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CONFIDENTIAL

July 23, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Mexico - Request for Stand-By Arrangement - Letter of Intent

Attached for consideration by the Executive Directors is a copy of the letter of intent from the Mexican authorities requesting a stand-by arrangement equivalent to SDR 1,400 million for a period of 18 months, together with a technical memorandum of understanding. The staff paper describing and analyzing the financial program of Mexico will be circulated in due course.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Pujol, ext. 8480.

Att: (1)

Washington, D.C.
July 22, 1986

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. de Larosière:

1. Mexico experienced severe economic problems in 1981-82, and in late 1982 the Government undertook a comprehensive adjustment program that had as its objectives the restoration of financial stability and sustained economic growth. That program had the support of the international financial community and of the International Monetary Fund through an extended arrangement covering the period 1983-85. Under the program the Mexican economy made substantial gains in 1983 and 1984. Despite a sharp fall in output in the second half of 1982 and first half of 1983, the level of employment was preserved and economic activity began to recover in the second half of 1983 in response to the measures adopted; the recovery gathered momentum in 1984 and the first half of 1985. Inflationary pressures abated after 1982, although the rate of price increase remained high. The public sector deficit was substantially reduced, despite rising interest payments, and the balance of payments strengthened markedly.

2. Difficulties in the implementation of the program became apparent in the last quarter of 1984 and became more pronounced in the first half of 1985. The upswing in private economic activity together with some deviations in fiscal performance, due partly to higher than expected interest payments and the lack of availability of external financing, resulted in pressures on prices and the balance of payments. In addition, during 1985 the country had to weather the impact on the public finances and the balance of payments of the weakening of the international petroleum market and the traumatic effects of the September earthquakes. The growth in the financing requirements of the public sector led to reduced credit availability for the private sector towards the end of the year, with adverse effects on private investment which had led the 1984 recovery and had remained strong in the first part of 1985. Moreover, for a time, exchange rate policy was not sufficiently active to prevent a deterioration of the balance of payments. However, a steep adjustment of the exchange rate in July 1985, accompanied by a considerably more flexibly managed float of the controlled official exchange rate, helped to arrest the weakening in the external accounts in the latter part of the year.

3. The 1986 budget was drafted with the aim of inducing a further correction of the public sector deficit so as to compensate for the 1985 deviations and consolidate the earlier gains made in the strengthening of the balance of payments, the reduction of inflation, and the rationalization of public sector operations. However, in early 1986 the economy was greatly affected by the sharp drop in international petroleum prices and the consequent fall in national income, export receipts and public sector revenue, with the decline being estimated on an annual basis at about 6.5 percentage points of GDP. The result has been increased balance of payments and domestic price pressures, notwithstanding the tightening of credit policies and the real depreciation of the currency which has stimulated significantly the growth of nonpetroleum exports. At the same time, output has shown signs of severe contraction.

4. The Mexican Government has responded to this worsening of the economic situation by adopting an economic program of growth-oriented adjustment and structural reform. On the basis of this program, which is described below, the Government of Mexico requests the use of the financial resources of the International Monetary Fund for the equivalent of SDR 1,400 million in the form of a stand-by arrangement for a period of 18 months.

5. In mapping its economic strategy for the period ahead, the Government has been guided by a set of principles which served as the basis for the economic and financial program. These are:

a. The fundamental objective of the program designed by the Mexican authorities is to restore sustainable growth in the economy in a climate of financial stability.

b. The economic program has been framed in a medium-term horizon to encompass both the demand management measures required to deal with pressing domestic and external imbalances and the supply oriented structural policies necessary to foster economic efficiency and thus reinforce the country's growth prospects in the longer run. These policies constitute a salient feature of the program.

c. The program should attract the necessary external support under adequate terms and conditions among all parties that have been involved in the financing of Mexico's development in the past. Given that a significant portion of Mexico's external debt was used to develop the country's oil capacity, it would seem appropriate that existing creditors continue to participate in supporting Mexico's efforts.

d. Because of the magnitude of the dependence and vulnerability of Mexico to oil price fluctuations, as well as the uncertainties prevailing in this area, it was considered appropriate to ensure that unforeseen developments in the price of oil, by themselves, would not jeopardize the success of the program. To this end, an important feature of the program is that some of its targets and the structure of the financial package depend on the evolution of the oil market.

e. To ensure the attainment of a moderate rate of growth, the program includes a contingency element that will permit an increase in selected public sector capital outlays if the economy does not appear to be overcoming recession by the first quarter of 1987.

6. The strengthening of public finances is a major element of the program because it contributes to the moderation of inflation, the reduction of pressures on interest rates, and an increased availability of resources to the private sector. To this end, public sector expenditure, price, and tax policies will be designed to promote greater efficiency in the allocation of resources. In the presence of high inflation, it is difficult to evaluate progress in the macroeconomic implementation of fiscal measures only by means of conventional methods of calculating the fiscal deficit. To separate, therefore, the inflationary component of the service of the internal public debt, the concept of an operational deficit is to be used alongside the usual calculations of total public sector borrowing requirements. The fiscal effort envisaged under the program measured at the level of the primary balance would be of the order of 3 percent of GDP, and the resulting reduction in the public sector borrowing needs would be achieved through a combination of changes in the structure of the tax system, adjustments in the prices and tariffs of the public enterprises, and reductions in public expenditure in relation to GDP.

7. The Mexican tax system was not designed to operate in an environment of high inflation and it increasingly has become less responsive to changes in nominal income. Moreover, actions taken to mitigate the impact of inflation and foreign exchange losses on firms' financial positions, together with the granting of tax incentives, have eroded the total taxable base. To correct the distortions and revenue loss that have evolved from the application of the tax code in its present form, the Government has decided to embark on a structural reform of the tax system. The key feature of the reform would be the correction of the base of the corporate income tax, to be calculated on a notional broad income base which would result from stricter limitations on the deductibility of interest payments. In addition, measures are being taken to reduce the revenue losses accruing to the Government from lags between the accrual and collection of taxes. The program also will involve improvements in tax administration. The potential yield of the tax package in 1987 which will be submitted for the consideration and approval of Congress has been estimated at 1.3 percent of GDP on an annual basis. Over the medium term, the Government's objective is to recover the ground lost in the area of tax revenue over the last few years.

8. In 1983 and 1984 there were major adjustments in the prices and tariffs charged by public enterprises aimed at strengthening public finances, improving resource allocation, and reducing unjustified subsidies. In developing these policies, a major concern of the authorities was to pay close attention to the protection of the purchasing power of low-income groups. During 1985 some of these prices and tariffs began to lag behind the rise in the overall price level, while costs of production generally rose with inflation. In response to this situation, in late 1985 and early 1986 catch-up adjustments for a number of public sector prices went into effect in an attempt to raise revenue to cover operational costs. Prices of most petroleum products were brought up to international levels; electricity tariffs were increased by 51 percent to 65 percent and a schedule of automatic monthly adjustments of 3 1/2 percent was authorized; more generally, prices and tariffs were revised in accordance with the originally approved schedules for 1986. Despite fairly strict adherence to these schedules, further price realignments have become necessary because inflation in 1986 is running at a rate higher than had been projected. The objective is to attain a structure of public prices consistent with the improvement of the efficiency in the use of resources in the economy and the elimination of inequitable subsidies. Because of the prevailing high rate and variability of inflation, there will be in some cases an initial realignment of public sector prices to be followed by frequent corrections to avoid the re-emergence of lags with respect to the overall rise in prices. The possibility of appropriate adjustments in several specific tariff categories, which at present contain a subsidy element, will be given careful consideration. Railroad tariffs and airline fares will continue to be reviewed so as to achieve a better price/cost relationship and closer ties with relevant international indicators. Telephone rates recently were raised to compensate for past inflation, and subsequent adjustments will be implemented as required to strengthen the financial position of the telephone company. With minor exceptions, prices of goods and services provided by a number of other state enterprises have been and will be kept up-to-date in terms of inflation and production costs. The general intention is to keep the revenues of the public enterprises under close watch to prevent situations where unplanned transfers from the Government or borrowing would be required to meet operating costs. Indicative of the Government's continuing intention to follow through on these commitments has been its decisive stance in politically sensitive areas such as the pricing of basic staples and urban transportation. In this connection, it should be noted that the price of a Mexico City subway fare, which up to now has been kept at Mex$1 per trip, will rise next August to Mex$20. It is estimated that the programmed increases in prices and tariffs will raise public sector revenues over the next 18 months by 1.2 percentage points of GDP with respect to their 1985 level.

9. Over the last four years, public expenditures have been adjusted drastically. Total public expenditure on goods and nonfinancial services under budgetary control on a cash basis have declined to 26.5 percent of GDP in 1985 and a projected 24.9 percent in 1986, from its 1981 peak of 35 percent. Public investment has fallen from 8.3 percent of GDP in 1981 to 3.9 percent in 1986, equivalent to a 55 percent reduction in real terms. However, because of the effects of persistent high inflation on the rates of interest payable on the stock of domestic public debt, the interest component in total public outlays has gone up considerably. As a consequence, total interest payments rose from 5 percent of GDP in 1981 to 12.3 percent in 1985, and an estimated 18.5 percent in 1986. Thus, there is little margin for the curtailment of public sector expenditures without serious short- and long-term effects on its operational capacity. The fiscal program calls for a reduction in public expenditure on goods and nonfinancial services by the equivalent of 0.5 percentage points of GDP in 1987. At the same time, it emphasizes the policy of structural change. In order to allow for an increase in capital outlays in strategic productive and social sectors while reducing the share of current expenditure. On present plans for 1987, capital outlays will rise by 0.5 percentage point of GDP, or by some 15 percent in real terms. In order to make room for this rise in public investment, the real growth in current expenditure will be kept to a minimum and will be somewhat lower than the expected growth of real GDP.

10. The Mexican authorities intend to intensify their efforts in implementing their current policy of structural change in the area of public expenditure along two major lines: "desincorporación" and industrial reconversion. The Mexican authorities reaffirm the principle stated in the Constitution and various laws of Mexico of maintaining under state control the strategic and priority public enterprises. Within this general principle, the policy of "desincorporación"--which includes the selling, merging, closing, and/or transferring of nonstrategic and nonpriority firms--will continue. At the beginning of the present Administration, in December 1982, there existed 1,155 public entities; the number has since been reduced to 697 and a further reduction will take place during the coming months. In accordance with the principles stated in the 1985 document "General Criteria of Economic Policy for 1986", the authorities intend to raise the levels of efficiency and productivity of the strategic and priority firms of the public sector. Actions implemented over the last months will be carried on and strengthened in the future. CONASUPO has reorganized its operations, and rationalized subsidies. Interest rate subsidies granted by development banks have been cut substantially. Industrial reconversion plans are being carried out in the sugar, fertilizer, and steel sectors to reduce operating costs and to make room for productivity-increasing investments. Shipyards are being restructured to benefit from new technology and to increase capacity utilization. Greater flexibility is being introduced in the operations of the railways and airline companies.

11. Despite the measures adopted by the Banco de Mexico since early 1985 to contain the monetary effects of the growing financial needs of the public sector in the absence of external financing, there was a substantial loss in net international reserves in the first seven months of that year. The reserve position improved in the latter part of 1985 in response to increased flexibility in the management of the exchange rate and tighter controls on credit, including that to the private sector, with had adverse repercussions on economic activity. The weakening of the fiscal situation in the first half of 1986 as a result of the severe decline in oil revenues has resulted in rapid rates of domestic credit expansion and, in recent months, a renewed deterioration in the official net international reserve position. For the period of the program the conduct of monetary and credit policy is to be in conformity with the objectives of slowing the rate of inflation, achieving the balance of payments target of the program, and supporting output recovery. As regards the latter, the policy stance of the Banco de Mexico will be consistent with an improved availability of credit to the private sector as resources become available.

12. Following various measures of monetary regulation adopted by the Banco de Mexico to absorb excess liquidity in 1985, interest rates payable on domestic-currency denominated deposits rose in nominal terms and real rates have since remained positive. This, however, has not been sufficient to arrest a progressive weakening of financial savings because of an apparent deterioration in the public's expectations regarding inflation and the exchange rate. The adoption of a more flexible interest rate posture in late 1985 and early 1986 has prevented a further deterioration in the willingness of the public to raise its holdings of financial assets in real terms. It is the intention of the authorities to continue to pursue a flexible interest rate policy to secure a competitive yield on domestic savings and to rely more on interest rates to promote an efficient utilization of financial resources. In this connection, an auction system for the placement of government securities has been recently reintroduced, and a new financial instrument denominated in domestic currency with yields linked to movements in the exchange rate will be offered shortly. As regards the distribution of credit, compulsory portfolio requirements on commercial banks have been reduced somewhat from their extremely restrictive levels to provide increased room for credit to the private sector.

13. The credit operations of the national development banks and the official trust funds will continue to be monitored closely. The preferential lending rates granted by these institutions will be offered more selectively to users involved in high priority activities, and will be subject to periodic adjustments to prevent marked differences from the cost of funds. The structure of these rates will be reviewed periodically with a view to reducing dispersion.

14. The exchange rate system underwent major changes in mid-1985. In July 1985, commercial banks were authorized to operate in the nonbank exchange market and the so-called banking "free rate" disappeared. New rules for the operation of exchange houses were issued and new procedures were adopted for managing the rate in the controlled market which accounts for about 80 percent of external transactions. All these actions were aimed at making more flexible the operations of the exchange market. Prior to that time, the peso in the controlled market had been depreciated daily against the U.S. dollar by predetermined amounts. The rate of depreciation, however, did not compensate fully for the differential rate of inflation between Mexico and its trading partners, and the competitive margin that had become available as a result of the 1982 devaluations was progressively eroded. In July 1985, the peso in the controlled market was devalued by 17 percent, and in August a new, more flexible, system of managed floating was applied in the controlled market. Under this system, the rate in the controlled market has been depreciated faster than domestic inflation, particularly in the months immediately following the sharp decline in petroleum prices. Flexibility in exchange rate management will continue to be exercised during the program period in order to protect Mexico's external competitive position, help rebuild international reserves, and facilitate the liberalization of commercial policy. Policy decisions as regards exchange rates will be guided by internal and external price and wage developments, the evolution of the terms of trade, and the balance of payments results and targets. The authorities will continue their present policy of permitting free access to foreign exchange and maintain their objective of exchange market unification. The exchange rate differential, which had been large at various times over the last two years, has now been significantly reduced and, at present, it is well below 10 percent. The authorities recognize the distortions to which sustained differentials can give rise and, accordingly, intend to exercise the flexibility required to reduce the differential with a view to its elimination as the policies of the program yield their results and uncertainties diminish.

15. During the period 1979-82 Mexico relied increasingly on external credit to meet the large financing needs of the public sector. The sudden loss of access to these credits in 1982 triggered the financial crisis of that year. The restructuring of Mexico's foreign debt was to be an important element in the process of alleviating the country's debt problem and in re-establishing normalcy in the country's external economic relations. During 1984 and 1985 Mexico reached agreements with commercial banks on the restructuring of debts with original maturities amounting to US$48.7 billion that would have fallen due in the period 1985-90. These restructuring agreements incorporate explicit provisions permitting the exchange by creditors of public sector debt for equity in private sector companies as well as in nonpriority, nonstrategic public sector companies. The first tranche of about US$250 million of a prepayment totaling US$1.2 billion of the 1983 US$5 billion agreement was effected on January 2, 1985. However, as a result of the financial strains caused by the earthquakes of September

1985 and by the sharp decrease in petroleum receipts, Mexico and the banking community agreed to defer the payment of the second tranche of US$950 million due in October 1985 for a period of six months. This deferment was extended for an additional period of six months in March 1986. The authorities would expect that the medium-term restructuring or refinancing of this amount of US$950 million would be a feature of the financial package now being envisaged. In the field of private sector debt the records and coverage of external credits have been improved; in particular, FICORCA continues to operate successfully, with approximately US$11.6 billion of private sector debt being serviced under the program, of which more than 50 percent is subject to definitive restructuring agreements.

16. With the agreement on the multiyear restructuring (MYRA) with foreign commercial banks, the authorities' plan for 1985 was to reduce Mexico's reliance on external financing and to restrict the external borrowing of the country to bilateral and multilateral sources. It was the expectation of the authorities that in the following years there could be a return to normal market practices under which voluntary credit again would become available. However, the sharp deterioration in the price of oil and the uncertain prospects in this market have substantially increased Mexico's borrowing requirements and have diminished the prospects for voluntary credits. Mexico is taking the measures necessary to absorb part of the petroleum shock on the economy, but the authorities believe that a significant amount of external resources, estimated at about US$11 billion, is needed to close the financing gap in the period through the end of 1987. Although multilateral and bilateral creditors are also expected to increase substantially their exposure in Mexico, a sizable portion of these resources is expected to be provided by commercial banks. These resources are to support the policies that the Mexican authorities are undertaking to set the stage for a resumption of economic growth and external payments viability. Through continued implementation of appropriate demand management and supply-oriented structural policies, the authorities intend to raise domestic savings and improve the allocation of resources so as to strengthen the balance of payments in the medium term.

17. With regard to foreign trade policies, the authorities will maintain the process of trade liberalization, reducing biases against export growth and promoting a better allocation of resources. On July 25, 1985 the Mexican Government announced a major reform of the import regime. The requirement of import permits for 3,604 tariff items (representing some 36 percent of the value of 1984 imports) was eliminated. As a result, the ratio of controlled imports to total import value decreased from 75 percent to 39 percent, thereby going beyond our objectives in this area for 1985, the last year of the extended arrangement from the Fund. The authorities also undertook a series of initial adjustments to modify the structure of tariffs which resulted in a marginal increase in the average overall tariff from 23.4 percent to 25.4 percent, while dispersion was reduced from 22.5 percent to 18.9 percent. In the framework of its trade policy, the

Government has decided to achieve by October 1988 a tariff structure with rates in the range of 0-30 percent with no more than five tariff levels; three interim adjustments are planned for the purpose of reaching these objectives. On April 30, 1986 the Government lowered tariffs to a maximum of 45 percent. The rates below 45 percent also were reduced by 2.5 percentage points, and the existing 5 percent tariff was abolished; the products which were formerly subject to the 5 percent rate were moved to the 10 percent rate or left untaxed. In the future, temporary protection may be granted through tariff surcharges which will not exceed 50 percent of the June tariff rate set for the product. It is intended to publish the regulations pertaining to the Foreign Trade Law of 1985 before September 1986. Official import reference prices for the determination of custom duties will be eliminated not later than December 1987. Furthermore, the Government intends over the next 30 months to continue the process of replacing license permits by import tariffs. Overall nontariff barriers (including import permits) will be eliminated on a further 5 percent of production before the end of 1986. In November 1985, Mexico initiated the negotiations for entry into the GATT. The GATT working party on the accession of Mexico concluded its work on July 1, 1986, and the GATT Council has recommended to the contracting parties approval of the draft protocol for Mexico's accession. As of July 21, two-thirds of the members of the GATT had already voted in favor of Mexico' accession. It is expected that Mexico will be a full member by the start of the new round of trade talks scheduled for September 1986.

18. In the trade area, another objective of the Government has been to diversify exports in order to reduce Mexico's dependence on petroleum products. In recent months nonpetroleum exports have recovered substantially from last year's decline, reflecting improvements in external competitiveness and the effects of other policies in this area. In particular, the Government has introduced an import tax drawback scheme; has eliminated licensing requirements for most exports; has continued to simplify administrative procedures and customs requirements; and has reached understandings with the United States on subsidies and countervailing duties. More recently, a new credit instrument to facilitate imports by domestic suppliers of local exporters has been introduced; trading companies have been granted a zero tax rate; and changes in the exchange control regulations have been enacted. The new regulations allow exporters to retain up to 100 percent of their foreign currency earnings to cover payments for imported production inputs and extend all the benefits currently available to exporters to their domestic suppliers. The financial requirements of enterprises engaged in export activities have received increased attention. The Government will continue strengthening its policies of export promotion.

19. Over the last four years, the Mexican authorities have conducted a selective policy of promoting foreign investment, with special emphasis in areas related to non-oil exports and the transfer of technology, within the current legal framework. During the period 1983-

1985, more than 150 projects with 100 percent foreign-owned capital have been approved. Steps have been taken recently, and will be strengthened in the future, to streamline the administrative procedures for initiating and approving foreign investment projects, so as to increase the flow of foreign capital in appropriately selected sectors. In particular, approval of investment projects fundamentally oriented to export markets will be granted automatically if after a period of 30 days no contrary decision has been reached. Special efforts also will be made to facilitate an enlarged access to the Mexican market by small and medium-sized foreign companies.

20. In view of the dependence of the Mexican economy on petroleum exports and the degree of instability which presently affects oil markets, the Mexican Government requests the support of the international financial community in the implementation of a mechanism aimed at protecting temporarily the economy from additional oil price shocks, facilitating its orderly adjustment, and thus preventing major disruptions in the pattern of resource allocation. It is also recognized that if oil prices were to increase substantially, Mexico's external financing requirements would be lowered. To this end, it is proposed that the program incorporate a special mechanism to relate certain program targets to variations in oil prices. Accordingly, the following courses of action are to be observed in response to changes in the international price of oil:

a. The baseline scenario

As long as the average price of the Mexican oil export mix remains within a band US$9 to US$14 per barrel in a given quarter, it is proposed that the net external financing to the public sector contemplated in the program not be modified. If the price fluctuates within this band the corresponding adjustment will be carried out by a combination of reserve utilization/accumulation and exchange rate and credit policies, while the operational fiscal balance and other relevant program targets will be modified accordingly.

b. Lower-end scenario

If prices drop below US$9 per barrel, it is expected that the program will be fully protected for a period of nine months on a basis of a one-to-one additional financing for each dollar drop in the price of oil, and the operational balance and other relevant targets will be modified to accommodate the revenue loss. In this context, the Mexican authorities request that the International Monetary Fund contribute toward the financing of this shortfall. Other creditors also will be invited to participate in the scheme. The potential supplementary financing from all sources would not exceed US$2.5 billion over a period of 18 months. After the initial nine months there would be a sharing of the shortfall between domestic adjustment and external finance, whereby domestic adjustment would progressively absorb the shortfall over the subsequent five quarters.

c. Upper-end scenario

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

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

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

Gustavo Petricioli
Secretary of Finance and
Public Credit of Mexico

Technical Memorandum of Understanding 1986-87

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

I. Foreign financing

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

II. Public finance

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

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

III. Banco de Mexico operations

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

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

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

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

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

IV. Contingency mechanisms

Oil price contingency mechanism

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

(a) Lower-end scenario

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

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

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

(b) Upper-end scenario

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

(c) Baseline scenario

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

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

Supplementary capital expenditure contingency mechanism

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

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

V. Other

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

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

	Actual Jan.-Dec. 1985	1986 Actual March	1986 Prel. June	1986 (Targets and Ceilings) Sept.	1986 (Targets and Ceilings) Dec.	(Targets and Ceilings) Jan.-Dec. 1987
	(In billions of Mexican pesos)					
Cumulative overall public sector borrowing requirements 1/ 2/						
Unadjusted	4,580	1,074	4,000	8,350	13,640	... 3/
Adjusted	--	--	--	4/	4/	5/
Cumulative changes in financial intermediation (effective flows)	389	-109	300	600	898	... 3/
Cumulative nonfinancial public sector operational balance 6/						
Unadjusted	-88	626	186	-340	-1,670	... 3/
Adjusted	--	--	--	4/	4/	5/
Cumulative changes in net domestic assets of the monetary authorities (effective flow) 7/	1,409	138	1,108	2,779	711	... 3/
Net credit to the nonfinancial public sector by the monetary authorities 8/						
Unadjusted	5,735 9/	6,492	7,978	9,624	8,206	... 3/
Adjusted 10/	--	--	--	13,133	13,700	3/
	(In millions of U.S. dollars)					
Cumulative net foreign borrowing by the public sector 1/						
Unadjusted	400	-430	-500	-100	5,000	5,100
Adjusted	--	--	--	4/	4/	5/
Cumulative change in net international reserves of the monetary authorities	-3,400	-342	-1,863	-3,763	500	900

Sources: Mexican authorities; and Fund staff estimates.

1/ Limit tested at the end of each period.
2/ Effective flows of financing measured on a cash basis.
3/ Limit to be agreed upon with the Fund before December 31, 1986.
4/ Adjustment for additional external financing authorized in line with provisions under oil price contingency mechanism.
5/ Adjustment for additional external financing authorized in line with provisions under oil price and supplementary capital expenditure mechanisms.
6/ Defined as the difference between the overal public sector borrowing requirements excluding cumulative charges in financial intermediation and the inflation component of the stock of domestic public sector debt denominated in local currency.
7/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the monetary authorities.
8/ Effective stocks calculated by adding effective flows to nominal stocks outstanding as of December 1985.
9/ Stock outstanding at the end of December 1985 unadjusted for changes in the exchange rate (used as base).
10/ Ceiling can be adjusted upward by an amount equivalent to the sum of commercial banks' lending to the nonfinancial public sector that would result exclusively from implementing mandatory portfolio requirements. The counterpart of this adjustment would be an equivalent peso reduction of the commercial banks' lending to the nonfinancial public sector based on mandatory portfolio requirements.

Table 2. Mexico: Public Sector Operations

(In percent of GDP)

	1985	1986	1987
PSBR	10.05	16.90	...
Financial intermediation	0.85	1.11	1.11
Deficit outside budget	1.75	0.63	0.63
Of which: interest	0.20	0.43	0.43
Economic balance under budgetary control (deficit -)	-7.44	-15.15	...
Receipts	31.34	28.34	30.17
Petroleum receipts	13.86	10.68	11.13
Nonpetroleum receipts	17.48	17.52	19.04
Public enterprises	8.15	8.07	8.29
Federal Government	9.33	9.45	10.75
Expenditure	38.77	43.36	...
Programmable	22.27	21.78	21.28
Investment	3.93	3.90	4.40
Other	18.34	17.88	16.88
Nonprogrammable	16.51	21.58	...
Interest payments	12.27	18.51	...
Of which: inflationary component of interest payments on domestic debt denominated in Mexican currency	7.23	13.72	...
Other	4.23	3.07	3.07
Primary balance (deficit -)	3.29	3.15	5.61
Under budget control	4.83	3.35	5.81
Outside budget control	1.54	-0.20	-0.20
Real interest payments on domestic debt denominated in Mexican currency and payments on debt denominated in foreign currency	5.24	5.22	...
Operational balance (deficit -)	-1.95	-2.07	...

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