24.6	26.3	27.5	27.5
Public sector	5.1	4.8	5.1	5.5	5.9	6.4	6.6
Private sector	15.3	16.4	18.4	19.1	20.3	21.1	20.9
Gross national savings	18.9	18.9	21.6	22.6	24.3	25.5	25.5
Public sector <sup>1/</sup>	0.9	2.6	4.4	4.8	5.2	5.8	5.9
Private sector	18.0	16.3	17.2	17.9	19.1	19.7	19.6
External savings	1.6	2.4	2.0	2.0	2.0	2.0	2.0
<u>Memorandum items</u>							
Nominal GDP (billions of U.S. dollars)	176.6	201.1	216.7	237.6	260.7	287.4	316.8
Velocity of money (GDP/M-4)	3.7	3.3	3.3	3.2	3.2	3.2	3.2
Gross ICOR	15.1	10.7	5.5	4.6	4.0	3.9	3.9

Sources: Mexican authorities; and Fund staff estimates.

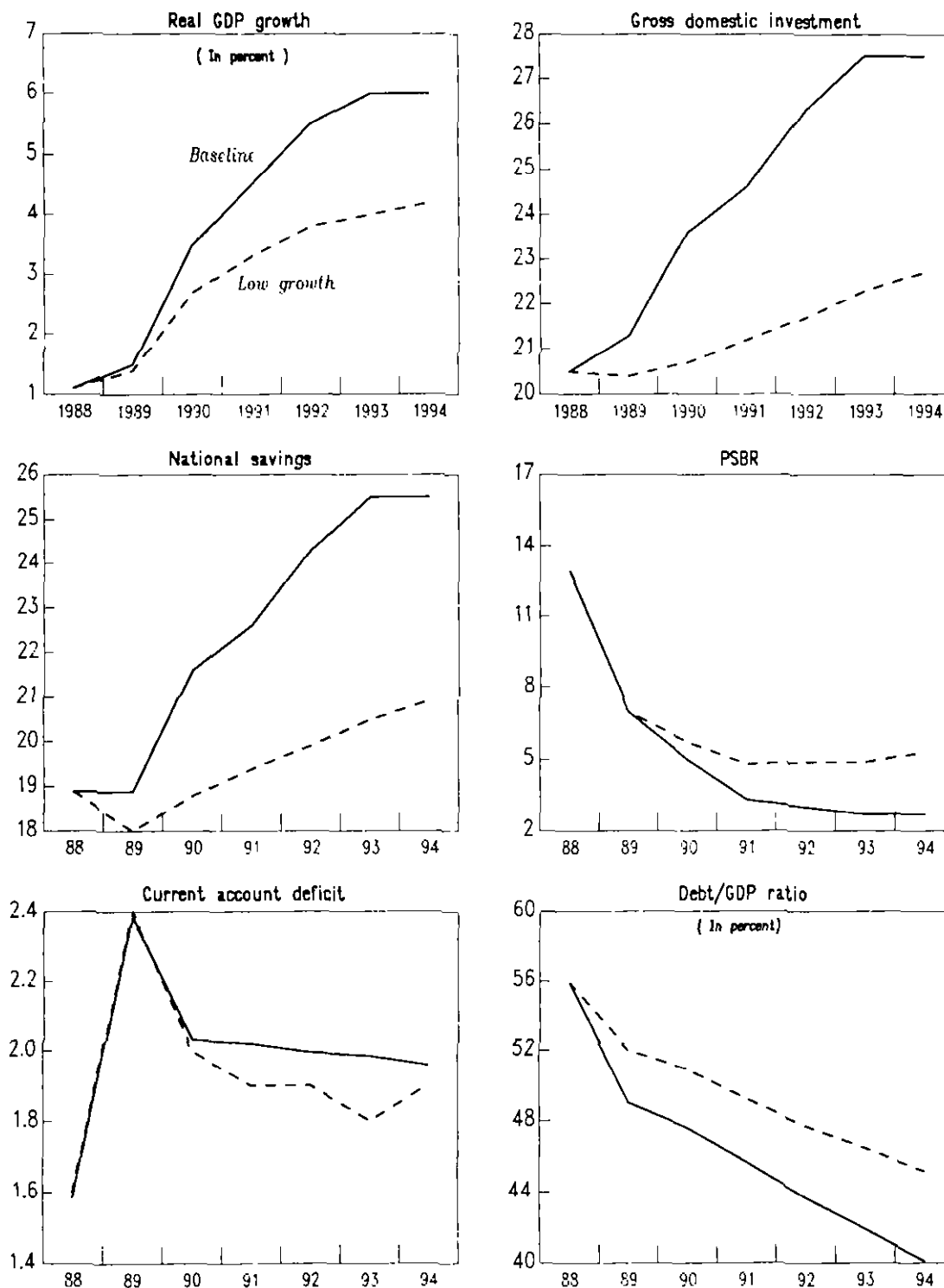
<sup>1/</sup> Adjusted for the inflationary component of interest payments on domestic debt.

CHART 9

MEXICO

**MEDIUM TERM SCENARIOS 1/**

(In percent of GDP, unless otherwise indicated)



Sources: Mexican authorities; and Fund staff projections.

1/ Solid line refers to baseline (optimal) scenario; and dashed line to low growth scenario. Do not include debt reduction operations.



growth objectives or modalities that such a reduction might involve, it is prepared to develop scenarios to help clarify the issues involved.

In the baseline scenario it is assumed that GDP will grow by 1.5 percent in real terms in 1989, with the rate of growth increasing to 5.5 percent by 1992 and 6 percent by 1994 (see Table 8 and Chart 9). The rate of inflation would come down from 18 percent in 1989 to 12 percent by 1990 and then to 6 percent in subsequent years. Total savings would increase by 5 1/2 percentage points of GDP from 1988 to 1992 and by somewhat over 1 percentage point of GDP over the subsequent two years. Private sector savings would increase by 3 percentage points of GDP by 1994; per capita private consumption would rise over the period, with the rate of growth reaching 5 percent by 1994. As a result of a strengthening of the public finances (see Section III.1.c), public sector savings would increase by 3 1/2 percentage points of GDP over the period. Gross domestic investment would increase by 6 percentage points of GDP from 1988 to 1992 and by a further percentage point of GDP by 1994, and would take place mostly in the private sector.

The medium-term balance of payments projections (Table 9) are based on the following assumptions: (i) an annual rate of world inflation (in U.S. dollar terms) of 4 percent a year and stable terms of trade for Mexico; (ii) an average growth of 3 percent a year in the real GDP of Mexico's major trading partners; and (iii) a three-month LIBOR interest rate of 10.5 percent a year. The price of the Mexican mix of crude oil is projected to rise slowly in line with other international prices from a reference level of US\$12 a barrel in 1989.

The projections assume that Mexico will follow exchange rate, financial and structural policies that ensure adequate incentives for a continued shift of resources to the production of tradable goods. Nonpetroleum exports would thus continue to expand in real terms at a somewhat faster rate than the growth of external markets, while the increase in imports, after an initial sharp increase associated with trade liberalization, would drop off gradually to a pace approximately equal to that of real GDP. Despite an expected gradual decline in the volume of petroleum exports that reflects the impact of several years of severely constrained investment in production capacity, the trade surplus would increase until 1990 and, though declining gradually thereafter, would remain above current levels for the remainder of the projection period. The balance on nonfactor services and transfers is projected to record a gradually increasing surplus.

Under the assumption that the external financing being sought would be obtained entirely through the traditional new money approach, the improvement in the balance of goods, nonfactor services and transfers would be more than offset by rising interest payments, even in the absence of further increases in international interest rates. The higher payments would reflect both the obligations associated with the existing stock of debt and those stemming from the new borrowing. As a result, the external current account deficit would more than double from

Table 9. Mexico: Medium-Term Balance of Payments

(In billions of U.S. dollars)

	Prel. 1988	Projection					
		1989	1990	1991	1992	1993	1994
<u>Current account</u>	<u>-2.8</u>	<u>-4.8</u>	<u>-4.4</u>	<u>-4.8</u>	<u>-5.2</u>	<u>-5.7</u>	<u>-6.2</u>
Merchandise trade	4.1	4.3	4.6	4.6	4.5	4.3	4.2
Exports	23.0	25.0	27.0	29.2	31.7	34.6	37.8
Petroleum	6.7	6.5	6.8	7.0	7.2	7.4	7.7
Nonpetroleum	16.3	18.5	20.3	22.2	24.5	27.2	30.1
Imports	-18.9	-20.8	-22.4	-24.6	-27.3	-30.3	-33.6
Factor income	-7.4	-9.5	-9.8	-10.3	-10.7	-11.2	-11.8
Interest on public debt	-6.9	-8.9	-9.4	-10.0	-10.6	-11.3	-12.0
Other interest payments	-2.0	-1.7	-1.7	-1.7	-1.6	-1.5	-1.5
Other	1.4	1.1	1.3	1.4	1.5	1.6	1.7
Other services and transfers	0.6	0.4	0.8	0.9	1.1	1.2	1.4
<u>Capital account</u>	<u>-4.1</u>	<u>6.3</u>	<u>5.3</u>	<u>6.0</u>	<u>6.0</u>	<u>6.6</u>	<u>7.1</u>
Official capital	-1.2	6.1	4.8	5.4	4.8	5.2	5.1
Commercial banks	-1.5	4.3	4.0	4.7	4.4	4.4	5.0
Disbursements	1.2	5.5	6.0	7.0	7.0	7.0	8.0
Amortization	-2.7	-1.1	-2.0	-2.3	-2.6	-2.6	-3.0
Multilaterals	0.8	1.4	1.3	0.9	1.0	1.1	1.1
Disbursements	1.7	2.4	2.4	2.1	2.3	2.4	2.6
Amortization	-0.9	-1.0	-1.1	-1.2	-1.3	-1.3	-1.5
Bilaterals and suppliers	0.9	1.2	0.6	0.6	0.5	0.6	0.6
Disbursements	2.4	2.5	1.9	2.1	2.6	2.7	3.0
Amortization	-1.4	-1.3	-1.3	-1.5	-2.1	-2.1	-2.4
Other (including short term)	-1.5	-0.8	-1.1	-0.8	-1.1	-0.9	-1.1
Private capital	-2.8	0.2	0.5	0.6	1.2	1.4	1.6
Interest held abroad	-1.3	-1.5	-1.6	-1.6	-1.7	-1.8	-1.9
Direct investment	1.7	2.1	2.2	2.3	2.4	2.5	2.6
Net external credits	-3.0	-0.9	-0.8	-0.9	-0.4	-0.3	-0.2
Other (including errors and omissions)	-0.2	0.5	0.7	0.9	1.0	1.0	1.1
<u>Overall balance</u>	<u>-6.9</u>	<u>1.5</u>	<u>0.9</u>	<u>1.2</u>	<u>0.8</u>	<u>0.9</u>	<u>0.9</u>

Source: Mexican authorities; and Fund staff estimates.

1988 to 1994 in U.S. dollar terms, and increase as a proportion of GDP (see Tables 8 and 9). Management of the capital account could also become more difficult over time, when the grace periods associated with previous reschedulings expire and as amortization of the principal of previous borrowings begins to fall due. Despite the expectation of continued large net inflows from official (both multilateral and bilateral) sources, and notwithstanding some anticipated reflow of private capital and a projected strong performance of private investment, there would be a need for significant borrowings from the commercial banks throughout the medium term (Table 10).

As noted above, the envisaged growth of GDP under the baseline scenario would be unlikely to take place if reliance were placed solely on new money. Moreover, in present circumstances it might be difficult for Mexico to be able to obtain the envisaged full amount of financing in that form. Chart 9 presents a possible path for the key variables in the medium term with new money financing, when explicit account is taken of the likely adverse effect of the high debt burden, even if the structural adjustment measures are in place. In these circumstances, there would be a significantly lower level of GDP growth, of investment and of national savings, a significantly higher ratio of debt to GDP, and a higher PSBR than in the baseline scenario. Debt reduction operations would help avoid these adverse effects as they would strengthen confidence and would thus foster savings and investment. Thus, debt reduction operations could provide the additional assurance necessary for the program's objectives to be achieved.

b. Ability to repay the Fund

The strong commitment of the Mexican authorities to the adjustment program, which includes important structural policy reforms as well as appropriate macroeconomic policies, provides assurance that the balance of payments position will be strengthened over the medium term. Fund exposure to Mexico accounts for only a small proportion of Mexico's total external debt--it is equivalent to about one fifth of the current level of exports. As total debt is expected to decline in relation to GDP and the debt service ratio would be reduced over the medium term, there does not appear to be an unwarranted risk on present prospects that Mexico would encounter difficulties in effecting repurchases under the proposed arrangement as they fall due. Moreover, Mexico's past record of repurchases has been excellent, indicating that Mexico accords the Fund preferred creditor status. For these reasons the staff believes that the proposed use of Fund resources by Mexico under the extended arrangement is consistent with the need to safeguard the revolving character of those resources.

c. Public sector finances

As described in Section IV.2 below, in order to achieve the targets of the program for 1989, the authorities have formulated a budget aimed at consolidating previous gains; this effort would be continued in subsequent years. With the targeted reduction in inflation, and in

Table 10. Mexico: External Debt Indicators

	1984	1985	1986	1987	Prel. 1988	1989	1990	Projections			
								1991	1992	1993	1994
(In billions of U.S. dollars)											
External debt outstanding	94.0	94.8	98.5	104.5	95.9	102.2	107.0	112.3	116.9	121.6	127.1
Public debt	68.2	71.1	75.1	83.9	83.4	90.7	96.2	102.4	107.5	112.4	118.2
Direct debt	65.8	68.1	70.2	78.8	78.6	85.3	90.8	97.0	102.6	108.5	115.0
Medium- and long-term	65.5	67.7	69.7	78.3	77.9	84.8	90.3	96.5	102.1	108.1	114.5
Short-term	0.4	0.5	0.5	0.6	0.8	0.5	0.5	0.5	0.5	0.5	0.5
IMF	2.4	2.9	4.0	5.1	4.8	5.4	5.4	5.5	4.9	3.9	3.2
Other	--	--	0.9	--	--	--	--	--	--	--	--
Nationalized banks	8.2	7.9	7.6	5.7	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Private sector	17.6	15.9	15.8	14.9	6.5	5.6	4.8	3.9	3.5	3.2	3.0
External debt service (public debt only)											
Before rescheduling	14.4	18.4	17.2	24.8	25.5	23.4	21.3	16.1	17.4	18.0	18.8
Amortization	6.1	11.0	11.0	18.5	18.6	14.5	11.9	6.1	6.8	6.7	6.8
Of which: IMF	--	--	0.1	0.4	0.6	0.9	1.2	1.2	0.9	1.0	0.7
Interest	8.3	7.5	6.2	6.3	6.9	8.9	9.4	10.0	10.6	11.3	12.0
After rescheduling	11.4	11.0	9.8	11.4	15.0	13.5	15.2	16.1	17.4	18.0	19.3
Amortization	3.1	3.5	3.6	5.4	8.1	4.7	6.0	6.1	6.8	6.7	7.3
Interest	8.3	7.5	6.1	6.0	6.9	8.8	9.3	10.0	10.6	11.3	12.0
Memorandum item											
Interest payments on nonpublic debt	3.4	2.7	2.2	2.1	2.0	1.7	1.7	1.7	1.6	1.6	1.5
(As percent of GDP)											
Total external debt	53.5	51.4	75.8	74.0	54.3	50.8	49.4	47.2	44.9	42.3	40.1
Of which: IMF	1.3	1.6	3.1	3.6	2.7	2.7	2.5	2.3	1.9	1.4	1.0
External debt service (public debt only)											
Before rescheduling	8.2	10.0	13.2	17.6	14.5	11.6	9.8	6.8	6.7	6.3	5.9
Amortization	3.5	5.9	8.5	13.1	10.5	7.2	5.5	2.6	2.6	2.3	2.2
Interest	4.7	4.0	4.8	4.4	3.9	4.4	4.3	4.2	4.1	3.9	3.8
After rescheduling	6.5	5.9	7.5	8.1	8.5	6.7	7.0	6.8	6.7	6.3	6.1
(As percent of exports of goods and services)											
Total external debt	285.8	313.3	398.8	341.5	295.7	295.4	284.5	287.1	274.5	269.7	267.6
Of which: IMF	7.2	9.7	16.3	16.7	14.8	15.6	14.5	14.0	11.5	8.7	6.7
External debt service (public debt only)											
Before rescheduling	43.7	60.9	69.6	81.1	78.8	67.6	56.8	41.1	41.0	40.0	39.7
Amortization	18.5	36.2	44.6	60.6	57.4	41.9	31.8	15.5	16.0	15.0	14.4
Interest	25.2	24.7	25.1	20.5	21.3	25.7	25.0	25.6	24.9	25.0	25.3
After rescheduling	34.6	36.2	39.6	37.4	46.3	39.0	40.6	41.1	41.0	40.0	40.6
Effective interest rate on public debt (percent)	12.3	10.7	8.5	7.9	8.3	10.2	10.1	10.1	10.1	10.3	10.4

Sources: Mexican authorities; and Fund staff projections.



order to help create the conditions for an expansion in private investment, the authorities plan to reduce the PSBR from some 13 percent of GDP in 1988 to 7 percent in 1989 and to about 3 percent of GDP by 1992. The operational deficit is projected to narrow from some 4 1/2 percent of GDP in 1988 to 2 1/2 percent in 1989 and to 1 percent of GDP in 1992, as domestic real interest rates decline (see Table 8). The improvement in the PSBR and in the operational balance would be consistent with an increase in the primary surplus of 1 1/2 percentage points of GDP to 7 1/2 percent in 1989, and a cumulative decline of 2 percentage points over the subsequent three years.

Public sector savings would increase by almost 4 percentage points of GDP over the period through 1992, allowing for an increase in public sector expenditure in areas such as education, agriculture, health, and infrastructure so as to enhance the growth prospects of the economy and ameliorate the situation of the poorer segments of the population. The rise in public sector savings would be achieved through a continued effort to rationalize the tax system and improve the efficiency of the public enterprises as well as through timely adjustments of public sector prices.

## 2. Structural policies

The program for the coming years includes a major overhaul of the tax system, creation of conditions for increased direct foreign investment, a process of public enterprise reform and divestiture, completion of the trade liberalization effort, the improvement of export competitiveness and financial sector reforms to raise the efficiency of the banking system and to free interest rates.

### a. Public sector

In 1987, the authorities undertook a major reform of the tax system with the aims of improving its efficiency by removing distortions and establishing incentives for investment; supporting external competitiveness by harmonizing the domestic tax system with those abroad; promoting domestic savings; and improving income distribution. <sup>1/</sup> In designing the tax reform, the authorities were guided by the need to raise fiscal revenue and thus sought to broaden the tax base, lower marginal tax rates, and improve tax administration.

In early 1989 the Mexican authorities adopted major revisions to the tax system and accelerated the implementation of the fiscal reforms adopted in 1987. The main measures were (a) the system of dividend deduction was abolished and replaced by a tax on corporate dividends at the source with a view to preventing tax evasion while distributed dividends will be subject to a further tax in order to promote

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<sup>1/</sup> The main features of the 1987 tax reform are described in Appendix I, SM/88/47.

reinvestment; (b) the corporate income tax rate was reduced from 39.2 percent to 37 percent; (c) a minimum 2 percent tax, which can be credited against income tax liabilities, was introduced on firms' assets; (d) the number of personal income tax brackets was reduced from 12 to 6 with a substantial reduction in marginal tax rates; and (e) the dispersion in import tariffs was narrowed by increasing the minimum tariffs for most items to 10 percent, except for some basic foodstuffs and medicines, while maintaining the maximum rate at 20 percent. 1/

In the next few years, the authorities intend to overhaul the property tax system, which has been yielding decreasing revenue over the years, and review the exclusion of the transportation and agricultural sectors from the overall tax base. Also, tax administration will be improved through three interrelated programs: (a) decentralization of computerized registration and collection of income taxes, (b) automation of custom taxes operations, and (c) stricter enforcement of tax collection.

The Mexican authorities have embarked on a policy of restructuring the public enterprises either through divestiture or rationalization of their operations. Although the Government is to retain control of certain strategic and priority industries, such as petroleum and electricity, it has been withdrawing from many areas of economic activity, including pharmaceuticals, chemicals, textiles, and transportation. Of a total of 1,126 state-owned entities in existence in 1982, less than 500 remained under government control by late 1988. The rest have been divested through liquidation, merger, sale, or transfer to local governments. The Government will intensify its policy of withdrawing from nonstrategic industries in the next several years, and is in the process of identifying enterprises for a second round of divestitures to be carried out in 1989. In the future, the authorities would rely increasingly on cofinancing investment projects with the private sector, which would allow the Government to step up its investment effort while economizing on its own resources.

#### b. Financial sector

In the financial sector, new instruments such as the Pagafe (bond indexed to the controlled exchange rate) and Bonos de Desarrollo (treasury bills with longer maturities and flexible interest rates) have been developed in recent years. Further, a large market of bankers' acceptances and other instruments not subject to standard banking regulations and with flexible interest rates and maturities was developed toward the end of 1988. This deregulation of financial markets resulted in a significant reflow of resources into the banking system during the last two months.

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1/ For more details on the 1989 tax reform, see the accompanying Recent Economic Developments document.

In March 1989 the authorities adopted several measures to encourage banks to compete more effectively among themselves and with other intermediaries, including mainly the elimination of controls on interest rates and maturities for traditional bank instruments and the replacement of the reserve requirement regime applied to these instruments by liquidity coefficients similar to those applicable to bankers' acceptances. 1/

The measures recently taken by the Mexican authorities are part of a far-reaching reform of financial markets. Mandatory lending from banks to the public sector through reserve requirements has been eliminated in favor of open market operations. These measures are expected to be complemented by important reforms sufficient to provide investors with proper legal protection while increasing market efficiency, making financial institutions competitive at an international level and promoting domestic savings and investment. Also, the credit operations of the national development banks and the official trust funds are expected to be monitored closely, with structural programs implemented to enhance their efficiency and to promote their complementarity with commercial banks by restructuring some of them as second tier rediscounting institutions. Preferential lending rates will be subject to periodic adjustments to avoid marked differences with regard to costs of funds.

c. Trade policies

The authorities regard the major liberalization of the trade system and reduction in tariff rates that has been implemented since mid-1985 as an important means of improving efficiency of domestic producers and dampening inflationary pressures. They noted, in particular, that the liberalization of imported inputs had been an important factor in the rapid expansion of nonpetroleum exports. The authorities also have been implementing a program of tariff reform aimed at lower and more uniform rates of effective protection. In this context, the minimum tariff (with a few exceptions) was raised to 10 percent in January 1989, reducing further the dispersion of tariff rates (the maximum tariff had been reduced to 20 percent in December 1987) and contributing to a lower level of effective protection for many products.

d. Foreign investment

Foreign direct investment is expected to play a major role in the medium-term strengthening of the balance of payments and a complementary role in the promotion of employment, the modernization of plant and equipment, and the opening of new export markets. The achievement of the program's objectives of economic growth and financial stability should create a climate that would attract foreign investment. Among

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1/ See the accompanying Recent Economic Developments paper for a detailed description of the measures taken in March 1989.

the fiscal measures submitted to Congress in 1988, the proposed gradual reduction of corporate tax rates to international levels would create incentives for both foreign and domestic investment. Actions in this area are expected to take place in the near future.

#### IV. Policies for 1989

##### 1. Overview

During 1989 policies will be aimed at consolidating gains with regard to inflation while the effects of structural reforms on economic performance continue to take hold. Thus, real GDP is projected to increase by 1.5 percent, with a significant recovery expected to take place in the second half of the year in response to a decline in real interest rates as confidence strengthens (see Table 2 and Chart 2): per capita private consumption would decline somewhat reflecting in part recent trends in real wages, but would start recovering subsequently. Inflation is expected to decline to 18 percent during 1989. Investment would increase by about 4 1/2 percent in real terms, on the basis of an acceleration in private sector capital formation, while public sector investment would continue to fall. Domestic savings would increase but national savings would remain unchanged in relation to GDP, reflecting the impact of higher interest rates in international capital markets. Use of foreign savings, as measured by the external current account deficit, would increase by 0.8 percentage point to 2.4 percent of GDP or US\$4.8 billion, owing to a sharp increase in interest payments abroad, while the trade surplus would remain at about US\$4 billion. In turn, the net resource transfer, measured by the balance of goods and nonfactor services, would decline by 0.3 percentage points of GDP to 2 percent of GDP. These magnitudes are consistent with the baseline medium-term scenario (see Table 8). If debt reduction operations were carried out, national savings would be higher and the external current account deficit lower.

##### 2. Fiscal policy

The fiscal effort in 1989 will be reflected in a primary fiscal surplus of 7.3 percent of GDP (on the assumption of a price of oil of US\$12 per barrel) <sup>1/</sup> compared with 5.9 percent of GDP in 1988 (see Table 4). In light of the projected availability of foreign resources, and in response to the tight fiscal policies, nominal and real interest rates are expected to decline during the year. The operational deficit would be reduced to 2.5 percent of GDP in 1989 from 4.4 percent in 1988, while the public sector borrowing requirements would decline from some 13 percent of GDP in 1988 to 7 percent in 1989, reflecting in large part the lower rate of inflation.

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<sup>1/</sup> See Section IV.8 on oil price and interest rate adjustments.

The fiscal measures described above (Section III.1.c.), together with stricter enforcement of tax collection, are expected to yield a net increase of 0.9 percentage point of GDP in tax revenue. In addition, nontax revenue of the federal government is expected to increase by 0.4 percent of GDP as a result of an increase in sales of enterprises.

Gross receipts of the public enterprises would decrease reflecting a decline of public sector prices in real terms. At the beginning of 1989, most public sector prices and tariffs, except those of gasoline, diesel, and tariffs of electricity for residential purpose, were raised to reflect unit costs of production or international prices. These adjustments, which ranged from 30 to 50 percent, partially compensated for the loss experienced during 1988 as a result of the freeze set under the PACTO on the prices of almost all public sector goods and services. However, some real declines have taken place subsequently. Including the effect of the divestiture of three enterprises under budgetary control, the gross receipts of the enterprises (including PEMEX) would decline by 2.7 percentage points of GDP in 1989.

The authorities indicated that exercising control on public sector prices was essential for the success of their stabilization program, and that the revenue impact of the freeze is small, being implemented in a selective manner. The authorities intend to more than compensate for the net revenue shortfall of 1.2 percent of GDP of the public sector under budgetary control by reducing budgetary outlays on goods and nonfinancial services by some 1.7 percentage points of GDP.

As noted, the PSBR is expected to decline in 1989 by almost 6 percentage points of GDP, mainly because of the sharp reduction in the average monthly rate of inflation as compared with the previous year. Real interest rates, however, are not expected to decline proportionately, remaining high through much of the year, at least until the multiannual external financing package is secured. Consequently, real interest payments on the domestic debt are expected to average about 5 1/2 percentage points of GDP, implying a decline of only one half of a percentage point from the previous year. However, the combination of a stronger primary balance and lower real interest payments on domestic debt would reduce the operational deficit by almost 2 percentage points of GDP.

The authorities are of the view that the fiscal plan for 1989 is consistent with achievement of the program's objectives. In particular, as real interest rates decline during the year with the increased availability of foreign resources and increased confidence, there would be a considerable strengthening of public sector savings, eventually allowing for increased levels of investment in the public sector. However, the authorities stated that they would be ready to modify their policies as needed to secure their objectives. Accordingly, if aims in regard to inflation and the external current account are not achieved notwithstanding the observance of the fiscal targets, the authorities, in consultation with the Fund staff, would take additional policy

measures to tighten the fiscal stance. The nature of the measures adopted in such circumstances will depend on the magnitude of the imbalances being confronted. The authorities have indicated that the policy measures would be of a permanent nature (e.g., would not entail a postponement of spending to subsequent years).

Adjustments to the fiscal targets will be made for movements in oil prices and interest rates as described in Section IV.8 below.

### 3. Monetary policy

Monetary policy will be aimed at consolidating the recent gains in reducing inflation, and more generally will support the macroeconomic objectives of the program. With the recent institutional changes described above, open market operations have become the main instrument of monetary policy. These changes should result in increased efficiency in financial intermediation, a faster growth of financial savings, and a reduction in the spread between deposit and lending rates. The authorities intend to meet the domestic financing requirements of the public sector mainly through the placement of domestic securities in the market. It is expected that in 1989 the measures described in Section III.2.b would encourage financial intermediation, with private sector financial savings increasing by more than 4 percent in real terms. In combination with the above-mentioned balance of payments and fiscal targets, this would make possible an increase in commercial bank credit to the private sector of more than 4 percent in real terms.

### 4. Wages

In the context of the PACTO, after initial adjustments to the minimum wage at the end of 1987 and in January 1988, a freeze was instituted which continued until the end of the year, breaking the previous de facto indexation of wages. Within the context of the PECF, the authorities announced at the end of 1988 an 8 percent increase in the minimum wage through end-July 1989. During the first quarter of 1989, wage settlements in the private sector were running at a rate of 12 percent a year, a rate that is consistent with the current rate of inflation. The authorities intend to follow wage developments closely to ensure that settlements continue to be consistent with the inflation and fiscal objectives.

### 5. External policies

#### a. Exchange system

Following the step depreciation of the peso in the controlled market in December 1987, which eliminated the large spread that had temporarily emerged earlier in the year between the exchange rates in the controlled and free exchange markets, the exchange rate between the peso and the U.S. dollar remained unchanged during 1988 (with the exception of a small depreciation of the peso in February 1988)

(Chart 10). With inflation in Mexico higher than in its major trading partners during 1988, this contributed to a significant appreciation of the peso in real effective terms.

The authorities noted that the trade liberalization effort has helped preserve competitiveness, as it contributed to a substantial lowering of costs by enabling companies to obtain essential imports at prices more in line with international prices and on a timely basis; in many cases, higher quality intermediate goods are also now available. Moreover, in evaluating competitiveness it has to be noted that wages had lagged inflation, and the prices of a number of essential services had remained relatively stable. The authorities' assessment is that the level of competitiveness is adequate and consistent with the continuing rapid growth of non-oil exports (Chart 11).

As noted earlier, since the beginning of 1989, the peso has been depreciated against the U.S. dollar by some 1.3 percent a month as a means of maintaining the level of external competitiveness. This policy will continue through end-July 1989 in the context of the current stabilization pact. The authorities have indicated that exchange rate policy in 1989 will be managed so as to be consistent with the balance of payments objectives and they intend to keep the exchange rate under review, taking into account developments in international reserves, the trade balance and the real effective exchange rate.

In any event, exchange rate policy will be examined in detail in the context of the mid-term review of the program with the Fund scheduled to take place before August 31, 1989 (see Section IV.7). Moreover, the authorities have indicated that there will continue to be free access to foreign exchange in the free market to finance transactions for which payment cannot be made through the controlled market. The spread between the official and the free markets has remained below 2 percent since late 1987 (see Chart 10). The authorities have stated that it is a policy objective to unify the exchange markets when circumstances permit and to keep the spread within 2 percent.

b. External debt management

Over the past several years the authorities have taken a number of steps to contain the burden of external debt service. Approximately US\$52.5 billion of principal falling due on official debt to commercial banks during 1985-90 has been rescheduled, as was about US\$1.9 billion of principal and interest that fell due from late 1986 to early 1988 to Paris Club creditors. In 1987, it was agreed that up to US\$9 billion of private sector debt owed to commercial banks and previously restructured under the FICORCA scheme would be converted upon repayment into a long-term loan to the Government and rescheduled on terms comparable to those applying to debt owed to the commercial banks by the public sector. In the event, Mexican private borrowers prepaid most of this debt, taking

advantage of significant discounts offered by the banks for prepayment before the agreement became effective in mid-1988; only about USS1 billion was rescheduled.

The authorities also have taken a number of initiatives aimed at reducing external debt service by amortizing the public sector debt at a cost below its face value. A debt-bond exchange was implemented in March 1988 that involved the exchange of existing debt with a face value of USS3.7 billion for a new collateralized bond valued at USS2.6 billion. Since May 1986, debt-equity swap operations have been used as a means of reducing the stock of debt service obligations while promoting foreign investment. The total face value of amortizations through debt-equity swaps has amounted to USS3.6 billion. <sup>1/</sup> No new applications for such operations have been accepted since late 1987, reflecting the concern of the authorities about the macroeconomic implications of the scheme, the possible distortionary impact on investment incentives in particular sectors and the possible inhibiting effect on investment not covered by the scheme. Nonetheless, the authorities are currently reviewing the possible reinstatement of debt-equity swaps, particularly in the context of their privatization efforts.

The authorities intend to request a multiyear rescheduling of debt service payments falling due to Paris Club creditors and to the commercial banks. The program assumes for working purposes a level of financing from Paris Club creditors that would be consistent with a rescheduling during 1989-90 of 100 percent of amortization payments and 60 percent of interest falling due and not previously restructured on loans contracted through end-1985. Similarly, the program assumes that commercial banks will roll over amortization payments maturing during the program period. In addition, they would provide net additional inflows of some USS4.3 billion, equivalent to approximately 60 percent of the interest falling due on debt owed to the banks by the public sector, or some 40 percent of total interest payments made by Mexico to commercial banks after allowance is made for amortizations made by the private sector. The authorities have indicated that existing trade financing lines would not be subject to rescheduling, and that they intend to ask banks to maintain the level of existing interbank credit lines.

In discussions already under way with the commercial banks, the authorities are attempting to establish the basis for a significant reduction of debt and debt service. Their request for financing has been presented within a framework of options that involves new money, debt reduction, or debt-service reduction. Banks are being asked to

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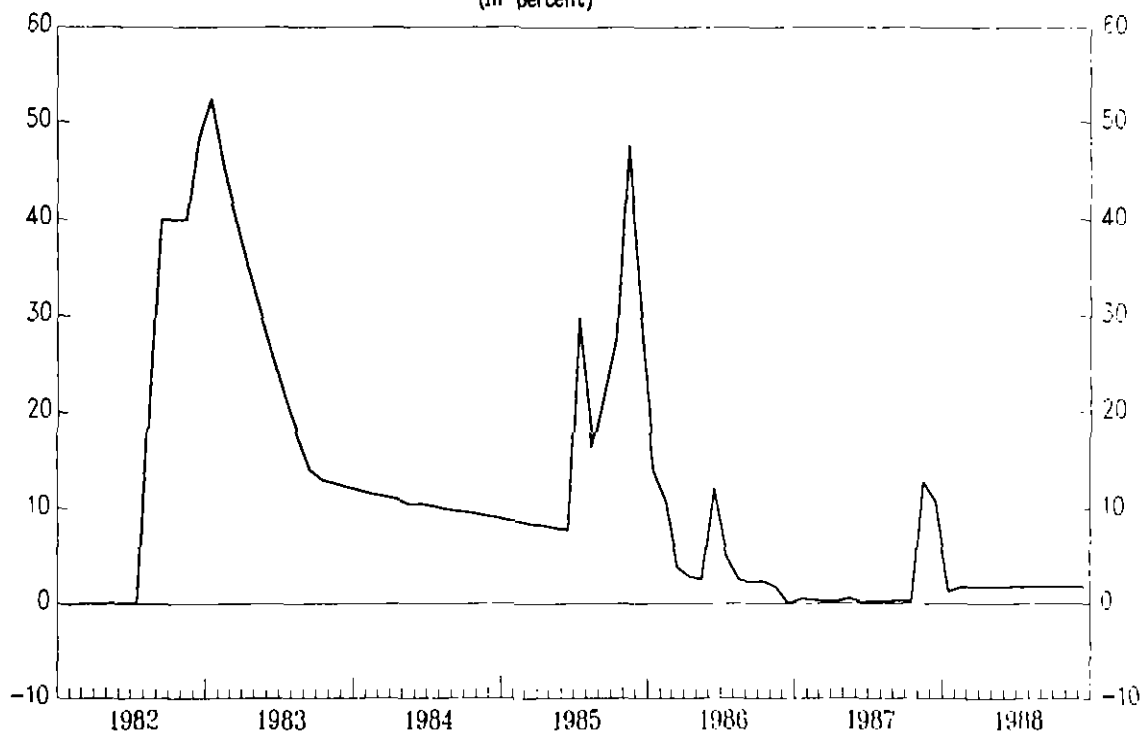
<sup>1/</sup> The face value of debt amortized through debt equity swaps amounted to USS0.4 billion in 1986, USS1.7 billion in 1987 and USS1.5 billion in 1988. Total new investment under the scheme is estimated at about USS3.1 billion.



CHART 10  
MEXICO

EXCHANGE RATE DIFFERENTIAL BETWEEN THE CONTROLLED  
AND FREE MARKETS 1/

(In percent)

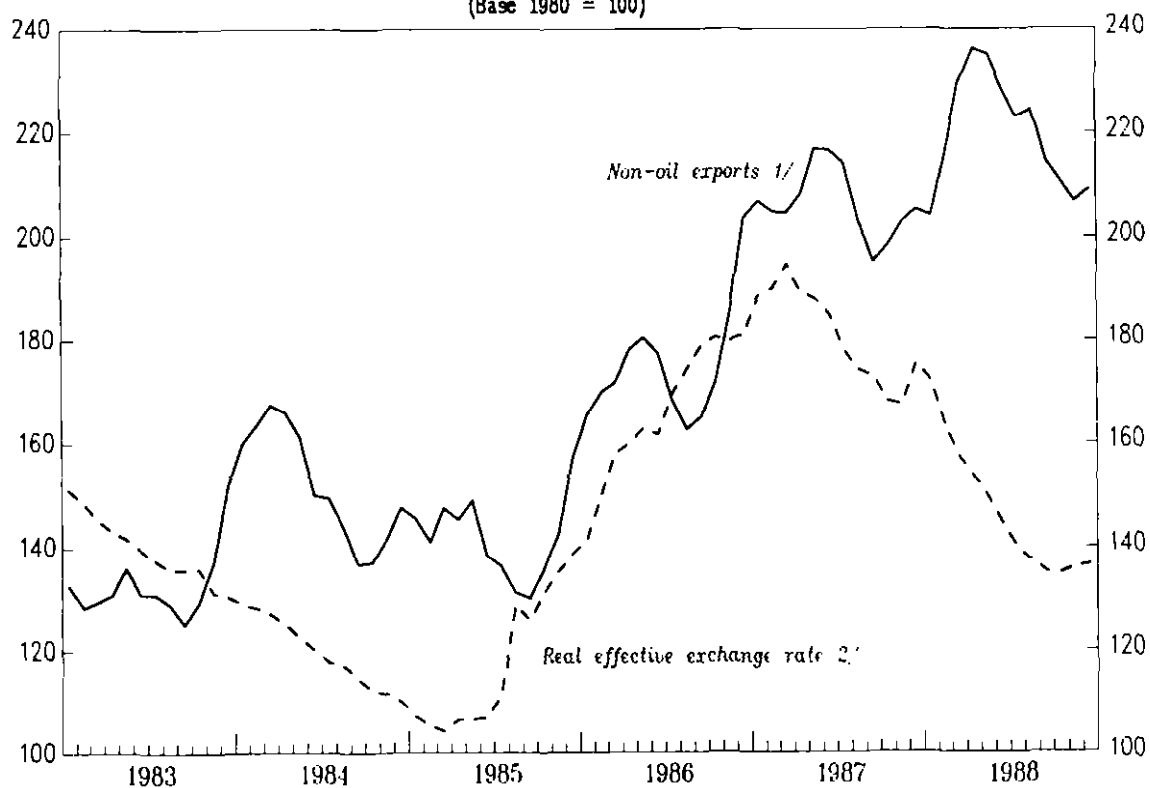


Sources: Bank of Mexico; and Fund staff estimates.

1/ Differential between the monthly average controlled and free market rates for the peso against the U.S. dollar, as percent of controlled rate



CHART 11  
MEXICO  
**NON-PETROLEUM EXPORTS**  
(Base 1980 = 100)



Sources: Mexican authorities; and Fund staff estimates.

1/ 3-month moving average of non-oil export volume deflated by US industrial production.

2/ Increase reflects depreciation.



make a multiyear commitment to refinance a substantial portion of interest payments falling due or to agree to a significant reduction in the outstanding stock of debt or a lower fixed interest rate on that debt. The authorities have indicated their strong preference for financing that involves the latter two modalities. Moreover, the authorities are seeking to obtain interim financing to help bridge what could become a tight cash flow position while the package is being completed.

Although the financing arrangements for Mexico are not fully in place, the extended arrangement is being proposed for approval so as to provide an endorsement of the authorities' economic program by the international community. This will help strengthen the authorities' ability to implement the program; in addition, approval of the extended arrangement would provide a clear signal of the Fund's support for Mexico's efforts to obtain external financing, and would help catalyze other resources, including from official bilateral and multilateral sources. In addition, because the negotiations with commercial banks have begun only recently it will take time to complete arrangements in this area. During the intervening period the extended arrangement will help establish a balance of payments framework within which the financing package can be developed and its implementation reviewed. It should be noted that without Fund approval at this stage, the cash flow position of Mexico would be even tighter than is envisaged at present.

#### 6. Balance of payments prospects

On the basis of an average price for the Mexican mix of crude oil of US\$12 a barrel (corresponding to a price of about US\$16 a barrel for the principal crudes in the market) and an international interest rate of 10.5 percent (three-month LIBOR), the external current account is expected to record a deficit of about US\$4.8 billion (2.4 percent of GDP) in 1989 (see Table 7). Interest payments would rise sharply from 1988 to 1989 mainly because of higher international interest rates. The merchandise trade surplus would improve slightly to US\$4.3 billion, despite a small decline in the volume of oil exports. Nonpetroleum exports (including the value added of in-bond industries) are projected to increase by nearly 14 percent (in U.S. dollar terms); this would be somewhat slower than in 1988, as unutilized capacity in industry diminishes. The rate of growth of imports is expected to drop off considerably, as the one-time effects of the trade liberalization come to an end.

Net movements of capital are projected to shift from an outflow of US\$4 billion in 1988 to an inflow of more than US\$6 billion in 1989, almost all of it to the public sector; the private capital account would register a small inflow after the large outflow associated with large private debt prepayments in 1988. The projected shift in capital inflows to the official sector in Mexico reflects mainly the intention of the authorities to request financing from the commercial banks and to approach the Paris Club for a rescheduling in 1989. Outflows associated

with long-term trade financing for Mexican exports are also expected to be substantially lower in 1989. Overall, a balance of payments surplus of about US\$1.5 billion is targeted for 1989, permitting some recovery of international reserves after the large drop experienced in 1988.

7. Performance criteria for 1989

In the letter dated April 11, 1989 and attached Technical Memorandum of Understanding 1989, the authorities described their economic program for 1989 and the performance criteria that have been established. As indicated in the letter, progress under the implementation of the economic program is to be reviewed before August 31, 1989. A second review with the Fund to reach policy understandings and establish performance criteria for 1990 is scheduled for completion before February 28, 1990. Subsequently, consultation discussions will take place before February 28, 1991 and before February 29, 1992, to reach policy understandings for 1991 and 1992, respectively. Appendix VII reviews the proposed schedule of drawings under the first year of the extended arrangement with Mexico.

As indicated in paragraph 7 of the Technical Memorandum attached to the letter of intent there would be modifications in fiscal policy, if the program's objectives are not achieved notwithstanding the observance of the fiscal targets specified in the program (see Section IV.2 above).

The quantitative performance criteria of the 1989 program, including estimates for March 1989, are summarized in Table 11. They are the following:

- (1) Quarterly limits on the overall public sector borrowing requirement (paragraph 4 of the Technical Memorandum attached to the letter of intent);
- (2) Quarterly limits on the operational balance of the nonfinancial public sector (paragraph 5 of the Technical Memorandum);
- (3) Quarterly targets for the primary surplus of the nonfinancial public sector (paragraph 6 of the Technical Memorandum);
- (4) Quarterly limits on the cumulative changes in the Bank of Mexico's net domestic assets (paragraph 9 of the Technical Memorandum);
- (5) Quarterly limits on the Bank of Mexico's net credit to the nonfinancial public sector (paragraph 10 of the Technical Memorandum);
- (6) Quarterly limits on the public sector's net use of foreign credit (paragraph 3 of the Technical Memorandum); and
- (7) Quarterly targets for the net foreign assets of the Bank of Mexico (paragraph 8 of the Technical Memorandum).

Table 11. Mexico: Quantitative Performance Criteria Under Extended Arrangement

	Est. March	1989		
		Targets and Ceilings		
		June	September	December
(In billions of Mexican pesos)				
Cumulative overall public sector borrowing requirement <u>1/2/3/</u>				
Ceiling				
Unadjusted	7,740	15,400	25,400	33,900
Adjusted <u>4/</u>				
Excess (-)/Margin (+)				
Cumulative nonfinancial public sector operational deficit <u>1/2/5/</u>				
Ceiling				
Unadjusted	3,110	5,600	8,920	12,130
Adjusted <u>4/</u>				
Excess (-)/Margin (+)				
Cumulative changes in net domestic assets of the monetary authorities (effective flows) <u>1/3/6/</u>				
Ceiling				
Unadjusted	--	3,330	1,120	-985
Adjusted <u>4/7/8/</u>				
Excess (-)/Margin (+)				
Net credit to the nonfinancial public sector by the monetary authorities <u>2/9/</u>				
Ceiling				
Unadjusted	32,686	33,910	34,210	34,520
Adjusted <u>4/</u>				
Excess (-)/Margin (+)				
Cumulative primary surplus				
Target <u>1/2/3/</u>				
Unadjusted	9,250	19,700	27,600	35,350
Adjusted <u>4/</u>				
Excess (-)/Margin (+)				
(In millions of U.S. dollars)				
Cumulative net foreign borrowing by the public sector <u>1/</u>				
Ceiling				
Unadjusted	-440	900	3,710	6,650
Adjusted <u>7/8/</u>				
Excess (-)/Margin (+)				
Cumulative change in net international reserves of the monetary authorities <u>1/2/</u>				
Target				
Unadjusted	-200	-1,010	-40	1,490
Adjusted <u>4/7/8/</u>				
Excess (-)/Margin (+)				

Sources: Mexican authorities; and Fund staff estimates.

1/ Cumulative changes from end-1988.

2/ Limit tested at the end of each period.

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

4/ Adjustments relating to provisions under oil price and/or interest rate adjustments.

5/ Defined as the difference between the overall public sector borrowing requirement excluding cumulative changes in financial intermediation and the inflation component of interest payments on the domestic public sector debt denominated in local currency.

6/ 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 Bank of Mexico.

7/ Ceiling can be adjusted for changes in timing of gross external financing.

8/ Ceiling can be adjusted for operations aimed at reducing external debt.

9/ Effective stocks calculated by adding effective flows to the nominal stock of Mex\$31,464 billion outstanding as of the end of 1988.

In addition, the general clause relating to the authorities' intentional in respect of imposition of new or intensification of existing multiple currency practices, restrictions on payments, and transfers for current international transactions, bilateral payments agreements, and restrictions on imports for balance of payments reasons, and the clauses relating to the authorities' intention to avoid the emergence of arrears and the incurrence of overdue payments to the Fund will be conditions for purchases under the proposed arrangement.

#### 8. Oil price and interest rate adjustments

The experience of Mexico indicates that the economy is highly sensitive to external developments, particularly as regards oil prices and international interest rates. An annual increase of US\$1 a barrel in the international oil price would give rise to an increase in public sector revenues and exports equivalent to some 0.23 percentage point of GDP, and a decline in the LIBOR of 1 percentage point results in an improvement in these aggregates of about 0.35 percentage point of GDP. The program provides that the relevant quantitative performance criteria would be adjusted if the price of oil deviates from the baseline level of US\$12 a barrel and LIBOR deviates from 10.5 percent a year, to the extent that the cumulative effect of both variables taken together exceeds an upper or lower threshold of US\$950 million, on an annual basis. <sup>1/</sup>

The authorities are of the view that thresholds are needed to provide them with a sufficient flexibility in dealing with fluctuations (oil prices have fluctuated by as much as US\$10 a barrel since late 1988); they are willing to take all necessary actions to offset the effect of adverse developments on the public finances and the balance of payments if an adverse deviation (e.g., low oil prices and high interest rates) takes place, with an impact smaller than would be indicated by the lower threshold. They have noted that they would not seek extraordinary financing--nor would they adjust their financing requirements--if deviations take place beyond the thresholds. Furthermore, the authorities are committed not to allow any deviation below the lower threshold to exceed US\$1.5 billion, to avoid undue pressures on the foreign reserve position.

*The threshold values with respect to the baseline scenario are roughly equivalent to 0.5 percent of GDP, or the combined effect of a change in the price of oil of US\$1 a barrel and of 0.75 percentage point in interest rates. Once the threshold values are exceeded, adjustments would be made to all quantitative performance criteria, except for the*

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<sup>1/</sup> The upper and lower threshold values will be limited to 50 percent of the total value for the year for the period through June 30, 1989 and 75 percent for the period through September 30, 1989.



fiscal primary surplus which is adjusted only for deviations in oil prices, and the foreign credit ceilings which would not be adjusted (see below).

As noted in paragraph 12 of the letter of intent, oil price adjustments will be calculated by multiplying the reference of crude oil exports (1.3 million barrels a day) by the difference between the mean price of Mexican oil exports and US\$12 a barrel. 1/ In turn, interest rate adjustments will be calculated by multiplying the value of the stock of debt subject to floating interest rates at the beginning of each quarter by the difference between the average external interest rate prevailing in the previous quarter and the base interest rate of 10.5 percent. 2/

In the event that the combined deviation of oil prices and interest rates for a given quarter results in an excess over the upper threshold, the target for the net international reserves for that quarter will be raised by the value of the excess. The program limits for the net domestic assets, public sector borrowing requirement, the operational deficit, and the net credit to the public sector by the Bank of Mexico will be lowered by the amount of the deviation. As noted, the target for the primary fiscal balance will be adjusted only for deviations corresponding to oil prices. The adjustment to the primary outcome would not exceed the total adjustment (i.e., the combined adjustment of external interest rates and oil prices). Equivalent adjustments will be made to performance criteria, to the extent that there are negative deviations (e.g., lower oil prices and higher interest rates) in excess of the lower end threshold value. 3/

#### V. Staff Appraisal

Mexico has embarked on a medium-term adjustment program and in support of this program the Mexican authorities have requested use of Fund resources under an extended arrangement.

In recent years Mexico has been confronted with significant external shocks. In response to these problems, and in line with the major reorientation of policies that began in late 1982, the authorities embarked on a comprehensive adjustment effort in 1986 aimed at addressing the country's macroeconomic and structural imbalances. In the

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1/ The mean price of oil is defined as the average price of the Mexican exports of Maya, Isthmus, and Olmeca crudes weighted by their share in exports, as reported by PEMEX.

2/ External interest rate deviations are calculated on the basis of the average LIBOR on three month deposits denominated in U.S. dollars.

3/ Appendix V presents hypothetical examples of possible circumstances in which the oil price and interest rate adjustments are triggered.

event, the fiscal and balance of payments position strengthened but inflation accelerated and economic activity remained sluggish.

In late 1987 the authorities modified their strategy in order to deal with inflation while preserving the gains made in reforming the structural aspects of the economy. The program centered on monetary and fiscal restraint, a major trade liberalization effort, and initial adjustments in the exchange rate, wages and prices, followed by a freeze that was extended through end-1988. The primary fiscal surplus increased significantly in 1988 notwithstanding lower oil prices, and the rate of inflation declined. However, doubts persisted about the sustainability of the strategy and real interest rates rose. Thus, the operational fiscal balance deteriorated with adverse effects on domestic savings and the external current account. Furthermore, because of large capital outflows, including the prepayment of private sector debt at a discount, the net international reserves declined.

For a number of years the performance of the Mexican economy has been adversely affected by a heavy external debt service burden. There has been a growing view in the international financial markets that this debt could not be serviced on the terms and conditions agreed so far, and this has been reflected in rising discounts in the secondary markets for Mexico's debt. These developments appear to have had adverse consequences for capital formation, and in all likelihood inhibited capital reflows.

The Mexican authorities have reformulated their economic strategy in a medium-term framework aimed at reducing inflation further and attaining a viable balance of payments, while restoring a satisfactory rate of growth. The program relies on financial policies to achieve external and internal balance, and on structural policies to improve efficiency and mobilize resources for increased investment. The success of the program depends mainly on the authorities' efforts. However, it would be difficult for Mexico to achieve its growth, price, and balance of payments objectives without the availability of external resources and access to Mexico's major export markets.

The program being implemented by the authorities seeks to tighten further the fiscal stance, as reflected in the proposed increase in the primary fiscal surplus in 1989. This, together with the projected decline in domestic interest rates and inflation, should lead to a strengthening in the operational balance and in the PSBR. While the projections can be viewed as realistic, the current high level of real interest rates on domestic debt indicates that developments will have to be monitored closely to ensure attainment of the program's objectives. It also will be important to give attention to the maintenance of an adequate structure of prices in the public sector.

For the medium term, the staff supports the authorities in their efforts to reorient expenditure so as to enhance growth prospects while protecting the poorer segments of the population and ensuring the fiscal

targets. Furthermore, the improvement in revenue performance, reflecting the continuing wide-ranging tax reform, and the efforts to reduce involvement by the Government in nonpriority areas, also will help in the achievement of the program's objectives.

The conduct of monetary policy will be aided by the recent reforms of the financial system, particularly the liberalization of interest rates, the availability of new financial instruments, and the simplification of reserve requirements. The greater reliance on market mechanisms and the declining financing requirements of the public sector should help to ensure achievement of the balance of payments and price objectives of the program, while allowing for additional resources to be made available for private sector investment.

Through 1987 wage developments were characterized by frequent adjustments and a strengthening of the link to past inflation, a process that exacerbated inflation without preserving the level of real wages. The existing policy stance has helped break indexation, and wage settlements have been running at a rate consistent with the current low rate of inflation. The authorities will need to follow wage developments closely in order to be in a position to respond quickly to any threats to the program's price and employment objectives.

The pursuit of a realistic exchange rate policy will be crucial for Mexico's efforts to deal with its difficult economic situation. After a significant adjustment in late 1987, the peso appreciated in real effective terms in the context of the authorities' anti-inflation effort. The recently adopted policy of daily depreciation has helped reduce uncertainties in the area of exchange rate policy. With the pursuit of financial and incomes policies that are helping to reduce the rate of inflation, the peso has depreciated slightly in real effective terms in early 1989. In view of the critical importance of an appropriate exchange rate policy, the authorities will need to follow developments in this area very closely to avoid external payments imbalances and undesirable consequences for growth and capital flows. The maintenance of an adequate exchange rate is also a necessary ingredient for the consolidation of the major trade liberalization that has been implemented by the authorities. The authorities intend to ensure that the differential between the exchange rates in the official and in the free market remains small, which implies a de-facto unification of the two markets. A formal unification of the two rates should be implemented at an early date.

Adequate and timely external financing for Mexico's program is essential. Furthermore, the success achieved in creating the conditions for growth will depend in large part on the presence in the financing package of a significant reduction of debt and debt service carried out in a voluntary fashion. For this purpose there will need to be close cooperation between Mexico and the international financial community, with all parties acting without delay to address both the long-term financing requirements of the program as well as the country's immediate

cash flow needs. In this connection, the Fund has supported the request by the Mexican authorities for interim financing from commercial banks while agreements are being negotiated. Concurrently, the proposed extended arrangement for Mexico and the structural adjustment loan package being negotiated with the World Bank lay the foundation for the coordinated efforts of the international financial community. The Mexican authorities are seeking a rescheduling of debt service from Paris Club creditors, and other sources of official financing are currently being sought. Also, the conditions for capital inflows and for direct foreign investment are being improved.

In sum, the Mexican authorities have embarked on, and are strongly committed to, a major medium-term growth oriented program. These efforts deserve the early support of the Fund in the form of an extended arrangement, which should help catalyze financing from other sources. While risks remain in certain areas of policy, the authorities have indicated that they stand ready to introduce policy modifications warranted by unexpected developments. The authorities' policy efforts are central to success of the program, but they need to be accompanied by an adequate and timely support of the international financial community in the context of the cooperative approach being pursued by the Mexican authorities.

It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Fund Relations with Mexico  
(As of March 31, 1989)

I. Membership Status

- (a) Member since December 31, 1945
- (b) Status - Article VIII

A. Financial Relations

II. General Department (General Resources Account)

- (a) Quota: SDR 1,165.5 million
- (b) Total Fund holdings of Mexican pesos:  
SDR 4,631.3 million or 397.4 percent of quota
- (c) Fund credit: SDR 3,465.8 million or 297.4 percent of quota  
Of which: SDR 674.2 million or 57.8 percent of quota  
under credit tranche  
SDR 956.3 million or 82.1 percent of quota  
under EFF  
SDR 1,835.3 million or 157.5 percent of quota  
under EAR
- (d) Reserve tranche position: None

III. Stand-by or Extended Arrangement and Special Facilities

- (a) Previous stand-by arrangement
  - (i) Duration: November 19, 1986 until April 1, 1988
  - (ii) Amount: SDR 1,400 million
  - (iii) Utilization: SDR 1,400 million
- (b) Emergency assistance
  - (i) Purchase in January 1986
  - (ii) Amount: SDR 291.375 million
  - (iii) Utilization: SDR 291.375 million
- (c) Previous extended arrangement
  - (i) Duration from January 1, 1983 to December 31, 1985
  - (ii) Amount: SDR 3,410.6 million
  - (iii) Utilization: SDR 2,502.7 million
  - (iv) Undrawn balance: 907.9 million

IV. SDR Department

- (a) Net cumulative allocation: SDR 290 million
- (b) Holdings: SDR 276.5 million or the equivalent of  
95.3 percent of net cumulative allocations

V. Financial Obligations due to the Fund (In millions of SDRs) 1/

	Overdue Financial Obligations (3/31/89)	Principal and Interest Due			
		4/1-12/31 1989	1990	1991	1992
Principal					
Repurchases	--	535.1	877.1	807.4	520.1
Trust Fund Repayments	--	--	--	--	--
Charges and Interest including SDR and TF (provisional)	--	168.8	226.9	158.2	96.1
Total	--	<u>703.9</u>	<u>1,104.0</u>	<u>965.6</u>	<u>616.3</u>

B. Nonfinancial Relations

VI. Exchange rate arrangement: Since August 5, 1985 two official markets have been operative in Mexico: a controlled market covering specified transactions amounting to about 80 percent of all trade and payments transactions, and a parallel market. The controlled market rate is determined under a managed float system guided by a set of indicators whereas the parallel market rate is established by market forces. Parties eligible to utilize the controlled market (with the exception of offices and agencies of the public administration) can choose to complete any transaction at a "retail rate" agreed between the parties and the financial institutions authorized to operate in this market, or at the "equilibrium exchange rate" of the day. The daily "equilibrium exchange rate" is determined each day at a fixing session at the central bank, where representatives of the various financial institutions operating in the market exchange bids for purchases and sales of foreign exchange; the central bank may also submit bids in these sessions. For transactions exceeding US\$50,000, the parties concerned may make completion of the transaction contingent upon the equilibrium exchange rate achieving a particular minimum or maximum value. As of March 31, 1989 the "controlled market equilibrium exchange rate" was Mex\$2,369 per U.S. dollar, the average "free" rate was Mex\$2,385 per U.S. dollar, and the differential between the ratio in the controlled and the free market was less than 1 percent.

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1/ Projected on the basis of transactions through March 31, 1989.

- VII. Last Article IV consultation: The last Article IV consultation and second review under the 1986-87 stand-by arrangement were completed by the Executive Board on March 10, 1988. The relevant supporting documents were ERS/88/23, Supplement 1, Correction 1, Supplement 1, and SM/88/47. For consultation purposes Mexico is on the 12-month cycle.

At the conclusion of the last consultation in March 1988, Executive Directors welcomed the actions taken by the authorities aimed at reducing inflation and maintaining a strong balance of payments position with the view to fostering sustained economic growth. Directors observed, however, that price performance, with the considerable initial elements in wage-price formation, had been disappointing during 1987, and that there had been a deterioration in the economic situation during the year. In these circumstances, Directors welcomed the authorities' actions in late 1987 to restore momentum to the adjustment effort and expressed support for the exchange rate adjustments at that time. However, they noted that more recently the peso had appreciated in real effective terms and there remained a risk that it would continue to do so in the months ahead with possible adverse effects on competitiveness and economic activity unless a very rapid fall in inflation were to take place.

- VIII. Technical Assistance: At the request of the Mexican authorities, during 1985 two teams from the Fiscal Affairs Department provided technical assistance in the fields of direct and indirect taxation, followed by a staff visit in January 1986. Also in October 1988 a technical team provided assistance in the area of external debt and international banking.

## Mexico: Selected Economic and Financial Indicators

	1984	1985	1986	1987	Prel. 1988	Prog. 1989
(Annual percentage change unless otherwise specified)						
<u>Income and prices</u>						
GDP	3.6	2.6	-3.9	1.5	1.1	1.5
GDP deflator	59.1	58.7	73.4	139.3	103.9	21.1
Consumer prices (end of year)	59.2	63.7	105.7	159.2	51.7	19.0
Consumer prices (average)	65.4	57.7	86.2	131.9	115.2	21.9
Consumer prices (monthly average)	4.0	4.2	6.2	8.3	3.7	1.4
<u>External sector</u>						
Exports (f.o.b.)	9.7	-9.5	-24.7	28.3	3.4	8.9
Export volume	8.0	-3.8	7.4	13.4	1.4	4.7
Imports (f.o.b.)	31.6	17.4	-13.5	6.9	51.7	9.9
Import volume	27.1	17.2	-11.7	4.3	43.2	5.6
Terms of trade (debt -)	-1.9	-5.3	-28.2	10.4	-5.6	-
Nominal effective exchange rate						
Average (depreciation -)	-24.4	-28.7	-59.3	-57.8	-37.6	-8.5
End of period	-19.9	-48.0	-81.8	-55.5	-9.2	-9.5
Real effective exchange rate						
Average (depreciation -)	16.9	2.9	-30.0	-8.1	21.2	-
End of period	18.5	-20.6	-23.5	3.3	28.7	-
<u>Nonfinancial public sector</u>						
Receipts	63.1	56.1	62.7	135.5	100.0	12.3
Outlays	56.9	66.4	89.3	139.3	94.9	-2.0
<u>Money and credit 1/</u>						
Domestic credit (net)	62.1	58.0	89.3	120.5	75.2	15.2
Public sector (net)	26.2	43.9	81.1	75.9	29.3	4.3
Private sector	35.8	14.1	8.2	44.6	45.9	11.3
Money and quasi-money (M-2)	70.1	46.3	94.4	141.0	42.4	10.3
Velocity (GDP/M-2)	4.1	4.3	4.1	4.4	5.3	5.2
Real growth in M-2	6.0	-7.6	-0.9	-0.4	6.9	4.5
Velocity (GDP/M-4)	3.6	3.7	3.4	3.4	3.7	3.3
Interest rate (monthly average rate, 1-month treasury bill)	4.0	5.0	6.6	7.8	5.8	3.5
(Percent of GDP)						
Public sector savings	0.3	-2.7	-9.3	-9.6	-6.0	-0.7
Public sector savings (adjusted) 2/	6.9	4.9	7.7	7.4	6.9	2.6
Public sector economic deficit	-7.1	-8.6	-14.8	-15.0	-11.3	-5.8
Primary balance	4.8	3.3	2.3	5.0	5.9	2.3
Operational balance	0.3	-1.0	-1.8	2.0	-4.4	-2.5
Public sector borrowing requirement	8.4	9.5	15.6	15.9	12.9	7.0
Gross domestic investment	19.9	21.2	19.1	18.6	20.5	21.3
Gross national savings	22.3	21.6	17.2	20.4	19.9	19.9
Current account deficit (-)	2.4	0.4	-0.9	2.9	-1.6	-2.4
Public external debt (including IMF) 3/	38.9	38.6	57.8	59.5	67.2	66.8
Interest payments on public debt 4/	4.7	4.1	4.7	4.3	4.0	4.4
(In percent of exports of goods and nonfactor services)						
Public debt service 5/						
Before rescheduling	47.7	66.6	78.2	89.9	96.8	69.8
After rescheduling	37.8	39.8	44.3	41.9	49.0	41.6
(In billions of U.S. dollars)						
Overall balance of payments	3.0	-3.4	-1.1	6.6	-6.9	1.5
Gross official reserves (months of imports) 6/	9.6	5.6	7.4	13.5	4.2	4.2

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

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

2/ Adjusted for the inflationary component of interest payments which is treated as debt amortization but includes inflation tax.

3/ Includes short-term debt, but net of gross international reserves.

4/ Interest paid on external public debt, net of interest earned on gross international reserves.

5/ Includes debt service on fund credit.

6/ Excluding gold and payments agreements.



Relations with the IBRD

Throughout the recent period of adjustment, Mexico has maintained close links with the IBRD. As of January 31, 1989, the Bank had an outstanding exposure of US\$7,172 million, of which 35 percent was concentrated in agriculture and rural development, 20 percent in industry, 16 percent in transportation, 8 percent in power, 16 percent in urban services, tourism, and vocational training, and 5 percent in multi-sectoral operations. Annual lending commitments rose rapidly from US\$598 million in FY 1985 to US\$2,030 million in FY 1988. Disbursements rose from US\$788 million in FY 1985 to US\$1,218 million in FY 1987, before declining slightly to US\$1,005 million in FY 1988. A listing of the World Bank Group operations in Mexico is presented below.

In recent years, the World Bank has transferred an increasing volume of resources through quick-disbursing, policy-based and sector adjustment lending, becoming the largest single source of external finance during the 1986-88 period. These loans were designed not only to support key structural adjustment reforms in trade, agriculture, and public enterprise management, but also as a catalyst to attract additional bilateral and commercial bank finance. Six World Bank loans, ranging in amounts from US\$250-500 million each, were linked, along with an IMF stand-by arrangement, to the parallel money and growth facilities negotiated as part of the 1986 commercial bank financing package. The World Bank also provided guarantees amounting to US\$750 million. To facilitate an exchange of new Mexican bonds for existing commercial bank claims, the Bank agreed in January 1988 to provide a limited waiver of its negative pledge rights.

Currently, the Bank is in an advanced stage of discussions on a new set of policy-based loans, totaling up to US\$1.5 billion, intended to support further policy reforms in finance, trade, industrial, and public enterprise management. In addition, project loans for transport, water, and other urban services, for housing, health, and nutrition, and to support the restructuring of agriculture, power, and industry are either approved or under preparation for Board presentation in the near future. Depending on the progress toward agreed measures, the level of World Bank commitments in FY 1989 may amount to US\$1.7 billion.

Status of Bank Group Operations in Mexico 1/

A. Statement of Bank Loans

(As of September 30, 1988)

(In millions of U.S. dollars)

Loan No.	Fiscal Year	Borrower	Purpose	Amount less Cancellations	Undisbursed
73 loans fully disbursed				4,969.62	
1706-5	1979	NAFINSA	Irrigation	92.00	26.27
1858-5	1980	NAFINSA	Irrigation	70.00	24.83
1990	1981	BANOBAS	Urban development II	144.00	10.80
2043	1982	NAFINSA	Integrated rural development	175.00	15.98
2142	1982	NAFINSA	Capital goods industry	152.30	9.32
2194	1983	BANOBAS	Urban engineering	9.20	4.85
2262	1983	NAFINSA	Agricultural marketing	115.00	24.78
2281	1983	BANOBAS	Third water supply	100.30	33.77
2325	1983	NAFINSA	Third small/medium industry	175.00	1.46
2331	1983	BANCOMEXT	Export development	350.00	15.78
2428	1984	BANOBAS	Highways	200.00	94.46
2450	1984	BANPFSCA	Ports	56.30	41.77
2525	1985	NAFINSA	Chiapas rural roads	22.00	19.95
2526	1985	NAFINSA	Chiapas agricultural development	90.00	75.86
2546	1985	NAFINSA	Small/medium scale mining II	105.00	72.91
2559	1985	NAFINSA	Vocational education	81.00	34.60
2575	1985	BANOBAS	Railways V	300.00	195.18
2612	1986	BANOBAS	Low-income housing I	150.00	71.07
2658	1986	NAFINSA	Proderith II	109.00	93.10
2665	1986	BANOBAS	Earthquake rehabilitation	400.00	62.40
2666	1986	BANOBAS	Municipal strengthening	40.00	37.98
2669	1986	BANOBAS	Solid waste pilot	25.00	19.83
2745	1987	BANCOMEXT	Trade policy loan I	500.00	10.94
2746	1987	NAFINSA	Industrial recovery	150.00	105.03
2747	1987	NAFINSA	Technology development	48.00	37.98
2777	1987	BANCOMEXT	Export development II	250.00	79.33
2824	1987	BANOBAS	Urban transport	125.00	107.45
2837	1987	NAFINSA	Agricultural credit	400.00	174.44
2858 3/	1987	NAFINSA	Small/medium industries IV	185.00	185.00
2859	1987	NAFINSA	Agricultural extension	20.00	17.07
2875	1987	BANOBAS	Highway maintenance	135.00	128.00
2876	1988	NAFINSA	Manpower training	80.00	74.00
2882	1988	BANCOMEXT	Trade policy loan II	500.00	77.74
2916	1988	NAFINSA	Steel sector restructuring	400.00	378.89
2918	1988	NAFINSA	Agricultural sector loan	300.00	289.36
2919 3/	1988	NAFINSA	Fertilizer sector loan	265.00	265.00
2946 3/	1988	BANOBAS	Ports rehabilitation	50.00	50.00
2947 3/	1988	BANOBAS	Housing finance	300.00	300.00
TOTAL				11,638.88	
Of which has been repaid to the Bank				2,867.65	
Total now outstanding				8,771.23	
Amount sold				92.34	
Of which as been repaid				92.34	
Total now held by Bank 2/				--	
Total undisbursed				8,771.23	3,264.15
					=====

1/ The status of the projects listed in Part A is in a separated report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

2/ Prior to exchange adjustments.

3/ Not yet effective.

B. Statement of IFC Investments

(As of September 30, 1988)

(In millions of U.S. dollars)

Fiscal Year	Obligor	Type of Business	Original Approvals		
			Equity	Loan	Total
1958/59	Industrial Perfect Circle, S.A. 1/	Industrial equipment	--	0.8	0.8
1958	Bristol de Mexico, S.A. 1/	A.C. engine overhaul	--	0.5	0.5
1961	Aceros Solar, S.A. 1/	Twist drills	--	0.3	0.3
1962/5/6/8	Fundidora Monterrey, S.A. 1/	Steel	21.4	2.3	23.7
1963	Tubos de Acero de Mexico	Stainless steel pipes	0.1	0.9	1.0
1963	Quimica del Rey, S.A. 1/	Sodium sulphate	--	0.7	0.7
1964/6	Industria del Hierro, S.A.	Construction equipment	2.0	--	2.0
1970	Minera del Norte 1/	Iron ore mining	--	1.5	1.5
1971	Celanes Mexicana, S.A. 1/	Textiles	--	12.0	12.0
1972	Promotora Papel Periodicos, S.A. de C.V. 1/	Pulp and paper	2/	--	2/
1973/9	Cementos Veracruz, S.A.	Cement	--	15.9	15.9
1974/81	Cancun Aristos Hotel	Tourism	0.3	1.0	1.3
1975/78	Mexinox, S.A.	Stainless steel	3.2	12.0	15.2
1978/81/84	Papeles Ponderosa, S.A.	Pulp and paper	5.0	10.7	15.7
1978	Teraftalatos Mexicanos, S.A.	Petrochemicals	--	19.0	19.0
1979/81/87	Hotel Camino Real Ixtapa, S.A.	Tourism	4.2	--	4.2
1979/84	Empresas Tolteca, S.A.	Cement	7.9	168.0	175.9
1979	Conductores Monterrey, S.A.	Electrical wire and cable	--	18.0	18.0
1980	Industrias Resistol, S.A.	Particle board	--	25.0	25.0
1980	Vidrio Plano de Mexico, S.A.	Flat glass	--	114.9	114.9
1980	Minera Real de Angeles, S.A.	Mining	--	110.0	110.0
1981/86	Celulosicos Centauro, S.A.	Pulp and paper	--	59.5	59.5
1981	Corporacion Agroindustrial S.A.	Agri-business	3.0	11.3	14.3
1984	Capital Goods Facility 1/	Capital goods financing	--	100.0	100.0
1984/88	Metalsa, S.A.	Auto chasis	1.4	8.0	9.4
1985	Proteison, S.A. de C.V.	Agri-business	0.8	2.0	2.8
1985	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemicals	--	16.4	16.4
1986/88	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and paper	3.1	10.0	13.1
1987	Agromex Phase I (AES A)	Vegetable and fruit processing	0.5	1.5	2.0
1987	Industrias Sulfamex, S.A. de C.V.	Chemical and petrochemical	0.5	2.0	2.5
1988	Sealed Power de Mexico	Auto assembly	--	9.0	9.0
1988	Apasco, S.A. de C.V.	Cement	--	46.0	46.0
1988	Salumi, S.A. de C.V.	Food and food processing	--	22.1	22.1
1988	Crescent Market Aggregates	Construction material	--	37.0	37.0
Total gross commitments			53.4	838.3	891.7
Less cancellations, terminations, repayment, and sales			26.1	681.6	707.7
Total commitments now held by IFC			27.3	156.7	183.0
			====	=====	=====
Total undisbursed (including participants)			--	64.0	64.1
			===	===	=====

1/ Investments which have been fully cancelled, terminated, written off, sold, or repaid.

2/ US\$25,000.

Mexico--Statistical Issues

1. Outstanding statistical issues

a. Real sector

Given the rates of inflation in the past several years, the weights (base 1978) for the wholesale price and consumer price indices may have become unrepresentative.

b. Government finance

The 1988 Government Finance Statistics Yearbook contains actual data for the consolidated central government through 1986, preliminary for 1987, and budgeted for 1988. Also, aggregate data on central government debt are included through 1986. The same data have been published in the April issue of IFS.

c. Balance of payments

The Bureau of Statistics is currently discussing with the authorities the most appropriate way to record exceptional financing transactions, debt/bond swaps, counterpart to valuation changes in reserves and counterpart to gold monetization.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Mexico in the May 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Mexico, which during the past year have been provided on a timely basis.

Status of IFS Data

		<u>Latest Data in May 1989 IFS</u>
Real Sector	- National Accounts	1987
	- Prices: WPI	January 1989
	- Production	04 1987
	- Employment	N.A.
	- Earnings	01 1985
Government Finance	- Deficit/Surplus	1988
	- Financing	1988
	- Debt	1986
Monetary Accounts	- Monetary Authorities	December 1988
	- Deposit Money Banks	December 1988
	- Treasury Bill Rate	October 1988
External Sector	- Merchandise Trade: Values	November 1988
	Prices	N.A.
	- Balance of Payments	02 1988
	- International Reserves	December 1988
	- Exchange Rates	March 1989

## Illustrative Examples of Oil Price and Interest Rate Adjustments

### 1. Introduction

This appendix seeks to illustrate the operations of the oil price and interest adjustment mechanisms described in Section IV.8.

The mechanism contemplates an upper-end and a lower-end adjustment based on the cumulative effect of the deviations in the price of oil and in external interest rates. The upper-end adjustment to performance criteria (e.g., high oil prices and low external interest rates) will be equivalent to any excess above a threshold of US\$950 million (or its Mexican peso equivalent) of the value of the combined cumulative effect of the deviations in the price of oil and external interest rates relative to their projected levels (as described below). The lower-end adjustment (e.g., low oil prices and high external interest rates) will be equivalent to any shortfall in excess of a threshold of US\$950 million (or its Mexican pesos equivalent) of the value of the combined cumulative effect of the movement in the price of oil and external interest rates relative to their projected levels (as described below) but will be limited to US\$1.5 billion (or its Mexican peso equivalent). <sup>1/</sup>

### 2. Upper-end adjustment

If in any calendar quarter beginning January 1, 1989, the combined cumulative effect of higher than projected oil prices and lower than projected external interest rates exceeds the threshold value, the target for the Banco de Mexico's net international reserves for the same quarter will be raised by the value of the excess. In addition, the corresponding limits on the net domestic assets of the Banco de Mexico, on the net credit from the Banco de Mexico to the public sector, on the PSBR, and on the operational deficit of the nonfinancial public sector will be lowered by the Mexican peso equivalent to the adjustment effected to the net international reserve target.

The cumulative upper-end adjustment formula for these variables is as follows:

(Actual average oil price - US\$12 a barrel) (daily volume of crude oil exports) (number of days) plus  
(0.105 - actual average interest rates lagged by one quarter, but excluding the first quarter) (total debt with floating interest rate) (number of quarters/4) minus  
US\$950 million (number of quarters/4).

---

<sup>1/</sup> For the June 30, 1989 and September 30, 1989 testing dates, the relevant threshold values will be limited to 50 percent and 75 percent, respectively, of US\$950 million (or its peso equivalent).

It is assumed that the daily value of crude oil exports is 1.3 million barrels a day; the amount of total debt subject to floating debt is about US\$60 billion.

Case 1. High oil price and low interest rate.

If, up to June 30, 1989, the actual oil price average would have been US\$15 a barrel and the average LIBOR were 9 1/2 percent for the period October 1988-March 1989, then the cumulative upper-end adjustment is:

$$[(US\$15 - US\$12) (1.3) (181)] + [(0.105 - 0.095) (US\$60 \text{ billion}) (1/4)] - [(US\$950 \text{ million}) (2/4)] = US\$380.9 \text{ million.}$$

This is the amount (or its Mexican peso equivalent) by which quantitative performance criteria will be adjusted.

Case 2. High oil price and high interest rate.

If for the three quarters ended September 30, 1989, the actual oil price averages US\$15 a barrel, but the average LIBOR is 11 percent for the three quarters ended June 1989, then the cumulative upper-end adjustment is:

$$[(US\$15 - US\$12) (1.3) (273)] + [(0.105 - 0.11) (US\$60 \text{ billion}) (2/4)] - [(US\$950 \text{ million}) (3/4)] = US\$202.2 \text{ million.}$$

The target for the primary balance of the nonfinancial public sector will be raised only by the excess above the threshold value corresponding to variations in the price of oil. However, this adjustment will not exceed the value of the adjustment for the other quantitative performance criteria (i.e., including external interest rates or US\$202.0 million) even though the value corresponding to variations in the price of oil is larger than that amount.

3. Lower-end adjustment

If in any calendar quarter beginning January 1, 1989, the combined cumulative effect of lower than projected oil prices and higher than projected external interest rates (as defined above) exceeds the threshold value, the target for the Banco de Mexico's net international reserves for the same quarter will be lowered by the value of the excess. In addition, the corresponding limits described in the previous section will be raised by the Mexican peso equivalent of the adjustment to the net international reserve target.

Case 3. Low oil price and high interest rates.

If, up to June 30, 1989, the actual oil price average is US\$10 a barrel and the average LIBOR is 11 percent then the cumulative lower-end adjustment is:

$$[(US\$12 - US\$10) (1.3) (181)] + [(0.11 - 0.105) (US\$60 \text{ billion}) (1/4)] - [US\$950 \text{ million} (2/4)] = US\$70.6 \text{ million.}$$

Case 4. Low oil price and high interest rate, constrained by lower limit on reserves.

If, up to September 30, 1989, the actual oil price averages US\$6 a barrel and the average LIBOR is 15 percent, then the cumulative lower-end adjustment is limited to US\$1,500 million as:

$$[(US\$12 - US\$6) (1.3) (273)] + [(0.13 - 0.105) (US\$60 \text{ billion}) (2/4)] - [US\$950 \text{ million} (3/4)] = US\$2,167 \text{ million. This amount is larger than US\$1,500 million, the maximum amount by which reserves could be adjusted downwards due to adverse external conditions.}$$



Summary of Extended Arrangement for 1989-92

I. Targets

1. Real GDP growth, which was almost zero on average during 1982-88, is projected to rise steadily from 1.5 percent in 1989 to 5.5 percent in 1992 and 6 percent in subsequent years. In the event that there is no debt reduction, a less favorable outcome is likely.
2. The 12-month rate of inflation, which decelerated from 160 percent in December 1987 to 52 percent in December 1988, is targeted to decelerate further to 18 percent in 1989 and to 6 percent by 1991.
3. Following a loss of almost US\$7 billion in 1988, net international reserves are targeted to increase by US\$1.5 billion in 1989 and by about US\$1 billion a year in the subsequent period, under the base scenario.

II. Assumptions

1. The inflation rate of Mexico's trading partners is assumed to be 4 percent a year (in U.S. dollar terms) and the terms of trade to be unchanged over the medium term. Crude oil export are expected to average 1.3 million barrels a day in 1989 and to decline slightly in the next few years reflecting capacity constraints. The price of Mexican mix of crude oil is projected to rise in line with other international prices from an initial level of US\$12 a barrel in 1989. On the basis of adequate exchange rate and structural policies, nonpetroleum exports are expected to expand at a faster pace than the growth in external markets, while the increase in imports would decelerate gradually to a pace in line with that of real GDP.
2. The program assumes that Mexico would be able to obtain the required external financing in the form of new money and/or debt/debt service reduction, in order to cover its external financing needs over the medium term. These gross needs are estimated to amount to about US\$7 billion a year.
3. External interest payments are projected on the assumption that the three-month LIBOR remains at 10.5 percent per annum throughout the period.
4. The velocity of money, defined as the ratio of nominal GDP to M4, is projected to decline from 3.7 in 1988 to 3.3 in 1989 and to remain constant thereafter.
5. Domestic real interest rates, which averaged 2 1/2 percent per month in 1988, are expected to remain high during much of 1989, until a multiannual financing package has been secured with the commercial banks. Real interest rates are expected to decline to less than 1 1/2 percent a month in 1990 and about 1 percent per month in subsequent years.

### III. Principal Elements of the Economic Program

#### 1. Medium-term policy framework

a. The Mexican economic program combines demand management measures and structural policies needed to foster economic efficiency and raise investment in order to set the stage for sustained economic growth.

b. In the public sector, the authorities have undertaken a major reform of the tax system, have rationalized public sector spending and have reduced the size of the public sector through divestiture of a large number of enterprises. In 1989, major revisions were made to the corporate and personal income taxes, and the structure of import tariffs in order to broaden the tax base, lower marginal tax rates, and reduce tax dispersion. In the next few years, the authorities intend to revise the property tax system, review the special tax bases, and strengthen considerably tax administration. In addition, the divestiture of non-strategic enterprises will be continued.

c. In the financial sector, the authorities have implemented a far-reaching reform of the sector since November 1988 which should enhance the efficiency of financial intermediation and improve its transparency. The most important of these measures were the elimination of controls on interest rates and on maturities of all instruments, and the replacement of the reserve requirement regime applied to these instruments by a uniform liquidity coefficient of 30 percent. This coefficient can be discharged in the form of deposits in the Bank of Mexico or investment in government paper.

d. At the end of 1987, the authorities undertook a major liberalization of the trade system which removed virtually all quantitative restrictions on imports and lowered the maximum tariff rate to 20 percent. Since then the authorities have reduced the tariff dispersion by raising the minimum tariff rate on all items to 10 percent, with the exception of some basic foodstuffs and medicines.

e. Other structural policies which will be pursued by the authorities in the immediate future relate to domestic and foreign direct investment, and pricing policies for public sector goods and services.

#### 2. Policies for 1989

a. The financial program for 1989 establishes quarterly performance criteria on the public sector borrowing requirements, the operational deficit, the primary surplus, the public sector's net use of foreign credit, net credit to the public sector by the Bank of Mexico, the net domestic assets of the Bank of Mexico, and net foreign assets of the Bank of Mexico. In view of the sensitivity of the macroeconomic aggregates to external developments, a band has been established so that adjustments will be made to the performance criteria only if the

cumulative effect of the deviations in the price of oil and interest rate from baseline assumptions were to exceed US\$950 million in either direction. Also, the lower end adjustment will be limited to US\$1.5 billion, in order to ensure an adequate level of foreign reserves. The fiscal primary surplus will be adjusted only for deviations in the price of oil while the public sector's net use of foreign credit will not be subject to any adjustment. Performance criteria will be adjusted in the event of debt reduction operations so that their macroeconomic effects are neutral.

b. In 1988, the overall public sector borrowing requirement (PSBR) was Mex\$51.2 trillion, or 12.9 percent of GDP; for the same year, the operational deficit totaled Mex\$17.6 trillion, or 4.4 percent of GDP, and the primary surplus was Mex\$23.3 trillion or 5.9 percent of GDP. In 1989, the PSBR is to be limited to Mex\$33.9 trillion, or 7 percent of GDP; the operational deficit is to be limited to Mex\$12.1 trillion, or 2.5 percent of GDP; and the primary surplus is to be at least Mex\$35.4 trillion, or 7.3 percent of GDP.

c. If, notwithstanding, the observance of the above quantitative performance criteria macroeconomic objectives would not be achieved, the authorities will adopt additional measures, as needed, in order to meet their macroeconomic targets.

d. In 1988, the public sector's net use of foreign credit was estimated at US\$0.4 billion. For 1989, the public sector's net use of foreign credit has been set at a maximum of US\$6.7 billion.

e. In 1988, the Bank of Mexico's net credit to the nonfinancial public sector increased by Mex\$17.5 trillion, equivalent to 240 percent of the stock of note issue at the beginning of the period. In 1989, the public sector's use of such credit shall not exceed Mex\$3.6 trillion or 27.5 percent of the note issue at the beginning of the period.

f. The net domestic assets of the Bank of Mexico, defined as the difference between note issue and the net foreign assets of the Bank of Mexico, rose by Mex\$21.3 trillion in 1988. In 1989, they should decline by at least Mex\$1.0 trillion.

g. In 1988, the net foreign assets of the Bank of Mexico fell by US\$6.9 billion, reflecting mainly a weakening in the current account and a substantial amount of private sector debt repayments. In 1989, the net foreign assets should increase by at least US\$1.5 billion.

h. In 1988, the Mexican peso appreciated by about 29 percent in real effective terms. From January 1 to July 31, 1989, the peso is being depreciated at the rate of 1 peso per dollar per day which, leading to some real effective depreciation in the first few months of the year. The authorities have indicated that exchange rate policy in 1989 will be managed so as to be consistent with their balance of payments and other macroeconomic objectives; they intend to keep the exchange rate under constant review.

IV. Review of Economic Program

The first review of Mexico's economic program is expected to be completed before August 31, 1989. A second review with the Fund to reach policy understandings and establish performance criteria for 1990 is scheduled for completion before February 28, 1990. Subsequently, consultation discussions will take place before February 28, 1991, and before February 29, 1992, to reach policy understandings for 1991 and 1992, respectively.

Mexico: Proposed Schedule for Drawings Under  
First Year of Extended Arrangement

Date of Drawing	Drawing Dependent on:	Amount (in millions of SDRs)
May 1989	Approval of extended arrangement	233.1
August 1989	Compliance with quantitative performance criteria for June 30, 1989 and completion of program review <u>1/</u>	233.1
November 1989	Compliance with quantitative performance criteria for September 30, 1989	233.1
February 1990	Compliance with quantitative performance criteria for December 31, 1989 and completion of second program review to reach policy understandings for 1990 <u>2/</u>	233.1

1/ Scheduled to be completed by Executive Board not later than August 31, 1989.

2/ Scheduled to be completed not later than February 28, 1990.

Mexico: Basic DataArea and population

Area	1,972,201 sq. kilometers
Population (mid-1988)	84.0 million
Population growth (1981-88)	2.4 percent
Open unemployment (1988)	3.6 percent
Population density per sq. km. of agricultural land	78.3
Distribution of land by farm size	Not available
Percentage of private income received by highest 20 percent of households	57.7
Life expectancy at birth (1986)	66.3 years
Infant mortality rate	50.6 per thousand
Child death rate	3.0 per thousand
Population per physician	1,200
Population per hospital bed	Not available
Population with access to safe water	58.0 percent
Population with access to electricity	Not available
Pupils reaching grade 6	64.9 percent
Per capita supply of:	
Calories (percent of requirements)	125.9
Protein (grams per day)	72.4

GDP (1988)

SDR 131.4 million
US\$176.6 million
Mex\$397.6 trillion

GDP per capita (1988)

SDR 1,564.4

	1985	1986	1987	Prel. 1988
<u>Origin of GDP (1980 prices)</u>				
		(In percent)		
Agriculture and fishing	8.5	8.7	8.5	8.2
Mining	3.7	3.7	3.8	3.9
Manufacturing	21.4	20.9	21.2	21.3
Construction	5.4	5.0	5.1	4.8
Electricity	1.3	1.4	1.4	1.4
Commerce	26.7	25.7	25.7	25.8
Transport and communication	6.2	6.4	6.3	6.4
Financial services	9.9	10.7	10.8	10.9
Other	17.0	17.6	17.2	17.3
<u>Ratios to GDP</u>				
Exports of goods and services	15.0	16.8	19.5	16.4
Imports of goods and services	10.0	12.6	12.1	14.1
Balance of payments current account	0.4	-0.9	2.9	-1.6
Public sector revenues	19.4	18.5	20.1	20.4
Public sector expenditure	28.1	33.2	35.2	31.8
Public sector savings (adj.) 1/	4.9	3.7	7.4	0.9
Public sector deficit 2/	-8.7	-14.8	-15.0	-11.3
External public debt (end of year)	38.6	57.8	59.5	47.2
Gross national savings	21.6	17.2	21.4	18.9
Gross domestic investment	21.2	18.1	18.6	20.5
Money and quasi-money (average of year)	23.3	24.3	22.6	18.7
Change in money and quasi-money	7.0	12.1	16.6	6.3
<u>Annual percentage change</u>				
Real GDP per capita	0.3	-6.6	-0.8	-1.1
Real GDP (at 1980 prices)	2.6	-3.8	1.5	1.1
Nominal GDP	60.8	67.6	142.9	106.1
Domestic expenditures	66.0	68.9	135.0	117.3
Investment	71.4	43.4	149.1	127.0
Consumption	64.5	76.1	131.7	114.9
GDP deflator	56.7	74.4	139.3	103.8
Consumer prices (average)	57.7	86.2	131.9	114.2
Public sector revenues	53.4	59.2	165.0	109.0
Public sector expenditures	68.8	98.1	157.1	86.1
Money and quasi-money (M2)	46.3	94.4	141.0	42.4
Money	53.2	72.1	129.7	58.1
Quasi-money	43.7	102.8	144.5	37.7
Net domestic credit 3/	59.0	89.3	120.5	73.3
Credit to public sector	44.9	81.1	75.9	29.3
Private sector	23.5	29.3	62.9	39.2
Merchandise exports (f.o.b.)	-0.8	-24.4	28.3	3.6
Merchandise imports (f.o.b.)	16.8	-13.6	7.0	54.9

	1985	1986	1987	Prel. 1988
<u>Public sector finances</u>	<u>(In billions of Mexican pesos)</u>			
Revenues	9,213	14,667	38,871	81,244
Expenditures	13,322	26,392	67,944	126,232
Current account	-1,299	-7,393	-18,589	-28,688
Overall deficit	-4,110	-11,725	-28,874	-44,987
<u>Balance of payments</u>	<u>(In billions of U.S. dollars)</u>			
Exports (f.o.b.)	22.9	17.3	22.2	23.0
Imports (f.o.b.)	-13.2	-11.4	-12.2	-18.9
Factor services	-8.9	-7.7	-7.2	-7.4
Other	-0.1	0.7	1.2	0.6
Current account	0.7	-1.2	4.0	-2.8
Official capital	0.3	-0.5	2.6	-1.2
Private capital (including errors and omissions)	-4.4	0.5	--	-2.8
Basic balance	-3.2	-1.1	6.6	-6.9
Net official reserve change (increase -)	3.4	1.1	-6.6	6.9
<u>International reserves</u> <sup>4/</sup>	<u>(In millions of SDRs)</u>			
Monetary authorities (gross)	5,598.5	5,724.9	10,622.4	4,907.7
Monetary authorities (net)	2,817.1	1,630.7	6,706.1	1,351.1

<sup>1/</sup> Adjusted for inflationary component of interest payments which is treated as amortization but includes inflation tax.

<sup>2/</sup> Includes net deficit of the public sector outside budget control.

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

<sup>4/</sup> End of period.

