INTERNATIONAL MONETARY FUND

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MEXICO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

November 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV Consultation with Mexico, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV Consultation, prepared by a staff team of the IMF for the Executive Board's consideration on November 25, 2013, following discussions that ended on September 30, 2013, with the officials of Mexico on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 8, 2013.

- An **Informational Annex** prepared by the IMF.

- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 25, 2013 consideration of the staff report that concluded the Article IV Consultation with Mexico.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

November 8, 2013

KEY ISSUES

Context: Over the past year, Mexico has maintained macroeconomic stability and has made significant progress in advancing growth-oriented structural reforms. The country's close ties with the global economy, while a source of strength, heighten the economy's exposure to external risks. The transition to a less accommodative monetary policy in the U.S. and other advanced economies is a key risk.

Recent Developments: In 2013, the economy has begun to operate below capacity, with growth expected to slow to 1.2 percent and core inflation running at historically low rates. Demand policies are consistent with preserving macroeconomic stability, while supporting a recovery in growth. The external current account deficit and real effective exchange rate are broadly in line with fundamentals and desirable policy settings. Mexico's asset markets showed more resilience than many other emerging markets after the Fed initiated its discussion of tapering on May 22.

Structural reforms: Over the past year, more than a half dozen major reforms have been approved to upgrade several areas, including labor markets, telecommunications, and education. Most recently congress approved a comprehensive fiscal reform. It is also considering an energy reform that opens the door for private investment in hydrocarbons and a financial sector reform that seeks to increase intermediation, promote competition and enhance financial stability. Staff estimates that these reforms will boost potential output growth to 3½ to 4 percent a year, compared with the pre-reform estimate of 3 to 3¼ percent a year, with upside risk to this outlook.

Fiscal reform: The recently approved fiscal reform should provide for a more transparent and effective fiscal anchor, while limiting the procyclicality of spending. In this context, the government defined a path for the public sector borrowing requirement (PSBR) through 2018 that entails a gradual decline in the PSBR to 2.5 percent of GDP by 2017. The authorities have introduced several legal provisions that give assurances that spending growth will fall in line with this objective, but care will be needed to avoid remaining risks of fiscal slippage.

Advice from Previous Article IV Consultation: The ambitious agenda of structural reforms is in line with Fund advice from past consultations and the financial sector reform implements a number of key recommendations of the 2011 FSAP Update. Staff supports the authorities' plan for the pace of medium-term fiscal consolidation in light of the economic slowdown in 2013, although this pace is not as rapid as envisaged in the 2012 consultation.

Approved By
Adrienne Cheasty and Vivek Arora

Discussions took place in Mexico City during September 16–30, 2013. The team comprised Robert Rennhack (Head), H. Kamil, E. Vesperoni (WHD), S. Acosta-Ormaechea (FAD), P. de Imus (SPR), and R. Guimaraes-Filho (MCM). Ms. Cheasty (WHD) joined the mission for the final discussions. Messrs. Zúñiga and Ramos (OED) also participated in many meetings.

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CONTEXT

1. **Over the past year, Mexico has maintained macroeconomic policy continuity while pursuing an ambitious agenda of growth-enhancing reforms.** Fiscal policy has been governed by a Fiscal Responsibility Law (FRL) since 2006, monetary policy operates under a credible inflation targeting framework, which includes a firm commitment to exchange rate flexibility, and the 2011 FSAP Update found that the financial regulatory and supervisory framework was sound. The authorities have refrained from adopting any capital flow measures, in line with their view that an open capital account reduces policy uncertainty and supports long-term growth. The macro-prudential framework aims at limiting maturity and currency mismatches in the banking system. The government has made impressive progress in advancing structural reforms through laws to upgrade education, make labor markets more flexible, and foster competition in telecommunications. Congress is currently debating a fundamental reform of the energy sector and is in the final stages of approving a reform to broaden access to financial markets. In October 2013, Congress modified the fiscal framework, reformed the main taxes, and introduced a universal pension scheme and unemployment insurance.

2. **Mexico has close ties with the global economy.** There are substantial trade, banking, portfolio and direct investment, and remittance connections with the United States, and Mexico's manufacturing sector is highly integrated into the U.S. supply chain (Figure 1). Mexico competes directly with China in the U.S. market, where China accounts for 23 percent of U.S. imports and Mexico accounts for 12 percent. Linkages with the rest of the Americas are relatively small. Foreign-owned banks account for about 70 percent of banking system assets, although these banks operate as a subsidiary—which means they are regulated and supervised by the National Commission of Banking and Securities (CNBV). The U.S. accounts for over half of Mexico's foreign portfolio liabilities and foreign direct investment, with another significant share coming from other advanced countries (such as the United Kingdom, Japan, Spain, Canada, and Germany). The internationalization of the domestic sovereign bond market increased sharply since the inclusion of Mexico in the World Global Bond Index (WGBI) in 2010. Based on a recent survey, the BIS reported that the Mexican peso is the most actively traded emerging market currency in the world, with a daily global trading volume of US$135 billion. This means that Mexico's deep and liquid foreign exchange and domestic equity and sovereign bond markets can serve as an early port of call for global investors in episodes of financial turbulence and hence are susceptible to risks of contagion.

RECENT DEVELOPMENTS

3. **In 2013, the economy has begun to operate well below capacity, with real GDP growth expected to slow to 1.2 percent (down from 3.6 percent in 2012).** In the first semester, activity declined sharply, opening a sizable output gap estimated at -1.5 percent of potential GDP in the second quarter. Growth in manufacturing (accounting for 16 percent of real GDP) stagnated, as weakness in U.S. manufacturing, especially in durables, led to virtually no growth in non-automotive

manufacturing exports. Supply-side bottlenecks in natural gas supply to manufacturing have played a role as well. Also public spending (16 percent of real GDP) fell by about 2 percent in real terms (Figure 2). Construction (about 7 percent of real GDP) declined much more sharply than expected, as the result of financial difficulties of the largest homebuilding firms, uncertainty about the government's low-income housing policy, and slow execution of public spending on infrastructure. Projected growth for 2013 assumes a strong rebound in the second semester, with manufacturing recovering in response to a pick-up in U.S. manufacturing, and public spending regaining its lost momentum. However, this projection assumes a gradual recovery in construction—where the financial difficulties of large homebuilders could persist and impose a drag on the rest of the sector. The storms that hit both coasts in September are expected to have only a modest effect on growth.

4. The slack in the economy is helping to contain price pressures, with headline inflation now projected at 3½ percent by the end of the year—somewhat above the target of 3 percent. Supply shocks had driven up food prices and pushed headline inflation above 4 percent earlier this year. (Figure 3). However, since mid-year these pressures on food prices have subsided, and core inflation has stayed at historical lows of 2½ percent y/y since July. Inflation in services—the central bank's preferred indicator of the strength of domestic demand—has been running at 2¼ to 2½ percent y/y since early 2013. Medium-term inflation expectations have remained firmly anchored at 3½ percent—albeit still above the mid-point of the target range.

5. Demand policies are supporting a recovery in growth. The public sector borrowing requirement (PSBR) is expected to reach 4.1 percent of GDP this year, compared with 3.7 percent of GDP in 2012 (Figure 4).[1] This stance would imply a considerable fiscal stimulus in the second semester, as the PSBR amounted to only 1.0 percent of GDP in the first semester. The central bank has reduced its policy rate so far this year by a total of 100 basis points to 3.50 percent in response to the widening of the negative output gap and in the absence of significant inflationary pressures.

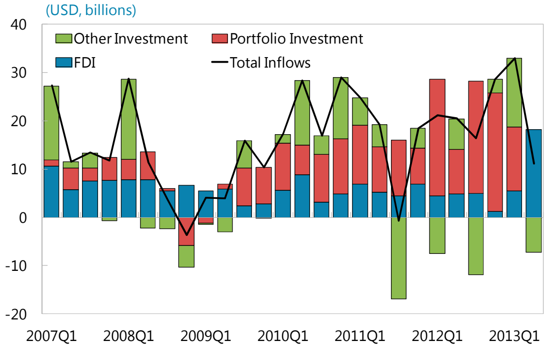
6. The external current account deficit is projected to widen to 1.7 percent of GDP in 2013 (Figure 5). The non-oil trade deficit would remain at 1 percent of GDP, while the oil trade surplus would fall to 0.6 percent of GDP, reflecting weaker production and exports of oil. The Fund's current account model and a range of exchange rate metrics in the External Balance Assessment (EBA) suggest that the current account balance and real exchange rate are broadly in line with fundamentals and desirable policy settings (Annex).

7. Mexico's financial asset markets showed more resilience than many other emerging markets after the Fed initiated its discussion of tapering on May 22. In this context, net capital inflows are projected to remain steady at about 4 percent of GDP in 2013. Through April, investor appetite for Mexican assets was underpinned by heightened prospects for further structural reforms, as well as the ample global supply of liquidity, generating a strong appreciation of the peso and a

[1] The 2012 outturn exceeds the 2012 PSBR projected at the time of the 2012 Article IV consultation (2.6 percent of GDP), as expected net inflows to the oil stabilization funds failed to materialize, in the context of slightly weaker oil prices and production, and higher energy subsidies reflecting higher imports.

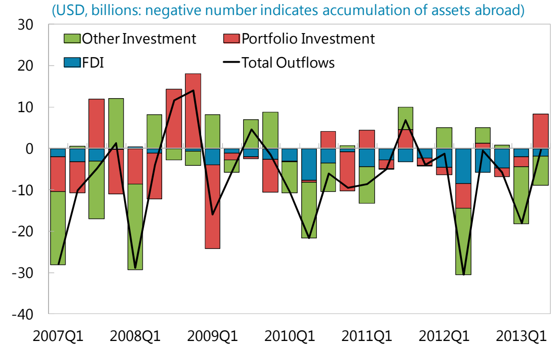
compression in sovereign debt yields. After the Fed initiated the discussion on the tapering of quantitative easing, asset markets reversed course for several months (Box 1).

Mexico: Gross Capital Inflows (by Foreigners)
(USD, billions)



Sources: Haver Analytics and Banxico

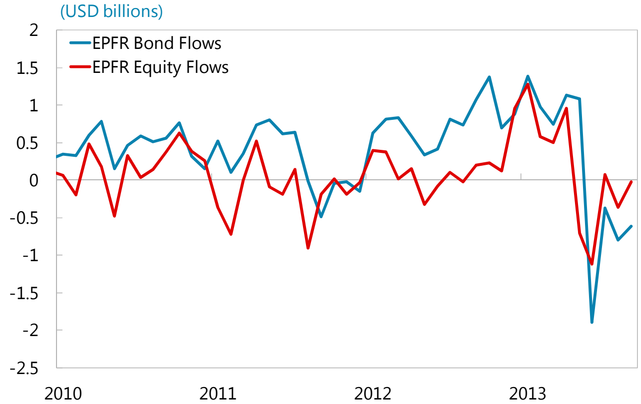
Mexico: Gross Capital Outflows (by Residents)
(USD, billions: negative number indicates accumulation of assets abroad)



Sources: Haver Analytics and Banxico

8. **In the second quarter, gross capital inflows, especially portfolio investment, from non-residents fell sharply from a peak in the first quarter**. Residents helped cushion the effects of this shift by keeping more of their funds within Mexico, leading to a smaller decline in overall net capital inflows. The recent delay in tapering announced by the Fed in mid-September has led to signs of a recovery in capital inflows. In late September, the government placed a record 10-year bond of US$3.9 billion at a spread of 135 basis points (Box 2). The central bank has refrained from any foreign exchange market intervention this year, while the government shortened the duration of its local debt issuance.

Mexico: EPFR Bond and Equity Flows
(USD billions)



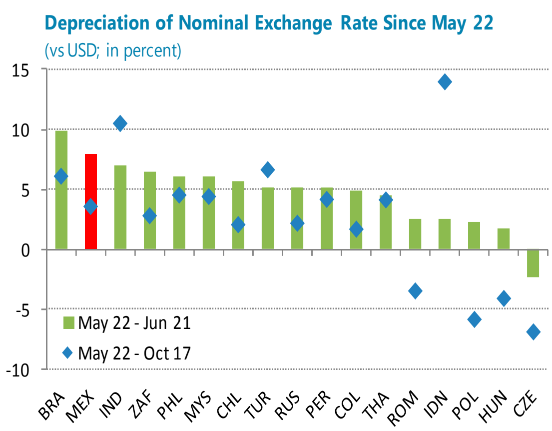
Sources: EPFR Country Bond and Equity Flows

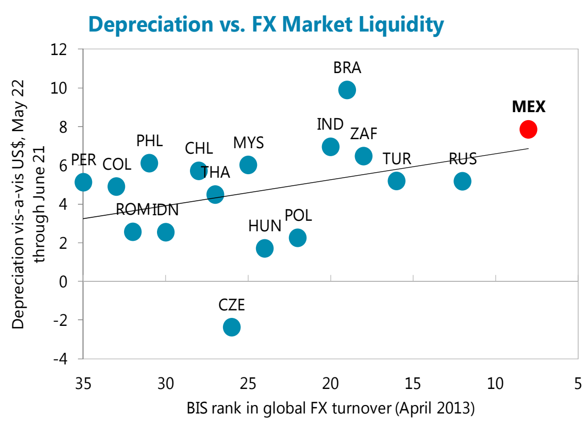
Box 1. Response of Foreign Exchange and Local Currency Bond Markets Post-May 22

Federal Reserve Chairman Bernanke's remarks on May 22, that asset purchases could be scaled back, triggered a sharp re-pricing of risk across global markets. Market participants moved forward their expectations about the onset of the tightening cycle, with the yield on the benchmark 10-year U.S. Treasury rising by about 60 basis points by mid-June. After the June 18–19 U.S. monetary policy meeting, when the Fed clarified that it could begin to trim asset purchases later in 2013, the 10-year yield on Treasury bonds also rose sharply, reaching 2.7 percent by end-June. The Fed is now expected to begin to scale back the Large Scale Asset Purchase program in the first quarter of 2014 and to start raising the target for the Federal funds rate in early 2015.

Foreign Exchange Market

The peso initially depreciated sharply vis-à-vis the U.S. dollar, but FX markets functioned in an orderly manner. Between May 22 and June 21 (the height of market turbulence), the depreciation of the peso and the increase in its volatility were among the highest in emerging markets. But the adjustment was orderly and the foreign exchange market functioned well, as reflected in normal levels of bid-ask spreads and no unusual movements in trading volumes. The Central Bank refrained from intervening in the foreign exchange market or imposing restrictions on capital outflows. The level and implied volatility of the exchange rate have fallen since, and the cumulative depreciation of the peso vis-à-vis the U.S. dollar was 6.6 percent through October.

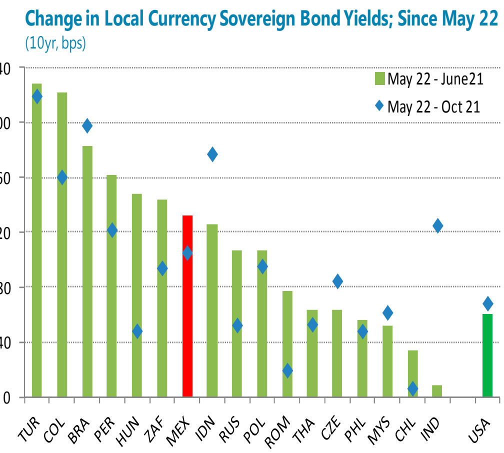




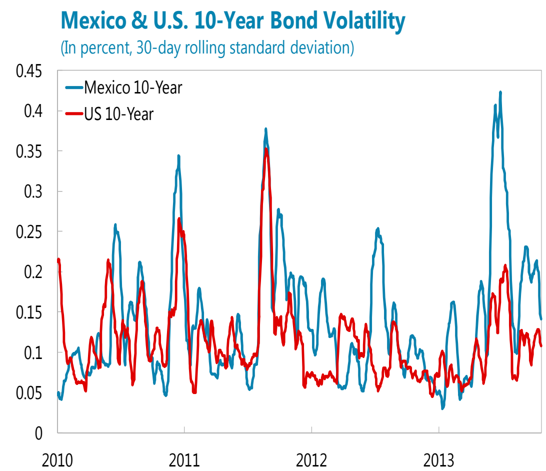
Sources: Bloomberg and BIS

Mexico's deep and liquid FX markets may have contributed to the marked depreciation of the peso during May-June. Emerging market countries with deeper financial markets may experience short-term pressures on their assets as these are sold as financial proxies for others with less desirable fundamentals, less liquid markets and/or capital account restrictions. The Mexican peso has become the single most traded emerging market currency, is fully convertible and trades 24 hours daily. Thus, investors may have hedged currency risk using the Mexican peso because it is deeper and more liquid than its peers in the region.

Box 1. Response of Foreign Exchange and Local Currency Bond Markets Post-May 22 (Concluded)



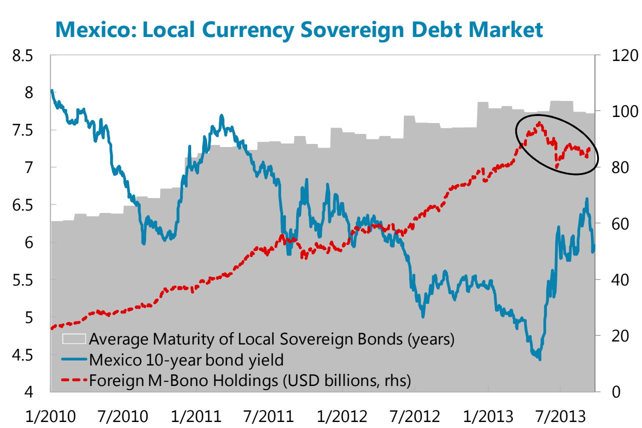
Sources: Bloomberg



Sources: Bloomberg

The bond market was characterized by a re-pricing—but not a selloff—of these securities. Between May 22 and June 21, the yield on 10-year bond (Mbonos) rose by about 130 basis points, but by end-October the Mbono yield had declined to 6.05 percent—an increase of about 100 basis points with respect to May 21. During this period, the rates on short-term government securities (CETES) fell in line with the cuts in the policy interest rate of 50 basis points, helping to steepen the slope of the yield curve on government securities. The volatility of Mbono yields picked up and some signs of illiquidity surfaced**.** Market participants reported that primary dealers had scaled back their willingness to make markets under all conditions, leading to higher intraday price volatility and wider bid-ask spreads. Some participants related this to a broad-based scaling back of risk-taking. Others pointed to regulatory changes that imposed higher capital charges on holdings of government securities and the possible implementation of the Volcker rule.

Investors hedged their exposure to interest rate risk by shortening duration through interest rate swaps, while offsetting currency risk in derivatives markets. The ability to hedge these risks helped keep foreign holdings of government securities relatively stable. This stability also reflects the broadening of the investor base that took place after Mexican sovereign debt was incorporated into Citigroup's World Government Bond Index in 2010.

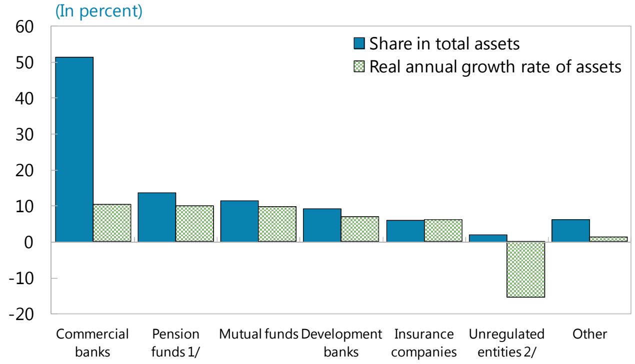


Sources: Banxico and Bloomberg

9. The banking system—which accounts for about 60 percent of financial system assets—has remained resilient (Figure 6). The expansion in bank credit to the private sector has slowed from about 15 percent in nominal terms in mid-2012 to 10 percent as of August 2013. As of July 2013, the system's capital adequacy ratio stood at 15.6 percent, largely unchanged from a year ago. Larger banks generally have more comfortable ratios, but even the smallest banks are well above the new regulatory minimums adopted after the implementation of Basel III. However, NPLs have increased to 4 percent of total loans in July 2013, from 3.1 percent at end-2012, although provisions still amounted to 174 percent of NPLs. Pockets of vulnerability have been concentrated in the construction sector—where the NPL ratio doubled to about 6 percent—and in some segments of consumer lending, especially payroll lending.[2] Housing prices have remained broadly stable in real terms over the last year after picking up in late 2011–early 2012, suggesting the absence of a bubble in this market. According to staff estimates, the growth slowdown in 2013 could raise the NPL ratio by another 0.3 percentage points by end-year.

10. Non-bank financial institutions hold about 40 percent of financial system assets, with pension funds and mutual funds accounting for nearly two-thirds of that total. In recent years, the growth rate of assets of pension and mutual funds has been higher than the one of banks and both are under the authorities' regulatory perimeter. The number of other unregulated entities (especially Sofomes and Sofoles) is large, but after the global financial crisis, these entities now account for a small share of financial system assets. The insurance sector is profitable, but has only experienced moderate growth in recent years, despite strong competition and significant foreign presence. Life insurance accounts for about 40 percent of the premiums and insurance companies are often part of a financial group, which includes a commercial bank. Pension funds and insurance companies have remained the most important institutional investors in domestic financial markets (equities and bonds), and they have gradually diversified their holdings away from government securities.

Mexico: Financial System Structure (2012)
(In percent)



Sources: Banco de Mexico, SHCP, CNBV, CNSF, Consar, Condusef and AMFE

1/ SIEFORES (AFORES)
2/ Unregulated sofoles and sofomes

[2] Though the rising NPLs to construction need to be monitored, banking sector credit to these firms represents only around 9 percent of total credit. Most non-performing loans have been concentrated in the largest three home-builders, and these are fully provisioned.

Box 2. Corporate Fund-Raising in Capital Markets

Mexican corporates' access to capital market funding has remained firm in 2013, despite the new signals about the pace of adjustment of U.S. monetary policy. Primary bond issuances (domestically and abroad) and syndicated bank loans have remained high through October 2013, while equity issuances are already at record levels.

Bond issuances and syndicated loans have held up after May 22, although on tougher terms. Mexican firms issued bonds in the amount of US$9.0 billion between January 2013 and May 22, and US$13.6 billion between May 22 and end-September. Syndicated loans rose from US$3.4 billion during the first period to US$14 billion in the second. Average yield to maturity on domestic currency issuances increased from 5.7 percent to 7.3 percent over the two periods, and from 4.9 percent to 6.2 percent for foreign currency issuances. Firms have also faced a shortening of maturities from an average of 11.9 years to 9.6 years.

Mexico Bond Issuances: Hardening of Terms Post May 22

(Jan. 2013 - May 22; May 22 - Sept. 30)

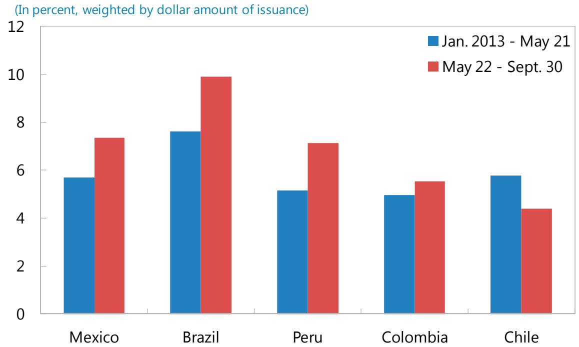
	Pre	Post
Total Value (USD, billions)	9.0	13.6
Share in Foreign Currency (in percent, weighted by value)	34.3	72.9
Yield to Maturity		
Foreign Currency (in percent, weighted by value)	4.9	6.2
Average Maturity (in years, weighted by value)	11.9	9.6

Sources: Dealogic and IMF staff calculations

Compared to other countries in the region, Mexican capital markets have been relatively unscathed by market uncertainty. The total value of bond issuances and syndicated loans in the four comparator Latin American countries has dropped significantly in the post-May 22 period. In addition to issuing less, firms in Brazil, Colombia, Peru, as well as Mexico, also face higher interest rates.

Average Yield-to-Maturity on Domestic Currency Coporate Bond Issuances 1/

(In percent, weighted by dollar amount of issuance)



Sources: Dealogic and IMF staff calculations

1/ Data for YTM is not available for all issuances

Corporate Financing in LAC

(Bond Issuances + Syndicated Loans denominated in local and foreign currencies; USD, billions)

	Jan. 1 - May 21	May 22 - Sept. 30	Percent Change
Mexico	12	28	126
Brazil	39.8	11.4	-71
Chile	8.1	3.5	-56
Colombia	7.0	3.7	-47
Peru	7.1	1.8	-75

Sources: Dealogic and IMF staff calculations

This year, Mexican firms have raised a record amount of funds in the domestic equity market, with a growing presence of Real Estate Investment Trusts (FIBRAs). In the first nine months of 2013, firms raised $11.4 billion through IPOs and follow-on offerings, compared to $8.4 billion for all 2012. Several additional IPOs are planned in the rest of 2013. Issuances this year have been buoyed by an increasing interest in FIBRAs, an investment vehicle that allows shareholders to invest in the real estate market, and provides tax incentives to certain investors, such as pension funds. These issuances accounted for one-third of the total value raised in the equity market. Since the first FIBRA entered the market in 2011, the now seven FIBRAs listed on the stock exchange have raised nearly $5.7 billion.

Equity Offerings

(USD, billions; through Oct. 2013)

	2011	2012	2013 YTD
Total	1.5	8.4	11.4
FIBRAs	0.3	1.4	4.0

Source: Dealogic and IMF staff calculations

OUTLOOK AND POLICY DISCUSSIONS

Structural Reforms Can Transform the Medium Term Outlook

11. The ambitious structural reforms will most likely stimulate faster growth over the medium term (Box 3). Over the past 20 years, real GDP growth has averaged about 2¾ percent a year, with virtually no growth in total factor productivity. If implemented properly, the reforms can have far-reaching effects on the economy. With the prospect of structural changes in many areas—such as higher production of hydrocarbons, increased competition (especially in telecommunications), financial deepening and enhanced labor market flexibility—potential output growth could increase through more investment, more employment in the formal sector and gains in total factor productivity.

Mexico Medium-Term Outlook

	2012	2013	2014	2015	2016	2017	2018
Real GDP Growth	3.6	1.2	3.0	3.5	3.7	3.8	3.8
Inflation (annual average)	4.1	3.6	3.0	3.0	3.0	3.0	3.0
Current Account Balance (percent of GDP)	-1.2	-1.7	-1.9	-2.0	-1.9	-1.9	-1.8
Output Gap (percent of potential GDP)	0.8	-1.0	-0.9	-0.5	0.0	0.0	0.0

Sources: Bank of Mexico; INEGI; Secretary of Finance and Public Credit; and IMF staff projections.

12. With these considerations in mind, staff raised its estimate of growth over the medium term. Real GDP is projected to rise by 3.0 percent in 2014, as demand policies as well as faster growth in the U.S. (especially in manufacturing) support the recovery in Mexico. As for the medium term, it will probably take several years to see the full effect of the reforms, since investors would probably wait for the adoption of all secondary regulations and clarity on the new rules of the game before undertaking major projects. For 2015–2018, staff projects that real GDP would grow by 3½ to 4 percent a year, faster than the previous estimate of potential growth of 3–3¼ percent, while inflation would remain in line with the central bank's target. With this growth projection, staff estimates that the output gap would not close until 2016.

13. The authorities believed that the reforms would have a more profound effect on growth. In their view, the reforms would boost growth to the range of 4 to 5 percent a year. It was agreed that conservative estimates of the effects of the reforms on growth at this stage would help guard against overly optimistic policies, since the effects are difficult to measure at the beginning of this potentially transformative process. The authorities emphasized the synergies that could come from such a wide range of reforms at the same time, and saw the reforms as a source of upside risk to the outlook. As the effects of the structural reforms take hold, the authorities stressed they would act to prevent any overheating that might arise from a surge in investment.

Box 3. Structural Reforms.

Pacto por México. When this government took office in December 2012, it signed an agreement with the two main opposition parties to promote political cooperation on structural reforms to strengthen competitiveness, growth and job creation. By end-2013, it is expected that congress will have approved over a half dozen major reforms that have been on the country's agenda for some time. The key reforms include:

- **Energy reform (approval pending).** This proposal opens the door for more private sector participation in the hydrocarbons and electricity sectors. It would modify Article 27 of the constitution by removing the ban on risk-sharing contracts in the hydrocarbons sector and broaden the scope for contracts with private firms in the electricity sector, while retaining the ban on concessions in both sectors. The constitution would still say that Mexico's hydrocarbon resources belong to the Mexican people. It would also alter Article 28 by removing the state's monopoly in upstream and downstream operations in hydrocarbons and in electricity. Once these amendments are approved, the government would submit the secondary laws essential to implement the reform. Critical issues to be decided include the nature of the contracts, the fiscal regime for hydrocarbons, and the legal framework for an independent operator in electricity transmission.

- **Fiscal reform (tax reform approved in October 2013, amendments to the Fiscal Responsibility Law (FRL) in reconciliation).** Amendments to the FRL will require the government to commit to a target for the Public Sector Borrowing Requirement (PSBR) consistent with a desired path for public debt, and limit current spending growth—net of pensions, interest payments, fuel costs of the state electricity company and revenue sharing—which will help curb the bias towards procyclical spending. Congress has approved a tax reform to boost tax revenues by 2.0 percent of GDP by 2018. Steps are also taken to strengthen collection of sub-national taxes and transparency in intra-governmental revenue sharing. PEMEX's fiscal regime will also be modified for all upcoming hydrocarbon contracts to replace some taxation by dividends. Finally, the reform expands the social safety net through the introduction of a universal pension and unemployment insurance.

- **Financial sector reform (approved by Chamber of Deputies in September 2013; Senate approval pending).** The reform would foster greater competition in the financial sector by, *inter alia*, granting more flexibility to development banks to extend credit within a sound prudential framework and improving the system of loan guarantees and collateral—including by streamlining dispute resolution through the creation of specialized business courts. The reform also includes steps to address several recommendations of the 2011 FSAP. It proposes to strengthen regulatory powers, enhance consumer protection, and establish consolidated supervision of financial conglomerates. It would also formalize Basel III rules, especially to set up a countercyclical capital buffer and phase in the new liquidity standards. Finally, more technical aspects of the reform include steps to strengthen bank resolution procedures and give the National Banking and Securities Commission more control over its salaries.

- **Education reform (approved in September 2013).** This reform aims to bring the quality of education in Mexico closer to the standards in other OECD countries. One of the key changes in the education reform is to create a professional system for evaluating, hiring, assigning and promoting teachers, while reducing labor unions' interference in access to teaching positions. Enhancing the quality of education would, among other things, reduce the skills gap and help integrate a greater share of the labor force into the formal sector.

- **Telecommunications reform (approved in mid-2013).** The reform includes three important measures to promote competition in this sector to provide broader and cheaper access to telecommunications. First, it allows for more foreign ownership of companies in segments of the telecom sector including satellite communications—up from 49 percent under current legislation. Second, it creates a new regulatory body which will have the power to grant and revoke telecommunications and broadcast concessions, including the ability to force break-ups or asset sales to eliminate anti-competitive effects. Third, by removing barriers to effective enforcement and resolution of disputes, the reform seeks to address the common practice of large firms to delay enforcement of administrative orders through injunctions.

Box 3. Structural Reforms (Concluded)

- **Labor reform (approved in late 2012).** This reform has three critical measures. First, to lower the cost of hiring workers and boost formal employment, the law introduces new contractual modalities, including flexible labor contracts. Second, to provide judicial certainty and reduce separation costs, the legislation streamlines the settlement of labor lawsuits and caps compensation for unjustified dismissals. Finally, to improve labor organization within firms, productivity and labor skills will take precedence over seniority as the main criteria for promotion and filling vacancies, which should increase incentives to invest in human capital.
- **Governance and Transparency reforms (pending).** The federal government will create a National Anti-Corruption Commission. Also, the Federal Institute for Access to Public Information and Data Protection will be given greater autonomy and its powers will be expanded. The key element of the security reform in the Pact involves the creation of a national gendarmerie.

14. **The reforms would most likely affect the balance of payments by generating a surge in foreign direct investment and imports followed by an expansion of exports**. Staff prepared an illustrative scenario with a rise in the external current account deficit to about 2 percent of GDP in 2015–16, assuming that foreign direct investment rises to 1½–2 percent of GDP a year over the medium term, compared with less than 1 percent of GDP in recent years (Table 3). These investments would lead to an oil trade surplus of 0.8 percent of GDP by 2018, compared with balance in a no-reform scenario. In this scenario, net international reserves would rise from US$167 billion at end-2012 to US$223 billion by end-2018, which would allow the central bank to broadly keep the reserve coverage ratio constant in terms of portfolio investment.

Global Economy Still Main Source of Downside Risks

15. **While Mexico's close ties to the global economy confer important benefits, the authorities stressed that Mexico's economy remains vulnerable to near-term risks from the global economy.** The most prominent risk arises from the expected shift towards a less accommodative monetary policy in the U.S. The transition is likely to proceed smoothly, but tail risk scenarios could be triggered by a faster-than-expected tightening of financial conditions in the U.S. In this event, the effect of tighter U.S. financial conditions would depend on whether these were associated with faster U.S. growth, which would boost Mexico's growth. Other risks could arise from a slowdown in EMs or a reemergence of financial distress in Europe. The staff noted that financial stress in the euro area could re-emerge as a result of stalled or incomplete delivery of policy commitments at the national or euro area level, a negative assessment of the asset quality review combined with insufficient backstops, or adverse developments in some peripheral countries. Disappointing activity in EMs—or a deeper than expected slowdown in China—would also bring about a reassessment that trend growth will be lower as a result of weaker than expected productive capacity and human capital. The effects of these scenarios would most likely operate through portfolio capital flows, as a reassessment of the risk premia in EMs could trigger a pullback from emerging market assets. There would also be some effect on exports, if global growth slowed as a result of these shocks. The transmission of these shocks would probably not come directly through the banking system, which is funded largely through local retail deposits and has a subsidiary structure for the foreign-owned banks.

Mexico: Risk Assessment Matrix 1/

Source of Risk	Up/Downside	Risk	Impact	Policy Response
Slippages in achieving medium-term fiscal targets	↓	L	H	Maintain expenditure control
Protracted economic and financial volatility, especially in emerging markets (triggered by prospective exit from UMP in advanced countries). This could lead to a sustained increase in risk premiums across EMs.	↓	H	H	Exchange rate flexibility, together with provision of FX liquidity. Monetary policy response would depend on domestic economic conditions.
Significant deceleration in the United States that could result, for example, from a fiscal shock in the United States that leads to a sharp fiscal contraction.	↓	L	H	Exchange rate flexibility as a first line of defense, coupled with monetary easing and automatic stabilizers.
Lower than anticipated EM growth potential, possibly due to incomplete structural reforms in other EMs. This could slow demand for Mexico's exports and affect financial markets.	↓	M	L	Exchange rate flexibility, together with provision of FX liquidity.
Bond market stress in the US due to fiscal sustainability concerns that triggers a sharp rise in the US's sovereign risk premium, which could spillover to financial markets in Mexico. 2/	↓	L	H	Exchange rate flexibility, together with provision of FX liquidity. Monetary policy response would depend on domestic economic conditions.

1/The Global Risk Assessment Matrix (G-RAM) shows events that could materially alter the baseline path. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The G-RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities in September 2013.
2/ Should the fiscal shock have negative real effects on U.S. growth, then the policy response may allow for some monetary easing.

16. The authorities agreed that these contagion scenarios are risky for countries like Mexico, especially given its high integration with international capital markets. The authorities emphasized that the best policy response in the event these risks materialize would be to maintain the strong policy framework—including an open capital account and reliance on exchange rate flexibility as a key policy buffer—and credibility in the central bank's inflation targeting regime by keeping inflation expectations strongly anchored.

Stronger Fiscal Framework

17. The recently approved fiscal reform is designed to build on the strengths of the previous fiscal framework. Previously, the Fiscal Responsibility Law (FRL) set a balanced budget target excluding investment by PEMEX, the state oil company (i.e., a 'traditional deficit' of about 2 percent of GDP a year), with escape clauses to allow fiscal stimulus in periods of economic downturn. A complex network of four oil stabilization funds was designed to handle savings from oil price windfalls (when actual oil prices exceeded the budget price). The public sector borrowing requirement (PSBR), however, was usually larger than the traditional deficit, since draw-downs from oil stabilization funds and other financing ('non-recurrent revenues') were used to pay for spending overruns during the year. Overall, this system provided a good balance between a numerical fiscal rule and discretion, with the PSBR declining from 5.1 percent of GDP in 2009 to 3.7 percent of GDP in 2012. However, it created non-transparent incentives to under-budget, and for the PSBR path to diverge from the traditional deficit.[3] Moreover, the oil stabilization funds have been virtually depleted after helping to finance countercyclical fiscal policy in the aftermath of the collapse of Lehman. Both the traditional deficit target and the PSBR tend to support expenditure procylicality, since they allow spending to rise in periods of higher revenues.

18. The new framework provides for a more transparent and effective fiscal anchor and limits spending procyclicality. The FRL has been amended to make the PSBR an explicit fiscal target in addition to the traditional measure of the deficit. The annual budget documents must include 5-year projections for the PSBR consistent with a sustainable debt path, as well as specific annual numerical targets. This step will enhance fiscal transparency and provide a closer link between fiscal policy and the evolution of public debt and domestic demand. The amended FRL requires the government to set a cap on real expenditure growth, which will help contain spending especially during periods of revenue windfalls. The cap will apply to Structural Current Spending (SCS)—defined as current primary expenditure including transfers to state and local governments for capital but excluding those outlays governed by automatic rules (pensions, subsidies for electricity, and subnational revenue-sharing). Staff suggested that a cap covering all primary spending would reduce incentives for reclassifying outlays to avoid the cap on SCS, but the authorities see little scope to cap public investment. The new FRL retains the current structure of the four oil stabilization funds. Staff noted that the rules governing these stabilization funds are exceedingly complex and still allow use of excess revenues to cover unexpected increases in

[3] The PSBR was reported but for information purposes only.

spending or shortfalls in other revenues. It would be important to simplify these funds to create more scope to save oil revenue windfalls.

19. Congress also approved a tax reform that moderately raised non-oil tax revenue and phased out subsidies on domestic sales of gasoline to try to reduce the dependence on oil revenues. Key tax measures include the extension of the 16 percent value-added tax to firms in border regions and an increase in income tax by broadening the tax base and applying higher tax rates to high income earners. The reform also includes an 8 percent 'junk food' tax and a mining tax. The domestic gasoline subsidy is to be phased out by end-2014. Afterwards the domestic gasoline price will rise with domestic inflation and the government will raise the domestic price further in line with increases in international gasoline prices to prevent the reemergence of the subsidy. The staff noted that the projected revenue yield of the tax reform, while realistic, is subject to risks. This makes the link between domestic and international gasoline prices all the more important to ensure that fuel subsidies are phased out permanently. Staff also commented that the tax reform will lead only to a modest increase in non-oil tax revenues, and further reform may be required in a few years to continue to reduce dependence on oil revenue. The fiscal regime for the state oil company (PEMEX) is to be updated in the context of the energy reform.

20. In the context of this new framework, the government defined a path for the PSBR through 2018. Initially the government intends to keep the PSBR at 4.1 percent of GDP in 2014 to avoid a fiscal contraction while the economy is operating well below capacity. The target reflects more transparent spending provisions to preclude under-budgeting, and incorporates spending that is based on a conservative assumption for the price of Mexico's exports of oil.[4] In its fiscal plan sent to congress in September 2013, the government announced its medium-term fiscal path, which stated the intention to reduce the PSBR to 2.5 percent of GDP by 2017—a medium-term anchor that would gradually reduce public debt in relation to GDP. The energy reform—which is expected to increase oil production from 2.5 million barrels per day (mbpd) to 3.0 mbpd by 2018—and the elimination of gasoline subsidies are expected to generate a moderate boost in oil revenues as a share of GDP, compared with constant production and declining oil revenues in a no-reform scenario. The tax reform would raise non-oil tax revenues from 10.0 percent of GDP in 2013 to 10.6 percent by 2017–18. Total expenditures would initially rise from 25.2 percent of GDP in 2013 to 26.4 percent in 2014, reflecting partly adjustments to avoid under-budgeting but also higher public investment and the cost associated with reforms such as the universal pension and unemployment insurance. As spending caps become effective and electricity costs are contained, expenditures would decline to 25.0 percent of GDP by 2018.

21. This fiscal path implies an increase in public debt from 44 percent of GDP at end-2012 to 47 percent by 2016, with a decline to 46 percent by 2018. The different DSA scenarios suggest that Mexico's public and total external gross debt levels are sustainable over the medium term, even

[4] The budget is based on an export price of US$85 per barrel for Mexico's oil mix, which is below the staff projection of US$98 per barrel.

under the most extreme shocks. In addition, the adjustment of the cyclically-adjusted primary balance in line with the authorities' medium term plan does not provide warning signals of being unsustainable, considering pre-2009 Mexican data or the distribution of cross-country evidence on recent fiscal adjustments. The broad institutional coverage of Mexico's public debt, which includes development banks and other key public entities such as PEMEX provide reassurance that gross public sector liabilities are well captured in the assessment. Given Mexico's favorable currency and maturity debt structure, moreover, the pass-through of interest rates or exchange rate shocks are relatively small, and thus the risks to the budget associated with these shocks appear to be low over the projection period. The new FRL also includes important steps to strengthen the finances of subnational governments by limiting their ability to take on debt and enhancing reporting requirements.

22. Staff endorsed the new fiscal framework, noting that it would allow for more effective control of fiscal policy. While a somewhat tighter fiscal stance in 2014 would be preferable, staff accepted that it would not be advisable to initiate fiscal tightening when the economy will be operating below capacity. It also noted that spending in 2014 was based on a conservative projection for the world price of oil, which could yield opportunities to achieve a somewhat lower PSBR. Staff emphasized the importance of the government's articulation of plans to carefully manage spending and revenues over the next three to four years to entrench confidence that the medium-term target for the PSBR can be reached.

23. In this context, the new FRL will include transitory articles that lock in key elements of fiscal policy through 2017. These transitory articles set ambitious targets to control current spending. The transitory provisions establish that SCS cannot grow faster than 2 percent in real terms—about half of the projected growth in 2014 and lower than the 5 percent real growth during 2006–2013—relative to the budget approved in the previous year. This ceiling will apply to spending execution throughout the year, aiming at providing more control over the planning and execution of the budget. The 5-year fiscal projections indicate that these spending caps are consistent with reducing the PSBR to 2.5 percent of GDP by 2017.

24. The authorities emphasized that other legal provisions will secure compliance with the spending targets. In particular, they noted that these provisions will focus on:

- *Curbing under-budgeting practices.* The amendments to the FRL will establish binding constraints on the real growth in expenditure ceilings not only during the budget process, but also during execution stage. This should eliminate incentives to under-budget.

- *Setting medium term spending goals for specific categories.* The government will publish detailed expenditure policy guidelines (PRONAFIDE)[5] for 2014–2018 that include annual goals and limits for specific budget categories that are consistent with the 2 percent annual growth rate limit on SCS. The real growth in the wage bill will be limited to 2.4 percent a year, implying a decline in

[5]The Medium Term Development Financing Program.

wages in relation to GDP. This policy will be supported by centralization of the education payroll at the federal level to improve control over teachers' wages and the opening of new teaching positions. It will also simplify the transition to performance based payment schemes adopted in the education reform. Real growth in subsidies will not exceed 2.6 percent a year, while transfers for capital expenditure by state and local governments will be held constant in real terms after 2014. Purchases of goods and services are to rise by 0.5 percent a year in real terms. The federal government will centralize procurement of health supplies to reduce these costs and enhance inventory controls.

- *Pacing investment*. PRONAFIDE will also establish a detailed capital expenditure schedule consistent with the medium-term path for the PSBR. This schedule would build in a significant decline in non-PEMEX investment in relation to GDP. However, there may be greater scope for non-PEMEX investment by 2017–18, as the energy reform gains momentum and allows for more investment by private firms and less by PEMEX in hydrocarbons.

Monetary and Exchange Rate Policy Well-Positioned to Manage Risks

25. The central bank reaffirmed its commitment to adjust the policy rate as necessary to keep annual inflation close to the 3 percent inflation target. It will also continue to rely on exchange rate flexibility to help the economy adapt to shifts in global economic conditions. Staff simulations suggest that—with the output gap projected to close very slowly—the current stance of monetary policy is broadly consistent with keeping inflation close to the target. The authorities noted that there was only limited room for further monetary easing, given the stance of fiscal policy as well as the fact that the policy interest rate was only slightly positive in real terms. The staff and authorities agreed that exchange rate flexibility would continue to work well as a shock absorber. Despite recent spikes in exchange rate volatility, there have been no balance-sheet or pass-through effects from the exchange rate adjustments.

26. The authorities stated that there are no plans to modify the mechanism for the acquisition of reserves from PEMEX's net trade balance. The current mechanism implies that the increase in international reserves will broadly maintain most coverage ratios at similar levels, except for a notable increase in the coverage of short-term debt. International reserves are adequate relative to some standard metrics, but coverage is lower for broad money and foreign portfolio liabilities (Annex). As of end-2012, reserves were at the lower end of the 100 to 150 percent desired coverage of the Assessing Reserve Adequacy (ARA) metric. Reserve coverage of imports, imports plus interest payments, and short-term debt at residual maturities were also above recommended levels at 4.5 months, 4.9 months, and 209 percent, respectively. However, coverage of broad money and foreign portfolio liabilities were lower at 19 and 39 percent, respectively.

27. Staff and the authorities agreed that the strong credibility of the inflation targeting framework would help Mexico navigate through unsettled global economic conditions. Developments in the U.S. economy are the main source of risk for Mexico, given the close links between these two countries. The authorities anticipate that the U.S. Fed will smoothly manage the transition to a less accommodative monetary stance. However, the authorities recognized that tail risks could arise from the normalization of U.S. monetary policy, since there is no precedent for unwinding such a large balance sheet. There is also the tail risk that, in the next round, the debt limit in the U.S. might not be dealt with in a timely manner.

28. The authorities were confident that they had the contingency plans—many tested in the Lehman crisis—to manage these tail risks. They noted that the Fund's support through the FCL was an extremely important safeguard and was an integral part of these plans. In this context, it was agreed that exchange rate flexibility will continue to play an important buffering role in the face of shocks. There was also agreement that handling tail risks would also call for continued careful public debt management, especially if investors seek to reduce duration risk in their sovereign debt portfolio. In an orderly tapering scenario, a more rapid rise than expected in the yield on 10-year U.S treasuries could be associated with faster growth in the U.S., which could lead to faster growth in Mexico and might require a hike in the policy interest rate, depending on domestic economic conditions (Box 4). However, other scenarios could involve higher yields on 10-year U.S. treasuries and slower growth in the U.S., which might provide scope for a lower policy interest rate in Mexico, since the strong credibility of monetary policy would keep inflation expectations well anchored.

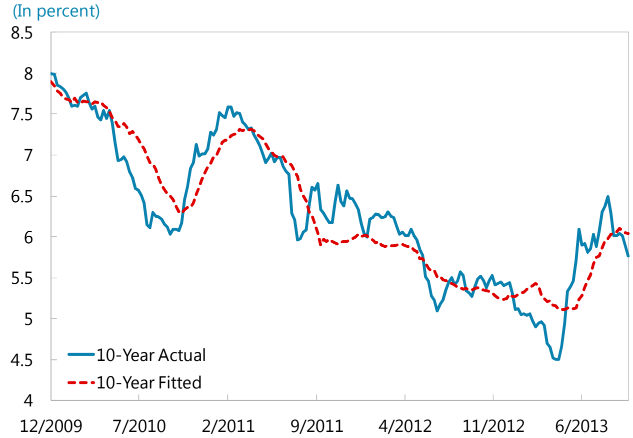
Box 4. Spillover Effects of the Shift to a Less Accommodative Monetary Policy in the U.S.

The expected transition in U.S. monetary policy towards a more normal stance will affect the Mexican economy through several channels. In the early stages of the process of normalization, the yield curve in the U.S. will most likely steepen, as the trimming of asset purchases pushes up yields on longer term rates, including on 10-year U.S. treasuries, while the Federal Funds rate stays constant. This trend will drive up long-term interest rates in Mexico, which would tend to curtail investment and growth. However, growth and investment in Mexico would be encouraged by the expected recovery in the U.S. economy which is leading to the transition in monetary policy. To assess these effects, staff estimated several models. First it estimated a model of the yield on 10-year Mbonos. It also developed a small open economy macroeconomic model for Mexico to analyze the effects of tighter financial conditions as well as faster growth in the U.S.

Effects on Mbono yields

Staff estimates suggest that changes in US Treasury yields have a significant short-term impact on local Mexican bond yields. A vector error correction model (VECM) was estimated to examine the relationship between yields on 10-year Mexican local currency sovereign yield and the domestic overnight interest rate, the 10-year U.S. government bond yield, a measure of global risk aversion, exchange rate risk and idiosyncratic sovereign credit risk. A one-standard deviation impulse to U.S. rates (about 10 basis points) translates into a 6.2 basis point response after two weeks, and peaks at 12.8 basis points (a conditional pass-through of nearly 1.3) after two months.

Mexican 10-Year Bond Yields: Actual and Model- Based Fitted Values
(In percent)



The model suggests that the reaction of yields on 10-year Mbonos after May 22 was in line with changes in fundamentals, with no evidence of overshooting. By end-April 2013 Mexican rates were significantly below their level implied by fundamentals: indeed, the actual yield was almost 70 basis points below the predicted value from the VECM. Starting in early May, Mexican bond prices reversed the rally and yields started rising, based on early signs of improvement to the U.S. economy. After May 22, the actual and model-implied fundamental values of the local sovereign yield moved in lock-step, suggesting that the yields on 10-year Mbonos are broadly in line with trends in the explanatory variables. The results also suggest that Mexican interest rates could rise sharply if Mexico faces further bouts of market volatility caused by shift in expectations or surprises about U.S. monetary policy.

Box 4. Spillover Effects of the Shift to a Less Accommodative Monetary Policy in the U.S. (Concluded)

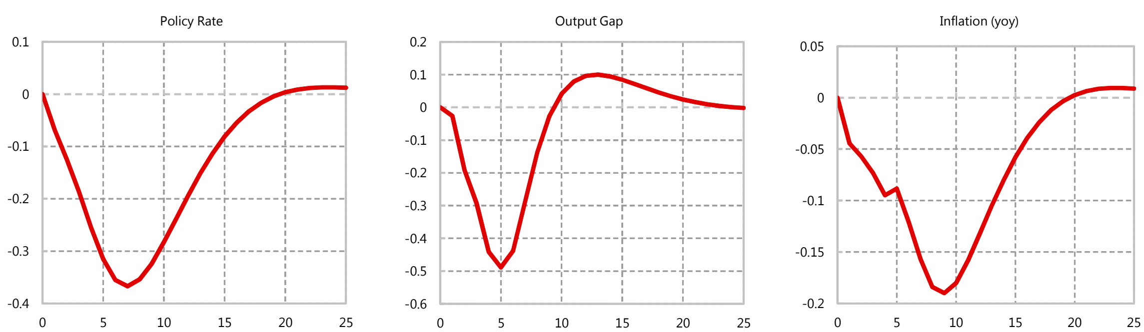
Small open economy macroeconomic model

Building on the IMF's Global Projection Model (GPM), we developed a small open-economy model for Mexico to discuss policy responses to faster than anticipated tapering in the U.S. In the baseline scenario, the current stance of monetary policy is broadly consistent with keeping inflation close to the target. This baseline assumes no change in the U.S. Federal Funds rate, a rise in the yield on 10-year U.S. treasuries to 3.25 percent by end-2014 and real GDP growth in the U.S. of 2.6 percent in 2014. A simulation using the GPM for Mexico suggests that, after a negative output gap emerged in the second quarter, the central bank could hold the policy rate broadly at its current level while continuing to allow the exchange rate to move in line with market forces.

An alternate scenario considers an orderly faster pace of unwinding of quantitative easing associated with a faster-than-expected U.S. recovery. In a GPM simulation that assumes a 1 percent faster rate of growth in the U.S for one year, growth in Mexico would be higher by about ¾ of a percentage point and the results suggest that a moderate increase in the policy rate might be required to keep inflation on target.

In a disorderly unwinding scenario where the yield on 10-year U.S. treasuries rises but without faster growth in the U.S., the credibility of monetary policy is critical. In this scenario, financial conditions in Mexico would tighten and lead to slower growth. If inflation expectations remain well anchored, the central bank could have scope to reduce its policy rate somewhat. However, the central bank would have to pay close attention to developments in the foreign exchange market, and may find it necessary to use the policy interest rate to help preserve orderly conditions in the foreign exchange market.

A Possible Unwinding Scenario



Source: IMF staff calculations.

In either scenario, the strength of bank balance sheets and sound financial regulations should help mitigate banking sector risks. The rise in yields on government securities would most likely raise lending interest rates, which could impair credit quality. As reported in the 2012 Financial Sector Stability Assessment (FSSA) and the most recent Financial Stability Report of the Bank of Mexico, market risk is manageable and banks' balance sheets can withstand increases in government bond yields However, the rise in interest rates would affect asset quality, with the staff's credit risk model suggesting that a 100 basis point rise in borrowing costs would raise the NPL ratio by 70 basis points, concentrated mainly in consumer credit.

Financial Sector Remains Resilient

29. The authorities commented that the banking system remained sound, with sufficient cushions to handle the recent increase in NPLs and market volatility. They added that supervision is strong and risks are closely monitored, as indicated by the findings of the standards assessments of the 2011 FSAP Update. The recent deterioration in asset quality in the construction sector was explained almost entirely by the financial difficulties of the three large homebuilding firms, which had taken on too much leverage to purchase assets of low value. They estimated that banks' capital can easily withstand any loan losses in this sector, partly because a significant share of the loans to the large homebuilders had been provisioned. The authorities emphasized that the government would not bail out these firms to avoid creating moral hazard. The authorities noted the recent steps to clarify the government's low-income housing policy, which should encourage a recovery in construction next year.[6] The authorities believed that credit risk in other sectors was under control, although NPLs in payroll and other personal loans still needed to be reduced further. The new FRL includes provisions to constrain the ability of state and local governments to take on debt, which will help contain credit risk to this sector.[7] The authorities noted that the process of adopting expected loan loss provisioning for commercial loans would be completed by end-2013, and their estimates suggested that this shift in methodology would not lead to an increase in overall provisioning levels. The recent increase in yields on local currency government securities has had very small effects on bank capital, consistent with the findings of the authorities' stress tests and those of the FSAP that the banking system is quite resilient to market risk.

30. The financial sector reform is expected to increase intermediation, promote competition and enhance financial stability. The reform would encourage access to credit through several channels. It streamlines the bankruptcy process and eases the legal hurdles for banks to repossess collateral in case of delinquency and default, including through the creation of specialized courts. It also establishes a centralized bureau for credit information. The authorities noted that competition in the banking sector was weak, and highlighted the measures aimed at promoting the portability of banking services, including housing loans, to promote competition. The financial sector reform would also include steps to address several recommendations of the 2011 FSAP, including strengthening regulatory powers and the bank resolution framework (Box 5). It would also strengthen supervision of financial conglomerates by allowing supervisors to obtain information and regulate the non-financial firms that are part of mixed conglomerates. The reform also strengthens oversight of Sofomes by requiring them to report information to credit bureaus, register with the consumer protection agency and comply with AML standards. Staff urged the authorities to remain vigilant that the enhanced role of development banks does not interfere with

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[6] In the view of the authorities, the previous strategy for low-income housing had created the wrong incentives, fostering residential construction too far from the urban centers where most people work and undermining the demand for this type of housing. In response, the government is developing a new subsidy policy that will focus on construction of apartments closer to urban centers starting in 2014.

[7] Specifically, these governments must have a two-thirds majority in their legislatures to issue new debt and they may not take on debt within six months of the end of their term.

the commercial banks' attempts to increase intermediation. It also encouraged the authorities to ensure that the CNBV's new powers to enforce investment guidelines for banks—aimed at boosting credit—be exercised judiciously. Finally the supervisory authorities should enhance their monitoring of indebtedness and balance sheet exposures in the economy, including through the development of comprehensive data on balance sheets on corporates and households.

31. The authorities noted that the effects of international financial regulatory reforms on Mexico's financial system have been manageable. They noted that all the foreign banks operating in Mexico were subsidiaries and were subject to macroprudential limits on transactions with their parent banks. In the recent post-May 22 market turbulence episode, primary dealers were less willing to act as market makers for government securities under all conditions. However, the authorities were uncertain whether this reflected a preference for less risk taking by those banks or the effects of reforms, such as higher capital risk weights on holdings of Mexican government securities or the prospect of the implementation of the Volcker rule. They also commented that the new framework for regulation of derivatives traded over the counter might have a significant effect on the trading volume of this kind of activity in Mexico.

32. Mexico has adopted many legislative and institutional measures to strengthen its AML/CFT framework in line with recommendations and specific observations of the 2008 Mutual Evaluation Report. While most issues have already been addressed, the authorities have noted that they remain committed to adopting all recommendations. Most recently, the government has submitted reforms to Congress to bring the legal framework for criminalization of money laundering and financing of terrorism fully in line with international standards. The government has also been more aggressive in prosecuting money laundering activities. The Financial Intelligence Unit has been strengthened to obtain more and better information from financial institutions and designated non-financial businesses and professions (DNFBPs); and will be issuing guidelines to all reporting entities to freeze the funds of those persons suspected of money laundering or financing of terrorism.

Box 5. FSAP Recommendations and Financial Sector Reform

Mexico's FSAP update was discussed by the Executive Board in December 2011. The main recommendations of the report were the following:

- **Address high levels of concentration risk.** The CNBV should have more legal powers to regulate financial groups. Prudential and risk management standards should apply fully to holding companies and financial conglomerates. A swift implementation of Pillar 2 of Basel II, including the introduction of capital charges for concentration risk and buffers above the regulatory minimum capital levels, should be considered. These improvements in regulation and supervision will require amendments to laws and are partly under consideration in the new financial reform bill.

- **Improve the financial safety network**. Several measures are needed to strengthen deposit insurance, including establishing a program to address the situation of credit cooperatives, transfer legacy debt of deposit insurance fund to the government, and set up emergency funding with government guarantee.

- **Enhance competition**. As in the case of financial safety nets, several measures are needed to improve competition, including review the current structure of retail banking fees, enhance consumer financial protection, change regulatory framework for pension funds to increase focus on long-term returns, and promote more contestability and access to financial services. Despite the authorities' efforts to increase the number of banks in operation, the sector remains concentrated.

- **Increase autonomy of supervisors**. The FSAP update highlighted the need for more operational autonomy of key financial supervisory agents (CNBV and CNSF), ranging from more latitude on internal staffing decisions to increased independence by appointing a fixed-term management team. Reducing overlapping of responsibilities should remain a medium term goal.

The government's financial sector reform bill has been approved in the Chamber of Deputies and is currently under consideration by the Senate. The financial reform is largely uncontroversial and is aimed at addressing longstanding issues that have limited financial inclusion. On the other hand, concentration risk remains largely unaddressed by the financial reform, and the CNBV would be given powers to establish benchmarks to increase bank lending to the private sector, which could create distortions in credit allocation if not applied judiciously. The reform addresses the main FSAP recommendations outlined above, including by:

- Fostering greater competition in the financial sector; this would be achieved by, inter alia, strengthening development banks and improving the system of loan guarantees and collateral (including streamlining the bankruptcy procedures). The latter goal would be achieved by streamlining the bankruptcy process and easing the legal hurdles for banks to repossess collateral through the creation of specialized courts. Competition would also be enhanced by allowing bank clients to switch banks with very low transactions costs.

- Strengthening regulatory powers and enhancing consumer protection; increased portability of banking services is also expected to improve consumer protection.

- Formalizing Basel III rules (recently adopted in early 2013) into the domestic regulatory and supervisory frameworks.

- Strengthening supervision of mixed conglomerates.

STAFF APPRAISAL

33. Mexico's resilience to the recent volatility in global financial markets attests to the confidence in its sound and predictable management of economic policies. The strong institutional framework for policies provides assurances of the country's commitment to macroeconomic stability, regardless of changes in government. Exchange rate flexibility plays an important role in helping the economy adjust to shifting global conditions, and the commitment to open current and capital accounts gives investors confidence that the rules of the game are stable. With this policy framework, the external current account balance and the real effective exchange rate are in line with economic fundamentals and desired policy settings.

34. Mexico is closely linked to the global economy, especially the U.S., heightening its exposure to external risks. Higher interest rates in advanced economies will potentially be associated with a reversal of capital flows and a sustained increase in risk premiums across EMs, which in turn may trigger an intensification of liquidity strains on sovereigns and leveraged corporations. Moreover, in the case of Mexico, the impact of policy uncertainty in the U.S. may not only have a financial impact as in other EMs, but also a significant impact on economic activity if the U.S. economy decelerates.

35. The progress in advancing so many far-reaching structural reforms is impressive and signals Mexico's commitment to address deep-rooted impediments to growth. Few, if any, other countries are undertaking such a broad agenda of transformative structural reforms, especially in the context of a broad coalition of major political parties. Laws have already been approved to upgrade public education, make labor markets more flexible, foster competition in telecommunications, and strengthen the fiscal policy framework. Currently under discussion are reforms to the energy and the financial sectors. These reforms are a source of optimism and upside risk to the growth outlook over the next 5 to 10 years. Of course, there is still uncertainty about the precise effects on growth, and it will be crucial to quickly approve all the secondary legislation and regulations associated with the reforms to provide a clear landscape for investors.

36. While the previous fiscal framework had worked well, the fiscal reform has put in place a more comprehensive medium-term fiscal framework. Fiscal policy will have a more effective anchor with a target on the PSBR that is consistent with a sustainable path for public debt. The bias towards procyclical spending will be diminished by the cap on real growth of current structural spending. While it would have been preferable to cap the real growth of all primary spending, the political concerns about limiting investment are understandable, and the current approach still represents an advance. The fiscal reform missed an opportunity to simplify the operations of the oil stabilization funds to transform them into a more effective vehicle for saving oil revenue windfalls. The tax reform includes important steps to enhance the efficiency of the tax system and will help bolster non-oil revenues. However, the increase in non-oil tax revenue is limited, which points to the need for another eventual round of reform. In this regard, it will be essential to preserve the gains coming from the elimination of the subsidy on domestic gasoline prices.

37. Staff supports the government's proposed medium term path for the PSBR. While staff would have preferred a somewhat tighter fiscal stance in 2014, staff agrees that it is not be advisable to initiate fiscal tightening while the economy is still operating below capacity. Moreover, the government is putting in place a more transparent approach to presenting expenditures in the budget, which means that actual outturn for the PSBR should be much more in line with the one presented in the budget. The government is also allowing for some spending related to structural reforms, including the universal pension and unemployment insurance. Staff notes that spending in 2014 is based on a conservative projection for the world price of oil, and urges the authorities to avoid raising spending in the event these prices turn out higher than expected. Importantly, the government has announced that it intends to reduce the PSBR to 2.5 percent of GDP by 2017, and consistent with this commitment, congress has approved several key legal provisions that establish binding caps on the real growth in current structural spending in 2015–2016. It is also important to add that Mexico's public debt would remain on a sustainable path, even under extreme shocks. Nonetheless, it will be essential to avoid any slippages in meeting these targets for the PSBR.

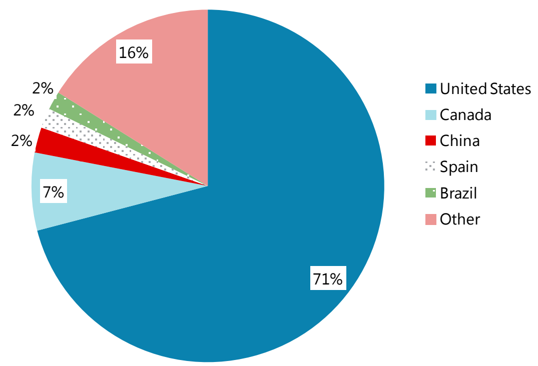
38. The central bank's track record in keeping inflation on target and letting the exchange rate respond to market forces has entrenched the credibility of its policies. Staff supports the current stance of monetary policy in view of the slack in the economy. Going forward, monetary and exchange rate policy are well-positioned to manage tail risks from the global economy, especially those that could arise as the U.S. moves to a less accommodative monetary policy and negotiates the next increase in the limit on debt of the federal government. The FCL arrangement continues to serve as a complement to reserves in the event that global tail risks materialize.

39. The financial sector remains sound, and the recent reform should promote competition and enhance access to the financial system. The financial sector reform is widely expected to foster competition and increase financial inclusion, while at the same time strengthening the regulatory powers of regulators and enhancing consumer protection. The supervision of financial conglomerates is also expected to be bolstered, but concentration risk remains largely unaddressed. The new CNBV powers to establish bank-specific benchmarks to increase lending to non-financial firms and households should be exercised judiciously.

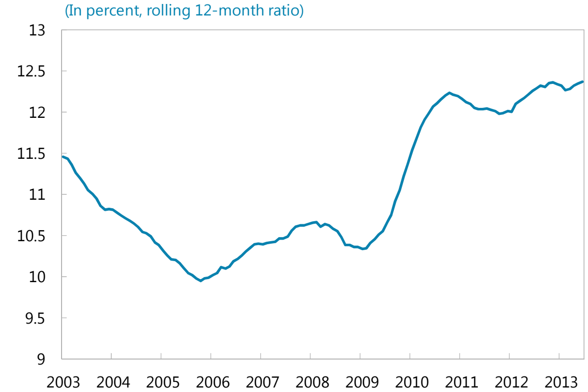
40. It is proposed that the next Article IV consultation with Mexico will take place on the standard 12-month cycle.

Figure 1. Mexico: External Linkages

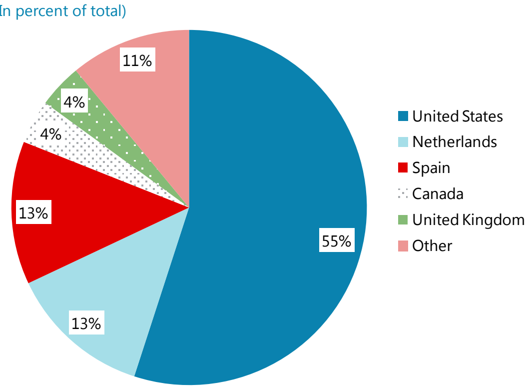
Total Exports by Destination, 2012
(In percent of total)



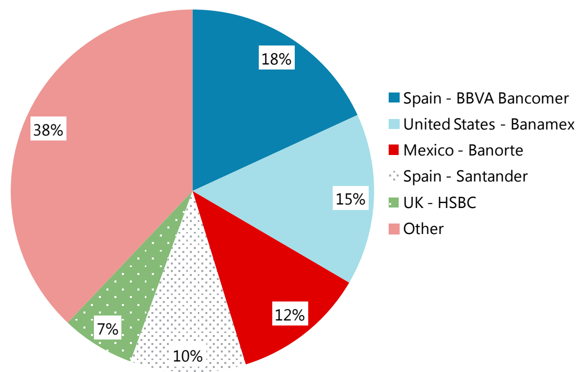
Mexico's Share in U.S. Manufacturing Imports
(In percent, rolling 12-month ratio)



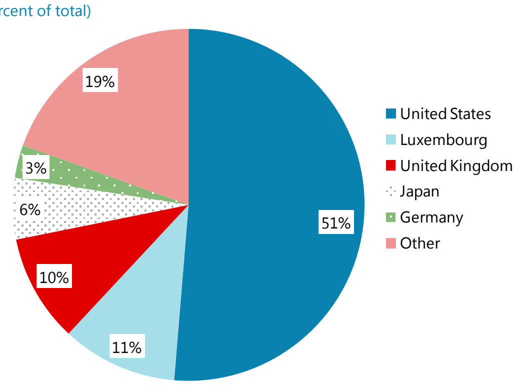
Stock of Inward FDI by Source Country, 2011
(In percent of total)



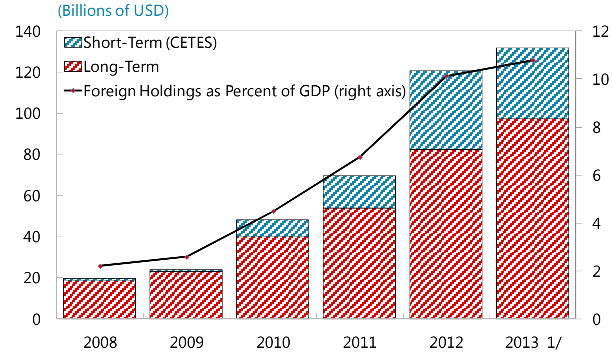
Largest Banks by Primary Country Affiliation
(In percent of total banking system assets)



Foreign Portfolio Liabilities by Source Country, 2011
(In percent of total)



Non-Residents' Holdings of Domestic Sovereign Debt
(Billions of USD)



Sources: Banxico

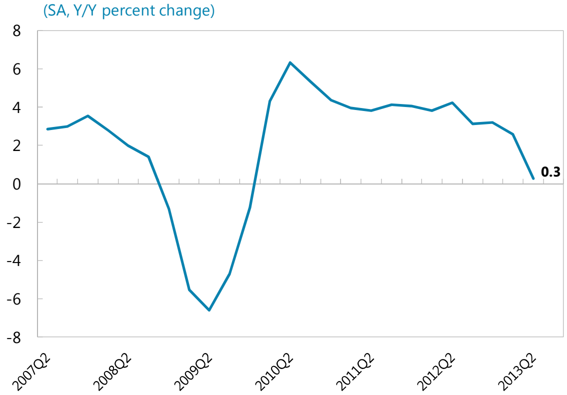
1/ As of October 4, 2013

Sources: Direction of Trade Statistics (2012); Coordinated Portfolio Investment Survey (2011); Coordinated Direct Investment Survey (2011)

Figure 2. Mexico: Real Sector

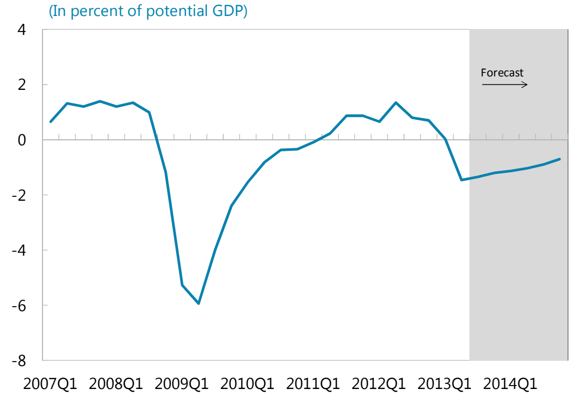
A sharp and unexpected deceleration in economic activity in the first half of 2013…

Real GDP Growth
(SA, Y/Y percent change)



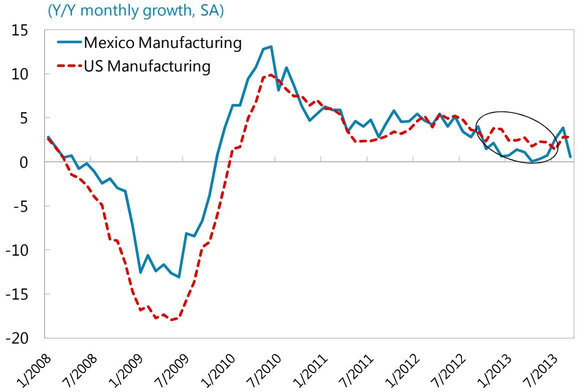
…opened a negative output gap.

Output Gap
(In percent of potential GDP)



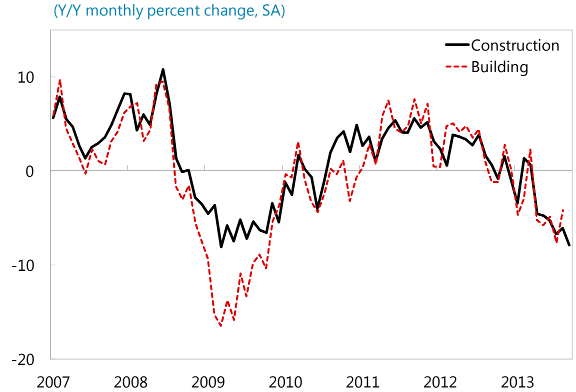
Slow economic activity was driven by sluggish external demand from the US….

Manufacturing
(Y/Y monthly growth, SA)



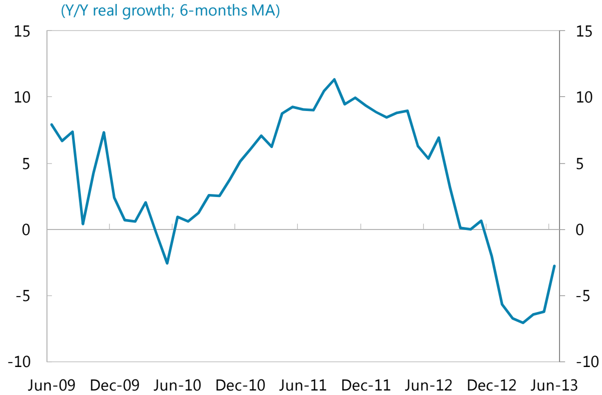
… weak residential construction…

Construction Activity and Components
(Y/Y monthly percent change, SA)



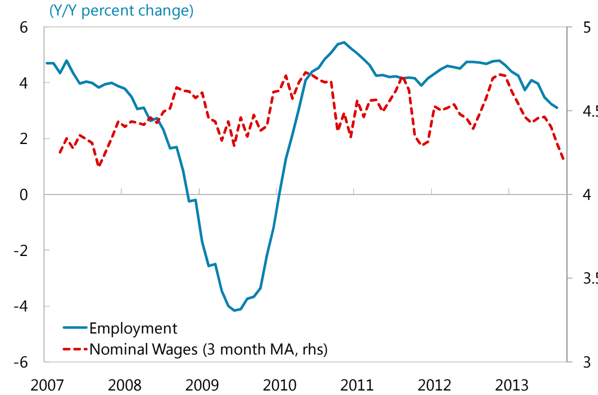
…and lower public spending…

Budgetary Expenditure
(Y/Y real growth; 6-months MA)



…leading to slack conditions in labor markets.

Formal Labor Market
(Y/Y percent change)

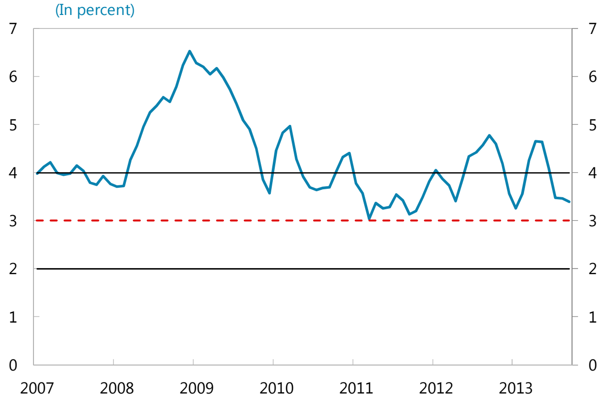


Sources: INEGI, Banxico; Haver Analytics; CNBV; SHCP; Federal Reserve Board; and IMF staff calculations.

Figure 3. Mexico: Prices and Monetary Policy

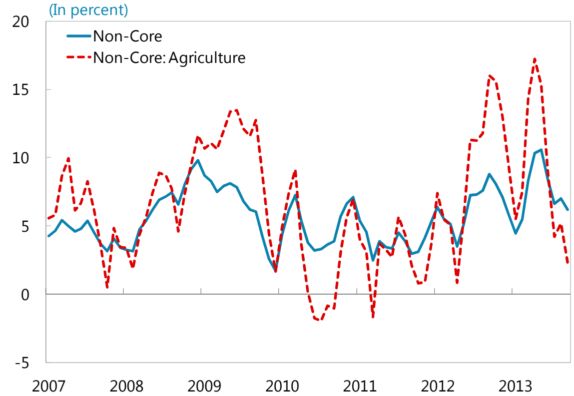
Headline inflation is low and within the target band…

Headline Inflation
(In percent)



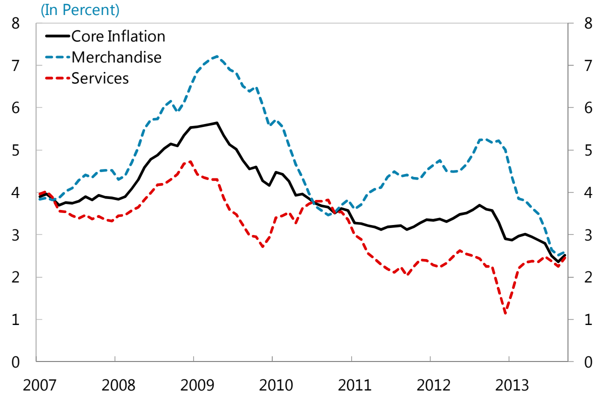
…driven by subsiding agricultural inflation…

Inflation Components
(In percent)



…and historically low core inflation, reflecting lower demand pressures…

Core Inflation: Components
(In Percent)

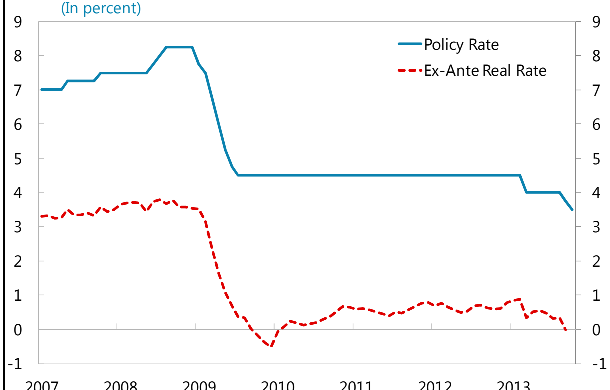


… and low pass through, despite the recent currency depreciation.

Mexico Nominal Exchange Rate
(Pesos/USD)

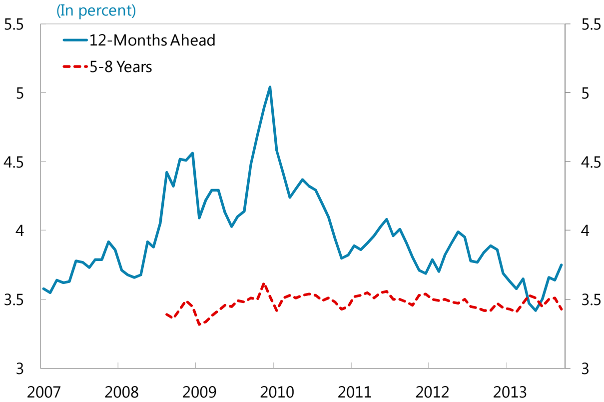
The central bank recently cut the policy rate to 3.5 percent in response to slowing economic activity…

Policy Rate and Real Rate
(In percent)



…amidst well anchored medium term expectations.

Inflation Expectations
(In percent)



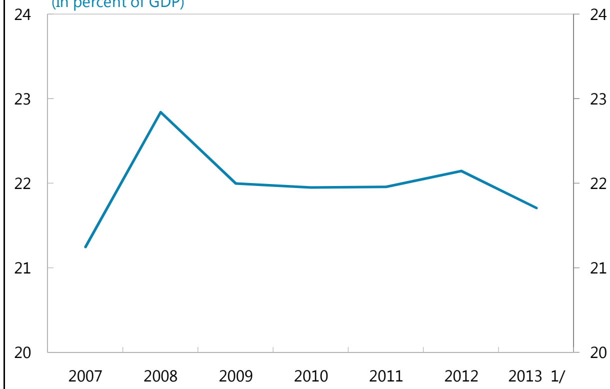
Sources: INEGI; Banxico; and Haver Analytics.

Figure 4. Mexico: Fiscal Sector

Weak total revenue…

Fiscal Revenue 2/

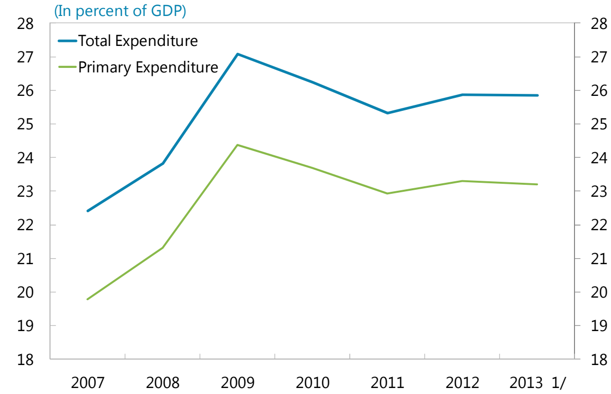
(In percent of GDP)



…in a context of stable total spending…

Fiscal Expenditure 3/

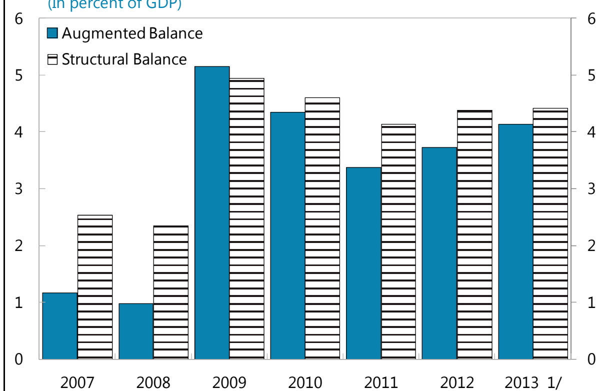
(In percent of GDP)



…are preventing fiscal consolidation…

Fiscal Deficit

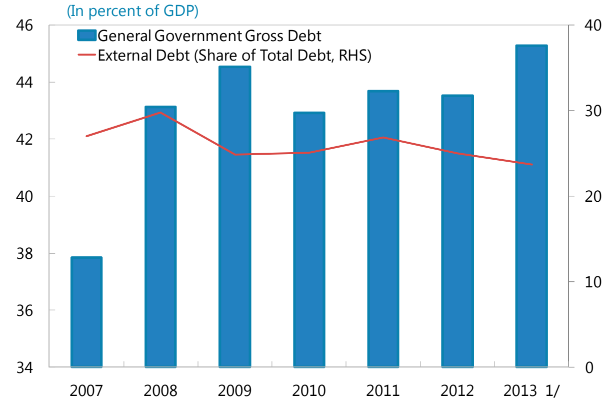
(In percent of GDP)



…yet gross debt levels remain relatively moderate.

General Government Gross Debt

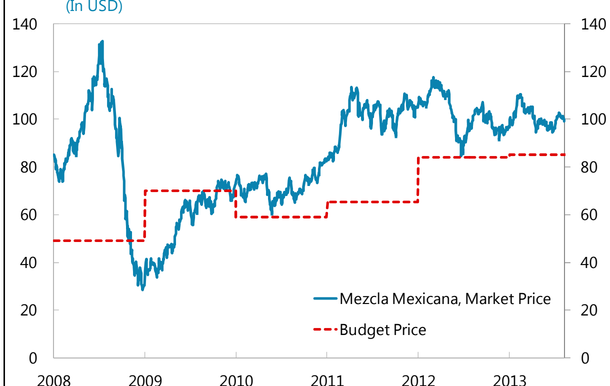
(In percent of GDP)



Oil windalls will likely be lower in the future…

Oil Price and Government Budget Oil Price

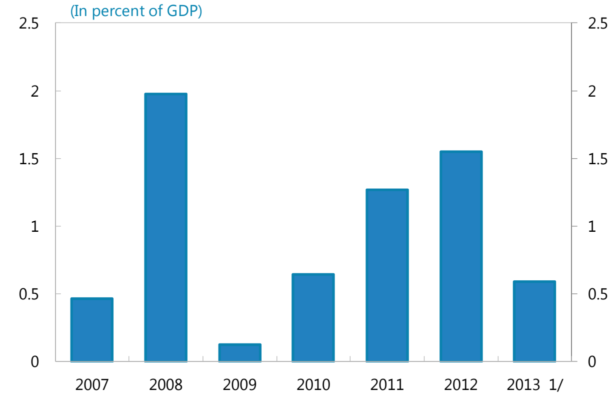
(In USD)



…and the government is already reducing fuel subsidies.

Fuel Subsidy Expenditure

(In percent of GDP)



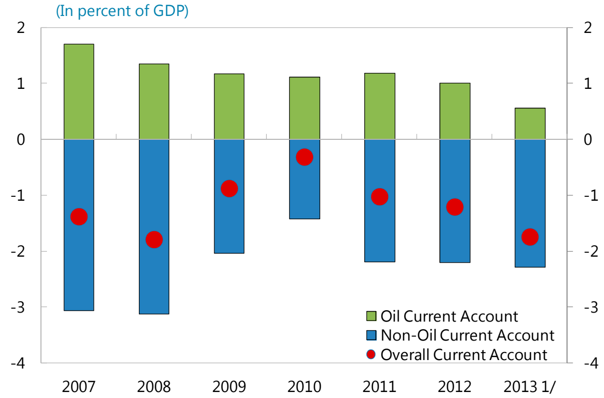
Sources: SHCP; Haver Analytics; Bloomberg; and IMF staff calculations.

1/ IMF staff projections.
2/Budgetary revenue excluding non-recurring revenue.
3/ Total budgetary expenditure consistent with the augmented deficit.

Figure 5. Mexico: External Sector

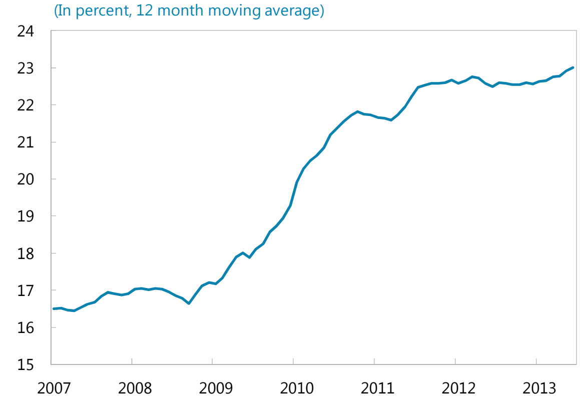
The current account deficit is projected to remain moderate…

Current Account Balance
(In percent of GDP)



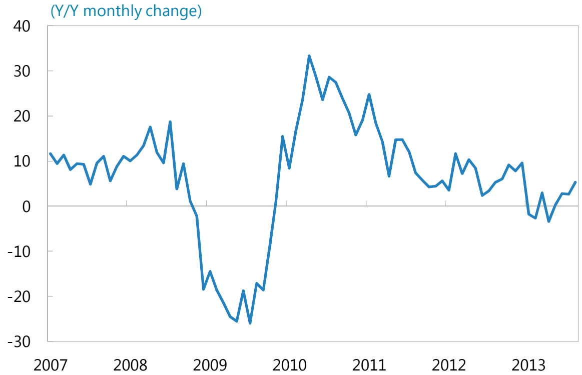
…with vibrant automotive exports,…

Mexico's Share of U.S. Automotive Imports
(In percent, 12 month moving average)



…but more sluggish non-automotive manufacturing exports.

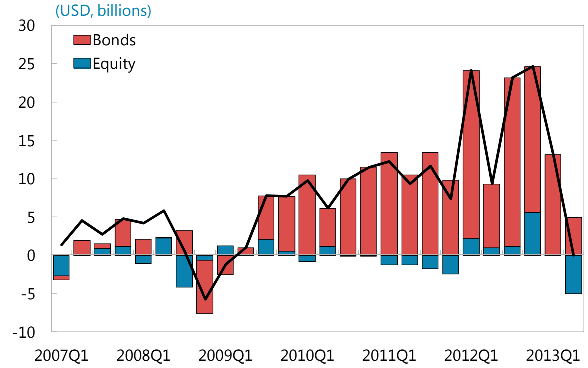
Non-Automotive Manufacturing Exports
(Y/Y monthly change)



Sources: INEGI

Gross portfolio inflows by non-residents came to a sudden stop in the second quarter of 2013…

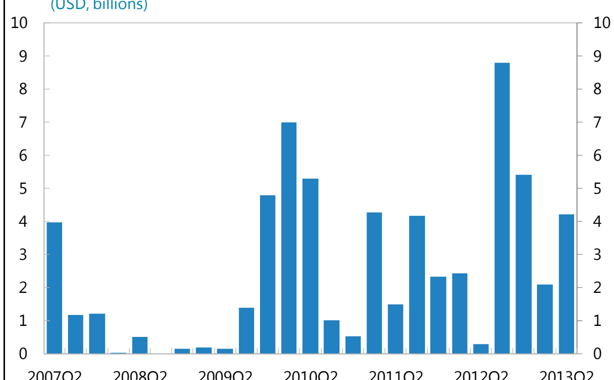
Gross Portfolio Inflows
(USD, billions)



Sources: Haver Analytics

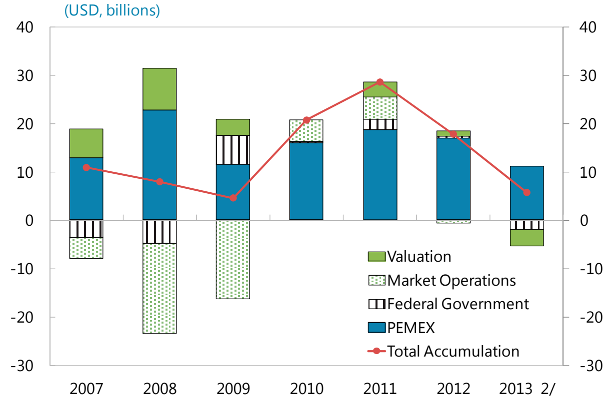
…however, corporate bond issuances held up well after the Fed's tapering announcement on May 22.

Corporate Bond Issuance: Foreign Placements
(USD, billions)



Reserve accumulation is slowing in part due to valuation effects from an increase US 10 year yields.

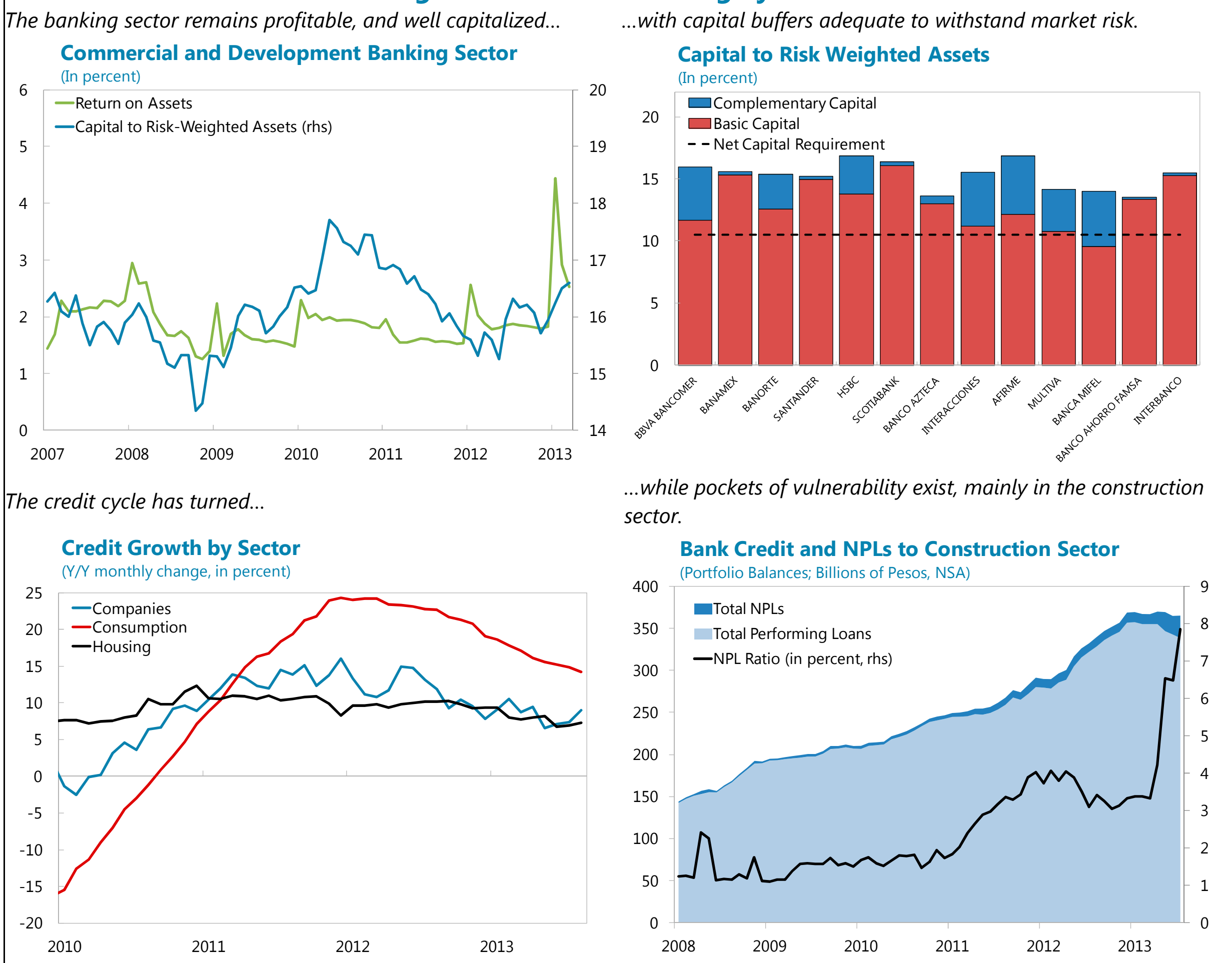
Sources of Reserve Accumulation
(USD, billions)



Sources: INEGI; Banxico; Haver Analytics; EPFR; and IMF staff calculations.

1/ IMF staff projections.
2/ Data through June 2013.

Figure 6. Mexico: Banking System



Sources: INEGI; Banxico; Haver Analytics; Dealogic; Bloomberg; and IMF staff calculations.

Table 1. Selected Economic, Financial, and Social Indicators, 2009–2014

I. Social and Demographic Indicators

GDP per capita (U.S. dollars, 2012)	10,063	Poverty headcount ratio (% of population, 2010) 1/	51.3
Population (millions, 2012)	117.1	Income share of highest 20 percent / lowest 20 percent	11.3
Life expectancy at birth (years, 2012)	74.3	Adult illiteracy rate (2011-2012)	6.4
Infant mortality rate (per thousand, 2012)	13.2	Gross primary education enrollment rate (2010)	114.1

II. Economic Indicators

	2009	2010	2011	2012	Proj. 2013	Proj. 2014
(Annual percentage change, unless otherwise indicated)						
National accounts in constant prices						
Real GDP	-4.5	5.1	4.0	3.6	1.2	3.0
External sector						
Exports of goods, f.o.b.	-21.2	29.9	17.1	6.1	2.6	5.0
Export volume	-7.7	15.8	2.2	9.0	2.4	5.3
Imports of goods, f.o.b.	-24.1	28.5	16.4	5.7	3.8	5.7
Import volume	-21.1	23.2	8.5	4.6	3.5	5.8
Terms of trade (deterioration -)	-11.2	7.6	6.8	-3.6	-0.2	-0.1
Exchange rates						
Nominal exchange rate (US$/Mex$)						
(average, depreciation -)	-17.6	6.9	1.7	-5.7	...	...
Real effective exchange rate (CPI based)						
(average, depreciation -)	-12.4	8.6	0.4	-2.9	8.4	0.9
Employment and inflation						
Consumer prices (annual average)	5.3	4.2	3.4	4.1	3.6	3.0
Formal sector employment, IMSS-insured workers (annual average)	-3.1	3.8	4.3	4.6	...	...
National unemployment rate (annual average)	5.5	5.4	5.2	5.0	4.8	4.5
Unit labor costs: manufacturing (real terms, annual average)	1.1	-6.7	-1.8	-2.8	...	...
Money and credit						
Bank credit to non-financial private sector (nonminal percent growth) 2/	-1.0	10.0	17.2	12.0	11.0	11.0
Broad money (M4a)	6.1	12.0	15.7	14.5	9.6	9.6
(In percent of GDP)						
Nonfinancial public sector						
Government revenue	23.3	22.4	22.7	22.7	22.8	22.9
Government expenditure	25.6	25.2	25.2	25.3	25.2	25.7
Traditional balance 3/	-2.3	-2.8	-2.5	-2.6	-2.4	-3.5
Augmented balance 4/	-5.1	-4.3	-3.4	-3.7	-4.1	-4.1
Gross public sector debt	43.9	42.4	43.6	43.5	45.3	46.8
Savings and investment						
Gross domestic investment 5/	22.9	22.1	22.4	22.9	21.3	21.5
Public	6.0	5.6	5.3	5.4	5.0	5.1
Private	16.5	15.5	16.6	17.2	16.3	16.3
Gross domestic saving 5/	22.2	21.9	21.5	21.7	19.6	19.6
Public 6/	0.8	0.9	1.4	1.2	0.4	0.5
Private	21.4	21.0	20.1	20.5	19.3	19.1
External current account balance	-0.9	-0.3	-1.0	-1.2	-1.7	-1.9
Memorandum items						
Gross external debt (in percent of GDP, end of period)	21.8	23.7	24.3	29.4	29.0	29.1
Total external debt service (in percent of exports and other FX income) 6/	6.7	4.8	4.9	4.8	5.3	5.5
Crude oil export price, Mexican mix (US$/bbl)	57.4	72.5	101.1	101.8	101.3	98.3

Sources: World Bank Development Indicators; CONEVAL; National Institute of Statistics and Geography; National Council of Population; Bank of Mexico; Secretariat of Finance and Public Credit; and IMF staff estimates.

Note: All national accounts data is seasonally adjusted, with base year 2008.
1/ Broadest national definition (CONEVAL).
2/ Total bank credit outstanding plus non-performing loans from commercial and development banks.
3/ Authorities' definition. The break in the series in 2009 is due to definitional and accounting changes of PIDIREGAS.
4/ Federal Government plus Social Security and State-owned Companies, excl. nonrecurring revenue and transfers to stabilization funds.
5/ Difference in historical series between aggregate and public/private breakdown is due to rounding decimals and statistical discrepancies.
6/ Estimated as the difference between the augmented fiscal balance, as reported by SHCP, and public investment, as reported in the national accounts.

Table 2. Mexico: Financial Operations of the Public Sector, 2009–2018

(In percent of GDP)

	2009	2010	2011	2012	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
Budgetary revenue, by type	**23.3**	**22.4**	**22.7**	**22.7**	**22.8**	**22.9**	**23.0**	**22.8**	**22.9**	**23.0**
Oil revenue	7.2	7.4	7.6	7.6	7.5	7.8	7.7	7.5	7.6	7.7
Crude oil export value		3.4	4.3	4.0	3.4	3.1	3.0	2.8	2.8	3.0
Net sales oil derivatives		3.3	2.8	3.2	3.6	4.2	4.2	4.3	4.3	4.2
Net sales natural gas		0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Net sales petrochemicals		0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Non-oil tax revenue 1/	9.3	9.9	10.0	9.8	10.0	10.5	10.6	10.6	10.6	10.6
Income taxes	4.8	5.1	5.3	5.2	5.3	5.4	5.5	5.5	5.5	5.6
VAT	3.4	3.8	3.7	3.7	3.8	3.9	4.0	4.0	4.0	4.0
Excises (excl. fuel excises)	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Other taxes (import tariffs; IDE; automotive taxes; payroll taxes	0.8	0.6	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Non-oil non-tax revenue	6.8	5.1	5.1	5.2	5.3	4.7	4.7	4.7	4.7	4.7
Budgetary revenue, by entity	23.3	22.4	22.7	22.7	22.8	22.9	23.0	22.8	22.9	23.0
Federal government revenue	16.5	15.7	16.1	15.8	16.7	17.4	17.6	17.8	18.0	17.9
Tax revenue, *of which:*	9.3	9.5	9.0	8.5	9.4	10.4	10.9	11.1	11.4	11.5
excises (including fuel)	0.4	0.0	-0.5	-0.8	-0.1	0.6	0.9	1.1	1.3	1.4
Nontax revenue	7.2	6.2	7.1	7.3	7.3	7.0	6.8	6.6	6.6	6.4
Public enterprises	6.8	6.7	6.6	6.8	6.1	5.5	5.4	5.1	5.0	5.1
PEMEX	3.2	2.9	2.7	3.0	2.3	1.8	1.7	1.4	1.3	1.4
Other	3.6	3.7	3.9	3.9	3.8	3.7	3.7	3.7	3.7	3.7
Budgetary expenditure	**25.6**	**25.2**	**25.2**	**25.3**	**25.2**	**26.4**	**26.0**	**25.3**	**24.9**	**25.0**
Primary	23.4	23.3	23.3	23.3	23.1	23.7	23.5	22.9	22.4	22.4
Programmable	20.2	19.8	19.8	20.0	19.8	20.2	20.0	19.5	18.9	18.9
Current	15.1	14.8	15.0	15.2	15.4	15.8	15.6	15.6	15.4	15.4
Wages	6.3	6.0	6.0	6.0	6.0	5.9	5.8	5.8	5.8	5.7
Pensions	2.4	2.6	2.7	2.8	2.9	3.3	3.4	3.5	3.6	3.7
Subsidies and transfers	2.9	2.8	3.1	3.2	3.2	3.4	3.3	3.2	3.1	3.0
Other	3.5	3.3	3.2	3.3	3.3	3.2	3.1	3.0	3.0	2.9
Capital	5.0	5.0	4.9	4.8	4.3	4.4	4.4	3.9	3.5	3.6
Physical capital	4.5	4.7	4.5	4.4	4.3	4.4	4.4	3.9	3.5	3.6
Of which: non Pemex	*2.5*	*2.7*	*2.7*	*2.4*	*2.3*	*2.4*	*2.4*	*1.9*	*1.5*	*1.6*
Financial capital 2/	0.5	0.3	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Nonprogrammable	3.2	3.5	3.4	3.3	3.4	3.5	3.5	3.5	3.5	3.5
Of which: revenue sharing	3.1	3.3	3.3	3.2	3.3	3.4	3.4	3.4	3.4	3.4
Interest payments 3/	2.2	1.9	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.6
Unallocated buffers 4/	...	...	...	...	...	0.5	0.2	0.0	0.0	0.0
Traditional balance 5/	**-2.3**	**-2.8**	**-2.5**	**-2.6**	**-2.4**	**-3.5**	**-3.0**	**-2.5**	**-2.0**	**-2.0**
Traditional balance for balanced budget rule	-0.2	-0.8	-0.6	-0.6	-0.4	-1.5	-1.0	-0.5	0.0	0.0
Adjustments to the traditional balance	**2.8**	**1.5**	**0.9**	**1.1**	**1.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
PIDIREGAS	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
IPAB	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Budgetary adjustments	0.3	0.4	0.2	0.5	0.6	0.3	0.3	0.2	0.2	0.2
PEMEX, oil stabilization fund, FARP (-: net inflows)	1.2	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FARAC/FONADIN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debtor support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development banks (changes in capital)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Nonrecurring revenue	1.3	0.4	0.7	0.5	1.1	0.2	0.2	0.2	0.2	0.2
Augmented balance 6/	**-5.1**	**-4.3**	**-3.4**	**-3.7**	**-4.1**	**-4.1**	**-3.6**	**-3.0**	**-2.5**	**-2.5**
Augmented interest expenditure 7/	2.7	2.5	2.4	2.6	2.6	2.7	2.8	2.9	3.1	3.2
Augmented primary balance	-2.4	-1.7	-1.0	-1.2	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Memorandum items										
Total revenue 8/	22.0	22.0	22.0	22.1	21.7	22.7	22.8	22.6	22.7	22.8
Total expenditure 9/	27.1	26.2	25.3	25.9	25.9	26.8	26.4	25.7	25.3	25.3
Total primary expenditure 10/	24.4	23.7	22.9	23.3	23.2	24.1	23.6	22.8	22.2	22.1
Structural current spending 11/	13.7	13.0	13.0	13.1	13.0	12.9	12.7	12.5	12.3	12.1
Structural current spending real growth (y/y, in percent) 11/	4.7	-0.3	5.7	4.6	0.7	3.0	2.0	2.0	2.0	2.0
Crude oil export price, Mexican mix (US$/bbl)	57	72	101	102	101	98	92	88	86	84
Non-oil augmented balance 12/	-9.1	-8.4	-8.1	-8.3	-8.6	-8.8	-8.2	-7.5	-7.1	-7.2
Structural Primary Fiscal Balance	-2.4	-2.2	-1.9	-1.9	-1.8	-1.5	-0.8	-0.2	0.6	0.9
Fiscal Impulse 13/	2.5	-0.2	-0.3	0.0	-0.1	-0.3	-0.7	-0.7	-0.8	-0.2
Gross public sector debt	43.9	42.4	43.6	43.5	45.3	46.8	47.6	47.7	47.2	46.7
Domestic (percentage of total debt)	75.2	74.9	73.2	75.0	76.3	76.6	76.9	76.8	76.6	76.3
External (percentage of total debt)	24.8	25.1	26.8	25.0	23.7	23.4	23.1	23.2	23.4	23.7
Net public sector debt	36.3	36.4	37.8	38.0	39.7	41.2	42.0	42.1	41.6	41.2
Nominal GDP (billions of Mexican pesos)	12,089	13,226	14,420	15,506	16,359	17,428	18,592	19,858	21,230	22,689

Sources: Mexican authorities and IMF staff estimates. Data refer to non-financial public sector, including PEMEX and other public entities but excluding state and local governments (except as noted).

1/ Total tax revenue excluding excise tax on gasoline.
2/ Due to lack of disaggregated data this item includes both financing and capital transfers.
3/ Includes transfers to IPAB and debtor support programs.
4/ Given by revenue assumptions based on a higher-than-budgeted oil price. Specific allocations will be determined when revenue materializes.
5/ The break in the series in 2009 is due to definitional and accounting changes.
6/ Public Sector Borrowing Requirements.
7/ Treats transfers to IPAB as interest payments.
8/ Budgetary revenue, excluding nonrecurrent revenue.
9/ Budgetary expenditure, including adjustments to the traditional balance with the exception of adj. for nonrecurrent revenue.
10/ Total expenditure minus augmented interest payments.
11/ Total budgetary spending, excluding: (i) interest payments; (ii) non-programable spending; (iii) fuel costs of CFE; and (iv) direct physical and financial investment of the federal government.
12/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, excise tax on gasoline) and PEMEX operational and physical capital expenditure.
13/ Negative of the change in the structural primary fiscal balance, measured adjusting tax revenue for the cycle and oil net exports using a long-term moving average of oil prices.

Table 3. Mexico: Summary Balance of Payments, 2009–2018

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Staff Projections					
					(In billions of U.S. dollars)					
Current account	-7.7	-3.2	-11.8	-14.2	-22.4	-26.0	-28.5	-28.9	-30.0	-30.2
Merchandise trade balance, f. o. b.	-4.7	-3.0	-1.5	0.0	-5.1	-8.0	-10.2	-10.7	-9.9	-6.5
Exports	229.7	298.5	349.4	370.7	380.2	399.4	428.5	462.1	502.7	549.7
Of which:										
Petroleum and derivatives	30.8	41.7	56.4	52.9	48.9	47.0	47.5	46.3	49.7	54.8
Manufactures	189.7	245.7	278.6	302.0	315.0	335.1	364.7	400.6	439.3	476.5
Imports	-234.4	-301.5	-350.8	-370.8	-385.3	-407.4	-438.7	-472.8	-512.6	-556.3
Petroleum and derivatives	-20.5	-30.2	-42.7	-41.1	-41.8	-41.8	-40.7	-40.4	-40.5	-40.1
Factor Income	-14.2	-11.3	-18.8	-22.4	-24.5	-25.6	-26.3	-26.8	-29.2	-33.1
Net services	-10.2	-10.6	-14.8	-14.6	-15.7	-16.2	-16.7	-17.3	-17.9	-18.7
Net transfers	21.6	21.5	23.0	22.6	22.9	23.7	24.8	25.9	27.0	28.2
Of which: Remittances	21.3	21.3	22.8	22.4	…	…	…	…	…	…
Financial account	15.4	43.5	50.7	48.4	49.9	41.0	43.6	43.7	45.8	45.9
Public sector 1/	11.9	33.3	37.0	56.9	23.6	19.0	17.9	13.9	14.9	15.9
Medium- and long-term borrowing	8.0	10.2	5.3	10.2	8.0	7.5	8.2	8.9	9.6	10.3
Disbursements	19.1	18.8	14.6	18.3	18.1	18.5	19.0	17.7	18.4	19.1
Amortization 2/	11.1	8.7	9.3	8.0	10.1	11.0	10.8	8.8	8.8	8.8
Pidiregas, net 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other, including short-term borrowing and change in assets	4.0	23.1	31.6	46.6	15.6	11.5	9.7	5.0	5.3	5.6
Of which: oil hedging capital income	5.1	…	…	…	…	…	…	…	…	…
Private sector	3.4	10.2	13.8	-8.5	26.3	22.0	25.6	29.8	30.9	30.0
Direct investment, net	7.0	7.5	10.9	-8.0	20.1	20.2	21.1	21.9	22.8	23.7
Bonds and loans	-7.6	35.0	7.4	5.7	2.1	-2.5	0.0	3.0	2.9	0.7
Equity investments and change in assets abroad	-9.4	-30.5	-4.7	9.9	4.0	4.3	4.5	4.9	5.2	5.6
Errors and omissions and valuation adjustments	-3.1	-19.6	-10.3	-16.4	-10.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase -)	-5.4	-22.8	-28.9	-21.0	-17.5	-15.0	-15.1	-14.8	-15.8	-15.7
					(In percent of GDP, unless otherwise indicated)					
Memorandum items										
Current account balance	-0.9	-0.3	-1.0	-1.2	-1.7	-1.9	-2.0	-1.9	-1.9	-1.8
Nonoil current account balance 4/	-2.0	-1.4	-2.2	-2.2	-2.3	-2.3	-2.5	-2.3	-2.5	-2.7
Nonoil trade balance	-1.7	-1.4	-1.3	-1.0	-1.0	-1.0	-1.2	-1.1	-1.2	-1.3
Oil trade balance	1.2	1.1	1.2	1.0	0.6	0.4	0.5	0.4	0.6	0.9
Gross financing needs (billions of US$) 4/	73.3	76.7	117.8	114.3	120.5	128.1	145.6	147.4	160.5	165.6
Gross international reserves (change, billions of US$) 5/	4.6	20.7	28.6	17.8	17.5	15.0	15.1	14.8	15.8	15.7
End-year (billions of US$)	99.9	120.6	149.2	167.1	184.6	199.5	214.7	229.4	245.2	261.0
Months of imports of goods and services	5.1	4.8	5.1	5.4	5.7	5.9	5.9	5.8	5.7	5.6
Months of imports plus interest payments	4.7	4.5	4.7	5.0	5.3	5.4	5.4	5.4	5.3	5.1
Percent of broad money	17.2	17.5	21.2	19.3	19.3	19.4	19.2	18.9	18.5	18.1
Percent of foreign portfolio liabilities	41.6	39.6	48.2	39.0	39.3	40.9	42.1	43.2	44.3	45.2
Percent of short-term debt (by residual maturity) 6/	154.9	174.0	180.4	194.2	207.4	209.3	217.6	223.3	229.6	232.9
Crude oil export volume (millions of bbl/day)	1.2	1.4	1.3	1.3	1.2	1.2	1.3	1.3	1.3	1.3
Crude oil export price, Mexican mix (US$/bbl)	57.4	72.5	101.1	101.8	101.3	98.3	92.4	88.5	85.8	84.0
Gross total external debt	21.8	23.7	24.3	29.4	29.0	29.2	28.9	28.5	28.0	27.4
Of which: Public external debt	13.4	15.2	16.0	21.0	21.1	21.7	21.9	21.6	21.3	21.1
Gross total external debt (billions of US$)	195.0	247.9	282.2	346.9	372.6	389.1	407.0	423.9	441.7	458.3
Of which: Public external debt	120.4	158.9	186.2	246.9	270.5	289.5	307.4	321.3	336.2	352.1
External debt service (in percent of exports and other FX)	6.7	4.8	4.9	4.8	5.3	5.5	5.3	4.7	4.5	4.6
					(Annual percentage change)					
Export volume	-7.7	15.8	2.2	9.0	2.4	5.3	7.9	7.9	8.2	8.6
Non-oil exports	-7.3	17.3	3.3	9.8	4.0	6.2	8.0	8.6	7.9	8.2
Import volume	-21.1	23.2	8.5	4.6	3.5	5.8	8.6	8.0	8.1	8.1
Consumer goods	-31.8	23.7	19.6	5.3	2.1	6.3	6.3	5.3	5.4	5.2
Intermediate goods	-19.0	29.3	6.1	7.5	5.2	8.4	8.1	9.6	10.1	9.8
Capital goods	-22.4	-3.9	10.8	11.8	-5.4	-12.7	16.9	0.2	-5.7	-4.5

Sources: Bank of Mexico; Secretary of Finance and and Public Credit< and IMF staff projections.

1/ Including the financing of PIDIREGAS.

2/ Includes pre-payment of external debt.

3/ Break in the series in 2009 due to accounting changes.

4/ Excluding oil exports and petroleum products imports.

5/ Excludes balances under bilateral payments accounts. For 2009, includes the allocation of SDR 2.337 billion in the general allocation implemented on August 28, 2009, and another SDR 0.224 billion in the special allocation on September 9.

6/ In percent of short-term debt by residual maturity. Historical data include all prepayments.

7/ Includes gross external debt of the federal gobvernment, development banks and nonfinancial public enterprises, and is adjusted for PIDIREGAS.

8/ Includes amortization on medium and long-term bonds and debt, and interest payments.

Table 4. Mexico: Financial Soundness Indicators, 2009–2013

(in percent)

	2009	2010	2011	2012	2013 1/
Capital Adequacy					
Regulatory capital to risk-weighted assets	15.9	17.1	16.4	15.8	16.6
Regulatory Tier 1 capital to risk-weighted assets	14.0	15.1	14.3	13.8	14.9
Capital to assets	9.8	10.8	10.0	10.5	11.1
Gross asset position in financial derivatives to capital	82.3	65.1	72.8	78.4	74.2
Gross liability position in financial derivatives to capital	85.5	65.8	72.6	78.1	72.5
Asset Quality 2/					
Nonperforming loans to total outstanding loans 3/	3.7	2.8	2.9	2.9	4.0
Provisions to Nonperforming loans	157.2	175.2	176.4	179.8	174.2
Earnings and Profitability					
Return on assets	1.6	2.0	1.6	1.9	2.5
Return on equity	17.2	18.1	15.9	18.3	23.1
Liquidity					
Liquid assets to short-term liabilities	56.7	56.8	56.9	50.9	47.3
Liquid assets to total assets	41.5	41.8	42.5	37.7	35.0
Customer deposits to total (noninterbank) loans	88.8	85.9	82.8	88.6	87.3

Sources: Financial Soundness Indicators

1/ As of March 2013.

2/ Data on asset quality is as of September 2013.

3/ Includes both commerical and development bank loans to the non-financial private sector.

Table 5. Mexico: Indicators of External Vulnerability, 2009–2013

	2008	2009	2010	2011	2012	2013 Latest 1/
Financial market indicators						
Exchange rate (per U.S. dollar, end-period)	13.5	13.1	12.4	14.0	13.0	12.9
(year-to-date percent change, + depreciation)	24.6	-3.5	-5.4	13.2	-7.0	-0.6
28-day treasury auction rate (percent; period average)	7.7	5.4	4.4	4.2	4.2	3.8
EMBIG Mexico (basis points; period average)	254	301	186	186	188	186
Stock exchange index in U.S. dollar terms (year on year percent change)	-39.2	48.8	26.8	-15.0	26.8	-9.4
Financial system						
Bank of Mexico net international reserves (US$ billion)	85.4	90.8	113.6	142.5	163.5	172.1
Real credit to the non-financial private sector (12-month percent change)	8.0	-6.0	5.6	13.3	7.6	7.1
Commercial banks' nonperforming loans (percent of loans granted to non-financial private sector)	2.7	3.7	2.8	2.9	2.9	4.0
Exports and imports						
Trade balance (US$ billion; year-to-date)	-17.3	-4.7	-3.0	-1.5	0.0	-3.3
Exports of goods (year to date, annual percentage change) 2/	7.2	-21.2	29.9	17.1	6.1	2.6
Of which						
Non-oil	5.2	-17.4	29.1	14.1	8.5	2.6
Imports of goods (year to date, annual percentage change) 2/	9.5	-24.0	28.6	16.4	5.7	3.8
Of which						
Consumer goods	11.3	-31.5	26.2	25.0	4.8	8.3
Capital goods	16.4	-21.6	-1.3	15.8	10.1	4.3
Terms of trade (12-month percent change)	1.3	-11.2	7.6	6.8	-3.6	-0.2
Real effective exchange rate (CPI based; 12 month percent change, eop) 3/	-12.1	2.6	6.7	-9.3	8.9	4.7
External Debt						
Non-financial public sector external debt (percent of GDP) 4/	11.9	13.4	15.2	16.0	21.0	21.1
Private sector external debt (percent of GDP) 4/	6.7	8.3	8.5	8.2	7.6	6.8
Memorandum items:						
Gross international reserves to short-term debt (by residual maturity, percent)	147.0	154.9	174.0	180.4	194.2	207.4
Monetary base to gross international reserves (percent)	44.8	48.5	46.5	36.6	39.1	33.4
Gross international reserves to M2	19.1	18.3	19.4	24.4	24.8	24.9

Sources: Bank of Mexico; National Banking and Securities Commission; National Institute of Statistics and Geography; Secretary of Finance and Public Credit; and IMF staff estimates

1/ Financial market indicators data as of September, all other data as of August.
2/ In U.S. dollar terms.
3/ Increase represents appreciation.
4/ Projections for end-year 2013.

Table 6. Mexico: Baseline Medium Term Projections, 2009–2018

					Staff projections					
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
	(Annual percentage change, unless otherwise indicated)									
National income and prices										
Real GDP	-4.5	5.1	4.0	3.6	1.2	3.0	3.5	3.7	3.8	3.8
Consumer prices (end of year)	3.6	4.4	3.8	3.6	3.4	3.0	3.0	3.0	3.0	3.0
Consumer prices (average)	5.3	4.2	3.4	4.1	3.6	3.0	3.0	3.0	3.0	3.0
External sector										
Non-oil current account balance (as a share of GDP) 1/	-2.0	-1.4	-2.2	-2.2	-2.3	-2.3	-2.5	-2.3	-2.5	-2.7
Exports, f.o.b.	-21.2	29.9	17.1	6.1	2.6	5.0	7.3	7.8	8.8	9.3
Imports, f.o.b.	-24.1	28.5	16.4	5.7	3.8	5.7	7.7	7.8	8.4	8.5
Terms of trade (deterioration -)	-11.2	7.6	6.8	-3.6	-0.2	-0.1	0.2	0.2	0.2	0.3
Oil export price (US$ / bbl)	57.4	72.5	101.1	101.8	101.3	98.3	92.4	88.5	85.8	84.0
	(In percent of GDP)									
Non-financial public sector										
Public sector borrowing requirement	-5.1	-4.3	-3.4	-3.7	-4.1	-4.1	-3.6	-3.0	-2.5	-2.5
Primary balance	-2.4	-1.7	-1.0	-1.2	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Saving and investment										
Gross domestic investment 2/	22.9	22.1	22.4	22.9	21.3	21.5	21.9	22.4	22.8	23.3
Fixed investment	22.5	21.2	21.9	22.6	21.3	21.4	21.9	22.3	22.7	23.3
Public	6.0	5.6	5.3	5.4	5.0	5.1	5.2	5.1	4.6	4.7
Private	16.5	15.5	16.6	17.2	16.3	16.3	16.7	17.3	18.1	18.6
Gross domestic saving 2/	22.2	21.9	21.5	21.7	19.6	19.6	19.9	20.5	20.9	21.5
Public	0.8	0.9	1.4	1.2	0.4	0.5	1.1	1.5	1.6	1.7
Private	21.4	21.0	20.1	20.5	19.3	19.1	18.8	18.9	19.3	19.9
Current account balance	-0.9	-0.3	-1.0	-1.2	-1.7	-1.9	-2.0	-1.9	-1.9	-1.8

Sources: Bank of Mexico; National Institute of Statistics and Geography; Secretary of Finance and Public Credit; and IMF staff projections.

Note: All national accounts data is seasonally adjusted, with base year 2008.

1/ Excluding oil exports and petroleum products imports.

2/ Difference in historical series between aggregate and public/private breakdown is due to rounding decimals and statistical discrepancies.

Table 7. Mexico: Statement of Operations of Non-financial Public Sector, 2006–2012 1/

(In percent of GDP)

	2009	2010	2011	2012	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
Budgetary revenue, by type	**23.3**	**22.4**	**22.7**	**22.7**	**22.8**	**22.9**	**23.0**	**22.8**	**22.9**	**23.0**
Oil revenue	7.2	7.4	7.6	7.6	7.5	7.8	7.7	7.5	7.6	7.7
Non-oil tax revenue 1/	9.3	9.9	10.0	9.8	10.0	10.5	10.6	10.6	10.6	10.6
Non-oil non-tax revenue	6.8	5.1	5.1	5.2	5.3	4.7	4.7	4.7	4.7	4.7
Budgetary revenue, by entity	23.3	22.4	22.7	22.7	22.8	22.9	23.0	22.8	22.9	23.0
Federal government revenue	16.5	15.7	16.1	15.8	16.7	17.4	17.6	17.8	18.0	17.9
Tax revenue, *of which:*	9.3	9.5	9.0	8.5	9.4	10.4	10.9	11.1	11.4	11.5
excises (including fuel)	0.4	0.0	-0.5	-0.8	-0.1	0.6	0.9	1.1	1.3	1.4
Nontax revenue	7.2	6.2	7.1	7.3	7.3	7.0	6.8	6.6	6.6	6.4
Public enterprises	6.8	6.7	6.6	6.8	6.1	5.5	5.4	5.1	5.0	5.1
PEMEX	3.2	2.9	2.7	3.0	2.3	1.8	1.7	1.4	1.3	1.4
Other	3.6	3.7	3.9	3.9	3.8	3.7	3.7	3.7	3.7	3.7
Budgetary expenditure	**25.6**	**25.2**	**25.2**	**25.3**	**25.2**	**26.4**	**26.0**	**25.3**	**24.9**	**25.0**
Primary	23.4	23.3	23.3	23.3	23.1	23.7	23.5	22.9	22.4	22.4
Programmable	20.2	19.8	19.8	20.0	19.8	20.2	20.0	19.5	18.9	18.9
Current	15.1	14.8	15.0	15.2	15.4	15.8	15.6	15.6	15.4	15.4
Wages	6.3	6.0	6.0	6.0	6.0	5.9	5.8	5.8	5.8	5.7
Pensions	2.4	2.6	2.7	2.8	2.9	3.3	3.4	3.5	3.6	3.7
Subsidies and transfers	2.9	2.8	3.1	3.2	3.2	3.4	3.3	3.2	3.1	3.0
Other	3.5	3.3	3.2	3.3	3.3	3.2	3.1	3.0	3.0	2.9
Capital	5.0	5.0	4.9	4.8	4.3	4.4	4.4	3.9	3.5	3.6
Physical capital	4.5	4.7	4.5	4.4	4.3	4.4	4.4	3.9	3.5	3.6
Of which: non Pemex	*2.5*	*2.7*	*2.7*	*2.4*	*2.3*	*2.4*	*2.4*	*1.9*	*1.5*	*1.6*
Financial capital 2/	0.5	0.3	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Nonprogrammable	3.2	3.5	3.4	3.3	3.4	3.5	3.5	3.5	3.5	3.5
Of which: revenue sharing	3.1	3.3	3.3	3.2	3.3	3.4	3.4	3.4	3.4	3.4
Interest payments 3/	2.2	1.9	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.6
Unallocated buffers 4/	…	…	…	…	…	0.5	0.2	0.0	0.0	0.0
Traditional balance 5/	**-2.3**	**-2.8**	**-2.5**	**-2.6**	**-2.4**	**-3.5**	**-3.0**	**-2.5**	**-2.0**	**-2.0**
Traditional balance for balanced budget rule	-0.2	-0.8	-0.6	-0.6	-0.4	-1.5	-1.0	-0.5	0.0	0.0
Adjustments to the traditional balance	**2.8**	**1.5**	**0.9**	**1.1**	**1.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
PIDIREGAS	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
IPAB	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Budgetary adjustments	0.3	0.4	0.2	0.5	0.6	0.3	0.3	0.2	0.2	0.2
PEMEX, oil stabilization fund, FARP (-: net inflows)	1.2	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FARAC/FONADIN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debtor support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development banks (changes in capital)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Nonrecurring revenue	1.3	0.4	0.7	0.5	1.1	0.2	0.2	0.2	0.2	0.2
Augmented balance 6/	**-5.1**	**-4.3**	**-3.4**	**-3.7**	**-4.1**	**-4.1**	**-3.6**	**-3.0**	**-2.5**	**-2.5**
Augmented interest expenditure 7/	2.7	2.5	2.4	2.6	2.6	2.7	2.8	2.9	3.1	3.2
Augmented primary balance	-2.4	-1.7	-1.0	-1.2	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Memorandum items										
Total revenue 8/	22.0	22.0	22.0	22.1	21.7	22.7	22.8	22.6	22.7	22.8
Total expenditure 9/	27.1	26.2	25.3	25.9	25.9	26.8	26.4	25.7	25.3	25.3
Total primary expenditure 10/	24.4	23.7	22.9	23.3	23.2	24.1	23.6	22.8	22.2	22.1
Structural current spending 11/	13.7	13.0	13.0	13.1	13.0	12.9	12.7	12.5	12.3	12.1
Structural current spending real growth (y/y, in percent) 11/	4.7	-0.3	5.7	4.6	0.7	3.0	2.0	2.0	2.0	2.0
Crude oil export price, Mexican mix (US$/bbl)	57	72	101	102	101	98	92	88	86	84
Non-oil augmented balance 12/	-9.1	-8.4	-8.1	-8.3	-8.6	-8.8	-8.2	-7.5	-7.1	-7.2
Structural Primary Fiscal Balance	-2.4	-2.2	-1.9	-1.9	-1.8	-1.5	-0.8	-0.2	0.6	0.9
Fiscal Impulse 13/	2.5	-0.2	-0.3	0.0	-0.1	-0.3	-0.7	-0.7	-0.8	-0.2
Gross public sector debt	43.9	42.4	43.6	43.5	45.3	46.8	47.6	47.7	47.2	46.7
Domestic (percentage of total debt)	75.2	74.9	73.2	75.0	76.3	76.6	76.9	76.8	76.6	76.3
External (percentage of total debt)	24.8	25.1	26.8	25.0	23.7	23.4	23.1	23.2	23.4	23.7
Net public sector debt	36.3	36.4	37.8	38.0	39.7	41.2	42.0	42.1	41.6	41.2
Nominal GDP (billions of Mexican pesos)	12,089	13,226	14,420	15,506	16,359	17,428	18,592	19,858	21,230	22,689

Sources: Mexican authorities and IMF staff estimates. Data refer to non-financial public sector, including PEMEX and other public entities but excluding state and local governments (except as noted).

1/ Total tax revenue excluding excise tax on gasoline.
2/ Due to lack of disaggregated data this item includes both financing and capital transfers.
3/ Includes transfers to IPAB and debtor support programs.
4/ Given by revenue assumptions based on a higher-than-budgeted oil price. Specific allocations will be determined when revenue materializes.
5/ The break in the series in 2009 is due to definitional and accounting changes.
6/ Public Sector Borrowing Requirements excl. nonrecurrent revenue and adjustments to stabilization funds.
7/ Treats transfers to IPAB as interest payments.
8/ Budgetary revenue, excluding nonrecurrent revenue.
9/ Budgetary expenditure, including adjustments to the traditional balance with the exception of adj. for nonrecurrent revenue.
10/ Total expenditure minus augmented interest payments.
11/ Total budgetary spending, excluding: (i) interest payments; (ii) non-programable spending; (iii) fuel costs of CFE; and (iv) direct physical and financial investment of the federal government.
12/ Excludes oil revenue (oil extraction rights, PEMEX net income, oil excess return levies, excise tax on gasoline) and PEMEX operational and physical capital expenditure
13/ Negative of the change in the structural primary fiscal balance, measured adjusting tax revenue for the cycle and oil net exports using a long-term moving average of oil prices.

Table 8. Mexico - Central Government's Public Sector Financial Balance Sheet 1/

(In billions of Pesos)

		2007			2008			2009			2010			2011			2012		2013
	Opening balance	Transactions	Other flows 2/	Opening balance	Transactions	Other flows 2/ 3/	Opening balance	Transactions	Other flows 2/	Opening balance	Transactions	Other flows 2/	Opening balance	Transactions	Other flows 2/	Opening balance	Transactions	Other flows	Opening balance
Net worth	....			....			....			....			....			....			
Nonfinancial assets	....			....			....			....			....			....			
Net financial assets	**-3,135.4**			**-3,314.5**			**-4,063.4**			**-4,382.3**			**-4,813.2**			**-5,450.6**			**-5,890.8**
Financial Assets 4/	**843.0**	130.4	-7.7	**965.6**	125.5	94.8	**1,185.9**	-209.9	-46.1	**929.9**	-47.7	-86.5	**795.7**	98.7	-59.5	**834.9**	94.0	-73.5	**855.4**
Liabilities	**3,978.4**	246.1	55.6	**4,280.1**	322.5	646.7	**5,249.3**	103.5	-40.7	**5,312.1**	404.0	-107.2	**5,608.9**	487.7	188.8	**6,285.5**	596.1	-135.4	**6,746.3**
Memorandum items:																			
Net financial worth (in % of GDP)	-29.8			-29.1			-33.2			-36.3			-36.4			-37.8			-36.0
Financial assets (in % of GDP)	8.0			8.5			9.7			7.7			6.0			5.8			5.2
Liabilities (in % of GDP)	37.8			37.6			42.9			43.9			42.4			43.6			41.2
GDP nominal prices	10,526			11,395			12,250			12,089			13,226			14,420			16,359

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

1/ Excludes state and local governments.
2/ Includes exchange rate and various accounting adjustments.
3/ Includes Mex$ 291.9 billion in new liabilities due to the ISSSTE Law Reform that took place in 2008.
4/ Liquid financial assets excluding those classified as financial assets with policy purposes by official authorities.

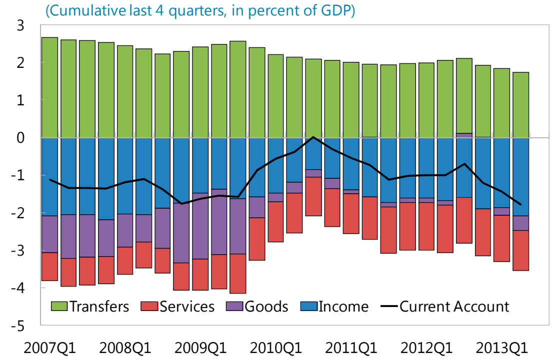
Annex. External Sector Assessment[1]

Mexico's current account deficit and exchange rate level appear broadly in line with fundamentals and desirable policy settings. The country's floating exchange rate has been a key shock absorber in the context of a volatile external environment. Despite the rise in market tensions in May/June 2013, authorities refrained from reactivating rule-based intervention in the foreign exchange market. Foreign investment in peso-denominated government debt remained at record high levels, even as yields increased. Reserve accumulation (from PEMEX's foreign exchange balance) has allowed Mexico to maintain adequate reserve buffers. However, the large stock of foreign portfolio investment can pose risk in an unsettled external environment. In this context, Mexico's FCL arrangement is an important complement to reserve buffers against global tail risks.

Current Account

1. **Mexico's current account (CA) deficit has remained relatively stable at about 1 percent of GDP in 2012, similar to 2011.** The oil CA surplus narrowed, as petroleum-related exports declined somewhat. This was offset by a narrower non-oil CA deficit, driven by robust merchandise exports particularly in vehicle and parts-related exports to the U.S. Mexico is highly integrated into the U.S. manufacturing supply chain. Remittance inflows, particularly from the U.S., remained large and steady, but this was more than offset by the net factor income deficit (driven primarily by interest payments to foreign holders of Mexican debt) and the non-factor services deficit. The external balance assessment (EBA) results suggest that the cyclically-adjusted balance is about 1 percentage point of GDP narrower than the model's CA norm. Comparing the 2013 projection for the CA deficit, which is slightly wider than in 2012, suggests that the gap between the model and the projection is narrower than 1 percent of GDP.

Current Account
(Cumulative last 4 quarters, in percent of GDP)



Sources: Haver Analytics

2. **Over the medium term, the current account deficit is expected to widen modestly to between one and a half and two percent of GDP.** The widening is largely attributed to larger

[1] This assessment reflects more recent trends in the external sector. For a longer horizon discussion, please see Annex I of the 2012 Article IV staff report.

factor income deficit, as foreign holding of Mexican portfolio and direct investments increase. We project a deterioration in the oil trade balance, which will somewhat offset by modest improvements in the non-oil trade balance (led by robust manufactured exports). Macro policy continuity and growth-promoting structural reforms introduce upside potential for exports and direct investment, in manufacturing, energy, and telecommunications. However, this is likely to be associated with wider CA deficits in the short-run, after reforms and projects are in place, as foreign services and equipment are employed to achieve the goals of the reforms.

Exchange Rate

3. **Mexico's flexible exchange rate has served as an important buffer against heightened external risks and uncertainties.** The nominal exchange rate has shown significant volatility during the recent periods of global risk aversion, but without posing major difficulties for the balance sheets of households, corporates and financial institutions. This volatility is due to significant hedging activity of foreign exchange risk by foreign holders of Mexican assets. Additionally, the peso market is highly liquid, open around-the-clock, and therefore used by market participants as a proxy against broader emerging market risks in reaction to external developments. Despite this the heightened volatility, exchange rate markets functioned relatively well, and the Mexican authorities did not revive the use of its rule-based intervention strategy (which has been used sparingly in the past when markets became dysfunctional).

4. **A range of metrics and methodologies indicate that Mexico's exchange rate is broadly in line with fundamentals.** The analyses in the 2013 Pilot External Sector Report and the EBA using the equilibrium real exchange rate (REER) methodology indicated that Mexico's real effective exchange rate was 11 percent undervalued at the end of 2012. However, about 6 percentage points of the result represents an unexplained residual between the outturn and the model. Also an analysis using October 2013 WEO data and a Consultative Group on Exchange Rate Issues (CGER)-like REER model suggests that Mexico's REER is 11 percent overvalued. Given these conflicting results, it is important to rely on the alternative approaches—the macrobalance and external sustainability methods—which suggest that Mexico's real effective exchange rate broadly is in line with fundamentals. Also this exchange rate assessment appears to be consistent with the CA assessment, since the gap between the EBA model estimates and the

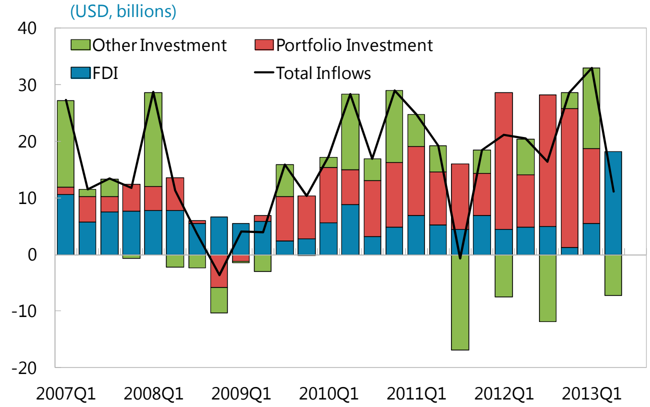
Exchange Rate Assessment

CGER-like methodology (October WEO data)	CA/GDP Norm	CA/GDP Proj (2013)	Implied REER Gap
Macrobalance approach	-1.8%	-1.7%	4.5%
External sustainability approach			0.6%
Equilibrium REER			11.3%
External Balance Assessment (consistent with 2013 Pilot ESR Report)	**Cyclically-adjusted CA/GDP Norm**	**Cyclically-adjusted CA/GDP actual (2012)**	**Gap**
EBA Current account	-1.5%	-0.3%	1.3%
Equilibrium REER			-11%

actual is modest. If the currency were significantly misaligned, one would expect the CA gap to be wider.

5. **Mexico experienced historically large portfolio capital inflows in full-year 2012 ($48 billion) and Q1 2013, continuing a trend seen in recent years.** This has been associated with lax global monetary conditions, very strong domestic macro fundamentals, and expectations of significant structural reforms. Foreign holdings and their share of local-currency government bonds reached record levels, especially after Mexico was included in the WGBI. However, the market turbulence in May/June led to a sudden stop in portfolio inflows in Q2 2013. Total net capital inflows declined, but remained positive due a large FDI transaction. The pace of increases in foreign holdings leveled off, and a large amortization led to a decline in their share during that period. However, foreign demand has gradually returned and holding are at record levels once again.

Gross Capital Inflows (by Foreigners)
(USD, billions)

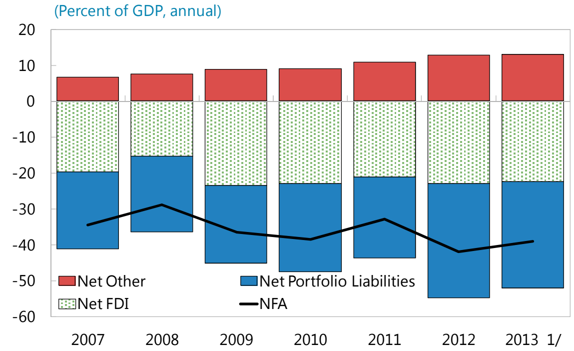


Sources: Haver Analytics

6. **Given the impact that a surge in global risk aversion could have on emerging markets as an asset class, including sound countries like Mexico, the large portfolio exposure of foreign market participants represents significant risks.** The risk of a disorderly unwinding of risk positions associated with reduced monetary accommodation in the U.S. or a fiscal shock is a particular risk to Mexico, given the large participation of U.S. investors in Mexican assets and the significant correlation of Mexican external financing conditions to the U.S. rates.

7. **International reserves are adequate relative to some standard metrics, but have lesser coverage for broad money and foreign portfolio liabilities.** While gross international reserves increased in 2012 to $167 billion (13.6 percent of GDP), the change in reserve coverage since last year's assessment has been mixed. Reserves were within the recommended range of coverage of the IMF metric at 119 percent, but the coverage ratio declined relative to last year's assessment of

Mexico: Composition of Net Foreign Assets
(Percent of GDP, annual)

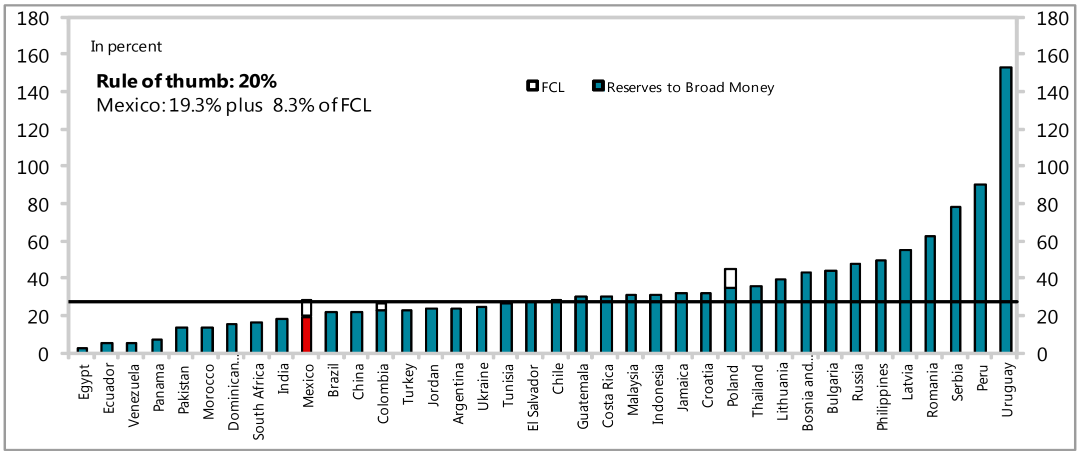


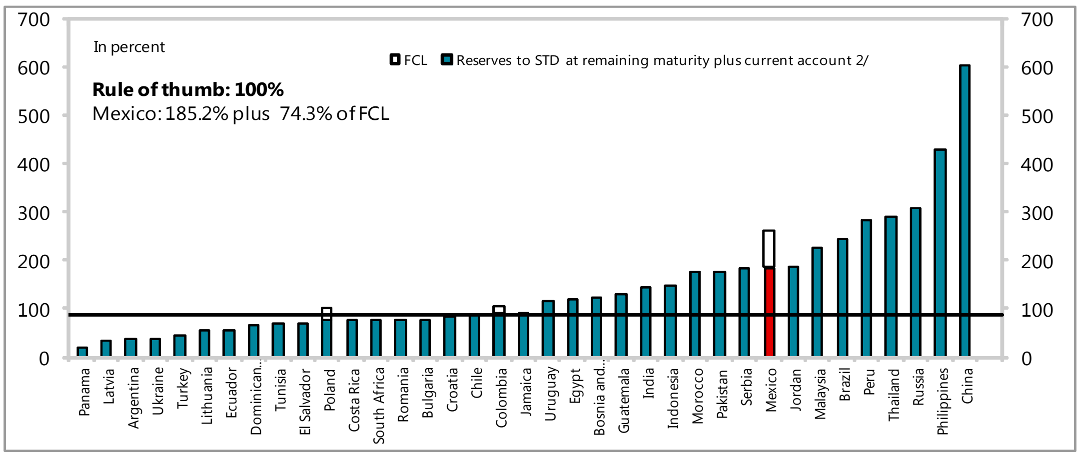
Sources: Banxico
1/ Through Q2 2013

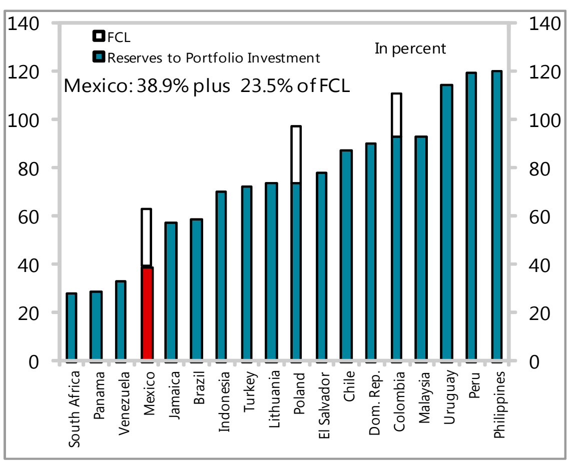
125 percent. Coverage of broad money and foreign portfolio liabilities also declined since last year to 19 and 39 percent respectively. In contrast, coverage of the imports, imports plus interest payments, and short-term debt at residual maturities all increased somewhat to 4.5 months, 4.9 months, and 209 percent respectively.

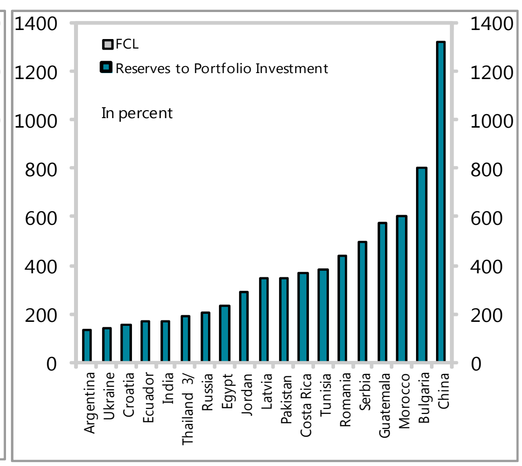
8. **Mexico's net foreign liability position remains moderate, but has been growing.** As of the end-2012, which does not reflect market turbulence in mid-2013, Mexico's net foreign liability position stood at about negative 42 percent of GDP, higher than the recent high of 40 percent at the end of 2010. Gross portfolio liabilities, particularly debt, has grown substantially to 22 percent of GDP reflecting the strong foreign demand for government bonds. Over the medium-term, however, the NFA is expected to remain broadly stable as the current account deficit is projected to be in line with the NFA-stabilizing level of 1.6 percent.

Annex Figure. Mexico: Reserve Coverage: An International Perspective 2012 1/



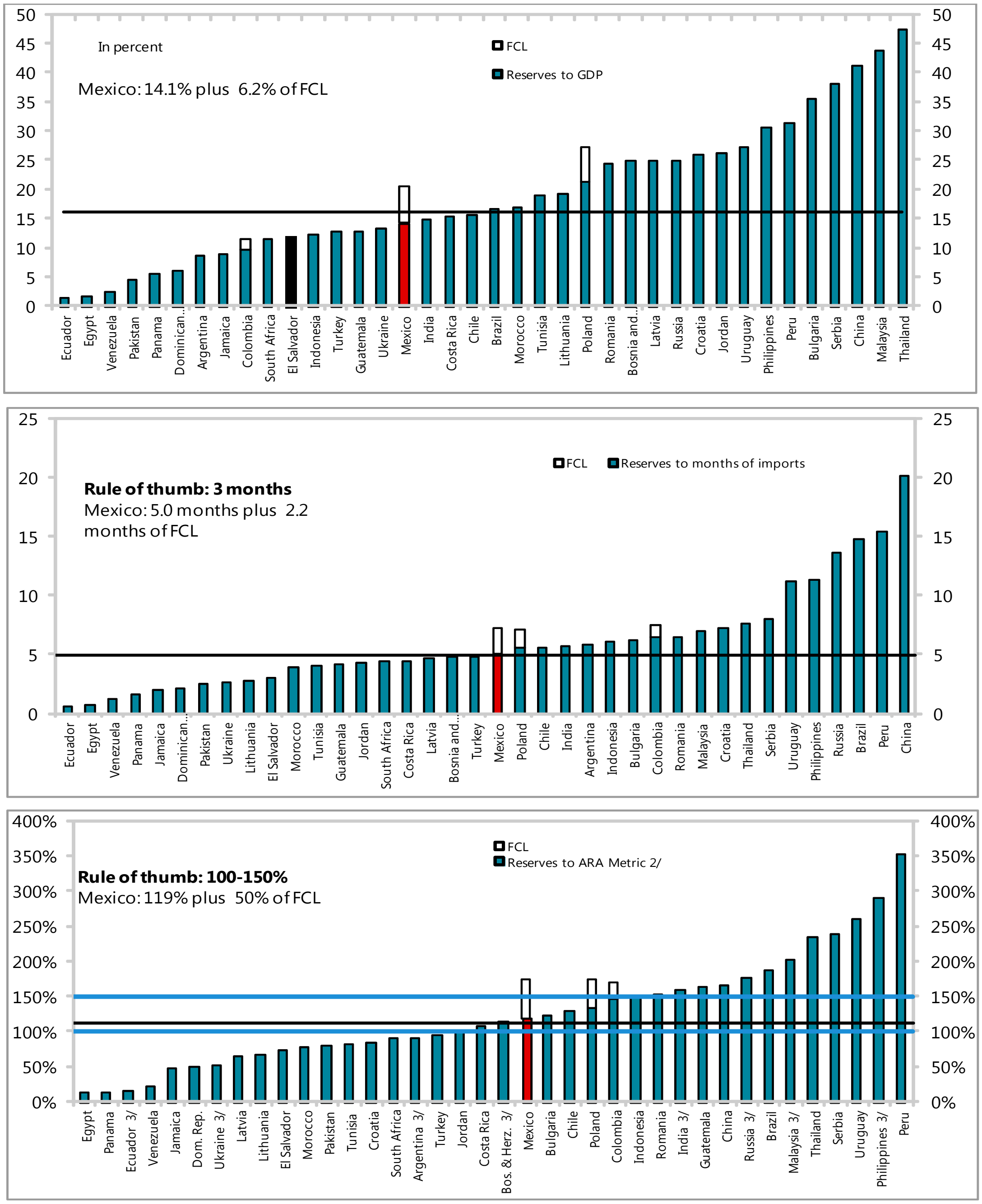






Sources: World Economic Outlook, and IMF staff estimates.
1/ Horizontal lines represent median in all the charts.
2/ Reserves at the end in percent of short-term debt at remaining maturity and estimated current account deficit in 2012. The current account is set to zero if it is in surplus.

Annex Figure. Mexico: Reserve Coverage: An International Perspective 2012 (Concluded) 1/



Sources: World Economic Outlook, Balance of Payments Statistics Database, and IMF staff estimates.

1/ Horizontal lines represent median in all the charts.

2/ The ARA metric was developed by SPR to assess reserve adequacy. For the stock of porfolio liabilities, data on 2011 or 2012 is used depending on data availability.

3/ Portfolio liabilities only available until 2011.

INTERNATIONAL MONETARY FUND

MEXICO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 8, 2013

Prepared By | The Western Hemisphere Department

CONTENTS

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FUND RELATIONS (AS OF SEPTEMBER 30, 2013)

The 2013 Article IV discussions were held in Mexico City during September 17–October 1, 2013. The staff team comprised Robert Rennhack (head), Herman Kamil, Esteban Vesperoni (all WHD); Roberto Guimaraes-Filho (MCM); Santiago Acosta Ormaechea (FAD); and Phil de Imus (SPR). Ms. Adrienne Cheasty (WHD) participated in the concluding meetings. The mission met with the Minister of Finance, the Governor of the Bank of Mexico, senior staff of several government ministries and agencies, representatives of regulatory agencies, and private sector representatives. Messrs. Gerardo Zúñiga and Erick Ramos-Murillo (OED) attended most meetings.

Mexico has accepted the obligations of Article VIII, sections 2, 3, and 4, and does not have any multiple currency practices or restrictions on the making of payments and transfers for current international transactions.

Comprehensive economic data are available for Mexico on a timely basis. It subscribes to the SDDS, and economic data are adequate to conduct surveillance.

Membership Status: Joined December 31, 1945

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	3,625.70	100.00
Fund holdings of currency	2,510.21	69.23
Reserve position in Fund	1,115.53	30.77
New Arrangement to Borrow	641.89	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	2,851.20	100.00
Holdings	2690.58	94.37

Outstanding Purchases and Loans: None

Latest Financial Arrangements

Type	**Arrangement Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
FCLC	Nov 30, 2012	Nov. 29, 2014	47,292.00	0.00
FCLC	Jan 10, 2011	Jan 09, 2013	47,292.00	0.00
FCLC	Mar 25,2010	Jan 09, 2011	31,528.00	0.00
FCLC	Apr 17, 2009	Apr 16, 2010	31,528.00	0.00

Projected Payments to the Fund (SDR million):

			Forthcoming		
	2012	2013	2014	2015	2016
Principal					
Charges / Interest	1.10	0.03	0.14	0.14	0.14
Total	1.10	0.03	0.14	0.14	0.14

Exchange Rate Arrangement: Mexico has a free floating exchange rate regime since November 2011. Mexico maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on November 19, 2012. The relevant staff report was IMF Country Report No. 12/316.

Technical Assistance

Year	Dept.	Purpose
2013	MCM	Post-FSAP Follow Up
2012	FAD	Pension and Health Systems
2012	FAD	Treasury
2012	FAD	Tax Regimes for PEMEX
2011	FAD	Custom Administration
2011	FAD	Tax Policy
2010	FAD	Fiscal Risks Management
2010	FAD	Treasury
2010	LEG	AML/CFT Risk Based Supervision
2009	STA	National Accounts
2009	FAD	Fiscal Framework
2009	LEG	AML/CFT Risk Based Supervision
2008	FAD	Customs Administration
2007	FAD	Intergovernmental Fiscal Relations
2007	FAD	Customs Administration
2007	FAD	Treasury

Resident Representative: None

RELATIONS WITH THE WORLD BANK AND BANK-FUND COLLABORATION UNDER THE JMAP

A. Relations with the World Bank

Mexico has had a longstanding partnership with the World Bank Group. A new Country Partnership Strategy (CPS) covering FY14–19—which has been jointly prepared with the Government of Mexico—is now ready for Board discussion in December 2013. This new CPS is fully aligned with the goals of Mexico's National Development Plan (NDP) for 2013–18 and describes the Bank’s engagement with Mexico as a partnership to achieve development results through a tailored package of financial, knowledge, and convening services. IBRD lending has remained an important part of this engagement throughout the years.

As a member of the OECD and the G20, Mexico has maintained economic stability through times of recent crisis, and increased economic and social well-being over the last two decades. Yet, Mexico is approaching the single borrower limit (SBL) of US$16.5 billion. After pre-paying some US$5 billion during FY07 to bring down its exposure to US$4.1 billion by end FY07, Mexico's exposure increased rapidly from FY08 with the unleashing of the global financial crisis and surge in IBRD lending: US$10.6 billion commitments in FY10–12 and decline in the size of repayments of loans following prepayment of loans in FY07.

As of September 30, 2013, Bank’s exposure was US$14.78 billion which positioned Mexico as the WBG first largest borrower in terms of debt outstanding. The active portfolio consisted of 12 IBRD projects for a net commitment of US$4.08 billion, placing Mexico amongst the top 10 countries with the largest portfolio under supervision in the World Bank. For FY14 total lending is envisaged at a low range of US$350 million.

B. Bank-Fund Collaboration under the JMAP

The Bank and Fund teams have discussed the following priorities:

- Need for non-oil revenue mobilization. These efforts are important to address Mexico’s longer-term fiscal challenges from gradually diminishing oil revenues and rising age-related spending.
- Structural reforms. Boosting potential growth will require a comprehensive approach to structural reforms to ensure that productivity gains accrue to all sectors and thus entrench the recent remarkable gains of Mexico’s manufacturing sector.
- Addressing climate change. Support authorities’ efforts to reduce Mexico’s carbon footprint, including increasing renewable energy sources, and improving efficiency of lighting and appliances.
- Financial sector surveillance. The Fund will continue with the surveillance of the financial sector. The FSAP update took place in the second half of 2011, a joint Bank-Fund effort.

STATISTICAL ISSUES

Data provision is adequate for surveillance. Mexico observes the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). In a number of cases, the periodicity and timeliness of disseminated data exceed SDDS requirements. A data ROSC update was completed on October 8, 2010 and was published as IMF Country Report No. 10/330. There are various areas where improvements could be made. The authorities are aware of this situation and are continuing work in this regard.

Although some items of the balance of payments statistics conform to the *Fifth edition of the Balance of Payments Manual*, a full transition has not yet been completed.[1] Several measures to improve external debt statistics have been carried out, including the compilation of data on external liabilities of the private sector and publicly traded companies registered with the Mexican stock exchange (external debt outstanding, annual amortization schedule for the next four years broken down by maturity, and type of instrument).

The national accounts statistics generally follow the recommendations of the *System of National Accounts, 1993 (1993 SNA).* Source data and statistical techniques are sound and most statistical outputs sufficiently portray reality. A broad range of source data are available, with economic censuses every five years and a vast program of monthly and annual surveys. For most surveys, scientific sampling techniques are used. Nonetheless, most samples exclude a random sample of small enterprises. Some statistical techniques need enhancement. For example, taxes and subsidies on products at constant prices are estimated by applying the GDP growth rate, a deviation from best practice.

The concepts and definitions for both the CPI and PPI meet international standards. The PPI is only compiled by product and not by economic activity. A ROSC mission on prices was conducted in November 2012.

The authorities compile fiscal statistics following national concepts, definitions, and classifications that make international comparison difficult. The statistics are comprehensive and timely, except for states and municipalities. The new government accounting law mandates accounting standards that follow international standards for all levels of government, and that take into account the information needs of international organizations and national accounts.

The authorities are committed to reporting government financial statistics in GFSM 2001 format, as well as data for the GFS Yearbook.

[1] Since the release of the balance of payments figures for the second quarter of 2010 (August, 25, 2010), Banco de Mexico has been publishing a new format that follows the guidelines of the Fifth edition of the Balance of Payments Manual.

The methodological foundations of monetary statistics are generally sound. However, the recording of financial derivative and, to a lesser extent, repurchase agreements transactions are overstating the aggregated other depository corporations (ODC) balance sheet and survey. Availability of data on other financial intermediaries such as insurance companies and pension funds allow for the construction of a financial corporations survey with full coverage of the Mexican financial system, which is published on a monthly basis in International Financial Statistics.

Mexico is reporting Financial Soundness Indicators (FSIs) for Deposit Takers on a monthly basis.

Mexico: Table of Common Indicators Required for Surveillance

As of Nov. 6, 2013

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Data Quality-Methodological Soundness[8]	Data Quality Accuracy and Reliability[9]
Exchange Rates	Oct. 2013	Oct. 2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sept. 2013	Sept. 2013	M	M	M		
Reserve/Base Money	Sept. 2013	Sept. 2013	M	D, M	W	LO, O, O, LO	LO, O, O, O, O
Broad Money	Sept. 2013	Sept. 2013	M		W		
Central Bank Balance Sheet	Oct. 2013	Oct. 2013	W	W	W		
Consolidated Balance Sheet of the Banking System	Sept. 2013	Sept. 2013	M	M	M		
Interest Rates[2]	Oct. 2013	Oct. 2013	D	D	D		
Consumer Price Index	Oct. 2013	Oct. 2013	Bi-W	Bi-W	Bi-W	O, O, LNO, O	LO, LNO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3]–Gen. Government[4]	Sept. 2013	Sept. 2013				LO, LNO, LNO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Sept. 2013	Sept. 2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept. 2013	Sept. 2013	M	NA	M		
External Current Account Balance	Q2 2013	Q2 2013	Q	Q	Q	LO, LO, LNO, LO	LO, O, O, O, LO
Exports and Imports of Goods and Services	Sept. 2013	Sept. 2013	M	M	M		
GDP/GNP	Q2 2013	Q2 2013	Q	Q	Q	O, O, O, LO	LO, O, LO, LO, O
Gross External Debt	Sept. 2013	Sept. 2013	M	M	M		
International Investment Position[6]	Q2 2013	Q2 2013	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC completed on October 8, 2010, except consumer prices which is based on the ROSC completed on May 23, 2003. For the dataset corresponding to the variable in each row, the assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, assessment and validation of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

MEXICO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

November 8, 2013

Approved By
Adrienne Cheasty and Vivek Arora

Prepared by the Staff of the International Monetary Fund

PUBLIC DEBT SUSTAINABILITY ANALYSIS ___ **2**

EXTERNAL DEBT SUSTAINABILITY ANALYSIS ___ **11**

PUBLIC DEBT SUSTAINABILITY ANALYSIS

Gross debt levels in Mexico, at 45 percent of GDP projected by end-2013, remain moderate. The broad institutional coverage of Mexico's public debt, which includes development banks and other key public entities such as PEMEX, the state oil company, provide reassurance that gross liabilities of the public sector are well captured in this new DSA assessment.[1,2] *Although gross financing needs are slightly above 11 percent of GDP in 2013 and 2014, they are on average below 10 percent of GDP for the whole forecasting period. Against this background, the different DSA scenarios presented here suggest that Mexico's public debt is sustainable even under the most extreme shocks. Given Mexico's debt structure, the pass-through of either interest rates or exchange rate shocks to the budget is relatively small over the projection period. Only the impact of lower GDP growth shifts the debt trajectory up significantly, but even under such scenario gross debt remains moderate and below 55 percent of GDP. While public debt profile indicators are below early warning benchmarks, there is a large share of debt held by non-residents—about 48 percent of total debt.*

Realism of Baseline Scenario

- ***Debt level***. Mexico's increase in gross debt levels in 2013 relative to 2012 is explained by a combination of a slight increase in the primary deficit and a much slower pace of growth, without major changes in sovereign yields. As fiscal consolidation plans kick in from 2015 onwards, gross debt levels are projected to decline from the peak of 47.7 percent of GDP in 2016 to 46.8 of GDP by 2018. This follows from the projected improvement in the primary balance, which is expected to reach the debt-stabilizing level—0.2 percent of GDP—in 2016. Staff projects that gross financing needs will decrease over time from 11.4 percent in 2013 to 7.3 percent of GDP by 2018.

- ***Growth.*** Past projections of growth outcomes suggest moderate forecast errors, with the only exceptions of 2009 and 2010, years influenced by the global crisis and the stronger-than-expected recovery that followed afterwards. In this context, there is no apparent systematic bias that could undermine the DSA assessment due to the growth outlook. Staff's current growth projections at 1.2 percent for 2013 have been severely revised downwards, which could result in a positive impact on debt if growth turns out to be higher than expected. Still, Mexico's debt dynamics are sensitive to sudden changes in GDP growth, as indicated by the relevance of growth shocks under the DSA stress tests.

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[1] New DSA guidelines can be found at: http://www.imf.org/external/np/pp/eng/2013/050913.pdf.

[2] Although Mexico does not provide consolidated fiscal accounts including subnational government data, latest available information indicate that consolidated subnational gross debt remains low and below 3 percent of GDP by end-2013. This debt is only held by residents.

- ***Sovereign yields.*** Despite the volatility observed in recent months, Mexico's sovereign yields remain at historical low levels, with the 10-year local currency bond yield at around 575 basis points as of October 23. For this bond, the spread against the U.S. 10-year Treasury bill during September remained on average at 340 bps, about the same level observed in January 2013. However, given upward projections for the U.S. Treasury bills and Libor rates over the medium term, the effective nominal interest rate on Mexico's sovereign debt is forecast to increase from 6.3 percent in 2012 to 7.2 percent by 2018. This level is consistent with the average effective rate observed between 2002 and 2010.

- ***Fiscal adjustment.*** Under the baseline, there is an important adjustment in the cyclically adjusted primary balance between 2013 and 2018. This adjustment is explained by better structural oil and non-oil revenues that follow from the effects of the 2013 tax and energy reforms, with primary spending being capped by a spending growth ceiling applying from 2014 onwards. Also, amendments to the Fiscal Responsibility Law approved in 2013, which introduce a new fiscal target on the broader public sector borrowing requirement (PSBR), provide an additional anchor to the medium-term fiscal scenario projected by the staff. Considering the distribution of fiscal adjustment episodes provided in the DSA template and pre-2009 Mexican historical evidence, the projected adjustment of the cyclically-adjusted primary balance over 3 years during the projection horizon, at around 1.5 percent of GDP, does not provide warning signals of being infeasible.

Debt Profile

- ***Maturity and rollover.*** Given the current debt structure (average maturity of almost 8 years by end-2012 with more than 80 percent of total debt at fixed interest rates) the direct pass-through of interest rate increases to the budget is limited in any given year. A 100 basis points positive shock to the yield curve across maturities is estimated to raise the interest bill by about 0.1 percentage points (ppts) of GDP per year. Similarly, given the large share of local-currency denominated debt (about 76 percent of total debt), the real exchange rate depreciation shock has a very minor effect on debt dynamics. Although around 46 percent of total gross debt is held by non-residents on average during the whole projection period, rollover risks are kept at reasonable levels, reflecting that approximately ¾ of non-resident holdings are held at maturities longer than one year. This is a consequence of the well diversified base of debt holders—which includes a large fraction of institutional investors with long-term holding strategies and a significant share of official creditors.

Stress Tests

- ***Primary balance shock.*** A deterioration of 0.8 ppts of GDP in the primary balance in 2014–15 shifts up public debt by a similar amount, reaching 48 percent of GDP by the end of the projection period—1 ppt of GDP above the baseline. Consequently, gross financing needs also increase moderately; however, effective interest rates on public debt do not show significant differences relative to the baseline.

- ***Growth shock.*** A one standard deviation shock to GDP growth rates lowers the growth rate by 2.8 percent, for 2 years starting in 2014. The nominal primary balance deteriorates significantly due to the associated fall in revenue, reaching -2.5 percent of GDP by 2015 (relative to -0.8 percent under the baseline). Accordingly, the debt-to-GDP ratio peaks at 53.4 percent of GDP in 2015 and falls back to 52.5 percent of GDP by the end of the projection period. Gross financing needs increase accordingly to 8.6 percent of GDP by 2018.

- ***Interest rate shock.*** This shock involves a permanent increase in the nominal interest rate by 200 bps starting in 2014. The government's interest bill climbs accordingly, giving rise to an average interest rate of 8.2 percent by 2018, about 1 percent higher than in the baseline. The debt-to-GDP ratio and gross financing needs similarly increase, reaching 48 percent and 8 percent of GDP, respectively.

- ***Combined shock.*** A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). In this case, debt would stabilize at about 57 percent of GDP by 2018, without showing signals of any unsustainable trajectory when inspecting the underlying debt dynamics over the whole forecasting horizon.

Stochastic simulations

- ***Fan Charts.*** The fan charts included in the template help to assess the sustainability of public debt incorporating uncertainty over the medium term. Under a constellation of possible random shocks for growth, effective interest rates, primary balances, and real exchange rates, alternative paths for public debt are generated. The underlying probability distribution given by the spectrum of possible random outcomes suggest an equally-distributed probability for debt to become larger than in the baseline, yet there is a 75 percent probability that debt will be below 50 percent over the medium term. If restrictions are imposed to the maximum size of the primary balance—for instance, by assuming that there are no positive shocks to the primary balance in a given year—the debt path is still projected to remain below 58 percent of GDP with 90 percent probability. To complement the analysis, an alternative stochastic simulation prepared by the staff is discussed below, which includes a larger data sample covering more than 30 years of quarterly data to make the assessment more comprehensive (the fan chart included in the DSA template is calculated based on annual data for the period 2002–12). Over the projection period, the distribution of the debt path projections generated by the alternative approach falls within the range of the distribution given by the fan chart from the DSA template.

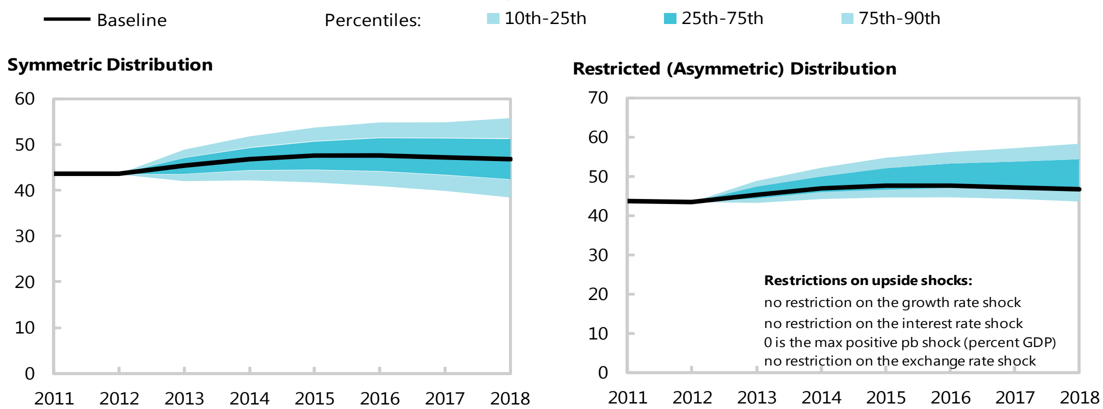
Mexico Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

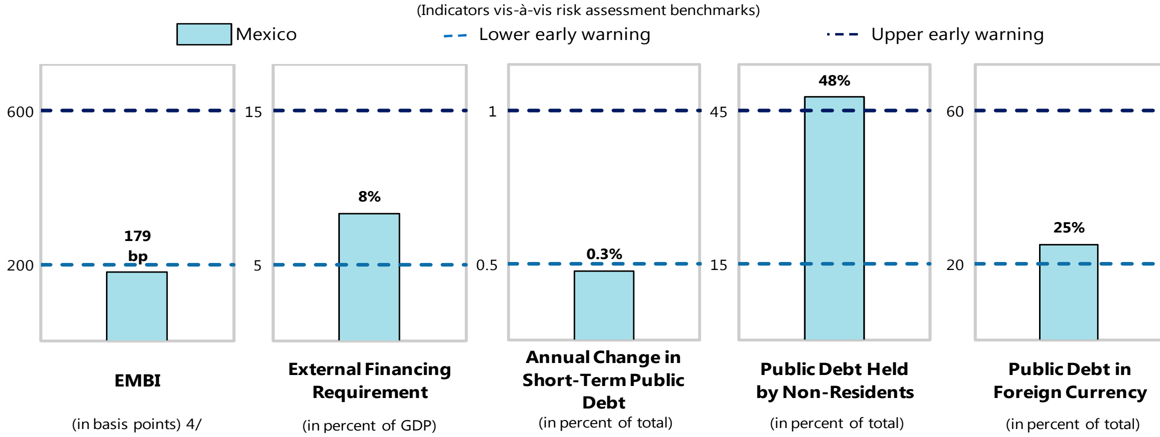
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

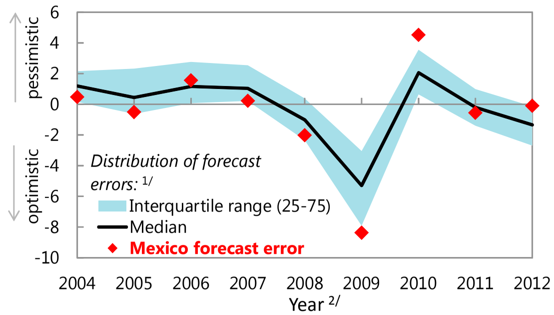
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ An average over the last 3 months, 26-Jul-13 through 24-Oct-13.

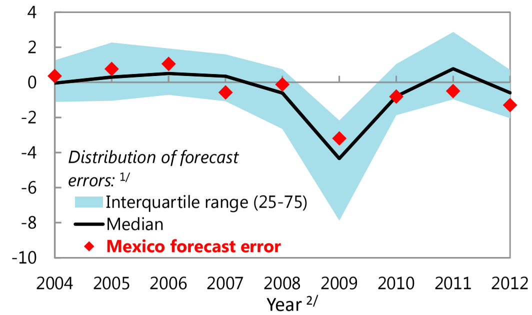
Mexico Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

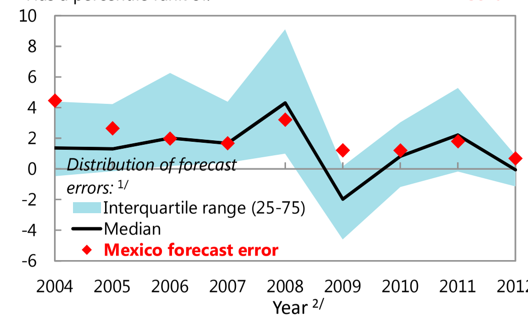
Real GDP Growth
(in percent, actual-projection)
Mexico median forecast error, 2004-2012: **-0.09**
Has a percentile rank of: **37%**



Primary Balance
(in percent of GDP, actual-projection)
Mexico median forecast error, 2004-2012: **-0.49**
Has a percentile rank of: **42%**

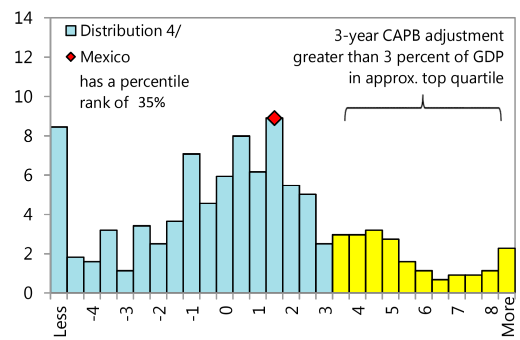


Inflation (Deflator)
(in percent, actual-projection)
Mexico median forecast error, 2004-2012: **1.80**
Has a percentile rank of: **59%**

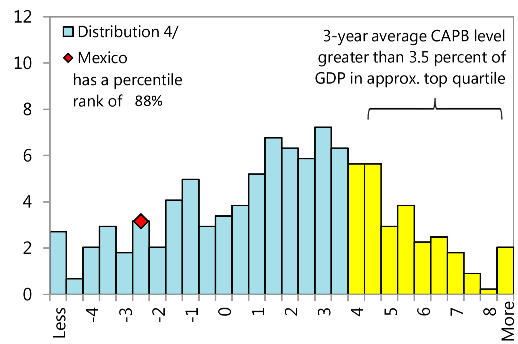


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)

Not applicable, since Mexico does not match the criteria for this analysis

Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Mexico has had a cumulative increase in private sector credit of 2 percent of GDP, 2009-2012. For Mexico, t corresponds to 2013; for the distribution, t corresponds to the first year of the crisis..
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Mexico Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

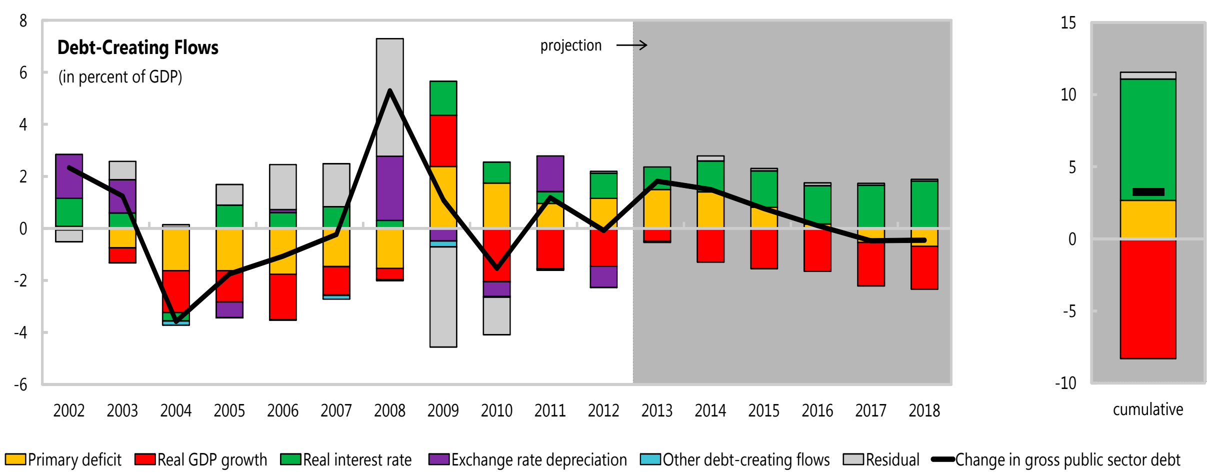
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	41.2	43.6	43.5	45.3	46.8	47.6	47.7	47.2	46.8
Public gross financing needs	10.6	10.9	11.5	11.4	10.3	8.9	10.2	9.1	7.3
Real GDP growth (in percent)	2.1	4.0	3.6	1.2	3.0	3.5	3.7	3.8	3.8
Inflation (GDP deflator, in percent)	5.4	4.8	3.8	4.3	3.4	3.0	3.0	3.0	3.0
Nominal GDP growth (in percent)	7.6	9.0	7.5	5.5	6.5	6.7	6.8	6.9	6.9
Effective interest rate (in percent) [4/]	7.3	6.2	6.3	6.4	6.3	6.3	6.4	6.9	7.2

As of October 24, 2013		
Sovereign Spreads		
EMBI (bp) 3/		193
CDS (bp)		104
Ratings	Foreign	Local
Moody's	Baa1	Baa1
S&Ps	BBB+	A-
Fitch	BBB+	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.2	1.18	-0.08	1.8	1.5	0.8	0.1	-0.5	-0.5	3.2	
Identified debt-creating flows	-0.2	1.23	-0.15	1.8	1.5	0.8	0.1	-0.5	-0.5	3.3	
Primary deficit	-0.5	1.0	1.2	1.5	1.4	0.8	0.2	-0.5	-0.7	2.7	0.2
Primary (noninterest) revenue and grants	21.2	23.1	23.6	22.3	22.8	22.7	22.5	22.6	22.7	135.7	
Primary (noninterest) expenditure	20.6	24.1	24.7	23.8	24.2	23.5	22.7	22.1	22.0	138.4	
Automatic debt dynamics [5/]	0.4	0.3	-1.3	0.3	0.1	0.0	-0.1	0.1	0.2	0.6	
Interest rate/growth differential [6/]	-0.1	-1.1	-0.5	0.4	-0.1	-0.1	-0.2	0.0	0.2	0.1	
Of which: real interest rate	0.7	0.5	1.0	0.9	1.2	1.4	1.5	1.7	1.8	8.4	
Of which: real GDP growth	-0.8	-1.6	-1.5	-0.5	-1.3	-1.5	-1.6	-1.7	-1.7	-8.3	
Exchange rate depreciation [7/]	0.4	1.4	-0.8	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization proceeds (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
(Specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.4	0.0	0.1	-0.1	0.2	0.1	0.1	0.1	0.1	0.5	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBI.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate;
a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

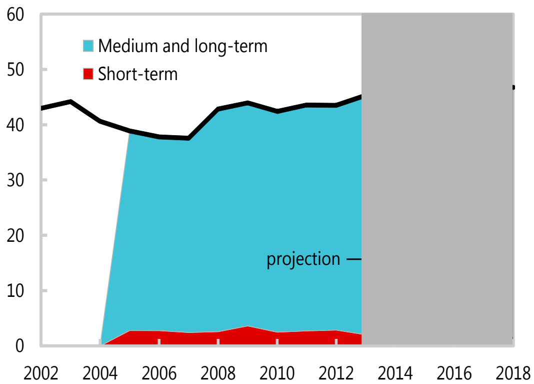
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Mexico Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

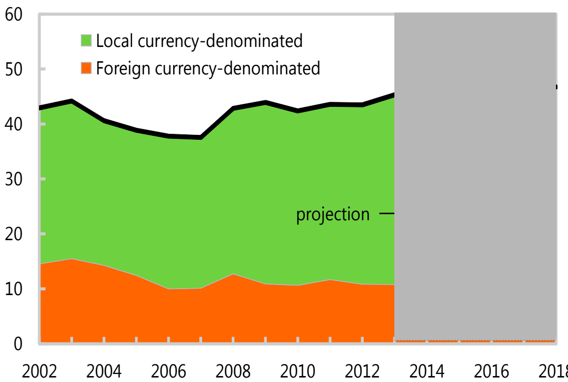
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

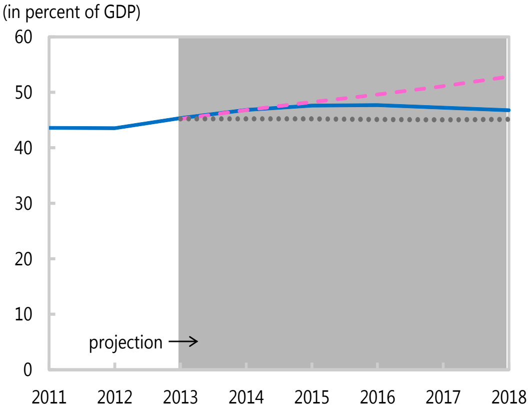


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

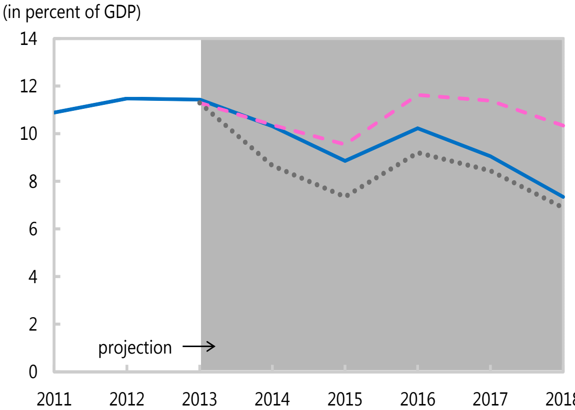
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

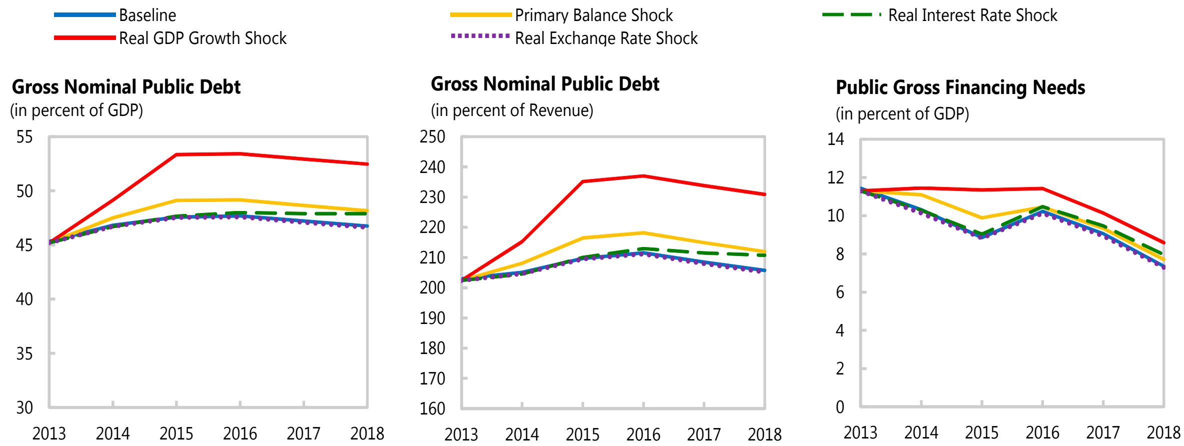
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	1.2	3.0	3.5	3.7	3.8	3.8
Inflation	4.3	3.4	3.0	3.0	3.0	3.0
Primary Balance	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Effective interest rate	6.4	6.3	6.3	6.4	6.9	7.2
Constant Primary Balance Scenario						
Real GDP growth	1.2	3.0	3.5	3.7	3.8	3.8
Inflation	4.3	3.4	3.0	3.0	3.0	3.0
Primary Balance	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	6.4	6.3	6.3	6.2	6.7	7.2

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	1.2	2.6	2.6	2.6	2.6	2.6
Inflation	4.3	3.4	3.0	3.0	3.0	3.0
Primary Balance	-1.5	0.3	0.3	0.3	0.3	0.3
Effective interest rate	6.4	6.3	6.0	5.8	6.0	6.3

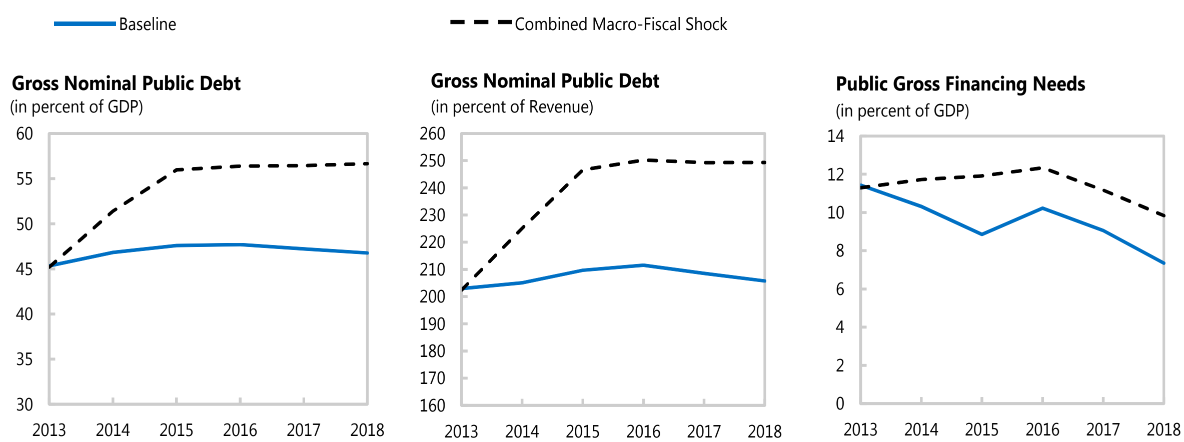
Source: IMF staff.

Mexico Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	1.2	3.0	3.5	3.7	3.8	3.8
Inflation	4.3	3.4	3.0	3.0	3.0	3.0
Primary balance	-1.5	-2.2	-1.6	-0.2	0.5	0.7
Effective interest rate	6.4	6.3	6.4	6.3	6.7	7.1
Real Interest Rate Shock						
Real GDP growth	1.2	3.0	3.5	3.7	3.8	3.8
Inflation	4.3	3.4	3.0	3.0	3.0	3.0
Primary balance	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Effective interest rate	6.4	6.3	6.8	6.9	7.7	8.2
Combined Shock						
Real GDP growth	1.2	0.2	0.7	3.7	3.8	3.8
Inflation	4.3	2.7	2.3	3.0	3.0	3.0
Primary balance	-1.5	-2.3	-2.5	-0.2	0.5	0.7
Effective interest rate	6.4	6.6	6.7	7.0	7.7	8.2

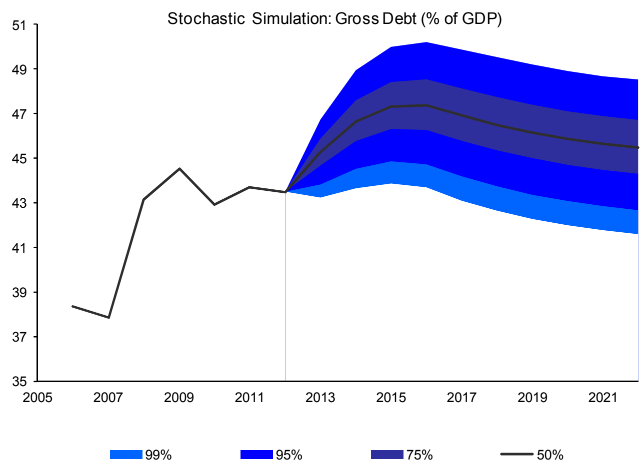
Real GDP Growth Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	1.2	0.2	0.7	3.7	3.8	3.8
Inflation	4.3	2.7	2.3	3.0	3.0	3.0
Primary balance	-1.5	-2.3	-2.5	-0.2	0.5	0.7
Effective interest rate	6.4	6.3	6.4	6.4	6.8	7.1
Real Exchange Rate Shock						
Real GDP growth	1.2	3.0	3.5	3.7	3.8	3.8
Inflation	4.3	8.3	3.0	3.0	3.0	3.0
Primary balance	-1.5	-1.4	-0.8	-0.2	0.5	0.7
Effective interest rate	6.4	6.6	6.3	6.2	6.7	7.0

Source: IMF staff.

Alternative Stochastic Simulations

To further assess the sustainability of the baseline scenario discussed in the staff report, stochastic simulations were performed to develop a probabilistic path for the public debt. Using Mexican data, an unrestricted VAR was estimated to assess the impact of shocks in non-fiscal determinants of public debt dynamics—output gap, real exchange rate, domestic real interest rate, commodity gap, and U.S. real interest rates.[3] Then, a sequence of random shocks was used to generate conditional forecasts around the baseline. Paths for revenue, expenditure, the fiscal balance and public debt were estimated. The path for the evolution of public debt is presented using a fan chart, which illustrates the confidence bands of the probability of each scenario around the median path.

The results from the stochastic simulations suggest that in the baseline scenario, public debt would begin a downward trajectory starting in 2017. Under the scenario, the median debt path suggests that public debt would fall to 45½ percent of GDP by 2022, and that there is a close to 50 percent probability that debt would be lower than in 2013. The baseline scenario puts the median of the public debt path on a declining trend in 2017. Given the more gradual consolidation path, there is a small probability—less than 5 percent—that public debt will reach 50 percent of GDP in 2015–2016.

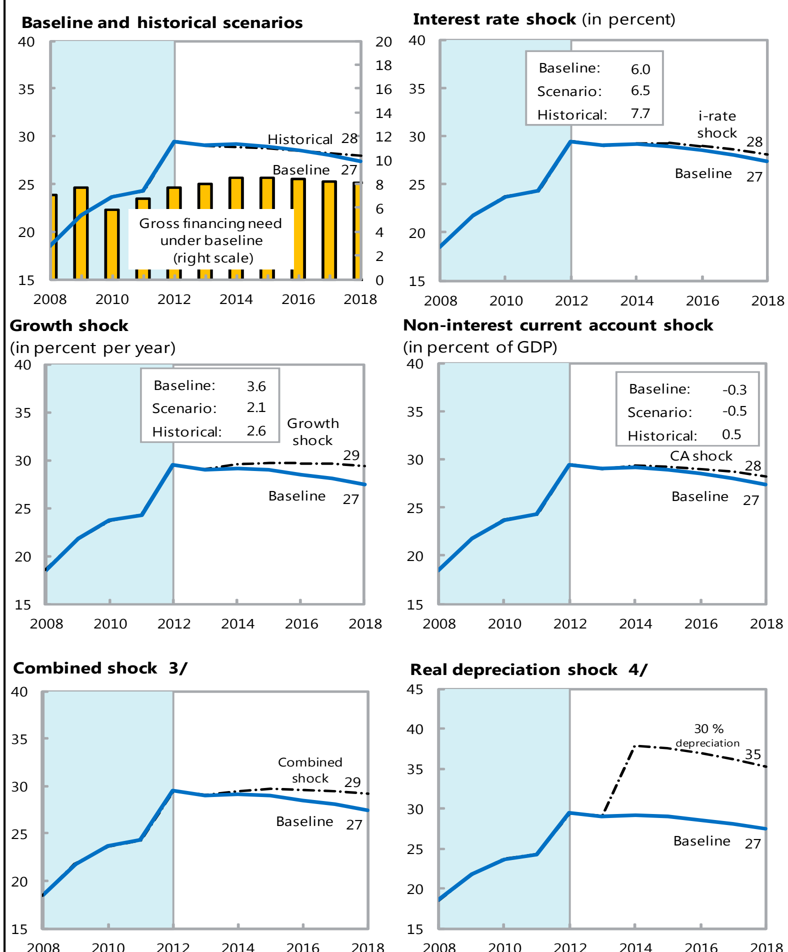


[3] The output gap is calculated using a Hodrick-Prescott filter over 1980–2013. The commodity gap is expressed in percent of the structural price, defined as the 7-year moving-average of the price of the Mexican oil mix. For the real domestic interest rate, the one-year CETES rate was used, adjusted by CPI. The foreign interest rate is the 10-year Treasury bond yield. The VAR uses quarterly data for 1990–2012 to calibrate the distribution of shocks. The variance-covariance matrix of the residuals characterizes the joint statistical properties of the contemporaneous disturbances.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

Mexico's external-debt-to GDP ratio continues to be low and sustainable (29 percent projected for end-2013), and is expected to remain stable over the medium-term. With the most extreme shock—a 30 percent real exchange rate depreciation—the debt-to-GDP ratio would increase to 40 percent, which is still a moderate level. Mitigating factors include the fact that a larger share of Mexico's (public) debt is now denominated in pesos, and Mexico has taken advantage of low interest rates and the recognition of its strong macroeconomic fundamentals to lengthen the maturity structure of its external debt. Other shocks, including to interest rates, current account and growth, have only a marginal impact on Mexico's debt-to-GDP ratio.

External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2013.

Table. Mexico: External Debt Sustainability Framework, 2008-2018

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
Baseline: External debt	18.5	21.8	23.7	24.3	29.4			**29.0**	**29.1**	**28.9**	**28.5**	**28.0**	**27.4**	**-1.8**
Change in external debt	-0.4	3.3	1.9	0.6	5.2			-0.4	0.1	-0.2	-0.4	-0.5	-0.6	
Identified external debt-creating flows (4+8+9)	-1.3	3.5	-3.4	-1.6	0.3			-0.5	-0.8	-0.9	-0.9	-1.0	-1.0	
Current account deficit, excluding interest payments	0.3	-0.6	-1.0	-0.5	-0.5			0.2	0.3	0.4	0.4	0.3	0.1	
Deficit in balance of goods and services	2.4	1.7	1.3	1.4	1.3			1.6	1.8	1.9	1.9	1.8	1.5	
Exports	27.8	27.3	30.0	31.4	32.8			30.8	31.2	31.7	32.3	33.2	34.1	
Imports	30.2	29.0	31.3	32.8	34.1			32.5	33.0	33.6	34.2	34.9	35.7	
Net non-debt creating capital inflows (negative)	-2.1	-1.2	-0.8	-0.4	-0.2			-2.0	-1.9	-1.9	-1.9	-1.8	-1.8	
Automatic debt dynamics 1/	0.5	5.3	-1.6	-0.7	1.0			1.2	0.8	0.6	0.6	0.6	0.7	
Contribution from nominal interest rate	1.5	1.4	1.4	1.5	1.7			1.6	1.6	1.6	1.6	1.6	1.7	
Contribution from real GDP growth	-0.2	1.0	-0.9	-0.9	-0.9			-0.3	-0.8	-1.0	-1.0	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	-0.8	2.8	-2.0	-1.4	0.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.9	-0.2	5.4	2.2	4.9			0.1	0.9	0.7	0.5	0.5	0.4	
External debt-to-exports ratio (in percent)	66.5	79.7	79.0	77.3	89.7			94.1	93.5	91.2	88.1	84.5	80.3	
Gross external financing need (in billions of US dollars) 4/	78.9	69.3	60.7	78.7	91.0			102.9	114.2	120.2	125.0	129.9	135.5	
in percent of GDP	7.1	7.7	5.8	6.8	7.7	10-Year	10-Year	8.0	8.6	8.5	8.4	8.2	8.1	
Scenario with key variables at their historical averages 5/								**29.0**	**28.9**	**28.7**	**28.5**	**28.2**	**27.9**	**-0.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	1.2	-4.5	5.1	4.0	3.6	2.6	2.8	1.2	3.0	3.5	3.7	3.8	3.8	
GDP deflator in US dollars (change in percent)	4.3	-14.9	11.3	6.6	-2.1	2.2	7.7	7.8	0.9	1.8	2.0	2.2	2.2	
Nominal external interest rate (in percent)	8.5	6.3	7.3	7.1	7.2	7.7	1.0	5.8	5.7	5.8	5.8	6.0	6.6	
Growth of exports (US dollar terms, in percent)	6.9	-20.9	28.3	16.3	6.0	9.1	12.8	2.3	5.1	7.3	7.8	8.7	9.2	
Growth of imports (US dollar terms, in percent)	9.0	-22.4	26.0	16.5	5.3	8.7	12.9	3.7	5.6	7.5	7.6	8.2	8.3	
Current account balance, excluding interest payments	-0.3	0.6	1.0	0.5	0.5	0.5	0.3	-0.2	-0.3	-0.4	-0.4	-0.3	-0.1	
Net non-debt creating capital inflows	2.1	1.2	0.8	0.4	0.2	1.6	0.9	2.0	1.9	1.9	1.9	1.8	1.8	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Mexico

On November 25, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Mexico.

Over the past year, Mexico has maintained macroeconomic policy continuity, while pursuing an ambitious agenda of growth-enhancing reforms. Reforms have already been approved to upgrade education, make labor markets more flexible, and foster competition in telecommunications. Congress is currently debating a fundamental reform of the energy sector and is in the final stages of approving a financial sector reform. In October 2013, Congress modified the fiscal framework, reformed the main taxes and introduced a universal pension scheme and unemployment insurance.

In 2013, the economy has begun to operate well below capacity, with real GDP growth expected to slow to 1.2 percent (down from 3.6 percent in 2012). In the first semester, activity declined sharply, opening a sizable output gap estimated at -1.5 percent of potential GDP in the second quarter. Projected growth for 2013 assumes a strong rebound in the second semester, with manufacturing recovering in response to a pick-up in U.S. manufacturing, and public spending regaining its lost momentum. However, this projection assumes a gradual recovery in construction. The storms that hit both coasts in September are expected to have only a modest effect on growth.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

The slack in the economy is helping to contain price pressures, with headline inflation now projected at 3½ percent by the end of the year—close to the 3 percent inflation target. Supply shocks had driven up food prices and pushed headline inflation above 4 percent earlier this year.

However, since mid-year these pressures on food prices have subsided, and core inflation has stayed at historical lows of 2½ percent y/y since July. Medium-term inflation expectations have remained firmly anchored at 3½ percent— albeit still above the 3 percent target.

Demand policies are supporting a recovery in growth**.** The public sector borrowing requirement (PSBR) is expected to reach 4.1 percent of GDP this year, compared with 3.7 percent of GDP in 2012. This stance would imply a considerable fiscal stimulus in the second semester, as the PSBR amounted to only 1.0 percent of GDP in the first semester. The central bank has reduced its policy rate so far this year by a total of 100 basis points to 3.50 percent in response to the widening of the negative output gap and in the absence of significant inflationary pressures.

The external current account deficit is projected to widen to 1.7 percent of GDP in 2013. The non-oil trade deficit would remain at 1 percent of GDP, while the oil trade surplus would fall to 0.6 percent of GDP, reflecting weaker production and exports of oil. The Fund's current account model and a range of exchange rate metrics in the External Balance Assessment (EBA) suggest that the current account balance and real exchange rate are broadly in line with fundamentals and desirable policy settings.

Mexico's financial asset markets showed more resilience than many other emerging markets after the Fed initiated its discussion of tapering on May 22. In this context, net capital inflows are projected to remain steady at about 4 percent of GDP in 2013. Through April, investor appetite for Mexican assets was underpinned by heightened prospects for further structural reforms, as well as the ample global supply of liquidity, generating a strong appreciation of the peso and a compression in sovereign debt yields. After the Fed initiated the discussion on the tapering of quantitative easing, asset markets reversed course for several months. In the second quarter, gross capital inflows, especially portfolio investment from non-residents fell sharply from a peak in the first quarter. Residents helped cushion the effects of this shift by keeping more of their funds within Mexico, leading to a smaller decline in overall net capital inflows. The recent delay in tapering announced by the Fed in mid-September has led to signs of a recovery in capital inflows in recent months.

The banking system—which accounts for about 60 percent of financial system assets—has remained resilient. The annual expansion in bank credit to the private sector has slowed from about 15 percent in nominal terms in mid-2012 to 10 percent as of August 2013. As of July 2013, the system's capital adequacy ratio stood at 15.6 percent, largely unchanged from a year ago. However, NPLs have increased to 4 percent of total loans in July 2013, from 3.1 percent at end-2012, although provisions still amounted to 174 percent of NPLs.

Executive Board Assessment[2]

Executive Directors noted that Mexico's very strong fundamentals, sound policy framework, and skillful macroeconomic management have allowed Mexico to deal with global volatility exceptionally well in recent months. At the same time, they noted that growth this year will be below potential, and downside risks remain from unsettled external conditions. Directors welcomed the authorities' commitment to maintain prudent macroeconomic policies and continue to implement far-reaching structural reforms.

Directors supported the moderately expansionary fiscal stance. They emphasized nonetheless that medium-term consolidation will be important as growth recovers. In this regard, Directors welcomed legislation that would facilitate achieving the medium-term fiscal targets and a sustainable path for the public debt. More broadly, Directors welcomed the more comprehensive medium-term fiscal framework recently put in place, which will provide a more effective anchor for policy and reduce procyclicality. They encouraged the authorities to consider further efforts to simplify the operations of the oil stabilization funds, bolster collection of nonoil tax revenues, and preserve the gains from the elimination of the subsidy on domestic gasoline prices.

Directors agreed that the current stance of monetary policy is appropriate, and that monetary and exchange rate policies are well positioned to manage tail risks from the global economy. Directors

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

noted that the Flexible Credit Line continues to serve as a complement to foreign reserves if global tail risks materialize.

Directors noted the resilience of Mexico's financial system. They mentioned that recent reforms should promote competition and access in the financial sector while strengthening regulation and consumer protection. Directors also encouraged the authorities to monitor private sector indebtedness and the rise in nonperforming construction loans.

Directors welcomed the progress in structural reforms aimed at upgrading public education, increasing labor market flexibility, and fostering competition in telecommunications. Together with other reforms currently under discussion, these reforms will provide an important, if gradual, impetus to medium-term growth. Implementation will be key, and Directors underscored the benefits of a prompt approval of the secondary legislation and regulations.

Mexico: Selected Economic and Financial Indicators 1/

	2009	2010	2011	2012	2013 2/
(Annual percentage changes, unless otherwise indicated)					
National accounts and prices					
Real GDP	-4.5	5.1	4.0	3.6	1.2
Real GDP per capita 3/	-6.1	3.5	2.7	2.4	0.2
Gross domestic investment (in percent of GDP)	22.9	22.1	22.4	22.9	21.3
Gross domestic savings (in percent of GDP)	22.2	21.9	21.5	21.7	19.6
Consumer price index (period average)	5.3	4.2	3.4	4.1	3.6
External sector					
Exports, f.o.b.	-21.2	29.9	17.1	6.1	2.6
Imports, f.o.b.	-24.1	28.5	16.4	5.7	3.8
External current account balance (in percent of GDP)	-0.9	-0.3	-1.0	-1.2	-1.7
Change in net international reserves (end of period, billions of U.S. dollars)	5.4	22.8	28.9	21.0	17.5
Outstanding external debt (in percent of GDP)	21.8	23.7	24.3	29.4	29.0
Nonfinancial public sector (in percent of GDP)					
Government Revenue	23.3	22.4	22.7	22.7	22.8
Government Expenditure	25.6	25.2	25.2	25.3	25.2
Augmented overall balance	-5.1	-4.3	-3.4	-3.7	-4.1
Money and credit					
Bank credit to the non-financial private sector (nominal percent growth) 4/	-1.0	10.0	17.2	12.0	11.0
Broad money (M4a)	6.1	12.0	15.7	14.5	9.6

1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.
2/ Staff projections.
3/ IMF staff estimates.
4/ Total bank credit outstanding plus non-performing loans from commercial and development banks.