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The International Monetary Fund has approved an 18-month stand-by credit for Mexico of up to the equivalent of SDR 12,070.2 million (about US$17.8 billion) in support of the Government's 1995-96 economic and financial program. Of the total, SDR 5.259 million (about US$7.8 billion) or 300 percent of Mexico's IMF quota[1] --is available immediately. As previously announced, the remaining SDR 6,810.3 million (about US$10 billion) will be provided by the IMF to the extent that contributions of governments and central banks fall short of the targeted amount of US$10 billion. This is the largest-ever financing package approved by the IMF for a member country, both in terms of the amount and the overall percentage of quota, 688.4 percent. The exceptional action was taken with a view to providing an adequate international response to Mexico's financial crisis and giving confidence to the international financial system. The IMF credit is intended to complement other external financing for Mexico announced in recent days..

Background

Mexico has achieved a remarkable economic transformation since the late 1980s on the basis of prudent macroeconomic policies and far-reaching structural reforms. The Government's program resulted in a sharp reduction in fiscal imbalances, a reduction in the role of the state in the economy, a lowering of inflation to close to international levels, and Mexico's greater integration into the global economy. The exchange rate strategy, which limited the movement of the currency within a band that was depreciated by a predetermined amount, played a key role in reducing inflation and ensuring labor's support for the Government's economic program. At the same time, there was a substantial real appreciation of the new peso and a sharp increase in the external current account deficit. Domestic investment increased over this period, while private savings declined substantially.

During 1994, investors' concerns about the sustainability of the current account deficit began to increase, against the background of dramatic adverse political events in Mexico, intense competition for foreign saving in other emerging markets, and generally higher interest rates abroad. To stem capital outflows, the Mexican authorities raised interest rates, allowed the currency to move to the more depreciated limits of the exchange rate band, and substituted short-term indebtedness denominated in foreign currency for local currency-denominated debt. Nevertheless, there was a significant loss of external reserves between February and April, after which the level of reserves stabilized until October.

A resurgence of investors' fears put further pressures on foreign exchange and financial markets and precipitated the present financial crisis and led to the floating of the peso in late December 1994. Events in Mexico contributed to serious pressures in financial and exchange markets in a number of other Latin American countries, as well as increased volatility in markets in other parts of the world.

The 1995-96 Program

The program formulated by the Mexican authorities, and supported by the stand-by credit, must be seen against the background of Mexico's favorable economic fundamentals and its past record of macroeconomic and structural reforms. The program involves a two-pronged approach aimed at consolidating the progress made in the past several years and addressing the current liquidity problem of dealing with substantial short-term obligations falling due. The availability of external financing to support the conversion of short-term government debt into medium- and long-term debt and to help domestic commercial banks to meet their short-term external obligations is expected to ease investors' immediate concerns about the situation in Mexico, and reverse the overshooting of the depreciation of the currency that has occurred.

The program's specific objectives for 1995 are: (i) the reduction in the external current account deficit from 8 percent of GDP in 1994 to 4 percent of GDP in 1995, and to 3-3 1/2 percent of GDP in 1996; and (ii) a lowering of the annualized rate of inflation to around 9 percent in the fourth quarter of 1995, from more than 30 percent in the first quarter of the year. Economic activity is expected to decline in the first half of the year, as the effects of the change in relative prices and the financial adjustment work through the economy. However, it is expected to recover in the second half of the year as financial conditions stabilize. Real GDP should grow by around 1.5 percent for 1995 as a whole.

To achieve these goals, the program is centered on a policy of wage, price, and credit restraint supported by an improvement in the fiscal position. The revised 1995 budget for the nonfinancial public sector provides for a fiscal surplus of 0.5 percent of GDP (compared with a balanced position in 1994), and a primary surplus (the overall balance excluding interest obligations) of 3.4 percent for the year as a whole, compared with a primary surplus of 2.6 percent of GDP in 1994. The contribution of the public sector to the adjustment process is to be particularly large in the first half of 1995. Moreover, the authorities stand ready to strengthen the public finances through additional measures if necessary.

The fiscal tightening should help to achieve an early stabilization of financial and exchange markets, and the measures can be expected to boost savings and result in a substantial reduction in imports. In addition, an acceleration in export growth should result from the real depreciation of the currency.

The policy on wages and prices that has been formulated within the context of the Agreement of Unity to Overcome the Economic Emergency signed between the Government, the Bank of Mexico, and the labor and business sectors, will set the path for the evolution of wages and public sector price rises during 1995. This agreement implies a significant reduction in real wages on average and represents a major contribution on the part of labor to set the basis for a resumption of growth. Wage policy under the agreement provides for an increase of 7 percent in minimum and public sector wages, and an additional 3 percent through an income tax credit for workers with incomes of up to twice the minimum wage. Contractual wage negotiations will adhere to these guidelines and, in addition, will include productivity bonuses freely negotiated between labor and business. The pact also limits the increase in public sector tariffs during 1995 to about 10 percent, or about two thirds of the expected average rate of inflation. The price strategy will result in a revenue loss for the public sector (of about 0.6 percent of GDP) that will be compensated by other fiscal measures. The authorities recognize the need to address price distortions that may result from these measures in due course.

Credit policy will play a critical role in achieving the objectives of the program. The monetary program establishes a limit on the growth of net domestic assets of the Bank of Mexico of MexN $10 billion in 1995, compared with MexN $60 billion in 1994. Under this limit, credit expansion by the Bank of Mexico would be 17 percent of the monetary base at the end of 1994, a rate which is less than that of projected nominal GDP and is consistent with the inflation target of 19 percent for 1995 as a whole. The Bank of Mexico stands ready to tighten credit conditions further to counter unforeseen pressures in the exchange market.

The program provides for a reduction in the rate of credit expansion by the development banks of more than one half (to 2.1 percent of GDP) in 1995. However, the development banks and trust funds will continue to provide net financing to priority sectors, including exports and agriculture.

The substantial depreciation of the exchange rate that has taken place is expected to contribute to a significant improvement in the current account of the balance of payments. Merchandise exports are projected to grow by close to 25 percent in 1995 helped by the devaluation, the increase in investment in export industries in recent years, and the contraction in internal demand. In addition, the effect of the peso depreciation, the policy of credit restraint, and the expected fall in real incomes should lead to a decline in imports of 7 percent in U.S. dollar terms.

The Bank of Mexico will support the floating exchange rate regime through limited intervention in the foreign exchange market. The authorities envisage that the strength of their economic program, together with external financial support will help to stabilize financial markets and result in a significant correction of the recent overshooting of the exchange rate.

For 1996, the authorities have indicated they will follow policies to lower inflation to single digits and further reduce the external current account deficit to 3-3 1/2 percent of GDP. With the return of financial and exchange market stability, investment could be expected to recover which, together with continued export expansion, would contribute to a rebound in real GDP growth to around 4 percent.

While specific proposals for 1996 will not be developed until the 1996 budget is prepared in the second half of 1995, the authorities are committed to review tax policies to at least maintain the surplus position of the public sector and improve the equity of the tax system.

Structural Reform Policies

Over the past several years, Mexico has made substantial progress in the area of structural reform. The program consolidates and extends this progress in important ways. It provides a reinforcement of the Government's strategy for privatization and the granting of concessions to the private sector in areas previously reserved for the public sector. In the past, the privatization efforts had focused mainly on commercial enterprises (although some concessions have been granted for the operation of highways). Beginning in 1995 privatization also will involve basic infrastructure (rail, ports, airports, electricity generation, and radio and telecommunications). The implementation of the new strategy will require some constitutional changes as well as reforms in the regulatory environment which are already under way.

The authorities expect revenues from privatization and concession operations to be about US$6 billion in 1995 and an additional US$6-8 billion in 1996-97. The privatization proceeds will be used largely for the cancellation of the public external debt.

International Financial Support

In addition to the IMF's US$17.8 billion stand-by credit, the United States is expected to provide US$20 billion, the G10 central banks through the Bank for International Settlements (BIS) US$10 billion, and the commercial banks US$3 billion.

Addressing Social Costs

During the late 1980s and early 1990s there was a significant reduction in the number of families living in extreme poverty, reflecting the strong economic growth and increases in real wages in this period, complemented by a program of targeted social expenditures. The authorities recognize, however, that the peso crisis and the adjustment measures that it entails could complicate efforts to sustain the steady improvement in the well-being of the poorest sectors in the short term. A number of policy measures are being implemented to protect the poor from the adverse effects of the adjustment process. While overall lending by the development banks is being scaled back sharply, it will be focused more heavily on financing of agriculture through specialized agencies that lend to small farmers. To limit the real wage adjustment for the lowest wage earners, employers will be allowed to supplement wages of those earning up to twice the minimum wage and to claim a corresponding tax credit.

The Challenge Ahead

The Mexican authorities have embarked on a strong adjustment program to help deal with the current crisis in financial and foreign exchange markets. The domestic adjustment package, combining prudent fiscal and strong monetary and credit policies, a disciplined incomes policy, and further structural reforms, provides an appropriate policy response to current circumstances. Furthermore, the authorities stand ready to strengthen the program as needed to achieve the program's objectives. The support of the international financial community is crucial to the success of the program.

Mexico is an original member of the IMF; its quota is SDR 1,753.3 million (about US$2.6 billion); and its outstanding use of IMF financing currently totals SDR 2,594.7 million (about US$3.8 billion).

Mexico: Selected Economic Indicators

	1990	1991	1992	1993	1994*	1995**
			(percent change)			
Real economic growth	4.5	3.6	2.6	0.4	3.1	1.5
Consumer prices (end of year)	29.9	18.8	11.9	8.0	6.9	19.0
			(percent of GDP)			
Overall fiscal balance	–2.8	–0.5	1.6	0.7	--	0.5
Primary fiscal balance	7.3	5.0	5.8	3.9	2.6	3.4
Gross domestic investment	21.9	22.4	22.8	20.6	21.6	21.0
Gross national savings	15.5	14.3	13.9	14.1	13.7	16.6
External current account balance (deficit –)	–3.2	–4.8	–6.8	–6.4	–8.0	–4.3
Net public external debt	31.7	26.1	30.5	31.1	29.2	27.1

Sources: Mexican authorities and IMF staff estimates
*Preliminary.
**Program.

1. A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its share in the allocation of SDRs.

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