FOR AGENDA

EBS/85/123

CONFIDENTIAL

May 13, 1985

To: Members of the Executive Board

From: The Secretary

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

Attached for the information of the Executive Directors is the staff report for the 1985 Article IV consultation with Mexico and the program for the third year of the extended arrangement. A draft decision appears on pages 43-45.

This subject has been tentatively scheduled for discussion on Friday, June 7, 1985.

Mr. Pujol (ext. 8480) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

MEXICO

Staff Report for the 1985 Article IV Consultation and Use of Fund Resources under the Extended Arrangement--Program for the Third Year

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, Central Banking, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Eduardo Wiesner and Manuel Guitian

May 10, 1985

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I. Introduction

The 1985 Article IV consultation discussions with Mexico and negotiations for the third year of the current extended arrangement were held in Mexico City and Washington in the period extending from October 30, 1984 to March 21, 1985.1/ In the course of these discussions the staff reviewed with the authorities the performance during the second year of the program. In the letter of intent dated March 25, 1985 and the attached Technical Memorandum of Understanding (EBS/85/70, 3/25/85), the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico assess the performance during the second year of the arrangement and describe the economic policies of the Government of Mexico for 1985.

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

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

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

provided for Mexico's access to Fund resources for the equivalent of SDR 3,611.25 million over the three year period (450 percent of the SDR 802.5 million quota in effect at that time), of which SDR 200,625 million was under the first credit tranche and SDR 3,410,625 million was under an extended arrangement.

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

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

Table 1. Mexico: The IMF Position (December 31, 1982-December 31, 1985) 1/

	Transactions in 1982 2/	Transactions in 1983	Transactions in 1984	Projected Transactions During Third Program Year				
				May-July	Aug.-Oct.	Nov.-Dec.	Jan.-Feb. 3/	Total
				(In millions of SDRs)				
Purchases	200.6	1,003.2	1,203.8	295.8	302.6	302.6	302.7	1,203.7
Ordinary resources	200.6	501.6	601.9	20.0	—	—	—	20.0
First credit tranche	(200.6)	(—)	(—)	(—)	(—)	(—)	(—)	(—)
Extended arrangement	(—)	(501.6)	(601.9)	(20.0)	(—)	(—)	(—)	(20.0)
Borrowed resources	—	501.6	601.9	275.8	302.6	302.6	302.7	1,183.7
Repurchases	—	—	—	—	—	—	—	—
Total credit outstanding (end of period)	200.6	1,203.8	2,407.6	2,703.4	3,006.0	3,308.6	3,611.3	3,611.3
				(In percent of quota)				
Purchases	17.2	86.1	103.3	25.4	26.0	26.0	26.0	103.3
Total credit outstanding (end of period)	17.2	103.3	206.6	231.9	257.9	283.9	309.8	309.8

Source: International Monetary Fund.

1/ Partials may not add up to totals because of rounding.
2/ There were no purchases outstanding prior to December 1982. For more details on the transactions with the Fund, see Appendix I.
3/ Last purchase is expected to take place at the beginning of 1986 on the basis of performance through December 31, 1985.

private external debt and in eliminating external payment arrears. They concluded by expressing their support for the policies being pursued by the Mexican authorities which they viewed as contributing importantly to the reestablishment of the conditions for a sustained economic expansion, although they noted the need for perseverence with the adjustment program, particularly in regard to its structural aspects.

II. Background Developments

Following a period of several years of rapid economic expansion, Mexico experienced serious economic difficulties in 1982. The large rise in public spending that dominated aggregate demand developments in the period 1979-82 led to a surge of imports, financed by a growing reliance on foreign borrowing, and a sharp increase in domestic costs and prices which eroded Mexico's international competitiveness and weakened the balance of payments. The deterioration in the public finances became more pronounced after the softening of the international oil market in the second half of 1981. As a result, the overall public sector deficit 1/ reached the equivalent of almost 15 percent of GDP in 1981 and 18 percent of GDP in 1982 (Table 2). This growing fiscal gap was covered by a very large volume of foreign borrowing and by increasing the share of domestic financial savings channeled to the public sector at the expense of credit to the private sector.

The deterioration in the public finances and the accelerating rate of inflation raised doubts about the appropriateness of existing economic policies and resulted in recurring episodes of capital flight (Chart 1). Although efforts were made during the course of 1982 to stabilize the economy, they proved insufficient and the situation continued to deteriorate. In the third quarter of 1982 Mexico's access to international capital markets was drastically curtailed, and in September 1982 the authorities nationalized the private Mexican banks and introduced generalized exchange controls. By the fourth quarter of 1982, the Mexican economy had entered into a severe recession, inflation had accelerated to a rate of 10 to 11 percent per month, international reserves had been virtually depleted, and external payments arrears had accumulated.

In late 1982 the Mexican authorities adopted a comprehensive economic program designed to deal with the crisis, and Fund support was sought for this program in the form of an extended arrangement. The program aimed at restoring the medium-term viability of the economy through a lowering in the public sector deficit while reducing reliance on foreign financing, increasing domestic savings, and pursuing policies to enhance economic efficiency. Particular emphasis was given to the objective of slowing inflation in order to create the conditions for a

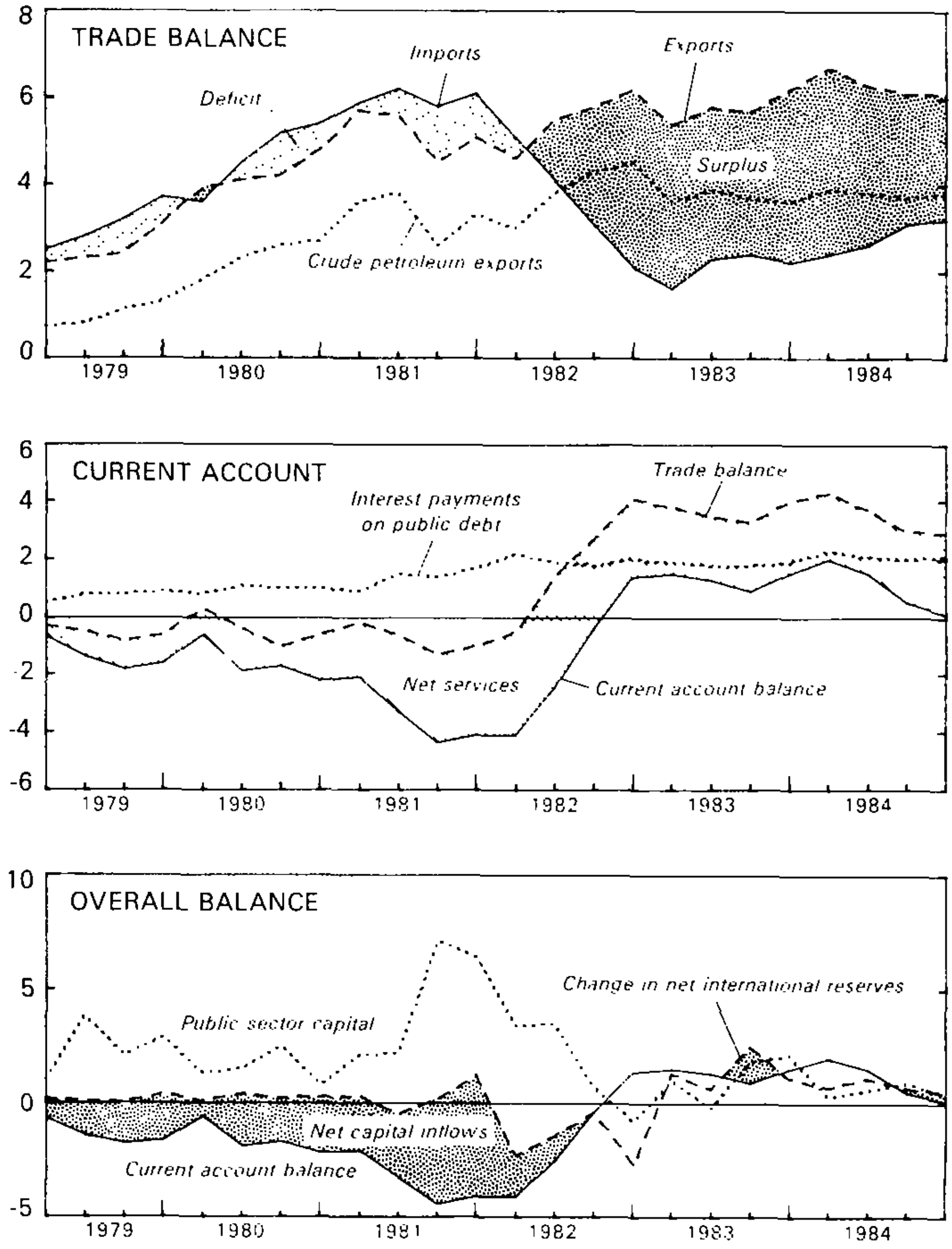
1/ The public sector as defined under the program covers the operations of the Federal Government and the nonfinancial public sector, but excludes the operations of the government-owned financial institutions.

CHART 1

MEXICO

BALANCE OF PAYMENTS

(Quarterly, in millions of U.S. dollars)



Sources: Bank of Mexico and staff estimates.

Table 2. Mexico: Summary Accounts of the Public Sector

(In percent of GDP)

	1981	1982	1983	1984 Program	1984 Actual	1985 Original Budget 1/
Public sector revenue	17.4	19.4	22.2	20.9	20.4	21.3
Taxes on petroleum sector	4.0	4.9	6.8	6.2	5.8	6.2
Other federal government taxes	11.0	10.3	10.7	10.2	10.2	10.9
Other federal government revenue	0.9	1.1	1.1	0.6	0.8	0.8
Social security contributions	2.8	3.0	2.5	1.9	2.3	1.9
Federal District	0.3	0.3	0.2	0.2	0.2	0.2
Operating surplus of public enterprises (net)	2.3	4.6	7.7	8.0	7.0	7.5
PEMEX	(4.2)	(6.5)	(10.9)	(9.9)	(9.2)	(8.8)
Electricity	(-0.3)	(-0.6)	(-1.1)	(-0.8)	(-0.7)	(-0.7)
CONASUPO	(-1.4)	(-0.8)	(-1.4)	(-0.9)	(-1.3)	(-0.5)
Railways	(-0.3)	(-0.2)	(-0.3)	(--)	(-0.1)	(--)
Other	(0.1)	(-0.3)	(-0.4)	(-0.2)	(-0.1)	(-0.1)
Less: taxes paid by public enterprises	-4.0	-4.9	-6.9	-6.2	-5.9	-6.2
Capital revenue of public enterprises	0.1	0.1	0.1	--	--	--
Public sector expenditure 2/	32.0	37.2	30.7	26.4	26.6	25.8
Government consumption	10.2	11.3	9.4	8.7	9.8	9.1
Wages and salaries	(5.4)	(6.0)	(4.9)	(3.9)	(4.6)	(4.3)
Goods and services	(2.8)	(3.1)	(2.3)	(2.5)	(3.0)	(2.5)
Transfers to local governments	(2.0)	(2.2)	(2.2)	(2.3)	(2.2)	(2.2)
Current transfers and subsidies	3.0	2.6	2.9	2.1	1.9	1.9
Interest payments	3.1	5.6	8.7	6.4	6.7	6.7
Exchange losses	--	4.0	0.6	0.3	0.7	0.3
Financing requirements, rest of public sector (net) 3/	1.5	2.6	1.2	0.7	0.7	0.2
Of which: local government	/0.2/	/0.2/	/0.1/	/.../	/0.2/	/.../
Unclassified (Ajenas)	1.1	0.5	0.2	0.2	0.4	0.1
Capital expenditures	13.1	10.6	7.7	8.1	6.4	7.5
Fixed investment	(12.8)	(10.2)	(7.1)	(8.0)	(6.2)	(7.5)
Of which: PEMEX	/3.9/	/3.0/	/2.0/	/2.0/	/1.6/	/1.7/
Financial investment and other 4/	(0.3)	(0.4)	(0.6)	(--)	(0.2)	(0.1)
Overall balance	-14.6	-17.8	-6.5	-5.5	-6.2	-4.5
Foreign financing (net)	7.4	3.7	3.5	2.4	1.5	0.1
Domestic financing (net) 5/	7.2	14.1	5.0	3.1	4.7	4.4
Memorandum items						
Petroleum exports	5.5	8.6	11.3	10.1	9.4	8.1
Current balance of public sector	-1.6	-7.4	-1.0	-2.5	0.1	2.9
Current balance excluding PEMEX	-5.9	-13.9	-11.9	-7.4	-9.1	-5.9
Operating expenditure of public enterprises	10.8	11.0	12.2	11.6	11.6	10.3
GDP in billions of Mexican pesos	5,874	9,417	17,142	27,700	29,438	43,000

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

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

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

3/ Includes residual financing of the nonconsolidated public sector.

4/ Includes acquisition of property.

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

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

1. Developments in 1983

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

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

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

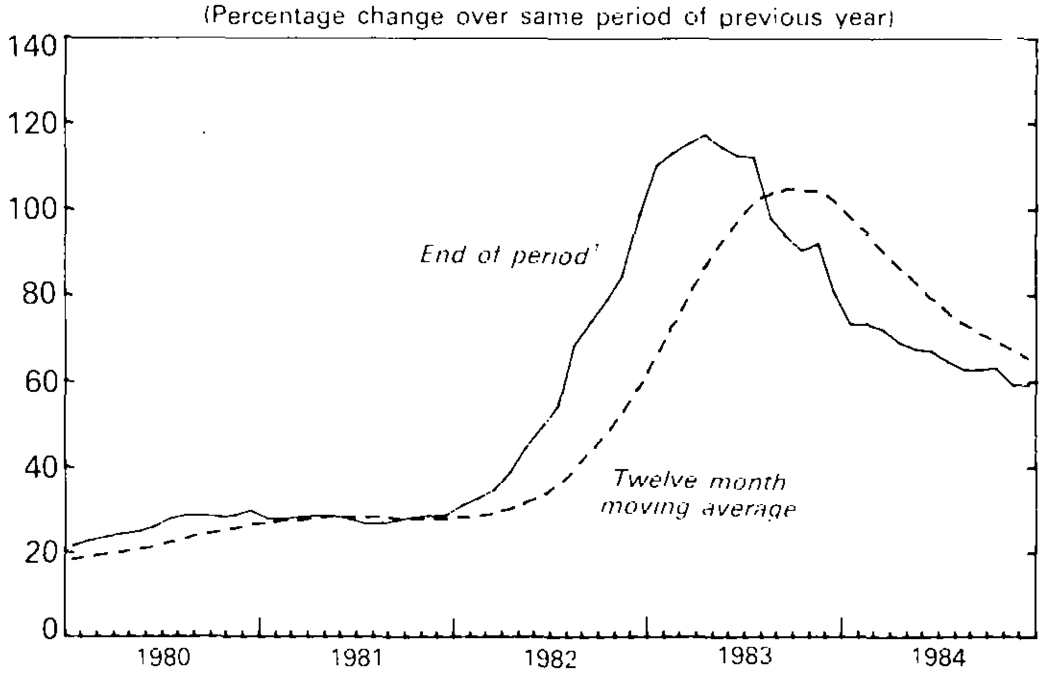
A key element in the turnaround of the balance of payments and fiscal situation in 1983 was the sharp devaluation that took place in December 1982. In that month the Mexican authorities announced the replacement of the generalized system of exchange controls that had prevailed since September 1982 by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

CHART 2

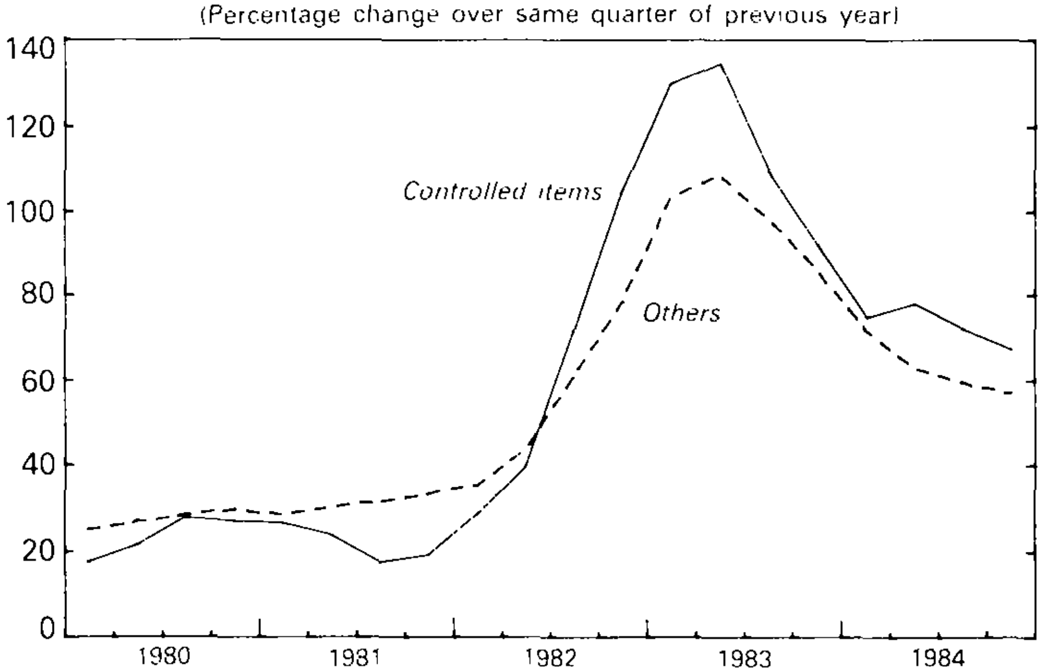
MEXICO

CHANGES IN THE NATIONAL CONSUMER PRICE INDEX

(Percentage change over same period of previous year)



(Percentage change over same quarter of previous year)



Source: Bank of Mexico

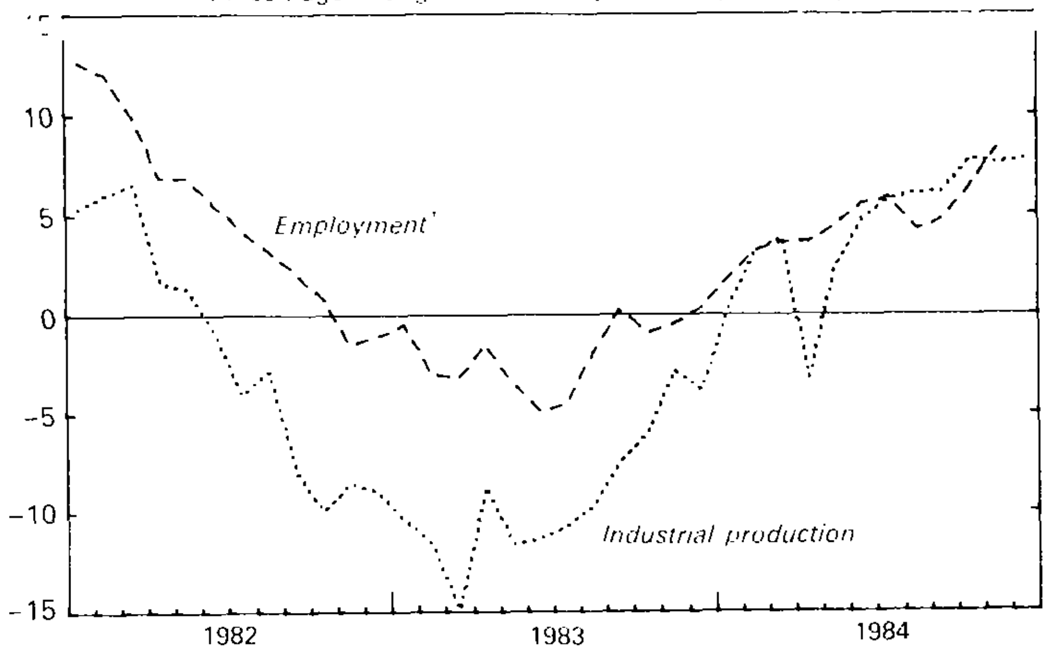
[1] Percentage change over same month of previous year

CHART 3

MEXICO

INDICATORS OF ECONOMIC ACTIVITY

(Percentage change over same period of previous year)



Source: Bank of Mexico and IMSS

[1] Social Security participant

Table 3. Mexico: Summary Balance of Payments, 1981-85

(In billions of U.S. dollars)

	1981	1982	1983	1984 Prog.	1984 Actual 1/	1985 Proj.
Current account	-13.9	-5.6	5.2	-1.0	4.1	2.1
Trade balance	-3.1	7.7	14.6	9.9	13.9	11.8
Exports, f.o.b.	20.9	22.1	23.1	23.9	25.2	25.8
Petroleum and derivatives	(14.6)	(16.5)	(16.0)	(16.3)	(16.6)	(15.8)
Other	(6.3)	(5.6)	(7.1)	(7.6)	(8.6)	(10.0)
Imports, f.o.b.	-24.0	-14.4	-8.5	-14.0	-11.3	-14.0
Public sector	(-8.8)	(-5.4)	(-4.3)	(-6.2)	(-4.8)	(-4.5)
Private sector	(-15.2)	(-9.0)	(-4.2)	(-7.8)	(-6.5)	(-9.5)
Travel	0.2	0.6	1.2	1.3	1.4	1.3
Border transactions	--	-0.2	-0.3	0.2	-0.2	-0.5
Factor income	-9.5	-11.7	-9.6	-10.9	-10.0	-9.3
Interest on public debt	-5.5	-7.9	-7.4	-8.2	-8.5	-7.6
Other interest payments	-2.9	-3.4	-2.9	-3.2	-2.9	-2.8
Other	-1.1	-0.4	0.7	0.5	1.4	1.1
Other services and transfers (net)	-1.5	-2.0	-0.7	-1.5	-1.0	-1.2
Capital account	15.1	-1.2	0.3	3.0	-1.1	-1.6
Official capital (net)	17.8	6.8	4.7	4.0	2.2	0.1
Medium- and long-term	(9.0)	(5.6)	(16.0)	(3.9)	(2.0)	(...)
Short-term (net)	(8.8)	(1.2)	(-11.3)	(0.1)	(0.2)	(...)
Private capital	-2.7	-8.0	-4.4	-1.0	-3.3	-1.7
Long-term	(4.0)	(2.1)	(2.0)	(...)	(0.1)	(...)
Short-term and errors and omissions	(-6.7)	(-10.1)	(-6.4)	(...)	(-3.4)	(...)
SDR allocation and gold valuation	--	--	--	--	--	--
Monetary authorities (increase -)	-1.2	6.8	-5.5	-2.0	-3.0	-0.5
Of which: arrears	--	1.4	-1.1	-0.3	-0.3	--
	(End of period)					
Memorandum items						
Net international reserves	4.9	-2.0	3.5	5.5	6.5	7.0
Gross reserves 2/ in months of merchandise imports	1.8	0.1	4.9	4.7	7.8	7.5

Sources: Mexican authorities; and Fund staff estimates.

1/ Preliminary estimate.
2/ Excludes gold and payment agreements.

covering about 80 percent of external transactions and a free market covering the remaining transactions.1/ All operations in the controlled market are carried out for the account of the Bank of Mexico, while the free market is operated by the commercial banks, with the Bank of Mexico keeping open the possibility of intervening in that market.

The exchange rate initially set in the controlled market on December 20, 1982 involved a depreciation in terms of Mexican pesos per U.S. dollar of some 35 percent in relation to the previous "ordinary" rate and of 90 percent in relation to the previous "preferential rate".2/ Following this initial devaluation, the Mexican peso in the controlled market was depreciated daily in relation to the U.S. dollar by predetermined amounts (initially at Mex$0.13 per U.S. dollar a day). The free market opened on December 20, 1982 at about Mex$150 per U.S. dollar (a rate somewhat more depreciated than the rate then being quoted in the parallel market); after a small appreciation, the free market rate remained virtually unchanged in the range of Mex$147-149 until late September 1983, when the rate of depreciation of Mex$0.13 per day in relation to the U.S. dollar was also extended to the free market.

Following negotiations with foreign creditors, Mexico reached agreement on a new US$5 billion loan from commercial banks in March 1983. Moreover, a total of US$18.8 billion of external public sector short- and medium-term obligations falling due between August 23, 1982 and December 31, 1984 were restructured over a period of eight years, with a four-year grace period. Negotiations also were undertaken with commercial banks and other private foreign creditors for the refinancing of a total of close to US$12 billion of private sector external obligations at maturities that ranged from six to 12 years, with a three- to four-year period of grace. Moreover, official credit agencies abroad were approached on the restructuring of Mexican private sector obligations which had received guarantees from these agencies. In June 1983 agreement was reached on the principles that would govern the restructuring of about

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1/ Three other special rates were established applying to forward cover contracts under the FICORCA scheme for the repayment of specified private sector medium- and long-term obligations outstanding as of December 10, 1982 with foreign financial institutions. The deadline for entering into the FICORCA scheme was end-November 1983; therefore, no new operations have been registered at these special rates after that date. One other special rate was maintained for the settlement of certain obligations contracted by financial institutions and leasing companies during the period when the generalized exchange controls were in effect; all transactions eligible for this special rate have now been completed.

2/ The exchange rate system in place before then had involved, since August 5, 1982, a two-tier exchange rate, with a "preferential rate" applicable mainly to sales of exchange for the servicing of external debt and the purchase of most imports, and an "ordinary" rate applicable to other transactions. Following the introduction of generalized exchange controls, a parallel market developed.

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

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

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

Despite some slippages, Mexico's performance under the adjustment program during 1984 continued to be positive. Economic activity strengthened significantly in response to the growth of non-oil exports and a recovery of private investment. Preliminary official estimates indicate that real GDP rose by 3 1/2 percent in 1984, compared with the 1 percent rise envisaged in the program. The balance of payments remained strong, with the trade account registering a positive balance of almost US$14 billion and the current account a surplus of more than US$4 billion. In contrast to 1983 when imports fell sharply, the strength of the trade account in 1984 reflected in large part the rise in nonpetroleum exports--they went up by 26 percent--rather than a very low level of imports. In addition, there was an improvement in the behavior of the private capital account (including errors and omissions). Net international reserves rose by about US$3 billion (compared with the US$2 billion contemplated in the program), notwithstanding a lower than programmed utilization of net official external borrowing (US$2.2 billion, compared with the US$4 billion that had been planned). All remaining external payments arrears, scheduled to be eliminated before year-end, were fully settled by the end of the first quarter of 1984.

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

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

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

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

The public sector's economic deficit 1/ for 1984 reached MexS1,826 billion on a cash basis (the equivalent of 6.2 percent of GDP), which was lower in proportion to GDP than the one registered in 1983, but in excess of the limit of MexS1,524 billion (5.5 percent of GDP) envisaged in the program for the year as a whole (Table 4). In addition, the payment of some MexS200 billion of interest due by the Government to the Bank of Mexico at the end of 1984 was postponed to 1985; if these interest payments due but not paid were taken into account, the public sector deficit on a commitment basis would be close to 7 percent of GDP. The deviation of the public sector deficit from the limits established in the program occurred in the latter part of the year and was largely due to higher current expenditures. While in nominal terms revenues of the public sector exceeded the original yearly target and disbursements for investment were slower than budgeted, outlays for interest payments and for goods and services were higher than their original appropriations. The rise in these payments reflected not only the higher than programmed inflation, which affected the level of domestic interest rates, but also some apparent relaxation of expenditure controls.

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

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

	1982	1983	1984 Program	1984 Actual	1985 Budget	1985 Program
	(In billions of Mexican pesos)					
Overall deficit	-1,679	-1,464	-1,524	-1,826	-1,922	-1,785
Public sector receipts 1/	2,850	5,895	8,993	9,420	13,615	13,745
Petroleum exports	812	1,939	2,784	2,780	3,477	3,541
Other PEMEX receipts	156	605	1 090	997	1,552	1,577
Other public enterprises	505	884	1,563	1,701	2,632	2,632
Federal Government	1,070	2,002	2,992	3,218	5,033	4,922
Social security	281	425	522	666	836	988
Federal District	26	41	42	59	85	85
Public sector outlays 1/	4,529	7,359	10,517	11,246	15,537	15,530
Operating expenditure 2/	1,578	2,630	3,942	4,505	6,050	6,023
Interest payments	813	2,181	2,819	3,098	4,195	4,468
Current transfers	452	879	1,213	1,211	1,771	1,656
Other current outlays 3/	688	351	311	541	279	296
Capital expenditure	998	1,318	2,232	1,890	3,242	3,087
Memorandum item						
Current account	-698	-167	680	40	1,255	1,236

	1982	1983	Actual 1984	Program 1985	Change in GDP Share 1984/1982	Change in GDP Share 1985/1984
	(In percent of GDP)					
Overall deficit	-17.8	-8.5	-6.2	-4.1	11.6	2.1
Public sector receipts 1/	30.3	34.4	32.0	31.6	1.7	-0.4
Petroleum exports	8.6	11.3	9.4	8.1	0.8	-1.3
Other PEMEX receipts	1.7	3.5	3.4	3.6	1.7	0.2
Other public enterprises	5.4	5.2	5.8	6.0	0.4	0.3
Federal Government	11.4	11.7	10.9	11.3	-0.4	0.4
Social security	3.0	2.5	2.3	2.3	-0.7	--
Federal District	0.3	0.2	0.2	0.2	-0.1	--
Public sector outlays 1/	48.1	42.9	38.2	35.7	-9.9	-2.5
Operating expenditure 2/	16.8	15.3	15.3	13.8	-1.5	-1.5
Interest payments	8.6	12.7	10.5	10.3	1.9	-0.3
Current transfers	4.8	5.1	4.1	3.8	-0.7	-0.3
Other current outlays 3/	7.3	2.0	1.8	0.7	-5.5	-1.1
Capital expenditure	10.6	7.7	6.4	7.1	-4.2	0.7
Memorandum item						
Current account	-7.4	-1.0	0.1	2.8	7.5	2.7

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

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

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

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

The public sector deficit in 1984 was financed largely from domestic resources as net foreign financing, at US$2.2 billion, was well below the US$4 billion contemplated under the program. The lower use of foreign financing came about partly because of the decision taken in the second half of 1984 to reduce the size of Pemex's acceptance facility with foreign commercial banks (by some US$560 million) and to postpone until March 1985 the last drawing (for US$950 million) of the US$3.8 billion commercial bank loan obtained in 1984.

During 1984 monetary and credit policies continued to be relatively restrained. The net domestic assets of the Bank of Mexico declined by Mex$53 billion in 1984, whereas the program had envisaged a contraction of Mex$43 billion, and, as noted above, the accumulation of net international reserves--at US3 billion--exceeded by a significant margin the original aim. An active program of auctions of central bank deposits was pursued during the year to mop up liquidity, and interest rates were managed flexibly. In general the policy was to lower nominal interest rates gradually as inflation decelerated, while maintaining--on average--positive real rates on short-term financial savings instruments and a competitive edge vis-a-vis foreign financial assets (Chart 4). Lending rates also followed a general downward trend and the spread between deposits and lending rates narrowed significantly. However, in May 1984, interest rates on deposits were raised to contain speculative pressures induced by rising foreign interest rates.

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

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

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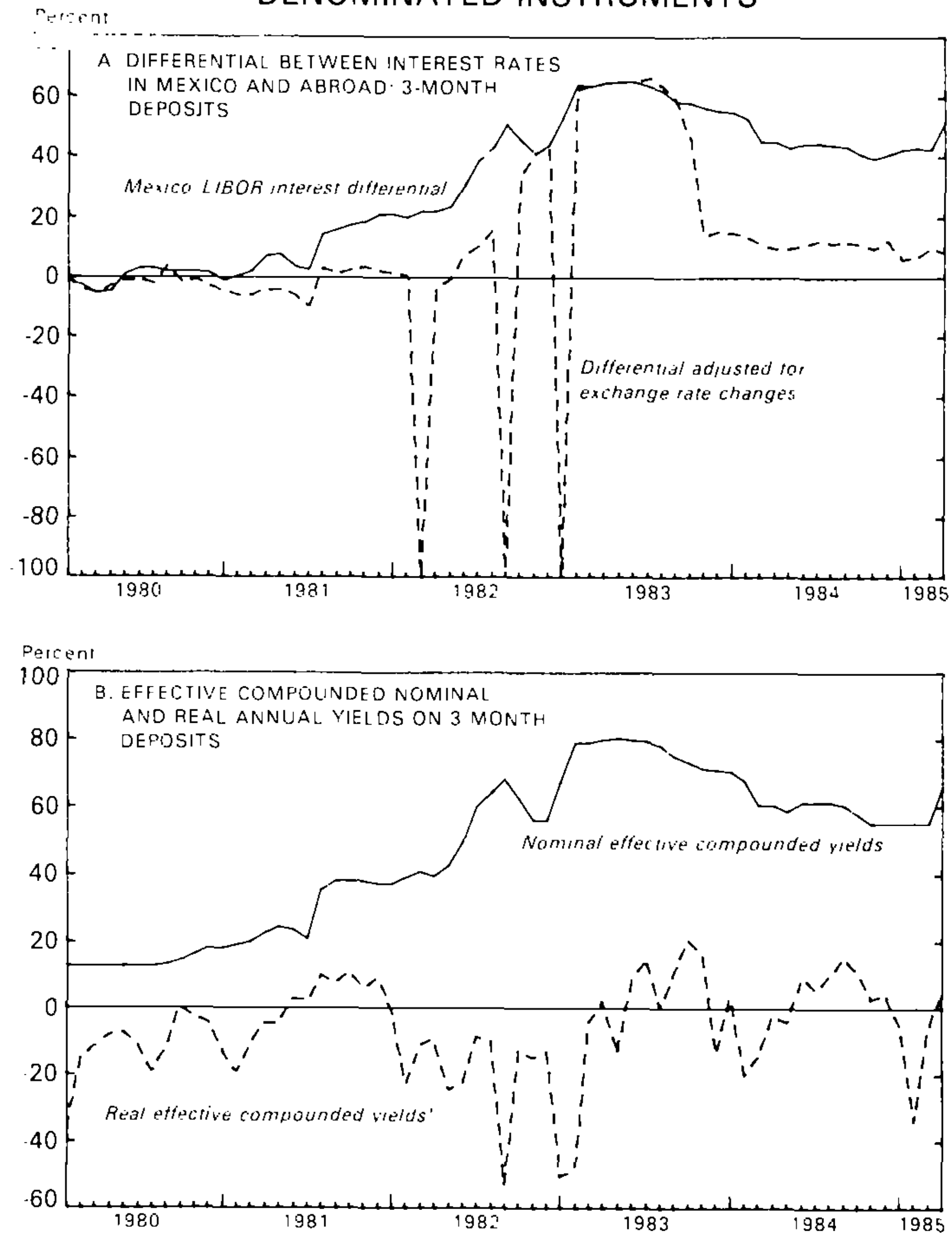
1/ The limit established by the program on these operations of financial intermediation could be adjusted upward by up to Mex$200 billion to the extent that there was still room under the ceiling for the overall public sector economic deficit, but by December 1984 there was no longer any room under that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

CHART 4

MEXICO

INTEREST RATE MOVEMENTS ON PESO DENOMINATED INSTRUMENTS



Sources: Bank of Mexico and Fund staff estimates.
[1] Adjusted for the monthly annualized cost of living index.

interest rates, has been subject to an overall limitation to reduce the potential burden that the extension of such credit may impose on the public finances in the future. During 1984 steps were taken to raise the interest rates charged on these operations to bring them closer to the cost of funds and to tighten access to such credits.

The exchange rates in the controlled and the free markets continued to be depreciated daily during 1984, by Mex$0.13 per U.S. dollar during the first 11 months of the year and by Mex$0.17 per U.S. dollar starting December 5, 1984. The cumulative rate of depreciation of the peso vis-a-vis the U.S. dollar in the controlled market was 33.8 percent for the year as a whole and that in the free market was 30.2 percent, but this depreciation fell short of the adjustment that would have been required to avoid a loss in competitiveness, taking into account movements in relative prices in Mexico and abroad. Thus, the real trade-weighted effective exchange rate appreciated in terms of Mexican pesos per unit of foreign exchange by 16 percent during 1984, and by the end of the year the index was at the levels observed in late 1979, a period when the exchange rate generally was not considered to be overvalued (Chart 5). The Mexican peso continued to appreciate in real terms in the first two months of 1985.1/ On March 6, 1985 the daily rate of depreciation was raised to Mex$0.21 per U.S. dollar.

On the basis of the negotiations with foreign creditors, a new US$3.8 billion loan with a ten-year maturity and five-and-a-half years of grace was signed in April 1984 with a group of about 500 commercial banks. In addition, negotiations for a multiyear restructuring of the amortization of the external public debt falling due in the period 1985-90 were started in the second half of 1984. The basic terms of the restructuring agreement reached in March 1985 involve a 14-year repayment period and a lowering of the interest spreads applicable to the restructured debt with respect to those applying to the 1983-84 restructuring. (A summary of the terms of this restructuring is presented in Table 5.) As part of the restructuring, Mexico agreed to prepay a total of US$1.2 billion of the 1983 US$5 billion loan. This multiyear restructuring exercise involves some US$48.7 billion (of which US$3.2 billion are dollar-denominated debts to foreign branches Mexican banks), including maturities under the US$5 billion loan obtained in 1983; some US$23.6 billion of maturities previously restructured in 1983 and falling due between 1987 and 1990; and US$20.1 billion of maturities falling due in 1985-90 and not previously restructured. The first part of the restructuring package, covering some US$28.6 billion of debt owed by the Federal Government and Pemex, was signed on March 29, 1985 and signing of the remaining contracts, covering the rest of the public sector, is expected to take place in the near future. A summary

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1/ The behavior of the real effective exchange of Mexico was the subject of an information notice to the Executive Board (EBS/85/99, 4/23/85).

Table 5. Mexico: Summary of Terms and Conditions of the Multiyear Debt Restructuring Agreement 1/

Types of Debt Rescheduled	Basis	Amount 2/ (in US$ billions)	Grace Period (Years)	Maturity (Years)	Spread Over LIBOR-CD Rate 3/
Public medium- and long-term debt not previously rescheduled falling due from 1985 to 1990 (Tranche A)	100 percent of principal	20.1	1	14 4/	7/8 in 1985-86 1 1/8 in 1987-91 1 1/4 in 1992-98
Public medium- and long-term debt previously rescheduled 5/					
Due in 1987 (Tranche B)	100 percent of principal	5.8	--	14 4/	7/8 in 1985-86 1 1/8 in 1987-91 1 1/4 in 1992-98
Due from 1988 to 1990 6/ (Tranche C)		17.8	--		
Syndicated loan of 1983	US$3.8 billion 7/	5.0	5	10	1 1/2 over LIBOR 8/ or 1 1/8 over Prime Rate

Sources: Financing Principles for Mexican Public Sector to Commercial Banks Maturing 1985 to 1990, September 8, 1984.

1/ Agreement in principle on September 8, 1984. The first part of the restructuring package--some US$28.6 billion was signed on March 29, 1985. According to the monitoring procedures agreed under this restructuring arrangement, creditors will be able to declare an "event of default" if they determine, based on the conclusions of the Article IV consultations with the Fund, that the implementation of Mexico's financial program is incompatible with sound and sustained economic growth, and with a viable external payment position.

2/ Includes US$3.2 billion of debt held by foreign branches of Mexican banks.

3/ There are no rescheduling fees; new spreads became effective on January 1, 1985; under certain conditions, banks are allowed to switch their loans from dollars to home country currencies.

4/ Maturities shown relate to the date of the agreement in principle.

5/ On August 27, 1983 commercial banks had agreed to reschedule public sector short-, medium- and long-term due from August 23, 1982 to December 31, 1984. The terms of this restructuring agreement were 8 years' maturity with a grace period of 4 years, at interest rates of 1 7/8 percent over prime and a commitment fee of 1 percent.

6/ Conditional upon the purchase of all amounts scheduled to become available in 1985 under the extended arrangement with the Fund and upon the achievement of Mexico's own economic targets to be monitored on the basis of the 1987 consultations with the Fund.

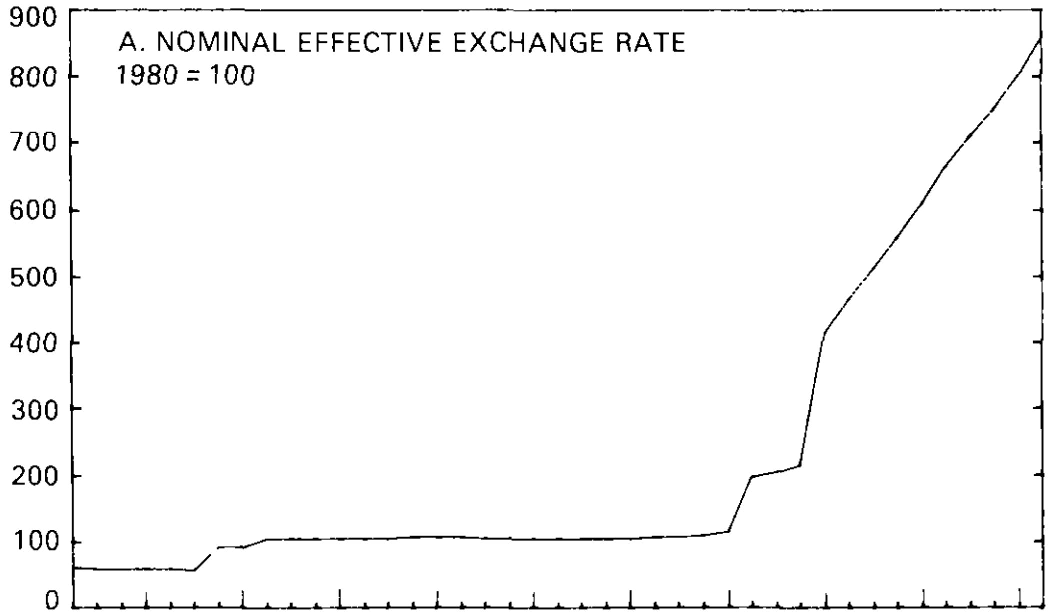
7/ An amount of US$1.2 billion was prepaid in the first semester of 1985 and the balance of the loan was restructured to match the repayment schedule on the 1984 US$3.8 billion of new money.

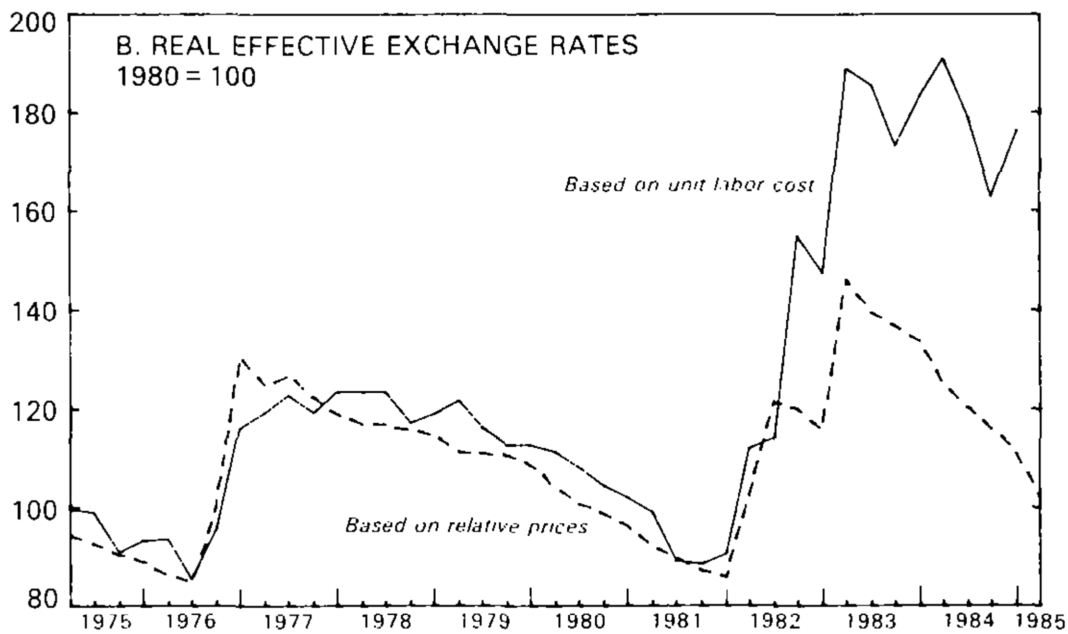
8/ The pricing of the 1983 loan was originally at 2 1/4 percent over LIBOR or 2 1/8 percent on the prime rate.

CHART 5

MEXICO

NOMINAL AND REAL EFFECTIVE EXCHANGE RATE INDICES[1]





Sources: Bank of Mexico; and Fund staff estimates.

[1] Defined in terms of Mexican pesos per unit of foreign exchange. Based on the controlled market rate starting in August 1982. Decline reflects appreciation.

of the original and restructured amortization profiles for 1985-90 is provided in Table 6; Chart 6 shows the effects of the restructuring agreement on the profile of Mexico's external public debt.

Mexico was able to make all the purchases scheduled under the extended arrangement during 1984, with the last purchase taking place in November 1984; all performance criteria were met through end-September 1984, which was the last date governing the release of purchases from the Fund during 1984 (Table 7 and Chart 7). In the period ended December 1984, the limits on the cumulative overall public sector deficit and on the financial intermediation by development banks and official trust funds were exceeded, but the limits for end-December were indicative and did not affect Mexico's right to make purchases during the second year of the arrangement. However, as was described above, the first purchase in 1985 is subject to performance criteria as of the end of March 1985.

3. Relations with the IBRD

Mexico has continued to maintain close links with the IBRD during the period of the adjustment program. IBRD lending operations cover most sectors of the economy, including infrastructure, agriculture, manufacturing, mining, regional development, municipal services, and vocational training. Credits from the IBRD amounted to US$576 million in FY 1984, and are expected to reach US$800 million in FY 1985. A major effort is being made to expand the IBRD's lending program for future years in support of public sector investment projects, various lines of credit, and selected sector-wide development programs. The IBRD is also considering the possibility of supporting Mexico's program of trade liberalization through its lending program. Cofinancing with commercial banks is being explored as a vehicle for the mobilization of private capital over the years ahead. The IBRD's current program of economic and sector work includes, inter alia, studies on trade policy, development of the financial sector, public sector investment, employment and labor markets, and the agricultural sector.

III. Summary of Policy Discussions

The discussions on the 1985 Article IV consultations were held in the context of the negotiations of the program for the third year of the EFF arrangement. These negotiations were started in late October 1984 with an examination of the performance under the second year of the arrangement. As the negotiations evolved, there were certain changes in international economic conditions and domestic policy developments that affected the outlook. These changes led to modifications in the authorities' original plans for 1985 which had been incorporated in the budget for 1985 and had been presented to Congress in mid-November of 1984. These modifications are included in the letter of intent of March 24, 1985 (EBS/85/70), and take into account both the changes in

Table 6. Mexico: Multiyear Restructuring of External Public Debt, 1985-98

(In billions of U.S. dollars)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Total
Original amortizations	4.2	7.2	11.5	10.4	9.1	6.3	--	--	--	--	--	--	--	--	48.7
By creditors															
To Mexican banks	--	--	0.8	0.8	0.8	0.8	--	--	--	--	--	--	--	--	3.2
To foreign banks	4.2	7.2	10.7	9.6	8.3	5.5	--	--	--	--	--	--	--	--	45.5
By loans															
1983 jumbo	--	1.6	1.5	1.5	0.4	--	--	--	--	--	--	--	--	--	5.0
Tranche A 1/	4.2	5.6	4.2	2.9	2.8	0.4	--	--	--	--	--	--	--	--	20.1
Tranche B 2/	--	--	5.8	--	--	--	--	--	--	--	--	--	--	--	5.8
To Mexican banks	(--)	(--)	(0.8)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(0.8)
To foreign banks	(--)	(--)	(5.0)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(5.0)
Tranche C 3/	--	--	--	6.0	5.9	5.9	--	--	--	--	--	--	--	--	17.8
To Mexican banks	(--)	(--)	(--)	(0.8)	(0.8)	(0.8)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(2.4)
To foreign banks	(--)	(--)	(--)	(5.2)	(5.1)	(5.1)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(15.4)
Amortizations after restructuring	1.2	0.2	0.5	1.0	2.7	2.6	3.5	4.1	4.4	5.1	5.6	5.7	6.0	6.1	48.7
By creditors															
To Mexican banks	--	--	--	--	0.2	0.1	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	3.2
To foreign banks	1.2	0.2	0.5	1.0	2.5	2.5	3.2	3.8	4.1	4.7	5.2	5.3	5.6	5.7	45.5
By loans															
1983 jumbo	1.2	--	--	--	0.2	0.8	0.8	0.8	0.8	0.4	--	--	--	--	5.0
Tranche A 1/	--	0.2	0.4	0.7	1.0	0.7	1.0	1.4	1.3	2.0	2.8	2.8	2.9	2.9	20.1
Tranche B 2/	--	--	0.1	0.1	0.3	0.2	0.4	0.5	0.6	0.7	0.7	0.7	0.7	0.8	5.8
To Mexican banks	(--)	(--)	(--)	(--)	(--)	(--)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.8)
To foreign banks	(--)	(--)	(0.1)	(0.1)	(0.3)	(0.2)	(0.3)	(0.4)	(0.5)	(0.6)	(0.6)	(0.6)	(0.6)	(0.7)	(5.0)
Tranche C 3/	--	--	--	0.2	1.2	0.9	1.3	1.4	1.7	2.0	2.1	2.2	2.4	2.4	17.8
To Mexican banks	(--)	(--)	(--)	(--)	(0.2)	(0.1)	(0.2)	(0.2)	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(2.4)
To foreign banks	(--)	(--)	(--)	(0.2)	(1.0)	(0.8)	(1.1)	(1.2)	(1.5)	(1.7)	(1.8)	(1.9)	(2.1)	(2.1)	(15.4)
Debt relief	3.0	7.0	11.0	9.4	6.4	3.7	-3.5	-4.1	-4.4	-5.1	-5.6	-5.7	-6.0	-6.1	--
From Mexican banks	--	--	0.8	0.8	0.6	0.7	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	--
From foreign banks	3.0	7.0	10.2	8.6	5.8	3.0	-3.2	-3.8	-4.1	-4.7	-5.2	-5.3	-5.6	-5.7	--

Sources: Mexican authorities; and Fund staff estimates.

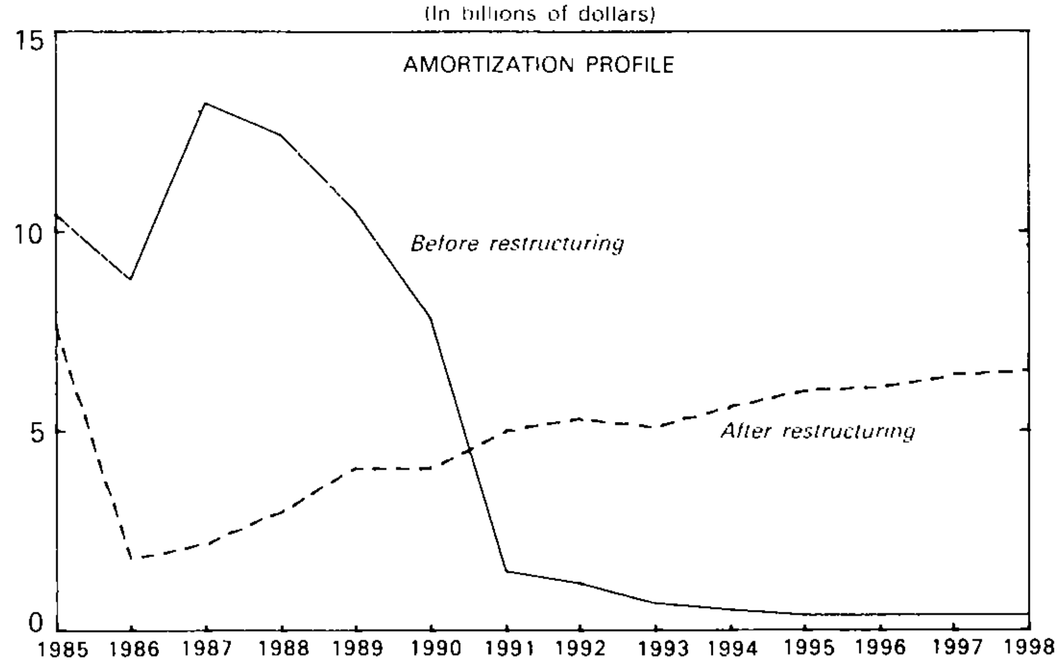
1/ Tranche A includes maturities originally due in 1985-90 and not previously restructured.
2/ Tranche B includes maturities previously restructured and due in 1987.
3/ Tranche C includes maturities previously restructured and due in 1988-90.

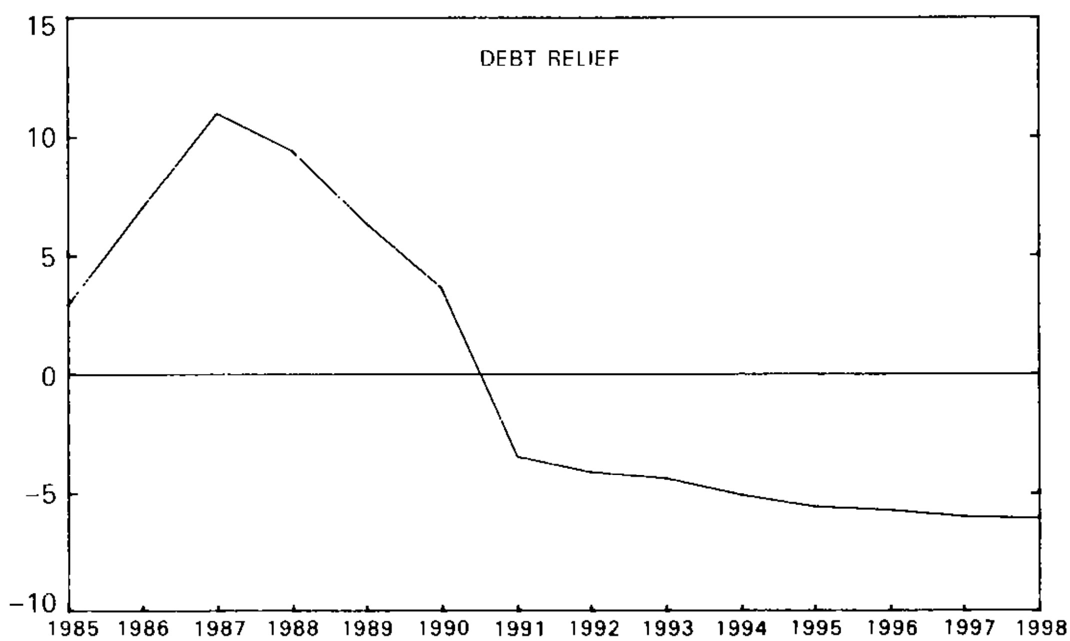
CHART 6

MEXICO

IMPACT OF MULTIYEAR RESTRUCTURING ON EXTERNAL PUBLIC DEBT PROFILE[1]

(In billions of dollars)





Sources: Ministry of Finance and Public Credit; and Fund staff estimates.

[1] Includes debt with foreign branches of Mexican banks; excludes amortization on debt disbursed in 1985.

Table 7. Mexico: Extended Arrangement—Quantitative Performance Criteria for the Second Program Year

	1983		1984							
			Jan.-Mar.		Apr.-June		July-Sept.		Oct.-Dec.	
	Sept.	Dec.	Program	Actual	Program	Actual	Program	Actual	Program	Actual
	(In billions of Mexican pesos)									
Cumulative overall public sector deficit 1/										
Unadjusted	629	1,523	330	260	640	580	980	787	1,524	1,826
Adjusted 2/			318	260	640	580	891	787	1,524	1,826
Cumulative changes in financial intermediation (effective flow)3/										
Unadjusted	175	259	70	82	130	58	170	259	200	398
Adjusted 4/			82	82	130	58	259	259	200	398
Net credit to the public sector by the monetary authorities 5/	2,503 6/	2,971	3,023	2,944	3,205	3,033	3,397	3,023	3,734	3,722
Cumulative changes in net domestic assets of the monetary authorities (effective flow)7/	-557	-502	-40	-141.1	-71	-243	-113	-343	-43	-53
	(In millions of U.S. dollars)									
Cumulative net foreign borrowing by the public sector 1/	2,555	4,686	1,100	190	2,100	879	3,100	1,828	4,000	2,189
Cumulative change in net international reserves of the monetary authorities 1/8/	4,365	5,480	300	756	800	1,861	1,300	2,529	2,000	2,990
Cumulative reduction in arrears 9/	521	1,088	...	280	...	280	...	280	280	280

Sources. Mexican authorities; and Fund staff estimates.

1/ Limit tested at the end of each period.
2/ Limit adjusted downward by the equivalent of the excess of changes in financial intermediation over its limit in the same quarter.
3/ Financial intermediation was not a performance criterion during 1983. Figures shown are for reference only.
4/ Any excess of the cumulative flow of financial intermediation over its limit for the quarter is deducted from the ceiling for the overall public sector deficit.
5/ Effective stocks calculated by adding effective flows to nominal stock outstanding as of the end of November 1983.
6/ Stock outstanding at end of November 1983 unadjusted for changes in the exchange rate (used as base).
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 reserve of the monetary authorities.
8/ Includes payments arrears on account of interest and amortization due on foreign suppliers' loans to the private sector not included in restructuring of external debt.
9/ Limit tested at end of calendar year.

the international economic environment and the measures taken by the authorities to prevent a recurrence of the slippages that occurred in the implementation of the program in late 1984.

The authorities consider that the reduction of inflation is crucial to the attainment of the medium-term objective of stable economic growth while maintaining a strong balance of payments position. To achieve this goal they intend to continue to reduce the size of the public sector deficit relative to GDP, to strengthen financial and exchange rate policies, and to intensify the process of reducing effective protection and generally liberalizing commercial policy. The authorities stressed their commitment to adopt further corrective policy measures if they were required.

1. Fiscal policy

The strengthening of the public finances continues to be the cornerstone of the adjustment process. In 1985, the authorities intend to reduce the public sector economic deficit to 4.1 percent of GDP, from the 6.2 percent of GDP experienced in 1984. In addition, as part of the process of achieving a more efficient management of the public sector in the medium term, steps are being taken to reduce the public sector's involvement in a number of economic activities. Accordingly, the Federal Government has already identified some 236 publicly owned enterprises or entities which will be sold, merged, closed down, or transferred to states and municipalities.

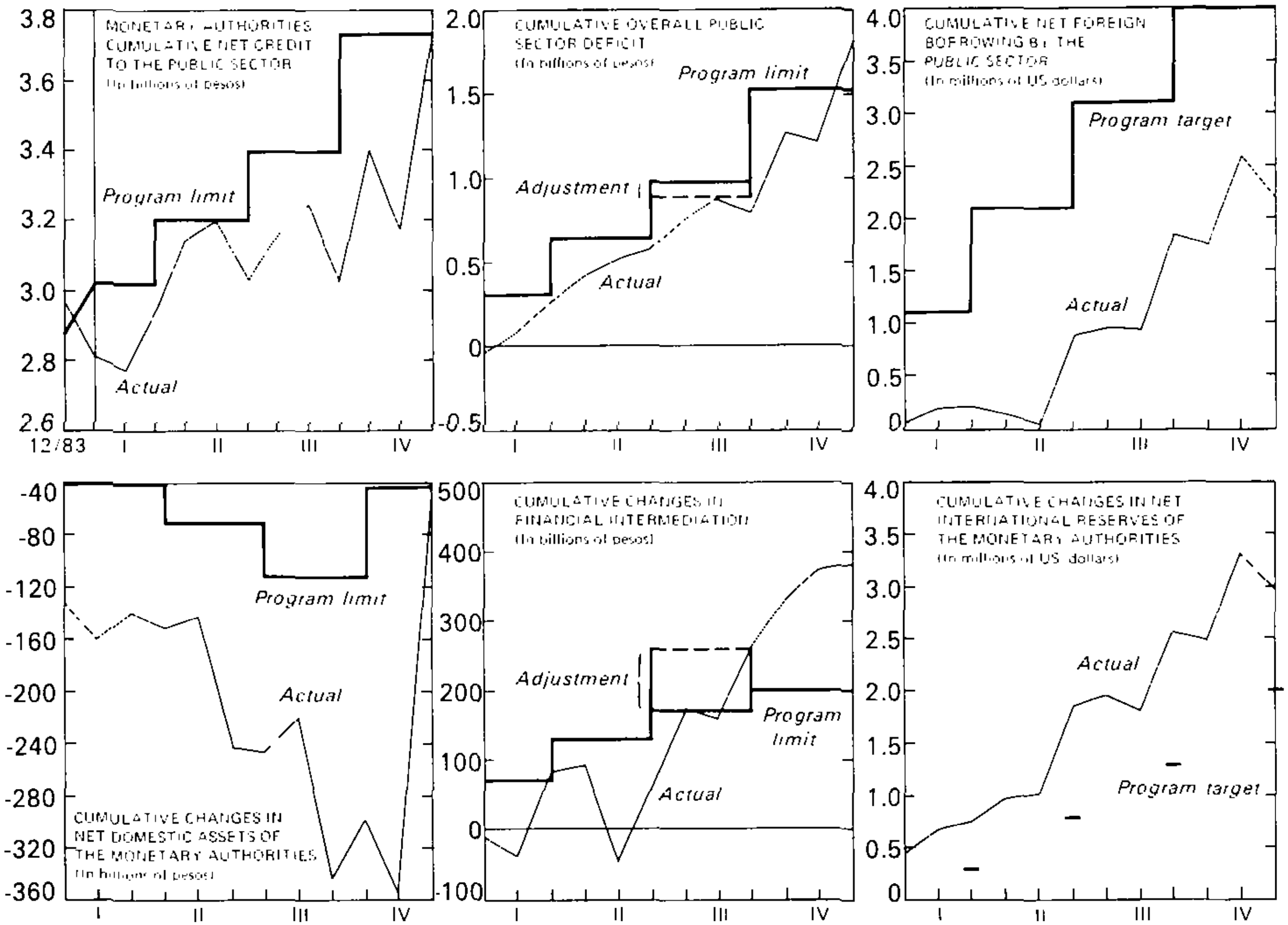
The budget for 1985 that was sent to Congress in November 1984 had set a limit of Mex$2,197 billion on the overall financing requirements of the public sector (equivalent to some 5.1 percent of projected GDP) and a limit of Mex$1,922 billion on the overall economic deficit of the public sector (4.5 percent of GDP). The difference between these two concepts reflects the financial resources required by the development banks and official trust funds to cover their net lending operations to the private sector. Congress also had authorized the possibility of increasing the fiscal deficit by an additional amount of Mex$200 billion (0.5 percent of GDP) on a contingency basis, to be activated in the event of adverse external developments resulting from either a sharp rise in international interest rates or a large fall in international oil prices. At the time that the budget was submitted to Congress, there were large uncertainties about the likely behavior of these two variables.

The authorities indicated that since the approval of the budget they had become increasingly concerned about the possible rekindling of inflationary pressures. The rate of public spending in the last few months of 1984 and early 1985 was higher than had been expected and probably was contributing to inflationary pressures. The rate of increase in domestic prices, which in the first half of 1984 had shown a significant downward tendency, seem to have stabilized at around 3 to 3 1/2 percent a month in the second half of the year. Furthermore,

CHART 7

MEXICO

EXTENDED ARRANGEMENT QUANTITATIVE PERFORMANCE CRITERIA FOR 1984



Sources: Bank of Mexico, Ministry of Finance and Public Credit, and Fund staff estimates.

prices experienced an acceleration in December 1984-January 1985 that went beyond that expected from seasonal factors taking into account the adjustment of controlled prices. Accordingly, in February 1985 the authorities decided to forego activation of the contingency deficit reserve and to reinforce the public finances to ensure that the 1985 overall economic deficit would be kept within MexS1,785 billion (the equivalent of 4.1 percent of GDP).

The authorities explained that receipts of the public sector in 1985 would be affected by the decline in international petroleum prices. However, in local currency terms, the drop in the dollar value of petroleum exports would tend to be somewhat offset by the faster rate of depreciation of the peso adopted in December 1984 and March 1985. Nevertheless, the authorities were aware that there was a need for strengthening the administration of existing taxes and for adjusting the prices of public sector goods and services, to compensate for some of the loss of public sector revenue resulting from the fall in petroleum exports.

The authorities pointed out that substantial adjustments had taken place in the prices of public goods and services in 1983 and 1984, and a large part of the lag in prices accumulated in previous years had now been erased. In 1985 they intend to continue adjusting public sector prices to compensate for inflation, as well to reduce or eliminate operating losses of the state enterprises, but they indicated that the adjustments to be made in 1985 would be relatively smaller than in the previous two years. Prices of bread, tortilla and some other basic staples had been adjusted in December 1984, and that of gasoline in January 1985. Electricity rates were raised by 18 percent in January 1985, to be followed by monthly increases of 2.5 percent.

With respect to tax revenue, significant increases in rates had been introduced in 1983 in the excise tax on gasoline and in the value added tax. The yield of the change in the value added tax, however, had not been as large as had been expected, partly because of the decline in economic activity but also because of an apparent rise in tax evasion. Although the 1985 budget did not provide for tax increases, the authorities expected that the recent recovery in economic activity would strengthen tax receipts. They were also intensifying their efforts to increase the efficiency of the tax administration. In this connection, they referred to a comprehensive review which is being undertaken of both direct and indirect taxes with a view to widening the tax base, simplifying the tax structure, and reducing tax evasion; at the request of the authorities, the Fund is providing technical assistance in this area. The authorities recognized, however, that the effects of administrative reforms resulting from the current review were unlikely to be substantial in 1985.

The brunt of the fiscal adjustment during 1985 is expected to fall on public expenditures. The authorities indicated that emphasis would be placed on reducing current expenditures to make room for a small increase in real terms in the level of public investment. Public investment experienced a sharp contraction over the past three years, and in 1985 will be mainly directed to the completion of priority projects. The original budget for 1985 had already incorporated cuts in current expenditures and transfers, and the thrust of the steps taken to strengthen public finances in February and March 1985 was to reduce further current outlays.

The fiscal measures adopted in February and March 1985 in respect to expenditures included: (a) the elimination or freezing of all vacant positions in the Federal Government and in the state enterprises; (b) a 4 percent cut in government transfers to the nonconsolidated public sector and to the private sector; (c) a 4 percent reduction in current expenditures other than wages and interest payments; (d) a slowdown in disbursements under revenue sharing programs to state and municipalities; and (e) the cancellation or postponement of a number of nonpriority programs and projects. A quantification of the major revisions and adjustments to the original 1985 budget is presented in Table 8.

In addition to the above measures, the authorities have taken a number of steps to tighten controls over public sector outlays and to strengthen the performance of public enterprises, to prevent a recurrence of the expenditure overruns that had taken place in late 1984. For this purpose, they were reinforcing the role of high-level interministerial committees that approve and oversee the execution of the plans for financial rehabilitation of the main state enterprises, and they had instructed commercial banks not to grant credit to public enterprises or entities without prior authorization from the Ministry of Finance. Moreover, the new banking law enacted in December 1984 requires that all banks--including the central bank--capitalize any accrued interest payments on credit to the public sector at the end of each month, so that the accrued interest will count against the limits placed on each public sector entity's access to bank credit. In the past, interest accrued but not paid had not been counted in some cases against the overall spending limits placed on these entities. In the case of central bank credit to the Federal Government, a specific limit has now been introduced under the program to cover the accrual of interest with the Bank of Mexico.

2. Monetary and credit policy

In reviewing developments in the monetary and credit area, the authorities said that monetary policy had been managed cautiously during 1984. Their strategy had been to follow a flexible interest rate policy geared to having nominal interest rates decline in line with the deceleration of inflation, and to conduct auctions of central bank deposits to absorb excess liquidity. Two important constraints affected the way in which this strategy was implemented: first, interest rates had not been allowed to decline below those prevailing abroad (adjusted for changes in exchange rates); and, second, an attempt was made to

Table [illegible]. Mexico: Revisions and adjustments to the original 1985 Budget

(In billions of Mexican pesos)

Type and Institution	Change	Description
Receipts		
Federal Government	-111	
Value added tax	(+23)	Revised upward due to a higher estimate of nominal GDP
Other taxes	(+27)	
Import duties	(-41)	Revised downward due to delays in implementing the new tariff schedule
Gasoline excise	(-85)	Revised downward due to reassessment of impact of price increase on domestic demand for gasoline
Nontax revenue	(-35)	Revised downward to reflect revisions in the budget estimates
PEMEX	+89	Revised upward to reflect the impact of the increase in the rate of depreciation of the exchange rate since the preparation of the budget
Social security	+152	Revised upward to reflect the better than expected revenue performance in late 1984 and the wage award of January 1985
Outlays		
Interest payments	+273	Revised upward to reflect the the impact of higher domestic interest rates on the cost of servicing the public sector debt
Transfers to local government	-75	Revised downward as a result of decision to slow down the disbursement of the revenue sharing program
Operating expenditure other than interest and wages	-27	Revised downward as a result of a 4 percent across the board cut in purchases of goods and services and other operating expenditures
Current transfers	-40	Revised downward following the decision to cut 4 percent of transfers to nonconsolidated public sector and private sector
Capital expenditure	-155	Revised downward due to cuts in nonpriority projects announced in February and March
Net financial requirements of rest of public sector	-17	Revised upward to reflect higher deficits at the level of unconsolidated public sector entities after the reduction of central government transfers
Memorandum items		
Revised overall deficit		
In billions of Mex$	-1,785	
In percent of GDP	-4.1	

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

maintain, on average, positive real rates of return on the main short-term domestic savings instruments. Even though there were significant debt repayments abroad by the private sector during 1984, net private capital outflows (including errors and omissions) declined. At the same time, the rate of growth of domestic financial savings was positive in real terms, in contrast to the performance in 1982 and 1983 when financial savings had contracted in real terms (Chart 8). Interest rate policy in 1985 would continue to be guided by the approach adopted since the beginning of the program, the authorities said.

The authorities recognized that credit expansion in December 1984 and January 1985 had not been consistent with a further decline in inflation and probably had contributed to the loss in international reserves in the first months of 1985. Accordingly, credit had been tightened in February and March 1985 by placing monetary regulation bonds with commercial banks and by increasing interest rates--by as much as 8 percentage points for certain rates.

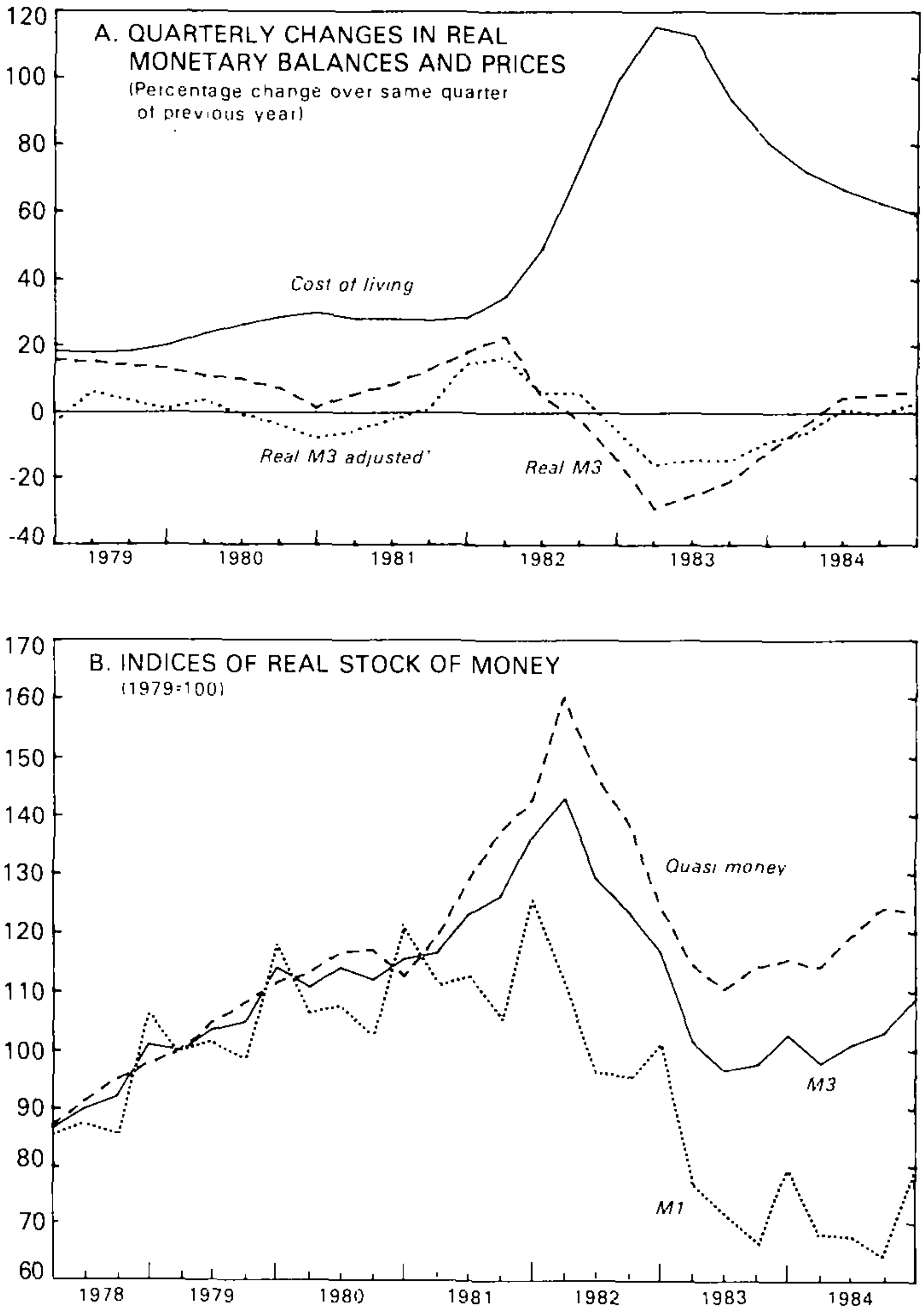
As was mentioned above, during 1984 the authorities had resorted to the auctioning of deposits at the Central Bank to commercial banks as a means of restricting overall liquidity, but the new bank legislation enacted in December 1984 provided greater flexibility in the conduct of monetary policy by permitting the Bank of Mexico to conduct open market operations either through intervention in the market for government securities (treasury bills) or by placing its own monetary regulation bonds. The authorities noted that in mid-February 1985 the Bank of Mexico had already carried out its first placement of monetary regulation bonds with commercial banks for a total of Mex$250 billion (equivalent to about 25 percent of currency in circulation at the end of 1984). Under the new central bank law, the proceeds from the placement of these bonds would not be available to finance credit to the Government but would be sterilized by the Bank of Mexico.

The new law also places restrictions on the access of the Government to Bank of Mexico credit and discontinues the procedure under which resources obtained from commercial banks through reserve requirements were channeled to the Government by the Bank of Mexico. According to the new procedures, the commercial banks' reserve requirements at the Bank of Mexico are being reduced from 48 percent to 10 percent. But commercial banks now will be required to channel to the Government, in the form of a portfolio requirement, 35 percent of the funds they capture through their deposits. Commercial banks also will be required to channel the equivalent of 3 percent of their deposits to the purchase of bonds issued by government development banks. Under the new law, the stock outstanding of direct credit to the Government from the Bank of Mexico cannot exceed 1 percent of total government receipts. The new law also requires that an annual ceiling be established at the beginning of each year on the credit to be extended by the Bank of Mexico.

CHART 8

MEXICO

INDICATORS OF REAL MONETARY BALANCES AND PRICES



Sources: Bank of Mexico, and Fund staff estimates.

[1]Changes in the real stock of M3 adjusted for changes in estimated real GDP.

The authorities' financial plan for 1985 is aimed at achieving US$500 million increases in net international reserves, and the growth of net domestic credit of the Bank of Mexico has been programmed in light of this target and on the basis of a 31 percent increase in currency issue (Table 9). The authorities believe that the resulting overall credit expansion--equivalent to 16 percent of the currency outstanding at the end of 1984--will be consistent with a significant reduction of inflation. Moreover, they pointed out that the limit placed on the Bank of Mexico's net claims on the nonfinancial public sector was being modified to take into account the commercial banks' credit to the Government under the new mandatory portfolio requirement, to ensure adequate room for the expansion of credit to the private sector.

During 1984 the spreads between lending rates and rates paid on deposits had been narrowed (Chart 9). This change reflected both increased competition among banks and a widening of the nonbank financial market, as well as the reduction of interest rates subsidies. Rates on a number of preferential credits were increased during 1984, and again in early 1985, to bring them more nearly into line with the cost of funds; in addition, access to these credits was restricted in many cases as part of a plan to reduce distortions. The authorities indicated that they expected the financial subsidies granted through preferential interest rates to decline further in 1985 as inflation abated. The financial operations of the development banks and official trust funds, where most preferential credits originate, would continue to be subject to an overall ceiling in 1985, with that ceiling calling for a reduction in the value of these operations as compared with 1984 (Table 10).

3. Prices and wages

The authorities indicated that the continuation of relatively high rates of inflation was the most serious problem facing Mexico today. Although a significant reduction in the rate of inflation had been achieved over the past two years, its current pace was too high if sustained growth was to be achieved and the risks of a recurrence of balance of payments difficulties were to be avoided. They pointed out that in the case of the goods and services provided by the public sector, the objective for 1985 was largely one of adjusting prices in line with changes in costs while reducing costs of production through increases in operating efficiency. Controls over prices in the private sector had been removed on most products since early 1983, but it appeared that some firms had taken advantage of a monopolistic position to raise their prices unduly. Thus, the policy that was being adopted to reduce effective protection and the barriers to trade was viewed by the authorites as being a very important step to strengthen competitive forces in the economy.

Table 9. Mexico: Summary Operations of the Financial System

	Actual Stocks Dec. 1984	Effective flows 1/ 1981	1982	1983	1984 Prog.	1984 Actual	Prog. 1985
		(In billions of Mexican pesos)					
		I. Bank of Mexico					
Net international reserves	1,249.1	30.1	-387.1	678.5	343.0	501.0	166.0
Net domestic assets	-114.0	57.7	613.0	-501.0	-43.0	-54.3	184.0
Net credit to the public sector 2/	3,740.1	251.7	696.6	748.2	857.0	751.4	-45.0
Net credit to official trust funds 3/	198.2	11.0	48.6	58.3	...	59.4	100.0
Credit to banks	183.5	-0.5	178.9	-237.4	...	50.1	474.1
Credit to private sector	43.9	1.1	2.7	4.2	...	6.1	...
Liabilities to banks	-3,739.3	-211.9	-335.1	-962.7	-900.0	-1,183.2	-422.1
Other (net) 4/	-540.4	6.3	21.3	-111.6	—	261.9	77.0
Note issue	1,135.1	87.8	225.9	177.5	300.0	446.7	350.0
		II. Financial System					
Net foreign assets	1,366.6	22.5	-397.4	691.3	343.0	449.5	166.0
Net domestic credit	14,483.6	928.1	1,150.3	1,556.9	1,907.0	3,351.4	4,546.7
Net credit to the public sector 5/	10,899.1	594.7	1,224.1	931.6	874.0	1,034.8	1,967.7
Credit to the private sector 5/	4,683.7	310.2	-102.8	764.7	1,152.0	1,978.0	2,579.0
Other (net) 4/	-1,099.2	23.2	29.0	-139.4	-118.0	338.6	—
Medium- and long-term foreign obligations	6,379.6	263.7	6.7	208.5	—	7.0	416.7
Liabilities to nonbank public financial intermediaries	524.1	54.8	10.8	148.6	—	129.4	116.0
Liabilities to private sector 6/	8,946.5	632.1	715.4	1,891.1	2,250.0	3,664.5	4,180.0
Money	2,221.3	151.3	379.0	411.2	...	818.6	869.0
Quasi-money	6,575.3	466.4	322.4	1,452.6	...	2,792.4	3,311.0
Capital and reserves	149.9	14.4	16.0	27.3	—	53.5	—
		(Percentage change in relation to note issue at the beginning of the period)					
Bank of Mexico's net domestic assets	...	29.3	215.1	-98.1	-6.1 8/	-7.9	16.2
Bank of Mexico's net credit to public sector	...	127.6	244.4	146.4	24.2 8/	109.2	-4.0
Note issue	...	44.5	79.3	34.7	43.4 8/	64.9	30.8
		(Percentage change in relation to liabilities to private sector at the beginning of the period) 7/					
Net domestic credit	...	72.0	58.9	47.2	36.3 8/	64.0	50.8
Net credit to the public sector 5/	...	46.1	62.7	28.2	16.6 8/	19.8	22.0
Credit to the private sector 5/	...	24.1	-5.3	23.2	21.9 8/	37.8	28.8
Liabilities to the private sector 6/	...	49.0	36.6	57.3	42.8 8/	69.9	46.7
		(In percent of GDP)					
Net domestic credit	49.2	15.8	12.2	9.1	6.9 8/	11.4	10.4
Net credit to the public sector 5/	37.0	10.1	13.0	5.4	3.1 8/	3.5	4.5
Credit to the private sector 5/	15.9	5.3	-1.1	4.5	4.1 8/	6.7	5.9
Liabilities to the private sector 6/	30.4	10.8	7.6	11.0	8.1 8/	12.4	9.6
Money	7.5	2.6	4.0	2.4	...	2.8	2.0
Quasi-money	22.4	7.9	3.4	8.5	...	9.5	7.6
Memorandum item							
Credit to the private sector as proportion of liabilities to private sector	52.4	49.1	-14.4	40.4	51.2 8/	54.0	61.7

Sources: Bank of Mexico; and Fund staff estimates.

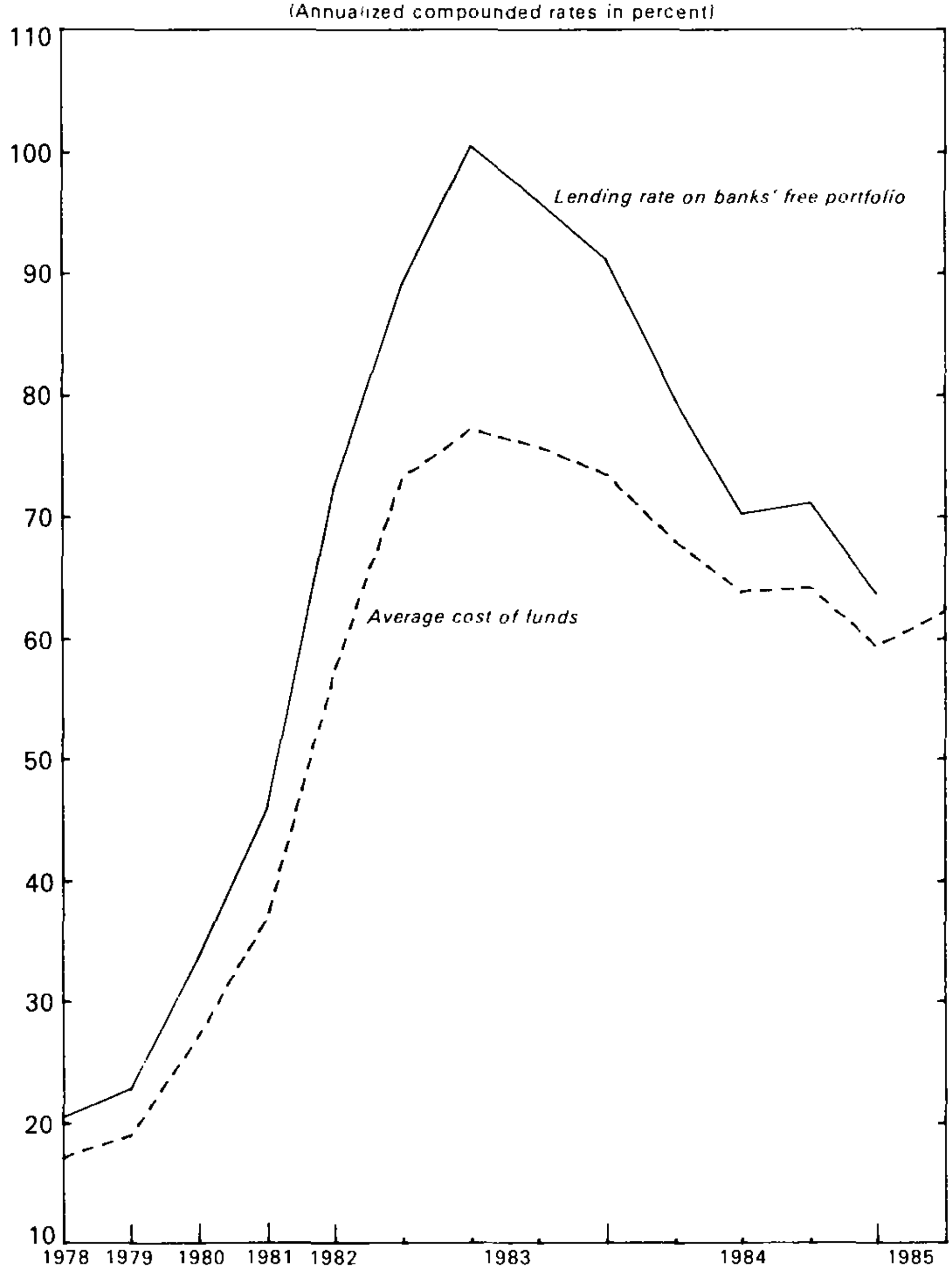
1/ Effective flows excluding valuation adjustments for exchange rate changes in foreign currency denominated accounts.
2/ Excludes net credit to official trust funds.
3/ Excludes FICORCA.
4/ Includes interest accrued on Bank of Mexico's claims on the nonfinancial public sector, official capital, gold price adjustments, valuation adjustments to Fund transactions, and other net unclassified.
5/ Includes credit financed with medium- and long-term foreign liabilities of the public sector channeled through the banking system. Data for total domestic credit to the public sector differs from that presented in Table 2 because in that table the banking system's credit to the public sector funded with foreign resources is classified as foreign financing.
6/ Excludes liabilities to the public sector previously classified as belonging to the private sector.
7/ Changes are effective flows in relation to the nominal stock of liabilities to the private sector at the beginning of each period.
8/ Percentages shown are calculated in relation to the projected figures at the time of program inception.

CHART 9

MEXICO

COST OF FUNDS AND LENDING RATES

(Annualized compounded rates in percent)



Source: Bank of Mexico

Table 10. Mexico: Financial Intermediation Operations of Development Banks and Official Trust Funds

(*In billions of Mexican pesos*)1/

	1981	1982	1983	1984	Prog. 1985
Total financial intermediation operations	-12.5	69.3	258.5	397.9	350.0
Bank of Mexico official trust funds	11.0	48.6	59.2	53.1	100.0
National development banks	-23.5	20.7	199.3	344.8	250.0
Credit to private sector	9.3	-1.4	218.0	458.2	250.0
Other	-32.8	22.1	-18.7	-113.4	—
Memorandum items					
Financial intermediation as percent of GDP	-0.2	0.7	1.5	1.4	0.8
Funds channeled to the private sector by official intermediaries as a percent of the financial system's total credit to the private sector	6.5	2/	36.2	25.8	13.6

Sources: Bank of Mexico; and Fund staff estimates.

1/ Effective flows adjusted for changes in the exchange rate.
2/ The financial system's net credit to the private sector was negative during 1982.

A number of measures had been taken over the last two years to protect the purchasing power of the lower income groups and to minimize the increase in open unemployment. These included a redirection of subsidies and the reallocation of certain investment expenditures toward labor intensive public works. Notwithstanding these efforts, the authorities are convinced that the most effective way to improve the purchasing power and welfare of the Mexican population is through a reduction in the rate of inflation and the achievement of a sustained recovery of economic activity.

It was generally recognized that wage developments in 1983 had made a contribution to the adjustment process. Real wages had fallen significantly in that year, and their sharp reduction had helped avoid a major fall in employment levels even in the face of a large drop in economic activity. It was important to note, however, that the fall in real wages that had taken place in 1983 was in relation to an unsustainable level achieved in 1981-82. In 1984, the increase in nominal wages was almost the same as the rise in prices while employment had increased.

Minimum wages were increased by 30 percent in January 1985, the same percentage increase as that granted in January 1984. The mission pointed out that in order to reinforce the downward expectations on inflation a lower adjustment in early 1985 would have been more appropriate. The authorities indicated that they would like to see some increase in real wages in 1985, but were aware that such an increase could only take place on the basis of increases in productivity. Accordingly, they were recommending that in reaching wage agreements the employers and the trade unions take account of the behavior of productivity, the objective of continued growth in employment, and the need to maintain the external competitiveness of the economy.

4. External policies

With the adoption of the stabilization program in late 1982 the authorities began to dismantle gradually the existing exchange and trade restrictions. The first step taken was to devalue the peso sharply in December 1982, and thereafter they started to liberalize the exchange and trade system. In the early stages, the authorities proceeded cautiously in eliminating restrictions because of the uncertainties that prevailed about the outlook and the limited international reserves available; initially, they focused their efforts on settling outstanding external arrears and restructuring the external debt.

Balance of payments performance was strong in both 1983 and 1984, arrears have been settled, the debt restructured, and international reserves have been rebuilt to a comfortable level. At the beginning of the program, a large part of the balance of payments adjustment was through the compression of imports. Now that the constraint imposed by an extremely low level of foreign exchange reserves is no longer present, the authorities intend to concentrate--during 1985 and beyond--on the medium-term structural aspects of their program of exchange and trade liberalization.

a. Exchange system

Discussions on exchange rate policy focused on the implications for the competitiveness of the economy of the real effective appreciation of the currency that has taken place over the last two years, the outlook for the unification of the exchange market, and the impact of the parallel exchange market.

The staff recognized that the exchange rate had been adjusted sharply in real terms in 1982, but it also emphasized the need to evaluate carefully the appropriateness of the pace of daily depreciation of the peso in light of the continuing inflation and developments in the parallel market. During 1983 and 1984 the rate of depreciation of the Mexican peso had not matched the differential of inflation between Mexico and its major trading partners and the competitive margin available in early 1983 had been progressively eroded. The Mexican peso appreciated in real terms by 48 percent from December 1982 to February 1985 (measured in Mexican pesos per U.S. dollar).

This development, together with the rise in domestic demand, contributed to a deceleration in the rate of growth of nonpetroleum exports and of nonfactor services-such as tourism--in the second half of 1984. The Bank of Mexico's international reserves continued to rise throughout most of the second half of 1984, but they declined by US$0.9 billion in the first quarter of 1985. While a significant part of this reserve loss can be explained by the concentration of public sector external amortizations in the period December 1984-March 1985, the erosion of competitiveness and the weakening of demand management policies in late 1984 and early 1985 seem to have contributed to the reserve loss.

The authorities were of the opinion that the Mexican peso was still competitive, however, particularly on the basis of developments in relative unit labor costs. While they recognized that during the course of 1983 and 1984 external competitiveness had been reduced, they still felt that the margin had become so wide after the December 1982 devaluation that there was still a competitive edge. Nonetheless, they indicated that they were prepared to be flexible in the management of the exchange rate, and pointed to the acceleration in the pace of daily depreciation in December 1984 and again in March 1985. The authorities said that they were prepared to adjust the pace of the daily depreciation again if needed in light of evolving circumstances. They pointed out that the current rate of depreciation of Mex$ 0.21 per U.S. dollar per day was consistent with no further appreciation of the peso in real terms if domestic inflation were to be around 40 to 45 percent a year, assuming no major further appreciation of the dollar vis-a-vis other key currencies. They reafirmed that flexibility in exchange rate policy would continue to be exercised to maintain the international competitiveness of the economy and ensure the viability of the liberalization of commercial policy.

The staff also discussed the timing for unification of the exchange rates and the implications of developments in the parallel market for the performance of the balance of payments. The authorities had indicated at the beginning of the program that the multiple currency practices were temporary measures to be applied while generalized exchange controls were being phased out, and the staff inquired about the prospects for unification before the end of the extended arrangement. The authorities responded that the free market had become less important over the past two years and that the difference between the free market exchange rate and the controlled market rate had been narrowing (it is now less than 8 percent). The staff noted that at the same time, however, the difference between the free market rate and the parallel market rate had widened, and that in recent months it had been as high as 10 percent. The authorities reiterated their willingness to seek a further liberalization and the eventual unification of the exchange markets but they wished to proceed cautiously in this area, given the uncertainties still prevailing in the foreign exchange markets.

b. Commercial policies

The authorities explained that the difficult external conditions prevailing in the early stages of the economic stabilization program had meant that commercial policy initially involved the control of many import items through licensing and the encouragement of import substitution. They recognized that such an approach was not desirable in the longer run because it introduced serious distortions into the system, and as the balance of payments strengthened, the focus of trade policy was being shifted toward enhancing efficiency.

Some steps were taken in 1984 to reduce the scope of the licensing system, although it is recognized that progress in this area had been slow. The Government is now in the process of carrying out a comprehensive revision of foreign foreign trade policy, with the objective of reducing the level and rationalizing the structure of protection. The authorities also expected this reform to have an effect in dampening inflationary pressures.

A major feature of the reform will be the shift from the licensing of imports to import tariffs as the major instrument of commercial policy. The authorities will introduce a new tariff schedule that will reduce the number of tariff rates from ten to seven in order to lower the dispersion of the rates; these rates, with few exceptions, will be in the range of 10 to 50 percent. It is their intention to raise the proportion of total imports exempted from permits, from about 17 percent of annual imports at the end of 1984 to between 35 and 45 percent before the end of 1985. This process of reducing the role of licenses would be continued over the next few years. An important aspect of the revision of trade policy is that the liberalization of imports would cover goods produced domestically whereas previously the efforts had focused mainly on intermediate and capital goods not produced at home. Also, the authorities indicated that locally produced raw materials and spare parts whose domestic price exceeded prices abroad by more than 50 percent will be granted import permits automatically.

The authorities noted that they intended to introduce shortly a new instrument (DIMEX) whereby exporters would be allowed to import without permit a value equivalent to a certain proportion of their export proceeds; the portion corresponding to the imported component of their export would be free from import duty. The authorities indicated that this new scheme is not intended to be a substitute for appropriate exchange rate management. More generally, the authorities expressed their intentions to aim at encouraging the development of internationally competitive activities and limiting the duration of infant industry protection being granted.

The authorities consider that expansion of non-oil exports and an efficient import substitution were crucial to ensure a viable balance of payments in the medium term. They pointed out that a number of measures were being introduced to simplify export procedures and to make exporting more attractive. Included among the latter is the extension of the system of temporary imports to benefit not only direct exporters but also local producers of inputs for export activities. The authorities warned, however, that the consolidation of Mexico's outward looking trade strategy would hinge on the assurance of access to foreign markets and, in particular, on the removal of barriers to access in key markets abroad.

c. External debt management

The authorities viewed the restructuring of Mexico's foreign debt, both public and private, as an important element in the process of re-establishing normality to the country's external economic relations. With the elimination of the external arrears and the agreement reached on the restructuring of the debt, Mexico is now in a much better position to handle its debt (Table 11). In the context of the multiyear restructuring of the public debt owed to commercial banks, the Mexican authorities foresee a role for the Fund in reviewing and appraising the adequacy of the country's annual financial programs. Monitoring procedures have been agreed with the commercial banks to improve the availability of economic information and the Mexican authorities have requested an enhancement of the arrangements for surveillance under the Article IV consultations once the current EFF arrangement expires.

In the case of the private debt, operations which total approximately US$12 billion have been registered under FICORCA's restructuring arrangements. With respect to the private debt guaranteed by foreign official creditors: bilateral restructuring agreements have been negotiated with France, the Federal Republic of Germany, Spain, the United Kingdom, and

Table 11. Mexico: External Public Sector Debt Indicators, 1980-90

(In billions of U.S. dollars)

	1980	1981	1982	1983	Prel. 1984	Projected 1985	1986	1987	1988	1989	1990
External public debt operations	4.7	17.8	9.0	3.8	3.4	1.0	0.8	0.7	0.5	0.7	0.4
Direct debt (net)	4.8	17.8	6.8	4.7	2.2	0.1	0.6	1.0	1.0	1.5	1.2
Medium- and long-term debt	4.1	9.0	5.6	16.0	2.0	-3.2	0.6	1.0	1.0	1.5	1.2
Disbursements	(7.8)	(13.8)	(10.6)	(23.1)	(8.2)	(7.2)	(9.9)	(15.1)	(14.4)	(13.3)	(11.4)
Restructuring 1982-84	/--/	/--/	/--/	/15.0/1/	/3.8/2/	/--/	/--/	/--/	/--/	/--/	/--/
Restructuring 1985-90	/--/	/--/	/--/	/--/	/--/	/3.0/	/7.0/	/11.0/	/9.4/	/6.4/	/3.7/
Other loans	/7.8/	/13.8/	/10.6/	/8.1/	/4.4/	/4.2/	/2.9/	/4.1/	/5.0/	/6.9/	/7.7/
Amortizations due	(3.7)	(4.8)	(5.0)	(7.1)	(6.2)	(10.4)	(9.3)	(14.1)	(13.4)	(11.8)	(10.2)
Debt outstanding end-1983	/3.7/	/4.8/	/5.0/	/7.1/	/6.2/	/10.2/	/8.7/	/12.8/	/11.9/	/9.7/	/7.1/
Of which: restructured	[--]	[--]	[1.3]	[4.9]	[3.8]	[3.0]	[7.0]	[11.0]	[9.4]	[6.4]	[3.7]
New disbursements 1984-90	/--/	/--/	/--/	/--/	/--/	/0.2/	/0.6/	/1.3/	/1.5/	/2.1/	/3.1/
Short-term debt (net) 3/	0.7	8.8	1.2	-11.3	0.2	3.3	--	--	--	--	--
Of which: restructured amortization	(--)	(--)	(6.3)	(10.1)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
Bank of Mexico (net)	-0.1	--	2.2	-0.9	1.2	0.9	0.2	-0.3	-0.5	-0.8	-0.8
IMF	(-0.1)	--	(0.2)	(1.1)	(1.2)	(0.9)	(0.2)	(-0.3)	(-0.5)	(-0.8)	(-0.8)
Purchases	/--/	/--/	/0.2/	/1.1/	/1.2/	/0.9/	/0.3/	/--/	/--/	/--/	/--/
Repurchases	/0.1/	/--/	/--/	/--/	/--/	/--/	/0.1/	/0.3/	/0.5/	/0.8/	/0.8/
Other	(--)	(--)	(2.0)	(-2.0)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
Interest payments	4.0	5.5	7.9	7.4	8.5	7.6	7.0	7.2	6.9	6.7	6.7
IMF	--	--	--	0.1	0.1	0.2	0.3	0.3	0.3	0.2	0.2
Other	4.0	5.5	7.9	7.3	8.4	7.4	6.7	6.9	6.6	6.5	6.5
Debt service payments 4/											
Amounts due before rescheduling	7.8	10.3	12.9	14.5	14.7	18.0	16.4	21.6	20.8	19.3	17.7
Amounts paid	7.8	10.3	11.6	9.6	10.9	15.0	9.4	10.6	11.4	12.9	14.0
Public debt outstanding, end of period	34.5	53.1	62.9	65.8	68.8	69.8	70.6	71.3	71.8	72.5	72.9
Direct debt	34.5	53.1	60.8	64.5	66.3	66.4	67.0	68.0	69.0	70.5	71.7
Medium- and long-term debt	(32.3)	(42.2)	(49.9)	(64.3)	(65.9)	(62.7)	(63.3)	(64.3)	(65.3)	(66.8)	(68.0)
Short-term debt	(2.2)	(10.9)	(10.9)5/	(0.2)	(0.4)	(3.7)	(3.7)	(3.7)	(3.7)	(3.7)	(3.7)
Bank of Mexico	--	--	2.1	1.3	2.5	3.4	3.6	3.3	2.8	2.0	1.2
IMF	(--)	(--)	(0.2)	(1.3)	(2.5)	(3.4)	(3.6)	(3.3)	(2.8)	(2.0)	(1.2)
Other	(--)	(--)	(1.9)	(--)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
Memorandum items											
Nationalized bank debt outstanding	5.1	7.0	7.9	8.6	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Interest payments of nationalized banks	...	...	0.8	0.9	0.8	0.8	0.8	0.8	0.8	0.7	0.7
Selected indicators (in percent)											
Effective interest rates 6/	12.4	12.6	13.6	11.5	12.6	11.0	10.0	10.2	9.7	9.3	9.2
Debt service ratio											
Excluding the Fund	30.9	33.4	44.6	49.8	45.1	52.8	44.7	55.4	49.8	42.1	[illegible]
Including the Fund	31.3	33.4	44.6	50.2	45.4	53.4	45.8	57.0	51.7	44.4	[illegible]
Total on amounts paid	31.3	33.4	40.1	33.2	33.6	44.5	[illegible]	[illegible]	[illegible]	29.7	29.8
Interest payments to GDP 7/											
Excluding the Fund	2.4	2.8	4.7	3.6	[illegible]	3.3	2.7	2.5	2.2	2.0	[illegible]
Total, net of interest on gross reserves	2.2	2.5	3.6	[illegible]	[illegible]	[illegible]	2.2	[illegible]	2.0	1.8	1.6
Interest payments to exports of goods and services	16.1	17.9	27.3	25.6	26.2	22.6	19.6	19.0	17.2	15.4	14.3
External debt ratio to GDP 7/											
Excluding the Fund	20.5	26.6	29.3	31.9	31.0	29.2	27.0	25.0	23.1	21.5	20.0
Total, net of gross reserves	18.9	24.8	29.3	30.9	28.7	26.9	24.3	22.1	20.2	18.4	16.7

Sources: Mexican authorities; and Fund staff estimates and projections.

1/ Covers the refinancing from banks obtained in 1983.
2/ Covers refinancing from banks in 1984.
3/ Includes net disbursements of PEMEX contracts in 1980-83.
4/ Includes amortization on medium- and long-term debt and interest payments on total debt; includes Fund transactions.
5/ Includes amounts subject to postponement in 1982.
6/ Interest rate on average debt outstanding during the period.
7/ GDP in U.S. dollars valued at average real exchange prevailing in 1979.

the United States; in the cases of Belgium, Canada, and Sweden, the amounts due either have been fully paid or were below the "de minimis" clause;1/ no outstanding debts have been identified with Norway; and in the cases of Italy and Japan the Mexican authorities have already contacted these Governments to determine whether any amounts are still due. The authorities said that virtually all of the private debt guaranteed by official creditors abroad has been covered by the agreements already signed, and that any small amounts not covered by these agreements most likely have been settled already through the free market. They have indicated to the staff that they are prepared to conclude any further bilateral agreement that might be necessary to settle any remaining obligations of this type.

The objective of public sector debt management is to lower the reliance on foreign borrowing and reduce the size of the overall debt in relation to GDP. In 1985 most of the gross foreign borrowing is expected to be from bilateral and multilateral sources. A limit of US$1 billion was placed on the public sector's net external borrowing in 1985, which is consistent with Mexico's capacity to absorb and service additional foreign sebt. However, the financial program assumes that actual net borrowing abroad is to remain in the neighborhood of US$100 million. This assumption reflects both the likely availability of funds in the market and the authorities' intention to limit their recourse to external borrowing in order to strengthen Mexico's chances of resuming normal access to international capital markets. To the extent that more external financing becomes available, recourse to domestic financing will diminish, with positive effects on the availability of credit for the private sector.

The authorities appreciated the support given by the international financial community to Mexico through special financial packages in 1983 and 1984, but realized that such borrowing procedures were of an exceptional character. Given the improvements achieved in public finances and the balance of payments during the past two years, they considered it appropriate to return to the normal market practices in which voluntary lending is the norm.

5. Performance criteria for the third year of the arrangement

In the letter dated March 24, 1985 and attached Technical Memorandum of Understanding circulated to the members of the Executive Board (EBS/85/70), the authorities described in detail their economic program for 1985 and the performance criteria that have been established. (A summary of the principal elements and assumptions underlying the program for 1985 is presented in Appendix IV.) For the year as a whole the public sector deficit on a cash basis is being limited to Mex$1,785 billion. Quarterly limits have been set with respect to the overall

1/ In the cases where the amounts due were below SDR 10 million, the Mexican authorities have made available the foreign exchange to make these payments immediately.

public sector cash deficit and its major sources of financing and a new quarterly ceiling has been introduced on public sector interest obligations accrued to the Bank of Mexico. As mentioned above, the limit on the public sector net foreign borrowing has been set at US$1 billion for 1985. The limits on the Bank of Mexico's claims on the nonfinancial public sector can be raised by the programmed lending from commercial banks to the nonfinancial public sector that results from the existing mandatory portfolio requirement equivalent to 35 percent of the deposit liabilities of commercial banks; however, if and when these limits on Bank of Mexico credit to the nonfinancial public sector are adjusted upward, the mandatory portfolio requirement on commercial banks will have to be reduced by an equivalent amount. The operations of financial intermediation carried out by the development banks and official trust funds continue to be subject to a quarterly limitation. The limits placed on the expansion of net domestic assets of the Bank of Mexico are consistent with the objective of achieving a US$500 million improvement in the net international reserve position during 1985; quarterly targets have been established on the changes in net international reserves to help guide the management of exchange rate policy.

The quantitative performance criteria of the program as summarized in Table 12 are: (1) a set of quarterly limits on the overall cash deficit of the public sector (paragraph 3 of the Technical Memorandum of Understanding attached to the letter of intent); (2) a set of quarterly limits on the unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector (paragraph 4 of the Technical Memorandum); (3) a set of quarterly limits on the Bank of Mexico net credit to the nonfinancial public sector (paragraph 2 of the Technical Memorandum); (4) a set of quarterly limits on the operations of financial intermediation conducted by the national developments banks and official trust funds, including the official trust funds of the Bank of Mexico but excluding FICORCA (paragraph 6 of the Technical Memorandum); (5) a set of quarterly limits on the Bank of Mexico's net domestic assets (paragraph 5 of the Technical Memorandum); (6) a set of quarterly limits on the public sector's net use of foreign credit (paragraph 1 of the Technical Memorandum); and (7) a set of quarterly targets for the net foreign assets of the Bank of Mexico (paragraph 7 of the Technical Memorandum). It will be noted that some performance criteria set forth in the authorities' Technical Memorandum of Understanding have been established for December 31, 1985, the last day of the extended arrangement for Mexico. It is intended that the last segment of the phased amount of the arrangement be made available only if Mexico is meeting those criteria. Accordingly, a sentence is included in the draft decision to the effect that a request for the purchase of that segment will be met only if the request was made on or before December 31, 1985, the data for that date have been received on or before February 20, 1986, and those data show that the performance criteria were observed on December 31, 1985.

Table 12. Mexico: Extended Arrangement—Quantitative Performance Criteria for the Third Program Year

	1984	1985			
		Targets and Ceilings			
	Dec.	Jan.-Mar.	Apr.-June	July-Sept.	Oct.-Dec.
	(In billions of Mexican pesos)				
Nonfinancial public sector cumulative deficit 1/2/	1,826	430	840	1,240	1,785
Unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector	491	805	805	705	568
Net credit to the nonfinancial public sector by the monetary authorities 3/					
Unadjusted	3,740	3,748	3,895	3,897	3,695
Adjusted 4/		3,958	4,426	4,676	4,902
Cumulative changes in financial intermediation (effective flow)	414	130	230	300	350
Cumulative changes in net domestic assets of the monetary authorities (effective flow)5/	-53	127	179	45	184
	(In millions of U.S. dollars)				
Cumulative net foreign borrowing by the public sector 1/	2,189	500	500	800	1,000
Cumulative change in net international reserves of the monetary authorities 1/	2,990	-1,000	-900	-100	500

Sources: Mexican authorities; and Fund staff estimates.

1/ Limit tested at end of each period.
2/ Effective flows of financing measured on cash basis.
3/ Effective stocks calculated by adding effective flows to nominal stock outstanding as of the end of 1984.
4/ Ceiling can be adjusted upwards by an amount equivalent to the commercial banks' lending to the nonfinancial public sector resulting from implementing mandatory portfolio requirements. The counterpart of this adjustment would be a downward adjustment of the mandatory portfolio requirements on commercial banks by the same amount as the upward adjustment of the Bank of Mexico's lending to the nonfinancial public sector allowed under the program.
5/ 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.

In addition, the general clause pertaining to the authorities' intentions 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 clause pertaining to the authorities' intention to avoid the emergence of new arrears (paragraphs 4(c) and 4(e) of the extended arrangement), remain in effect, and the extended arrangement is being amended in accordance with Executive Board Decision No. 7908 (85/26) of February 20, 1985 on overdue payments to the Fund (see ammended Extended Arrangement attached). Furthermore, the implementation of the economic program and the evolution of economic activity during the first half of 1985 will be reviewed with the Fund before September 30, 1985; purchases scheduled for the period after September 30, 1985 will be contingent on the completion of this review.

IV. Balance of Payments Prospects

1. Prospects for 1985

On the basis of the results obtained for 1984 and the policies being implemented in 1985, the current account of the balance of payments is projected to show a surplus of about US$2 billion in 1985 compared with one of US$4 billion in 1984 (Table 13). This reduction in the current account surplus would reflect mainly larger imports of goods and services. The continued expansion of economic activity and the planned liberalization of import controls are expected to result in an increase of private sector imports, with total imports projected to rise by 21 percent in volume terms and 24 percent in value terms in 1985. Petroleum export receipts are projected to decline by almost 5 percent this year, due to lower prices and a somewhat smaller volume. However, exports of nonpetroleum products are projected to continue to grow, although at a slower pace than in the past two years, and are expected to more than make up for the drop in petroleum receipts. Interest payments abroad are forecast to decline from the levels registered in the recent past because of the prevalence of lower interest rates (both because the base rates will be lower on average and the spreads will have been narrowed by the debt restructuring agreement).

For 1985 the capital account is expected to show a net outflow--despite a further slowing of private capital outflows--because of a decline in public sector borrowing abroad. In the case of the public sector, drawings from bilateral and multilateral official sources are expected to offset amortization payments to other creditors, but little gross borrowing from commercial banks is expected in 1985 since no special financial package will be sought. As was indicated above, the net international reserves of the Bank of Mexico are projected to increase by US$500 million in 1985.

Table 13. Mexico: Medium-Term Balance of Payments Projections, 1984-90

(In billions of U.S. dollars)

	1984	1985	1986	1987	1988	1989	1990
Current account	4.1	2.1	2.0	0.5	-0.2	-0.2	-0.5
Trade balance	13.9	11.8	11.1	10.2	9.4	9.5	9.7
Exports	(25.2)	(25.8)	(27.1)	(28.3)	(29.7)	(31.9)	(34.3)
Imports	(-11.3)	(-14.0)	(-16.1)	(-18.1)	(-20.3)	(-22.4)	(-24.6)
Factor income	-10.0	-9.3	-8.6	-9.1	-8.9	-8.8	-9.2
Of which: interest payments on public debt	(-8.5)	(-7.6)	(-7.0)	(-7.2)	(-6.9)	(-6.7)	(-6.7)
Other services and transfers	0.2	-0.4	-0.5	-0.6	-0.7	-0.8	-1.0
Capital account	-1.1	-1.6	-0.4	0.7	1.2	2.0	1.9
Official capital	2.2	0.1	0.6	1.0	1.0	1.5	1.2
Private capital 1/	-3.3	-1.7	-1.0	-0.3	0.2	0.5	0.7
Monetary authorities (increase -)	-3.0	-0.5	-1.6	-1.2	-1.0	-1.8	-1.4
Memorandum items							
Current account as percent of GDP							
At 1979 real exchange rate	1.9	0.9	0.8	0.2	-0.1	-0.1	-0.1
At current exchange rate	2.3	1.1	0.9	0.2	-0.1	-0.1	-0.2
Gross reserves, end of period 2/							
In billions of dollars	7.3	8.7	10.4	11.2	11.5	12.4	13.0
In months of imports	7.8	7.5	7.8	7.4	6.8	6.6	6.3

Source: Fund staff projections.

1/ Includes errors and omissions.
2/ Excludes gold and payments agreements.

2. Medium-term projections

The medium-term balance of payments has been revised in light of recent developments and the restructuring agreement reached with commercial banks. The major macroeconomic assumptions made in earlier exercises 1/ have been revised somewhat, taking into account the results for 1984 and the new projections for 1985. However, the basic underlying assumptions concerning the continuation of the adjustment policies have not been modified, and as a consequence the general course of growth, inflation, and the balance of payments has been maintained realtively unchanged (Table 14). On the basis of the latest policy assumptions, the projections indicate the feasibility of sustaining rates of real growth of about 5 to 6 percent of GDP over the next few years while achieving a gradual convergence of domestic inflation to that of Mexico's main trading partners and maintaining a strong balance of payments.

Working with these assumptions, the staff projects that Mexico's current account should be in approximate balance over the period 1986-90 taken as a whole. The virtual disappearance of the current account surplus would reflect a recovery of private investment, partly offset by a reduced public sector deficit. The recovery of private investment is expected to be accompanied by a further reduction in private capital outflows.

Underlying the medium-term trade balance projections is the maintenance through 1988 of an export volume for crude oil of 1.5 million barrels a day at the average prices now in effect, oil prices are assumed to increase thereafter by world inflation. The volume of nonpetroleum exports is projected to grow on average by 8 percent a year throughout the projection period. Import volume is expected to rise by 10 percent in 1986, 7 percent in 1987-89, and 5 percent thereafter.

Nonfactor services are assumed to grow by 10 percent a year in dollar terms during 1986-90. As a result of only moderate recourse to external borrowing and a projected reduction in world market interest rates, net factor payments abroad are expected to decline gradually as a proportion of GDP, from 5.7 percent in 1984 and 4.9 percent in 1985, to a range of 3 to 4 percent in 1986-90.

Mexico is expected to return to the international capital markets starting in 1986, but net borrowing is expected to be quite limited; some net inflows of private capital are expected after 1988. If the main balance of payments variables develop as outlined above, there should be scope for a modest accumulation of reserves in the years to come; the projection indicates that the gains should be sufficient to maintain a relatively comfortable level of foreign reserves as a proportion of current payments.

1/ See EBS/84/1. Sup. 1 (1/27/84), pp. 28-30.

Table 14. Mexico: Macroeconomic Projections

	1982	1983	1984	Projections 1985	1986-90 1/
	(Annual percentage changes)				
Production and prices					
Real GDP	-0.5	-5.3	3.5	3.5	4.5 to 6.0
GDP deflator	61.1	94.2	66.0	43.0-48.0	11.0 to 25.8
Consumer price index (end of period)	98.9	80.8	59.2	35.0-45.0	10.0 to 20.0
	(As percent of GDP)				
Balance of payments					
Trade balance	4.7	10.2	7.9	6.2	3.1 to 5.3
Net factor payments abroad	-7.1	-6.7	-5.7	-4.9	-3.0 to -4.1
Of which: interest payments on public external debt 2/	(-4.8)	(-5.2)	(-4.8)	(-4.0)	(-2.2 to -3.3)
Other services and transfers	-1.0	0.1	0.1	-0.2	-- to -0.3
Current account excluding factor services	3.7	10.4	8.0	6.0	2.8 to 5.0
Current account	-3.4	3.6	2.3	1.1	-0.2 to 0.9
Net official capital	4.1	3.3	1.3	--	0.3 to 0.5
Private capital (including errors and omissions)	-4.9	-3.1	-1.9	-0.9	-0.5 to 0.2
Net international reserves (surplus -)	4.1	-3.9	-1.7	-0.3	-0.4 to -0.8
Public sector					
Savings	-7.4	-0.9	0.1	2.8	3.7 to 5.3
Capital revenue	0.2	0.1	0.1	0.2	0.1
Investment	10.2	7.1	6.2	7.0	7.5 to 8.6
Other capital expenditure	0.4	0.6	0.2	0.1	0.2 to 0.3
Overall deficit	17.8	8.5	6.2	4.1	3.5 to 3.9
Domestic financing	(14.1)	(5.0)	(4.9)	(4.1)	(3.1) to (3.6)
External financing	(3.7)	(3.5)	(1.3)	(--)	(0.3) to (0.5)
Savings and investment					
Gross national investment	21.2	20.3	19.9	22.0	23.2 to 24.0
Public sector	(10.2)	(7.1)	(6.2)	(7.0)	(7.5) to (8.6)
Private sector 3/	(9.7)	(13.2)	(13.7)	(15.0)	(15.4) to (15.7)
Gross national savings	17.8	23.9	22.2	23.1	23.2 to 24.1
Public sector	(-7.4)	(-0.9)	(0.1)	(2.8)	(3.7) to (5.3)
Private sector	(25.2)	(24.8)	(22.1)	(20.3)	(18.5) to (20.4)
External debt					
Public sector external debt less gross international reserves of the Bank of Mexico 4/	29.3	30.9	28.7	26.9	16.7 to 24.3
	(In billions of US dollars)				
External financing and reserves					
Net external financing of the public sector	6.1	5.0	2.2	--	0.6 to 1.5
Change in net international reserves of the Bank of Mexico (increase -)	6.8	-5.5	-3.0	-0.5	-1.0 to -1.8

Sources: Mexican authorities; and Fund staff estimates.

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

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

3/ Includes inventory changes.

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

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

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

V. Exchange Arrangements Subject to Fund Approval

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

Multiple currency practices arise from the operation of:

(i) an exchange market comprising a controlled market rate for specified transactions; and

(ii) a free market rate for all other transactions.

The exchange restrictions resulting from the accumulation of payments arrears were eliminated in March 1984 and several special exchange rates 1/ introduced in December 1982 have now ceased to have operational significance as the transactions eligible to benefit from those rates have been concluded.

VI. Staff Appraisal

The economic program adopted by the Mexican authorities in late 1982 and supported by an extended arrangement with the Fund brought about a marked turnaround in economic conditions in 1983 and 1984 and helped Mexico to recover from the serious crisis that had developed. Despite some slippages, continuation of the adjustment effort in 1984 has served to consolidate the earlier gains and has been reflected in a further improvement in the overall economic performance. Economic activity strengthened significantly in 1984, reflecting an upturn in private investment and the growth of nonpetroleum exports. Real GDP expanded by 3 1/2 percent last year, following a contraction of over 5 percent in 1983, and employment rose.

The public finances continued to be strengthened in 1984, although not as much as had been programmed, and in the latter part of the year the program limits on the overall public sector deficit were exceeded. Interest rate policy remained flexible and credit expansion remained moderate during most of the year, but in the last quarter of 1984 the combination of private and public demands for credit created pressures on available financial savings. Inflation was reduced in 1984, but by less than had been aimed for under the program.

Balance of payments performance remained strong in 1984, and the gain in net international reserves exceeded the program target despite lower than projected net official external borrowing. The strength of the balance of payments reflected both a growth in nonpetroleum exports--which, however, decelerated in the second half of the year--and a further improvement in the private capital account. The rise in international reserves permitted an early settlement of the remainder of the external payments arrears that had accumulated in late 1982.

1/ One special exchange rate was established for the settlement of certain obligations contracted by financial institutions and leasing companies during the period when the generalized exchange controls were in effect and three other special rates were applied to forward cover contracts for the payment of external obligations outstanding as of December 10, 1982. These latter exchange rates may give rise to multiple currency practices at the time of foreign exchange delivery, insofar as a divergence could arise between the value of the deposit and other related costs, including interest foregone, and the actual exchange rate prevailing at the time that the transaction is finalized.

The Mexican peso appreciated significantly in real effective terms during 1983 and 1984 as the rate of daily depreciation of the peso did not match the differential of inflation between Mexico and its main trading partners. As a result, the very large margin of competitiveness that had become available in early 1983 was progressively eroded. By February 1985 the peso had appreciated in real effective terms to a level similar to that prevailing in late 1979. This development in the exchange rate together with the rise in domestic demand contributed to the deceleration in the rate of growth of nonpetroleum exports and nonfactor services in late 1984.

The policies announced by the authorities for 1985 seek a further reduction of inflation and a continuation of moderate growth along with the maintenance of a satisfactory balance of payments. Achievement of the inflation objective is particularly important for the restoration of confidence and the achievement of sustained economic growth.

The program for 1985 calls for a reduction of the public sector deficit on a cash basis to the equivalent of 4.1 percent of GDP. This cutback of the deficit is essential if inflation is to be slowed while the reliance on foreign financing is reduced and domestic investment is strengthened. Most of the fiscal adjustment during 1985 is to be achieved by cutting current expenditures. Particular attention also is being given to reducing the operating losses of certain public enterprises which provide subsidies. Steps are being taken to improve the efficiency of the management of these enterprises and to reduce the public sector's involvement in nonstrategic economic activites. These efforts should contribute to the continued strengthening of the public finances in the medium term and to a better use of resources in the economy in general. Since it is critically important that slippages from the path established for fiscal policy be avoided, it will be necessary to monitor developments in this area very closely.

The intentions of the authorities in regard to monetary and credit policies are consistent with the pursuit of the anti-inflation effort, the strengthening of financial savings, and the achievement of a more efficient allocation of credit in the economy. The steps to reduce financial subsidies and to regulate the volume of loans from development banks and official trust funds should reduce the burden that such credits might pose for the public finances in the future and should contribute to a more effective use of credit resources. The recent placement of monetary regulation bonds with commercial banks and the increase in domestic interest rates should serve to neutralize the excess liquidity that had developed in late 1984 and early 1985.

The relaxation of price controls during the program period has been a welcome step, and further action along these lines would be highly desirable. However, the liberalization of prices should be complemented by a policy of removing import controls as a means of improving market discipline. Wage settlements in 1983 were relatively moderate and thus contributed to the reduction of inflation while cushioning the drop in employment. In 1984, however, the size of the wage awards may have contributed to cost pressures and impeded the scaling down of inflationary expectations. The adjustment of minimum wages in January 1985, was of the same magnitude as that of the previous year, and therefore great care will have to be exercised with respect to the midyear adjustment if wage policy is to be consistent with the reduction of inflation.

The authorities reiterated their commitment to exercise flexibility in the management of the exchange rate policy, and in December 1984 and March 1985 they raised the pace of the daily depreciation. They said that the exchange rate policy would take into account internal and external price and wage developments, the evolution of the terms of trade, and the balance of payments results and targets. The authorities noted that the current rate of depreciation would be consistent with the maintenance of the present real effective exchange rate if their goal of reducing inflation during 1985 is achieved and the behavior of foreign exchange markets and inflation abroad conforms to current projections. The staff is concerned that the margin for maneuver on this front has become very thin, particularly in the context of the authorities' intention to open the economy on the import side. For these reasons, the staff would urge the authorities to monitor developments in the exchange rate area very closely to facilitate timely action to assure external competitiveness.

The dual exchange market was introduced as a transitory measure by the authorities, and they have reiterated their intention of eventually returning to a unified exchange market. However, the authorities are not prepared at this time to commit themselves to the elimination of the existing multiple currency practices before the expiration of the current extended arrangement on December 31, 1985. While exceptional conditions may still prevail, the staff would note that the existing limitations on access to the free market have encouraged the development of an informal parallel market, giving rise to certain distortions and risking unfavorable effects on confidence. Although the spread between the rates in the controlled and free market has narrowed over the past two years, the spread between these two markets and the parallel market rate has been significant in recent months.

The staff welcomes the elimination of the exchange restriction resulting from the accumulation of external payments arrears and the other measures designed to continue with the adjustment effort, but the staff is not in a position to recommend a further extension of the approval of the remaining multiple exchange practices. This is because in present circumstances there appear to be no balance of payments reasons for the maintenance of such practices and, although the general direction of economic policies is appropriate, there is no assurance that the resort to these practices will be temporary.

With regard to commercial policies, the staff welcomes the authorities' decision to accelerate the process of trade liberalization based on a new tariff schedule and a phasing out of import licenses. The implementation of these policies should promote greater efficiency and foster growth in the medium term, as well as assisting in the effort to reduce inflation. It is generally agreed that the medium-term viability of Mexico's growth and balance of payments hinges on a significant and sustained growth of non-oil exports. The promotion of such growth is one of the main purposes of the ongoing revision of commercial policies which should help avert obstacles in this area. The liberalization of imports is necessary to improve the economy's efficiency and should be pursued vigorously. The staff would urge the authorities to ensure that their efforts on the trade liberalization front are accompanied by an appropriate exchange rate policy.

The reduction of net external borrowing by the public sector has enhanced Mexico's creditworthiness in international markets, as reflected in the recently concluded multiyear restructuring of Mexico's external debt. The maintenance of appropriate demand and exchange rate policies by the authorities over the coming years should facilitate the servicing of the existing debt and the return of Mexico to the international capital markets under normal market conditions.

In summary, in the last few years Mexico has made remarkable advances in its efforts to recover from the economic crisis of 1981-82. Since the start of the program in late 1982 the authorities have implemented policies which have led to a substantial gains in Mexico's economic situation and an improvement in the structure of the economy. The authorities also have shown the capacity to correct economic policies when deviations from the programmed path have occurred, and they have reiterated their willingess to adopt further adjustment measures, as needed, to assure the success of the adjustment program. The policies undertaken by the authorities have been generally responsive to the recommendations of Executive Directors at the time of the last Article IV discussions with Mexico and, in the view of the staff, the program presented for 1985 is consistent with the attainment of the aims established under the extended arrangement.

VII. Proposed Decision

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

1. The Fund and Mexico have held consultations pursuant to paragraph 4(d) of the extended arrangement for Mexico (EBS/82/203, Sup. 4) and as contemplated in paragraph 29 of the letter dated November 10, 1982 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico attached thereto, in order to review the implementation of the measures described in that letter, to reach understandings on the policies and measures that Mexico will pursue over the remainder of the program period, and to establish suitable performance clauses for the year 1985.

2. The letter dated March 24, 1985 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico, together with the Technical Memorandum of Understanding attached thereto (EBS/85/70, 3/25/85), shall be attached to the extended arrangement for Mexico. The letter dated November 10, 1982, together with the Technical Memorandum attached thereto, and the letter dated January 3, 1984 together with the Technical Memorandum attached thereto (EBS/84/1, 1/3/84), shall be read as modified and supplemented by the letter dated March 24, 1985 and the attached Technical Memorandum.

3. Beginning on the effective date of this decision, Mexico will have the right to make purchases under the extended arrangement up to a total amount equivalent to SDR 1,203.7 million, provided that the amount of such purchases shall not, without the consent of the

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

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

(a) during any period in which:

(i) the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 1 of the attached Technical Memorandum, has not been observed; or

(ii) the data at the end of the preceding period indicate that the limit on the overall public sector deficit, as specified in paragraph 3 of the attached Technical Memorandum, has not been observed; or

(iii) the data at the end of the preceding period indicate that the limit on the unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector, as specified in paragraph 4 of the attached Technical Memorandum, has not been observed; or

(iv) the data at the end of the preceding period indicate that the target for the net international reserves of the Bank of Mexico, as specified in paragraph 7 of the attached Technical Memorandum, has not been observed; or

(v) the limit on the net credit to the public sector by the Bank of Mexico, as specified in paragraph 2 of the attached Technical Memorandum, is not observed; or

(vi) the limit on the net domestic assets of the Bank of Mexico, as specified in paragraph 5 of the attached Technical Memorandum, is not observed; or

(vii) the limit on financial intermediation conducted by the national development banks and official trust funds, as specified in paragraph 6 of the attached Technical Memorandum, is not observed; or

(b) after September 30, 1985, until the review contemplated in paragraph 8 of the attached Technical Memorandum is completed.

5. In accordance with Executive Board Decision No. 7908-(85/26) of February 20, 1985 on overdue payments to the Fund, the extended arrangement for Mexico is amended to read as set out in the Attachment.

Fund Relations with Mexico
(As of April 30, 1985)

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 3,573.0 million or 306.6 percent of quota

(c) Fund credit: SDR 2,407.5 million or 206.6 percent of quota
Of which: SDR 200.6 million or 17.2 percent of quota under credit tranche
SDR 1,103.4 million or 94.7 percent of quota under EFF
SDR 1,103.4 million or 94.7 percent of quota under EAR

(d) Reserve tranche position: None

(e) Current Operational Budget: Not applicable

(f) Lending to the Fund: Not applicable

III. Current Stand-By or Extended Arrangement and Special Facilities

(a) Current extended arrangement
(i) Duration from January 1, 1983 to December 31, 1985
(ii) Amount: SDR 3,410.6 million
(iii) Utilization: SDR 2,206.9 million
(iv) Undrawn balance: SDR 1,203.7 million.

(b) Previous extended arrangement
(i) Duration: 1977 to 1979
(ii) Amount: SDR 518 million
(iii) Utilization: SDR 100 million

(c) Special facilities: CFF
(i) Year approved: 1976
(ii) Amount: SDR 185 million

IV. SDR Department

(a) Net cumulative allocation: SDR 290 million
(b) Holdings: SDR 0.07 million, or the equivalent of 0.02 percent of net cumulative allocations
(c) Current Designation Plan: not applicable

V. Administered Accounts (amounts)

(a) Trust Fund Loans: Not applicable
(b) SFF Subsidy Account: Not applicable

B. Nonfinancial Relations

VI. Exchange rate arrangement: Since December 20, 1982 two foreign exchange markets have been operative in Mexico: a controlled market, covering specified transactions; and a free market. The exchange rates in both markets are established by the authorities, who currently preannounce the rates for period of four weeks in advance. As of April 30, 1985 the rate in the controlled market was Mex$215.20 per US$1 selling and Mex$215.40 per US$1 buying and the rate in the rate in the free market was Mex$222.55 per US$1 selling and Mex$227.05 per US$1 buying. Since September 23, 1983 the exchange rate in both the controlled and free markets have been depreciated by the same daily amount, initially by Mex$0.13, and subsequently by Mex$0.17 since December 6, 1984 and by Mex$0.21 since March 6, 1986. Three other special rates apply to forward cover contracts for the repayment of specified medium- and long-term obligations with foreign financial institutions.

VII. Last Article IV consultation and review under EFF: The last Article IV consultation discussions were completed by the Executive Board on July 30, 1984 (EBM/84/117). The relevant staff reports were SM/84/155 and SM/84/165. For consultation purposes, Mexico is in the 12-month cycle. The last review under the EFF and discussions of the 1984 program were completed by the Executive Board on March 2, 1984 (EBM/84/34 and EBM/84/35). The relevant staff report was EBS/84/1, Cor. 1, Sups. 1 and 2.

With regard to exchange restrictions and multiple practices, the decision approved at the time reads as follows:

"Approval of Multiple Currency Practices and Exchange Restrictions

Mexico maintains multiple currency practices as described in Section V of SM/84/155. In view of the circumstances of Mexico, the Fund grants approval of these multiple currency practices until March 31, 1985, the completion of the next review under the extended arrangement, or the completion of the next Article IV consultation, whichever is earlier."

VIII. Technical Assistance: At the request of the Mexican authorities, during 1985 two technical teams from the Fiscal Fiscal Department will be providing technical assistance in the fields of direct and indirect taxation.

Mexico--Basic Data

Area and population	
Area	1,958,201 sq. kilometers
Population (mid-1984)	76.9 million
Annual rate of population increase (1977-84)	2.7 percent
GDP (1984)	SDR 171 billion
	US$175 billion
	Mex$29,438 billion
GDP per capita (1984)	SDR 2,225

Origin of GDP	1982	1983	Prel. 1984
		(percent)	
Agriculture, livestock, and fishing	8.8	9.6	9.5
Mining (including petroleum)	3.8	3.9	3.8
Manufacturing	24.1	23.6	23.9
Construction	5.5	4.7	4.7
Electricity	1.6	1.7	1.8
Commerce	25.4	24.2	24.0
Transport and communications	7.5	7.5	7.6
Financial services	9.8	10.6	10.5
Other services	13.5	14.2	14.2
Ratios to GDP			
Exports of goods and services	13.5	14.5	15.1
Imports of goods and services	16.1	11.9	13.2
Current account of the balance of payments	-2.6	2.6	1.9
Central government revenues	16.3	18.6	16.8
Central government expenditures	24.8	26.2	21.9
Public sector savings	-7.4	-0.9	0.1
Public sector overall balance (deficit -) 1/	-17.8	-8.5	-6.2
External public debt (end of year)	29.3	31.9	31.0
Gross national savings	17.8	23.9	22.2
Gross aggregate investment	21.2	20.3	19.9
Money and quasi-money (end of year)	34.3	30.0	29.9
Annual changes in selected economic indicators			
Real GDP per capita	-3.2	-7.6	0.9
Real GDP (at 1970 prices)	-0.5	-5.3	3.5
GDP at current prices	60.3	82.0	71.7
Domestic expenditures (at current prices)	51.7	69.5	76.3
Investment	(17.5)	(73.5)	(68.4)
Consumption	(65.3)	(68.4)	(78.5)
GDP deflator	61.1	92.2	66.0
Wholesale prices (annual averages)	56.1	107.3	70.3
Consumer prices (annual averages)	58.9	101.9	65.5
Central government revenues	63.9	107.6	55.4
Central government expenditures	69.8	92.4	44.0
Money and quasi-money	70.1	59.2	71.1
Money	(61.9)	(41.5)	(58.4)
Quasi-money	(74.0)	(67.0)	(75.9)
Net domestic credit 2/	58.9	47.2	64.0
Credit to public sector (net)	(62.7)	(28.2)	(19.8)
Credit to private sector	(-5.3)	(23.2)	(37.8)
Merchandise exports (f.o.b., in U.S. dollars)	5.7	4.5	9.1
Merchandise imports (f.o.b., in U.S. dollars)	-40.0	-41.0	32.9

Federal government finances	1982	1983	Prel. 1984
	(In billions of Mexican pesos)		
Revenue	1,532	3,181	4,943
Expenditure	2,331	4,485	6,459
Current account surplus or deficit (-)	-331	-557	-662
Overall deficit (-)	-799	-1,304	-1,516
Public sector finances			
Current account surplus or deficit (-)	-698	-117	40
Overall deficit (-)	-1,679	-1,464	-1,826

Balance of payments	1982	1983	1984
	(In billions of U.S. dollars)		
Merchandise exports (f.o.b.)	22.1	23.1	25.2
Merchandise imports (f.o.b.)	-14.4	-8.5	-11.3
Travel and border transactions (net)	0.6	1.2	1.4
Interest on public debt	-7.9	-7.4	-8.5
Other interest payments	-3.4	-2.9	-2.9
Other services and transfers (net)	-2.6	-0.3	0.2
Balance on current and transfer accounts	-5.6	5.2	4.1
Official capital (net)	6.8	4.7	2.2
Private capital and errors and omissions (net)	-8.0	-4.4	-3.3
SDR allocations and gold revaluation	--	--	--
Change in official net reserves	-6.8	5.5	3.0

International reserve position	December 31 1981	1982	1983	1984
	(In millions of SDRs)			
Monetary authorities (net)	4,188.6	-1,779.9 3/	3,353.3	6,638.6
Monetary authorities (gross)	4,305.0	1,509.6 3/	4,908.4	9,162.9

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

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

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

Mexico: Selected Economic and Financial Indicators

	1982	1983	1984 Prog. 1/	1984 Prel.	1985 Prog.
(Annual percentage changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	-0.5	-5.3	1.0	3.5	3.5
GDP deflator	61.1	92.2	50.0	56.0	43.0-48.0
Consumer prices (end of period)	98.9	80.8	40.0	59.2	35.0-45.0
Overall public sector					
Receipts	73.1	106.8	59.0	59.8	44.5
Outlays	80.9	62.5	47.0	52.8	38.2
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	5.7	4.5	8.1	9.1	2.4
Export volume	(19.6)	(5.7)	(6.0)	(7.4)	(4.6)
Import, f.o.b.	-40.0	-41.0	64.7	32.9	23.9
Import volume	(-43.7)	(-44.6)	(56.1)	(32.5)	(21.5)
Terms of trade (deterioration -)	-17.0	-1.3	-3.4	1.3	-4.0
Nominal effective exchange rate (appreciation -)2/					
Average	101.3	138.4	...	37.2	...
End of period	261.6	46.9	...	31.5	...
Real effective exchange rate (appreciation -)2/					
Average	90.5	19.4	—	-14.9	—
End of period	86.3	-17.3	...	-16.0	...
Money and credit					
Domestic credit (net)3/	58.9	47.2	36.3	64.0	50.8
Public sector 3/	(62.7)	(28.2)	(16.6)	(19.8)	(22.0)
Private sector 3/	(-5.3)	(23.2)	(21.9)	(37.8)	(28.8)
Money and quasi-money (M3)	70.1	59.2	43.3	71.1	46.7
Velocity (GDP relative to M4)	2.7	3.1	3.8	3.2	3.3
Interest rate (annual rate, one-year term deposits)4/	50.0	47.4	44.0	39.6	40.0
(In percent of GDP)					
Overall public sector savings	-7.4	-0.9	2.5	0.1	2.8
Overall public sector deficit (-)	-17.8	-8.5	-5.5	-6.2	-4.1
Domestic financing	(14.1)	(5.0)	(3.1)	(4.9)	(4.1)
Foreign financing	(3.7)	(3.5)	(2.4)	(1.3)	(—)
Gross domestic investment	21.2	20.3	19.0	19.9	22.0
Gross national savings	17.8	23.9	18.4	22.2	23.1
BOP-current account (deficit -)	-3.4	3.6	-0.6	2.3	1.1
At 1979 exchange rate	(-2.3)	(2.6)	(-0.5)	(1.9)	(0.9)
External public debt 5/					
Inclusive of Fund credit	38.3	43.6	38.9	35.1	31.5
At 1979 exchange rate	(29.3)	(30.9)	(30.0)	(28.7)	(26.9)
Interest payments on external public debt 6/	4.7	5.0	4.7	4.5	3.5
At 1979 exchange rate	(3.6)	(3.6)	(3.6)	(3.7)	(3.0)
(In percent of export of goods and services)					
Debt service 7/					
Before rescheduling	44.6	50.2	42.8	45.4	54.6
After rescheduling	40.1	33.2	32.2	33.6	44.5
(In billions of U.S. dollars)					
Overall balance of payments	-6.8	5.5	2.0	3.0	0.5
Gross official reserves (months of merchandise imports)8/	0.1	4.9	4.7	7.8	7.5

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

1/ Annual changes and ratios to GDP in column "Prog. 1984" are those projected at the time of program inception.
2/ Indices of effective exchange rate measured in terms of local currency per unit of foreign exchange.
3/ Changes are effective flows adjusted for exchange rate changes in relation to total liabilities to the private sector at the beginning of the period.
4/ Maximum authorized rate at the end of the period net of withholding tax; excludes compounding.
5/ Includes short term debt, but net of gross international reserves.
6/ Interest paid on external public debt, net of interest earned on gross international reserves.
7/ Includes debt service on Fund credit.
8/ Excluding gold and payments agreements.

Mexico: Summary of the Financial Program for 1985

I. Targets

1. Real GDP growth is expected to reach 3.5 percent in 1985, the same rate of growth as in 1984. Private sector investment is expected to continue growing at a fast pace. The public sector's relative importance in total expenditure is expected to continue declining, although public sector investment will be increasing in real terms this year.

2. The inflation rate is expected to decline over the program period. The 12-month rate of increase in prices is projected at about 40 percent by the end of 1985 compared with about 59 percent by the end of 1984 and 81 percent by the end of 1983. The year on year price increase is expected to be about 48 percent in 1985.

3. The overall balance of payments surplus is expected to be US$500 million in 1985 in light of a smaller current account surplus and a negligible net flow of foreign borrowing by the public sector.

II. Assumptions

1. The rate of inflation of Mexico's trading partners is expected to be about 4 1/2 percent in 1985. Crude oil exports are expected to average 1.525 million barrels a day, a small decline in relation to 1984, whereas the prices of crude oil are expected to remain constant at their February levels (i.e., US$27.75 per barrel for light crude (Ithsmus) and US$25.50 per barrel for heavy crude (Maya)); nonpetroleum exports are expected to grow at about 16 percent, folllowing an increase of 28 percent in 1984. Import volumes are estimated to grow at a rate of 21 percent reflecting the continued expansion of economic activity and the intensification of the liberalization of commercial policy. The terms of trade are expected to deteriorate by 4 percent in 1984, as export unit values will decline following the fall in the price of oil at the beginning of the year.

2. Public sector net foreign borrowing is projected at less than US$0.1 billion in 1985 compared with US$2.2 billion in 1984 and US$4.7 billion in 1983. Concomitantly with this moderate reliance on foreign borrowing and a projected decline in interest rates, net factor payments are expected to decline from 5.7 percent of GDP in 1984 to 4.9 percent of GDP in 1985.

3. The effective interest rate on Mexico's external debt is projected to decline from 12 1/2 percent in 1984 to 11 percent in 1985.

4. Based on the behavior of financial savings, velocity--which is measured as the ratio of nominal GDP to average financial liabilities to the private sector (including holdings of Federal Government Securities)--is projected to decline from 4.1 in 1984 to 3.8 in 1985.

III. Principal Elements of the 1985 Program

1. Public sector policies

a. The overall public sector deficit is to be limited on a cash basis to Mex$1,785 billion (equivalent to 4.1 percent of projected GDP) in 1985. Quarterly limits have been established as performance criteria on the cumulative deficit of the public sector in 1985, with subceilings for credit to the public sector by the Bank of Mexico and for the nonfinancial public sector accrued and unpaid interest to the Bank of Mexico.

b. Quarterly limits have been established as performance criteria for net foreign borrowing by the public sector in 1985, including all publicly-owned financial institutions other than the Bank of Mexico. The maximum amount of net foreign borrowing under the ceiling (including all maturities) is US$1 billion during 1985. Nevertheless, the financial program projections have been made with less than US$0.1 billion in net foreign borrowing on the understanding that if there is a resumption of voluntary external lending, domestic borrowing by the public sector will be reduced pari passu.

c. The savings of the public sector are expected to continue their upward trend reaching 2.8 percent of GDP in 1985, up from 0.1 percent of GDP in 1984. In contrast with the experience of 1984, public sector receipts are expected to decline marginally in relation to GDP, as the reduction in the domestic value of petroleum receipts will not be fully compensated by increases in the receipts of other public enterprises and the Federal Government. On the expenditure side, the bulk of the adjustment will fall upon operating expenditures and other nonrecurrent expenditures. Adjustments in prices of the goods and services produced by the public sector will continue, although the relative increases will be considerably lower than in the recent past as needed corrections have become smaller. Public sector capital expenditure is the only component of expenditure which is expected to rise as a percent of GDP from 6.4 percent in 1984 to 7.1 percent in 1985.

2. Money and credit

a. The net domestic assets of the Bank of Mexico are to be subject to quarterly ceilings as a performance criterion. The ceilings provide for an increase in net domestic assets during 1985 of some 16 percent in relation to note issue at the end of 1984.

b. As was noted above, a subceiling has been established on the Bank of Mexico's net credit to the public sector and on the nonfinancial public sector accrued and unpaid interest to the Bank of Mexico. In addition the Bank of Mexico's net credit to the public sector ceiling can be adjusted upward, provided there is an equivalent reduction in the compulsory portfolio requirement on the commercial banks. According to a recently enacted banking law, commercial banks are required to maintain 35 percent of their liabilities to the private sector in government securities. The financial program assumes that this portfolio requirement will be the main source of domestic financing to the public sector. However, if the Bank of Mexico deemes appropriate to acquire government securities in the secondary market using up their ceiling they can do so, provided there is an equivalent reduction in the 35 percent portfolio requirement of commercial banks.

c. The growth of financial sector liabilities to the private sector is expected to be enough to accomodate the borrowing requirement of the public sector, an accumulation of net international reserves of US$500 million and a 10 percent real growth in credit to the private sector. Of this flow of financing to the private sector, about 14 percent will be channeled through the government development banks and official trust funds.

d. Interest rates for domestic financial instruments will continue to be managed with a view to making them competitive with other investment alternatives and to be in accord with the external objectives of the program. Moreover, efforts to reduce the scope of subsidies granted through the financial system will be continued.

e. Quarterly limits have been established on the amount of financial intermediation (net lending to the private sector) conducted by the Government development banks and all official trust funds (including those of the Bank of Mexico but excluding FICORCA).

3. Prices and wages

Wage policy will continue to be directed to the achievement of medium-term employment objectives of the program, in the framework of the adjustment effort and the anti-inflation aims of the program. Price controls are being revised in order to avoid the discouragement of production and employment, and to assure that profit margins are kept at a satisfactory level. In order to avoid the emergence of monopolistic rents, reliance upon import permits is being reduced during 1985.

4. External sector

a. Exchange rate policy will continue to be managed flexibly, with a view to fostering the competitiveness of the Mexican economy and helping to achieve the net international reserve target of the Bank of Mexico; the program calls for an improvement in the net international reserves of US$500 million in 1985. The exchange system will be managed so as to preclude the development of new arrears. The standard understandings on the introduction and/or intensification of exchange and trade restrictions and multiple currency practices are included as a performance criteria.

b. The protective system will be revised with a view to rationalizing the structure of protection and reducing the levels of effective protection, thereby improving resource allocation and assisting the anti-inflation effort. The authorities have embarked on a major revamping of the tariff system. The emphasis in commercial policy has shifted from import controls to protection through tariffs. By December 1984 a total of 17 percent of 1983 imports had been exempted from permits. In 1985 a new tariff schedule is being introduced to reduce the number of tariff rates and lower their dispersion. In addition, the process of substituting import licenses for tariffs will be accelerated to cover 35 to 45 percent of annual imports before the end of the year.

Mexico--Statistical Issues

1. Outstanding statistical issues

a. Government finance

At present, IFS data are the annual data published in the GFS Yearbook. However, monthly data on revenue and expenditure and annual data on domestic debt are now published in Indicadores Economicos, Bank of Mexico, through 1984. These data, which cover only the Budgetary Central Government (Gobierno Federal), are being processed with a view to their publication in IFS.

The presentation of the GFS Yearbook lacks at present detailed statistics on capital expenditure by function. This information has been requested from the authorities.

b. Balance of payments

The data published in IFS cover the latest information reported by the Bank of Mexico to the Bureau of Statistics. The June 1985 issue of IFS will include data through the third quarter of 1984, derived from official publications. However, the data in the IFS and in the Balance of Payments Yearbook lack a detailed explanation of the sources of exceptional financing. Explanations about the treatment given to this item in the Mexican official publications have been requested.

c. International banking

Provision has been made for a technical mission to visit Mexico in September 1985 to discuss work in progress on a study of the Mexican external debt with the Bank of Mexico.

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

The following table shows the currentness and coverage of data published in the country page for Mexico in the May 1985 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

		Latest Data in May 1985 IFS
Real Sector	- National Accounts	1984
	- Prices	February 1985
	- Production	December 1984
	- Employment 1/	n.a.
	- Earnings	October 1982
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	December 1984
	- Deposit Money Banks	December 1984
	- Other Financial Institutions	December 1984
	- Interest Rates	December 1984
External Sector	- Merchandise Trade: Value	December 1984
	Prices	June 1984
	- Balance of Payments	Q4 1983
	- International Reserves	January 1985
	- Exchange Rates	March 1985

1/ Data on manufacturing employment through November 1984 are available and consideration is being given to their publication on the IFS country page.

Mexico: Extended Arrangement

Attached hereto is a letter, with attached memorandum, dated November 10, 1982, from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico, requesting an extended arrangement and setting forth:

(a) the objectives and policies that the authorities of Mexico intend to pursue for the period of this extended arrangement;

(b) the policies and measures that the authorities of Mexico intend to pursue through December 31, 1983 in this extended arrangement; and

(c) understandings of Mexico with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Mexico will pursue for 1984 and 1985.

To support these objectives and policies, the International Monetary Fund grants this extended arrangement in accordance with the following provisions:

1. For a period of three years from January 1, 1983, Mexico will have the right to make purchases from the Fund in an amount equivalent to SDR 3,410.625 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Until January 1, 1984, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 1,003.12 million, provided that purchases shall not exceed the equivalent of SDR 100.31 million until May 15, 1983, the equivalent of SDR 401.25 million until August 15, 1983, and the equivalent of SDR 702.19 million until November 15, 1983.

(b) Until January 1, 1983, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,206.88 million.

(c) The right of Mexico to make purchases during 1984 and 1985 shall be subject to such phasing as shall be determined.

3. Purchases under this extended arrangement shall be made from ordinary and borrowed resources in the ratio of one to one until purchases under this arrangement reach the equivalent of SDR 2,247 million and then each purchase shall be made from borrowed resources, provided that any modification by the Fund of the proportion of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Mexico will not make purchases under this arrangement:

(a) Through December 31, 1983, during any period in which:

(i) the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 1 of the attached Technical Memorandum, has not been observed; or

(ii) the data at the end of the preceding period indicate that the limit on the overall public sector deficit, as specified in paragraph 3 of the attached Technical Memorandum, has not been observed; or

(iii) the limit on the net credit to the public sector by the Bank of Mexico, as specified in paragraph 2 of the attached Technical Memorandum, is not observed; or

(iv) the limit on the net domestic assets of the Bank of Mexico, as specified in paragraph 4 of the attached Technical Memorandum, is not observed; or

(v) the data at the end of the preceding period indicate that the target for the net international reserves of the Bank of Mexico, as specified in paragraph 5 of the attached Technical Memorandum, has not been observed; or

(b) After May 15, 1983, if the consultations contemplated in paragraph 29 of the attached letter have not been completed or understandings reached under these consultations are not being observed; or

(c) After December 31, 1983, if the intentions on payment arrears, mentioned in the fourth sentence of paragraph 6 of the Technical Memorandum, has not been observed; or

(d) For the year 1984 and 1985, if before January 1, 1984 and January 1, 1985, respectively, suitable performance clauses for each period have not been established in consultation with the Fund as contemplated in paragraph 29 of the attached letter, or if such clauses, having been established, are not observed; or

(e) Throughout the duration of the extended arrangement, if Mexico:

(i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Mexico is prevented from purchasing under this extended arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Mexico and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Mexico will not make purchases under this extended arrangement during any period in which Mexico has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

6. Mexico's right to engage in the transactions covered by this extended arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Mexico. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Mexico and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Purchases under this extended arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Mexico, the Fund agrees to provide them at the time of the purchase.

8. The value date of a purchase under this extended arrangement involving borrowed resources will be determined in accordance with Rule G-4(b) of the Fund's Rules and Regulations. Mexico will consult the Fund on the timing of purchases involving borrowed resources in accordance with Rule G-4(d).

9. Mexico shall pay a charge for this extended arrangement in accordance with the decisions of the Fund.

10. (a) Mexico shall repurchase the amount of its currency that results from a purchase under this extended arrangement in accordance with the provisions of the Articles of Agreement and Decisions of the Fund including those relating to repurchase as Mexico's balance of payments and reserve position improves.

(b) Any reductions in Mexico's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this extended arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

11. During the period of the extended arrangement Mexico shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Mexico or of representatives of Mexico to the Fund. Mexico shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Mexico in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

12. In accordance with paragraph 28 of the attached letter, Mexico will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria under paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the extended arrangement and while Mexico has outstanding purchases under this extended arrangement, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Mexico's balance of payments policies.