

I. THE ECONOMIC ENVIRONMENT

(1) Introduction

1. The Mexican economy experienced a severe recession in 1995, following the financial crisis of late 1994. Although real GDP growth rebounded by 5 per cent in 1996, the overall level of GDP remains lower than in 1994.¹ The most recent recession was also sharper than in the debt crisis of the 1980s, but recovery has been more rapid. Real export growth, which was about the same during both periods, was driven by manufactured goods in the most recent crisis and by oil exports in the early 1980s. In 1995, imports contracted substantially less than in the early 1980s, reflecting the increased import content of exporting activities. While macroeconomic stabilization has been at the forefront since the financial crisis, the increased openness of the economy (as measured by trade to GDP) and important structural reforms undertaken since the mid-1980s, also facilitated the speed of the recovery.² It should be noted that the 1995 crisis, unlike the earlier debt crisis, was not followed by controls on the current and capital accounts or by a widespread increase in the use of trade barriers.³

2. The economic recession had an immediate negative effect on Mexican living standards as GDP per capita decreased from US\$4,727 in 1994 to US\$3,602 in 1996; unemployment rose to a peak of 7.4 per cent in September 1995, but had fallen to 3.9 per cent in May 1997.⁴ Income disparities between rich and poor remain large (the poorest 20 per cent of the population receive 4 per cent of income⁵) and there are also wide differences in income levels between different regions of the country; for example, incomes in Chiapas, Hidalgo, Guerrero and Oaxaca are 30 to 50 per cent below the national average.⁶

3. Since 1990, the structure of the Mexican economy has continued to shift slowly towards services, away from agriculture (Table I.1). While the share of the farm sector decreased to 6 per cent of GDP in 1996 from 8 per cent in 1990, the contribution of services rose from 61 to 63 per cent. Expansion of services in recent years has been driven mainly by activities in transport, communications and financial services; the majority of the labour force (51 per cent) is employed in the services sector. The contribution of manufacturing to GDP has fallen from 23 to 19 per cent. Despite its modest contribution to GDP, the agricultural sector employs about a quarter of the labour force, more than double that of manufacturing (10 per cent). The salient features of some of these sectors are discussed in Chapter IV.

¹Banco de México (1997).

²Openness of the economy, measured as the ratio of trade (the sum of exports and imports) in goods and non-factor services to GDP, increased from 33 per cent in 1981 to 38 per cent in 1993. Since then, however, the growth has been spectacular; the ratio is estimated at 62 per cent for 1996.

³The only exceptions are some tariff increases on certain goods (e.g. clothing and footwear) (Chapter III).

⁴In the National Survey of Urban Employment (ENEU) persons aged 12 or more are considered employed if, *inter alia*, they have worked at least 1 hour for barter or money, or were self-employed.

⁵World Bank (1996), page 197.

⁶Economist Intelligence Unit (1995), page 17.

Table I.1

Basic social and economic indicators of the economy, 1970-96

Table 1. Selected indicators of the economy, 1970-96								
	1970	1980	1990	1996 ^a				
Population (million, mid-year)	48.2	66.8	81.2	92.0				
Growth of population (percentage change) ^b	..	2.9	2.3	2.1 ^c				
Urban population (per cent of total)	59	66	71	74				
Life expectancy at birth (years)	62	66	70	73				
Total fertility rate (births per woman)	6.8	4.7	3.3	2.8 ^d				
Infant mortality rate (per '000 live births)	74	54	39	28				
School enrolment ratio (per cent)								
Primary school	104	115	115	98 ^e				
Secondary school	22	46	55	88 ^e				
GNP per capita (US\$, current prices)	822	3,106	3,240	3,320 ^d				
	Share of GDP (per cent) ^f				Growth rates (per cent) ^f			
	1970	1980	1990	1996 ^a	1981-93 ^g	1994	1995	1996 ^a
Agriculture, forestry and fishing	11	8	8	6	1	0	2	1
Industry	31	33	33	26	2	5	-8	10
Mining	2	3	4	1	2	2	-3	8
Manufacturing	21	22	23	19	2	4	-5	11
Construction	6	6	5	4	1	8	-23	11
Electricity, gas and water	1	1	2	2	5	5	2	4
Services (including Government)	59	60	61	63	2	5	-6	3
Commerce, restaurants and hotels	28	28	26	18	1	7	-16	4
Transport and communications	4	6	7	9	3	9	-5	9
Financial services	10	9	11	15	4	5	-0	1
Social and community services ^h	17	17	18	20	2	1	-2	1
Banking services ⁱ	-1	-1	-1	-2

... Not available.

a Provisional.

b Average annual growth for the previous ten years.

c Average for 1990-94.

d 1995 data.

e 1994 data.

f Up to 1993 in 1980 constant prices, thereafter in 1993 prices.

g Annual growth rate.

h Includes professional, medical and other services.

i Banking services are imputed value.

Source: Government of Mexico; and World Bank, World Tables 1995, STARS version (growth of population, and school enrolment ratio for 1990).

(2) Recent Economic Developments

4. Since the previous Trade Policy Review in 1993, Mexico's economic scene has been dominated by the peso crisis and subsequent adjustment (Box I.1). The reform programme, undertaken in the wake of the debt crisis of the early 1980s, initiated a turnaround of the economy, with a sharp reduction in the fiscal deficit and a lowering of inflation to single-digit levels. Net capital inflows surged, financing current account deficits. Positive effects were also expected from membership of the North American Free Trade Agreement (NAFTA), which came into force on 1 January 1994.⁷ A real appreciation of the peso up to 1994 helped to control inflation, but also led to a buildup of large current account deficits, reversing the capital flows, causing reserve losses, and increasing dependence on short-term foreign currency borrowing. However, at the time of the previous review, it was thought that the

⁷See Chapter II for more details.

growth of imports, which included high levels of capital goods and intermediates, would contribute to increased exports over time and thus restore commercial balance. But by late 1994, Mexico's short-term liabilities far exceeded the reserves, placing the Government in a serious liquidity crisis. This was exacerbated by political events in the period leading up to the change in administration in December 1994. Economic and political factors thus combined to cause a loss of confidence that led to the devaluation and subsequent floating of the currency in December 1994 (Chart I.1).⁸

5. The post-crisis stabilization programme was supported by major packages of financial assistance from the international financial community, including the International Monetary Fund and the Government of the United States.⁹ In the short term, the programme focused on reducing the current account deficit and preventing a price/wage spiral following the currency depreciation. Although macroeconomic stabilization was at the forefront, structural reforms were also strengthened, for example, by further liberalization of the foreign investment regime, deepening of the already extensive privatization programme, reforms in social security and the banking sector, and the creation of futures markets for foreign exchange.

(i) Aggregate supply and demand

6. In the wake of the financial crisis, the Mexican economy initially experienced a sharp contraction in 1995, with a decline in real GDP of 6.2 per cent, in response to, among other elements, contractionary monetary policy and a decrease in external savings (Table I.2 and Chart I.1). Output fell in all sectors, but activities in the domestic market were the most affected (notably construction, commerce, and restaurants and hotels). Since then, however, the reform programme has yielded a positive supply response; the economy picked up in 1996, with real growth of 5.1 per cent. Initially led by the growth of exports, boosted by devaluation, the recovery of the manufacturing and construction sectors was particularly strong, with some 11 per cent growth in both cases. However, real private consumption increased by only 2.3 per cent, following the sharp drop of 9.5 per cent in 1995.

(ii) Public finances

7. Public finance now appears to be satisfactory. The overall public sector balance, which had registered an annual average deficit of 6.0 per cent of GDP from 1980 to 1992, had been brought into surplus in the early 1990s.¹⁰ Related to the electoral cycle, the overall position deteriorated somewhat in 1994, but has since been balanced. However, as discussed below, the cost of support to the banking sector and the social sector reforms is expected to be a serious drain on the budget for some time. If the Government is to maintain its targeted balanced budget, fiscal developments will have to be closely monitored.

⁸Frankel (1996) shows that the Mexican investors led the capital outflows; just before the devaluation, Mexican fund net asset values (mainly driven by Mexican investors) dropped faster than Mexican country fund prices (mainly driven by foreign investors). This may have been in expectation of a devaluation such as had occurred following earlier presidential elections (when exchange rates were not set by the market).

⁹The IMF provided a standby arrangement of US\$18 billion, equal to almost seven times the Mexican quota. This is the largest loan that the IMF has provided both in terms of per cent of quota and in absolute terms.

¹⁰The overall public sector includes the Federal Government; the Federal Districts; and State-owned enterprises.

Box I.1: Events leading up to the peso crisis

The causes of the peso crisis in December 1994 can be divided into three broad areas, although there is disagreement over their relative importance: (i) build up of macroeconomic imbalances (the peso overvaluation, and large current account deficit), which led to increasing reserve losses and growing dependence on short-term foreign currency borrowing; (ii) adverse external events (rise in U.S. interest rates); and (iii) a series of domestic political events. Some economists also argue that the financial crisis was aggravated by a speculative attack and therefore not entirely driven by underlying fundamentals. In any event, there was a loss of confidence which ultimately led to the collapse of the currency and the devaluation of 20 December 1994.

Several of the key economic indicators had looked promising. The government's fiscal deficit, which was 13 per cent of GDP in 1986, had dramatically improved to 0.4 per cent of GDP in 1993, although, related to the electoral cycle, it worsened somewhat in 1994. Inflation was reduced from 131 per cent in 1987 to 10 per cent in 1993. Moreover, the economy was growing at a healthy rate (annual average real GDP growth of 3 per cent between 1990 and 1993).

However, Mexico experienced substantial increases in private spending and trade deficits from 1988 to 1994. A marked real appreciation of the currency since 1991 contributed to the widening of the current account deficits; the current account deficit had reached about 5.8 per cent in 1993 and would peak at 7.0 per cent of GDP in 1994 as a result of a sharp rise in imports outweighing the rise in exports. The large current account deficits were, in a sense, over-financed by external resources. Attracted by a strong reform programme including important structural reforms (privatization, deregulation, and outward orientation) and the perceived positive economic outlook, net capital inflows surged during the same period and peaked with the passage of NAFTA in January 1994. A large part of the foreign inflows went into the stock market. Net international reserves rose from US\$7 billion at end-1988 to US\$24 billion at end-1993.

A series of domestic and external events affected the financial markets in 1994. In January there was civil unrest in the State of Chiapas. There was also turbulence in international bond markets and world interest rates rose significantly. Subsequent to the assassination of the leading Presidential candidate in March, the flow of portfolio investment almost dried up. Nominal interest rates were increased substantially, and the nominal exchange rate was pushed to the band ceiling.

Capital outflows continued during the year and the Mexican trade deficit was financed largely by drawdown of international reserves. To prevent further interest rate increases, the Government expanded domestic credit and converted short-term peso-dominated government liabilities (cetes) falling due to dollar-denominated bonds (tesobonos). As noted by Sachs (1996), by late 1994 Mexico's short-term liabilities far exceeded the reserves (public sector external short-term debt was more than three and a half times the international reserves), placing the Government in a liquidity crisis.

The use of a predetermined exchange rate to reduce inflation, coupled with very large capital inflows that were intermediated by a weak banking system, led to a situation of exchange rate overvaluation, a vulnerable financial sector and eventually, in December 1994, the collapse of the currency. Following a 15 per cent increase in the exchange rate ceiling on 20 December 1994, the Government adopted a floating exchange rate system on 22 December. Under this system, which is still in force, the external value is determined in the interbank market on the basis of supply and demand. At the time of the crisis the reserves had fallen to US\$6 billion from a high of US\$29 billion in January 1994 (the passage of the NAFTA).

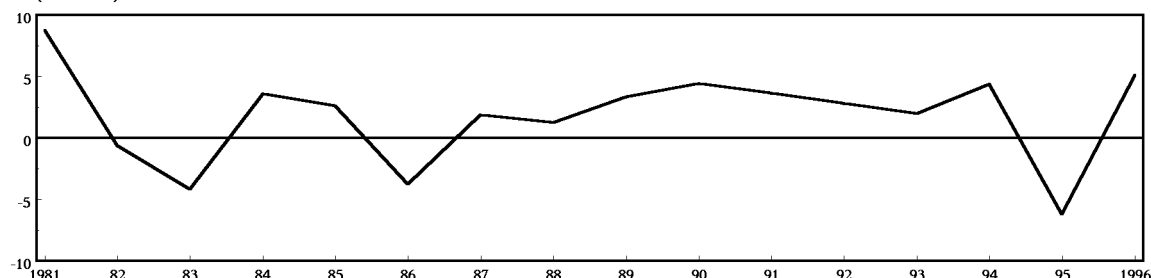
Source: IMF (1995), Working Paper 95/112 by Otker and (1996), Working Paper 96/6 by Masson.

Chart I.1

Selected economic indicators, 1980-1996

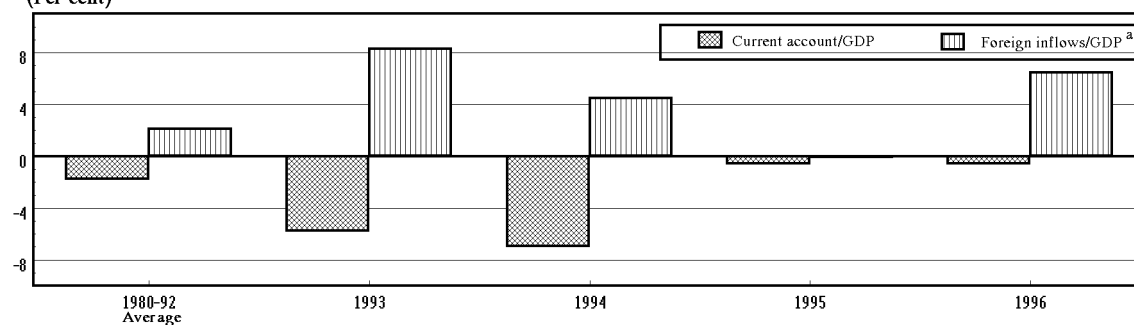
(a) Real GDP growth

(Per cent)

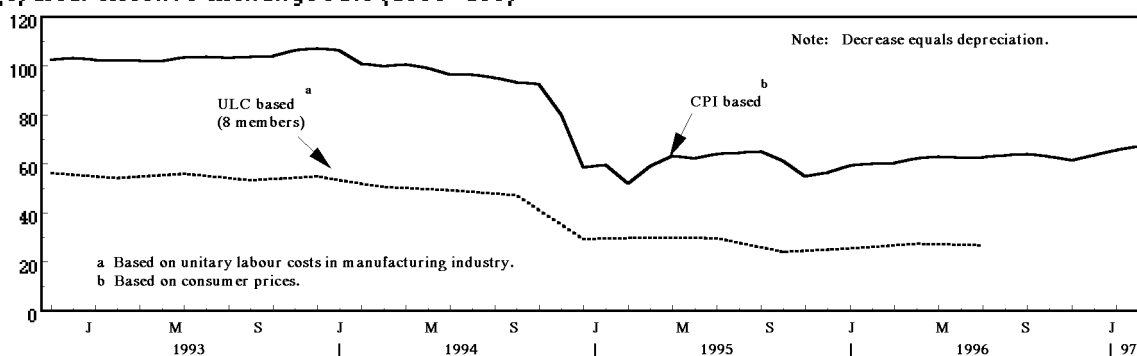


(b) Balance-of-payments developments

(Per cent)

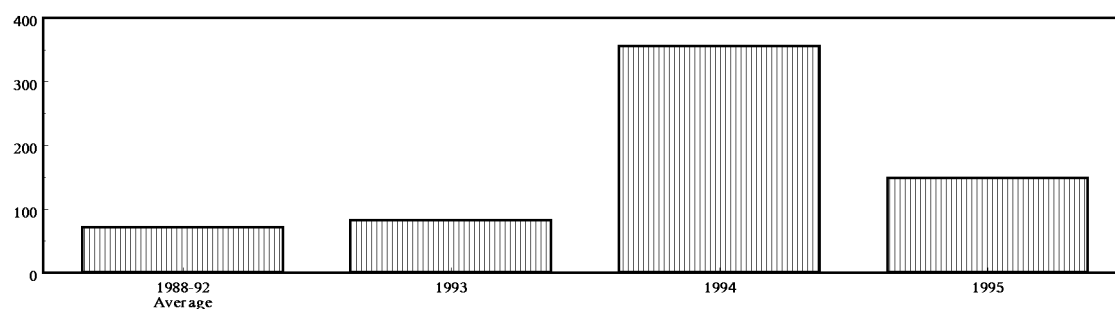
^a Foreign direct and portfolio investments.

(c) Real effective exchange rate (1980=100)



(d) Ratio of public sector short-term debt to international reserves

(Per cent)



Source: INEGI (1996).

Table I.2
Performance of the economy, 1980-96

	1980-92 ^a	1993	1994	1995	1996 ^b
Real GDP market prices (percentage change) ^c	2.0 ^d	2.0	4.4	-6.2	5.1
<u>Savings and investment (per cent of GDP)</u>					
Gross domestic savings	20.0	15.1	15.0	19.0	20.4
Public sector	4.2	5.1	4.0	4.7	4.4
Gross domestic investment	20.2	18.6	19.4	16.1	17.2
Private sector	13.4	14.8	15.6	12.9	13.5
<u>Prices and interest rates (per cent)</u>					
Consumer price inflation (period average)	58.8	9.7	7.0	35.0	34.4
Interest rate on 28-day T-bill (Cetes, annual rate)	46.5 ^e	15.0	14.1	48.4	31.4
Real effective exchange rate ^f					
Unit labour cost	2.0	-0.8	8.2	44.9	13.4
Consumer price	0.9	-6.5	5.7	38.3	..
<u>Government budget (per cent of GDP)</u>					
Federal Government balance	-6.2 ^g	0.4	-0.8	-0.6	-1.0
Revenue	16.2 ^g	15.4	15.2	15.2	15.4
Import duties	0.8 ^h	1.0	0.9	0.6	0.6
Current expenditures	20.0 ^g	13.0	13.3	14.1	13.9
Overall public sector balance	-6.0 ^g	0.7	-0.1	0.0	0.0
<u>Monetary sector (percentage change, end-of-period)</u>					
Narrow nominal money (M1)	61.6 ^h	17.7	3.8	7.0	40.7
Broad nominal money (M4)	65.5 ^h	26.4	24.0	20.7	31.2
Net domestic credit of the financial sector	59.1	11.5	29.2	5.0	-18.5
Net credit to private sector	68.1	24.3	40.3	-4.8	-17.7
<u>External sector (per cent of GDP)</u>					
Current account ⁱ	-1.8	-5.8	-7.0	-0.6	-0.6
Merchandise trade	1.9	-3.3	-4.4	2.5	2.0
Non-factor services	-0.4	-0.5	-0.5	0.2	0.2
Capital account	3.2	8.1	3.5	5.4	1.0
Foreign direct investment	1.3	1.1	2.6	3.3	2.3
Portfolio investment	0.8	7.2	1.9	-3.4	4.2
International reserves (US\$ billion) ^k	8.5	24.5	6.1	15.7	17.5
International reserves in months of imports (GNFS)	3.0	3.8	0.8	2.3	2.1
Gross external debt	44.8 ^h	36.4	38.3	59.2	49.3
Public external debt	35.9 ^h	23.1	24.1	41.2	33.3
Public short-term debt (PSTD)	3.2 ^h	5.6	6.0	8.2	...
PSTD/International reserves (per cent)	71.8 ^h	82.6	356.0	149.4	...
<u>Twelve-month growth rate, end-of-period (per cent)</u>					
Export growth value (GNFS) ^l	8.4	10.7	16.1	25.3	19.7
Non-oil export growth value (GNFS) ^{l, m}	12.5	14.5	18.3	26.7	17.8
Import growth value (GNFS) ^l	11.4	4.5	19.1	-11.1	22.4

Not available.

- | | | | |
|---|---|---|---|
| a | Annual average. | i | Average for 1981-92. |
| b | Provisional. | j | After official transfers. |
| c | Up to 1993 in 1980 prices, thereafter in 1993 prices. | k | As defined by the Banco de México Law; gross international reserves minus international liabilities of the Central Bank with maturities under six months. |
| d | Average for 1981-92. | l | Current US\$. Up to 1991, maquiladoras trade counted as an invisible item, thereafter as merchandise flows. |
| e | Excludes 1986. | m | Excludes crude oil and petroleum products. |
| f | Increase means depreciation, 1980 = 100. | | |
| g | Average for 1986-92. | | |
| h | Average for 1988-92. | | |

Source: Instituto Nacional de Estadística Geográfica e Informática (1996), *Anuario Estadístico* 1995; Banco de México (1997), *The Mexican Economy 1997*; and IMF, *International Financial Statistics* (various issues).

8. In 1995, a comprehensive reform of the domestic tax system was undertaken with the objective of increasing fiscal revenue. The value-added tax (VAT) was increased from 10 per cent to 15 per cent, and general tax legislation was simplified in order to improve tax compliance and reduce the cost of administration.¹¹ Despite these reforms, the revenue collected by the Federal Government only increased marginally, from 15.2 per cent of GDP in 1994 to 15.4 per cent in 1996. More recently, in 1997, further tax reforms were introduced to facilitate voluntary compliance with tax obligations, encourage prompt payment and thus strengthen the tax base.

9. Shedding of state companies has helped to bring the fiscal accounts under control, through lower transfers to these companies and the one-time windfall revenues from privatization proceeds.¹² The Government initiated its privatization programme in the early 1980s. The first phase, which ended in 1988, focused on the smaller enterprises (743 public enterprises were privatized reducing the number remaining to 412). The second phase of privatization, 1989-94, was driven by public finance concerns and brought in a large amount of revenue (US\$24.7 billion). Although the number of firms privatized (196) was smaller than during the first phase, the average size in the second phase was large, involving two airlines, a copper mine, steel mills, the national telephone company and 18 commercial banks.

10. In late 1994 the Government embarked upon the final phase of its privatization programme, with the objective of completing the structural changes in public enterprises and increasing the involvement of the private sector in critical areas such as transportation (railways, roads, and airports); communications (satellites and radio); electricity; and secondary petrochemicals. Since some of these areas were defined as "strategic" (telecommunications, train systems, ports and gas distribution) under the Constitution, the latter has been amended to allow private sector participation (Chapter II).

11. Before December 1994, the Mexican banking system had already experienced a substantial increase in the value of non-performing loans. The situation was aggravated as a result of the currency depreciation, as banks faced a massive increase in external debt-servicing. To avoid an overall banking crisis, the Government acted swiftly with a number of financial support programmes (Box I.2). In 1996 the cost of financing the banking crisis was estimated at 8.4 per cent of GDP in net present value terms.¹¹ In tandem with financial assistance, the banks have also been forced to adopt a wide reform agenda, including tightening of prudential standards, improved supervision procedures and new rules allowing higher levels of foreign ownership. Although the number of non-performing loans is still high and may call for additional resources, the cost increase should level off with economic recovery and lower inflation, enhancing the ability to repay current loans and increase new credit demand.

12. Another key area of reform of public finances - only recently initiated - is in the social security system. The previous public defined-benefit system is to be replaced by a defined-contribution system (capitalized), managed mainly by the private sector, to come into force in mid-1997.¹¹ Rules related to the application of the law, passed in December 1995, were established at the beginning of 1996, defining in particular how individual pension accounts will be managed. The first private pension funds started operation in July 1997. The reform is expected to stimulate savings and develop capital markets. The objective of the health care reform system is to improve access to services and coverage, reduce the financial burden on employers, and raise efficiency of delivery. A basic health package has been introduced for close to four million persons who had no, or little, access to health care.

¹¹OECD (1996b).

¹²The Government accounts privatization proceeds as a revenue item, as opposed to a financing item (i.e. below the line).

Box I.2: The banking crisis and subsequent reforms

The Mexican banking sector rapidly expanded credits to the private sector as a result of financial deregulation (1988), privatization of commercial banks (1991 and 1992), and fiscal adjustment. Prior to December 1994, the banks had already experienced a substantial increase in the number of non-performing loans (the ratio of due loans to total loans increased from 4.6 per cent at end-1991 to 8.5 per cent in March 1994). The situation was further aggravated by currency depreciation, costing the banks a massive increase in external debt servicing, and the associated rapid rise in interest rates (most Mexican loans have floating interest rates). Moreover, the economic recession, also had an adverse effect on the debtors' ability to pay.

The Government acted swiftly with a number of measures to avoid a collapse of the banking sector. As an immediate short-term measure, the Government announced in January 1995 a scheme to recapitalize banks with capital ratios below the 8 per cent stipulated minimum. Since then several programmes to support debtors and banks have been provided:

- restructuring of loans which are basically sound (UDI scheme), where outstanding floating interest rates are converted into long-term loans that carry a fixed real interest rate while the inflation component of the interest payment is capitalized;
- debt relief to various small debtors (small consumer, credit card, small business, and mortgage borrowers) (ADE scheme) in the form of interest subsidy and the possibility of restructuring under the UDI scheme;
- reduction of the financial burden of mortgage debtors in the form of additional resources for restructuring under the UDI scheme; payment discounts between 5 and 30 per cent over ten years; and, if difficulties remain, the property may be given to a trust fund and a minimum rent is payable;
- assistance to private toll road concessionaries who faced financial problems due to substantive decline in highway traffic as well as increased cost of debt service in the form of debt restructuring and interest rate swap arrangements;
- agricultural and fishing producers who keep up with repayment obligations may receive assistance in the form of restructuring of debt and new credits (FINAPE);
- support to small and medium-sized firms (FOPYME) in the form of discounts on debt repayment and new credits. FOPYME would be the final programme to support debtors;
- programmes to support banks: a capitalization programme (PROCAPTE) with the aim of raising the capitalization level of banks through mandatory convertible subordinated debentures; the Bank of Mexico (through FOBAPROA) provided a window for collateralized loans denominated in U.S. dollars; a portfolio purchase programme to complement the infusion of new private capital into weak banks; and assistance in domestic currency to banks and small financial institutions to address solvency and liquidity problems.

In tandem with the financial assistance, a wide range of reforms has been implemented. The permissible level of foreign ownership has been increased: to 100 per cent in existing banks that have less than 6 per cent of the total capital in the system; up to 25 per cent of net capital of the banking system; and to 20 per cent for an investment by a single investor in an institution. These measures were designed to add capital to the banking system. The prudential standards for banks have been tightened in an effort to protect banks from a further decline in asset quality. Banks are required to maintain a minimum loan-loss reserve of 60 per cent of their non-performing loan portfolio or 4 per cent of their total loan portfolio, whichever is the greater. Banking supervision procedures and methodologies have been improved. Finally, banks are now required to report their statements to the Mexican Banking Commission using a method similar to international accounting standards.

The cost of the banking crisis has been estimated at 8.4 per cent of GDP. However, the share of non-performing loans is still very high (according to the old methodology about 6.5 per cent of total loans), and the actual cost may be higher.

Source: IMF (1995), OECD (1996b) and World Bank (1996).

(iii) Monetary policy and exchange rate policy

13. Since the floating of the exchange rate on 22 December 1994, the Banco de México's overriding policy objective has been to control inflation.¹³ Thus, in 1995, the monetary programme was formulated in the context of an upper limit on the growth of net domestic credit (the monetary base minus net foreign exchange reserves) consistent with the expected increase in monetary base. Banco de México's main policy instrument for the management of the net domestic credit is its operations with the commercial banks. While there are no legal reserve requirements, banks are required to have a zero or positive cumulative balance at the Banco de México at the end of a 28-day period. Within this framework, the Banco de México is able to adapt the monetary conditions as needed.

14. To promote a better understanding of its monetary policy, Banco de México adopted a new information policy in 1995, in particular, publishing weekly balance-sheet summaries with important variables such as the monetary base, net domestic credit and foreign exchange reserves. Monetary policy was supported by a commitment on the part of the business community and labour to restrain wage and price increases within the framework of the socio-economic policy pacts.¹⁴ Such pacts, detailed in the 1993 Trade Policy Review, have been in effect and periodically renewed since 1988.

15. The monetary base (M0) increased by 17.0 per cent in 1995 and by 25.7 per cent in 1996, representing a contraction in real terms in both years.¹⁵ The monetary targets for 1997 envisage a 24.5 per cent increase in the monetary base in parallel with a US\$2.5 billion increase in international reserves, which is considered to be in line with the authorities' growth and inflation targets. Average inflation (measured by the consumer price index) increased from 7 per cent in 1994 to 35 per cent for 1995; this is explained mainly by the large depreciation of the currency. The average rate for 1996 was about the same, but estimates indicate a slowing down in 1997 (annualized average growth rate of 24.7 per cent January to April 1997).

16. The crawling peg foreign exchange system, under which the real exchange rate had been allowed to appreciate through 1994, was abandoned in December 1994 in favour of a floating exchange rate system, under which the external value is determined in the interbank market on the basis of supply and demand.¹⁶ Following the 8.2 per cent depreciation of the real effective exchange rate in 1994 (measured on the basis of unit labour costs in manufacturing industry) there was a further real depreciation of 44.9 per cent in 1995, and 13.4 per cent in 1996 (Chart I.1). These real depreciations have given a major boost to exports and adversely affected imports, as discussed below.

¹³In August 1993 the Constitution was amended granting autonomy to the Banco de México, entrusting it with the task of stabilizing the purchasing power of the currency. A new Law entered into force on 1 April 1994, giving the Banco de México the means to control the growth of its credit and thus achieve price stability.

¹⁴Under the system, representatives from the Government, business and labour meet to review the economy to reconcile objectives and agree on policies conducive to the economy. The pacts typically include agreement on changes in administrative prices, inflation targets and minimum wage as well as targeting average wage increases.

¹⁵In real terms, M(0) contracted by 26.8 per cent in 1995 and 1.6 per cent in 1996.

¹⁶Between 11.11.91 and the currency crisis 3 years later, the exchange rate system was characterized by an exchange rate intervention band with a fixed floor and ceiling crawl at a pre-announced rate. The Mexican new peso (1,000 old pesos) was introduced on 1.1.93. The name of the currency was changed to peso on 1.1.96.

17. The functioning of the floating exchange rate system has been assisted by the establishment of forward and futures markets for the domestic currency in March 1995, with the objective of reducing the volatility of the exchange markets. Already in April 1995 the Chicago Mercantile Exchange started trading futures contracts in pesos.

(iv) Balance of payments

18. As noted above, Mexico's recovery has been export led, although the growth of exports slowed somewhat in 1996. In 1996, the U.S. dollar value of exports of goods and non-factor services grew by 19.7 per cent, compared with 25.3 per cent in 1995. After a substantial contraction in 1995, imports picked up in 1996 in response to recovery in domestic demand. These developments on the trade account, and, to a lesser extent, small improvements in non-factor services trade (reduction in tourism expenditures by Mexican residents), are the major factors behind the turnaround in the current account, which was close to balance in 1995, moving from -7.0 per cent of GDP in 1994 to -0.6 per cent. Estimates for 1996 also place it close to balance.

19. From 1990 until 1993, a worsening current account deficit position was more than sufficiently covered by a capital account surplus, with foreign investment being the main financing source. These flows were dominated by portfolio investment, with funds going both to the stock market and government securities such as treasury certificates (Table I.3). This upward trend was sharply reversed in 1994, when net portfolio investment fell from a peak of US\$29 billion, equivalent to 7 per cent of GDP, at the end of 1993 to US\$8 billion (2 per cent of GDP) by the end of 1994 and to a deficit of US\$10 billion (3 per cent of GDP) by the end of 1995, reflecting movements in both bond and equity securities markets. The capital account position recovered in 1995 to a surplus of 5.4 per cent of GDP, driven by large loans taken by the Banco de México and the public sector. In 1996, the capital account surplus fell to 1 per cent of GDP as a result of substantial loan repayments (of some US\$11 billion) by Banco de México and the public sector, only partly offset by large inflows of foreign investment.

Table I.3
Portfolio investment in Mexico, 1990-96
(US\$ million and per cent)

	1990	1991	1992	1993	1994	1995	1996
Portfolio investment (net, US\$)	3,370	12,753	18,041	28,919	8,182	-9,715	14,154
Equity securities/port. inv. (%)	59	50	27	37	50	-5	21
Bond securities/port. inv. (%)	41	50	73	63	50	105	79
<u>Memo:</u>							
Portfolio investment/GDP (%)	1.3	4.0	5.0	7.2	1.9	-3.4	4.2

Source: IMF, International Financial Statistics.

20. Unlike the more volatile portfolio investment, the inward flow of foreign direct investment has continued to increase since 1994, albeit at a lower rate (Table I.4); the flows in 1994 more than doubled compared with the previous year. Net foreign direct investment increased from US\$2 billion in 1980 (1 per cent of GDP) to US\$10 billion in 1994 (2 per cent of GDP) falling to almost US\$7 billion in 1995 (2 per cent of GDP). Liberalization measures (NAFTA in particular), changes in the foreign direct investment regime (Chapter II) and strengthening of intellectual property rights (Chapter III) are likely to have spurred these flows.

Table I.4

Foreign direct investment in Mexico, 1980-96

(US\$ million, current values and per cent)

	New investment	Annual change (%)	New investment/GDP (%)	Cumulative investment	Annual change (%)
1980	1,623	100	0.8	8,460	24
1981	1,701	5	0.6	10,161	20
1982	627	-63	0.3	10,788	6
1983	684	9	0.4	11,471	6
1984	1,430	109	0.8	12,901	12
1985	1,729	21	0.9	14,630	13
1986	2,424	40	1.8	17,054	17
1987	3,877	60	2.6	20,932	23
1988	3,157	-19	1.7	24,089	15
1989	2,500	-21	1.1	26,588	10
1990	3,722	49	1.4	30,311	14
1991	3,565	-4	1.1	33,876	12
1992	3,600	1	1.0	37,475	11
1993	4,901	36	1.2	42,376	13
1994	9,963	103	2.4	52,339	24
1995	6,738	-32	2.4	59,078	13
1996 ^a	1,945	n.a.	n.a.	61,023	n.a.

n.a. Not applicable.

a Figures at end June 1996.

Note: Excludes portfolio investment. The methodology for compilation was significantly revised in 1995, and hence the 1980-94 data are not strictly consistent with the 1995-96 data.

Source: INEGI, *Anuario Estadístico* 1995; Government data for 1994, 1995 and 1996.

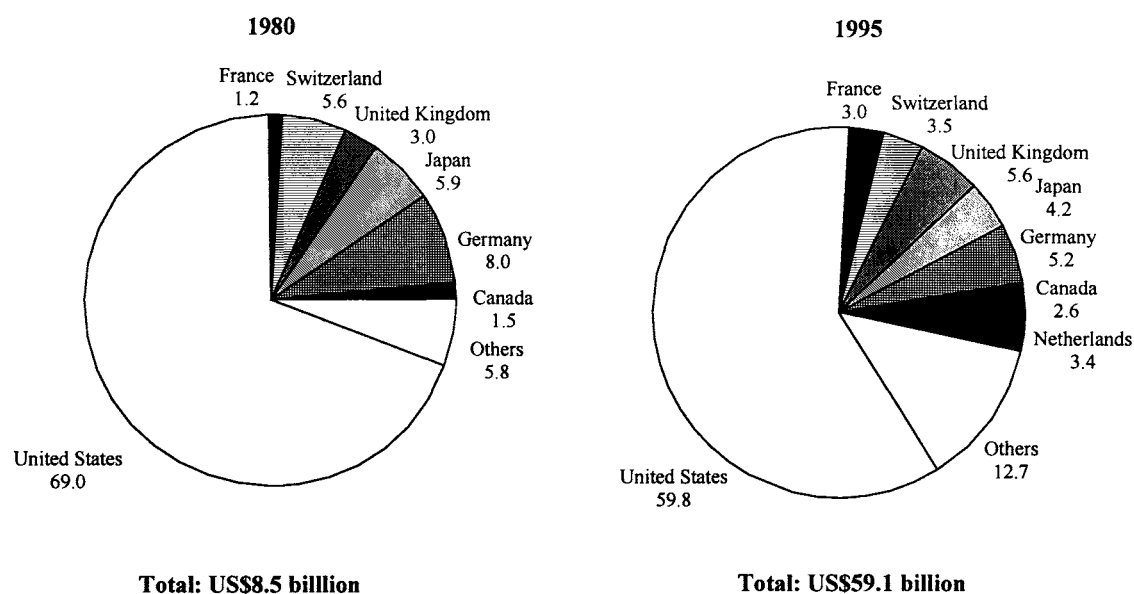
21. Foreign direct investment in Mexico continues to be heavily dominated by the United States. Although its share in cumulative foreign direct investment decreased from 69 per cent in 1980 to 60 per cent in 1995, the flows in current U.S. dollars increased more than six-fold over the same period. Other large foreign direct investors are the United Kingdom, accounting for 6 per cent of the stock in 1995, Germany (5 per cent) and Japan (4 per cent) (Chart I.2 and Table AI.1).

22. Although the industrial sector continues to attract most foreign direct investment, accounting for 56 per cent of the stock in 1995, its share has decreased from 78 per cent since 1980 (Chart I.2 and Table AI.2). Over the same period, foreign investment in the services sector has increased dramatically from 8 per cent to 33 per cent of the stock. As noted in the previous review, the liberalization of the economy since the mid-1980s has contributed to the attractiveness of Mexican industry for foreign investment, and this trend has been markedly strengthened by the NAFTA.

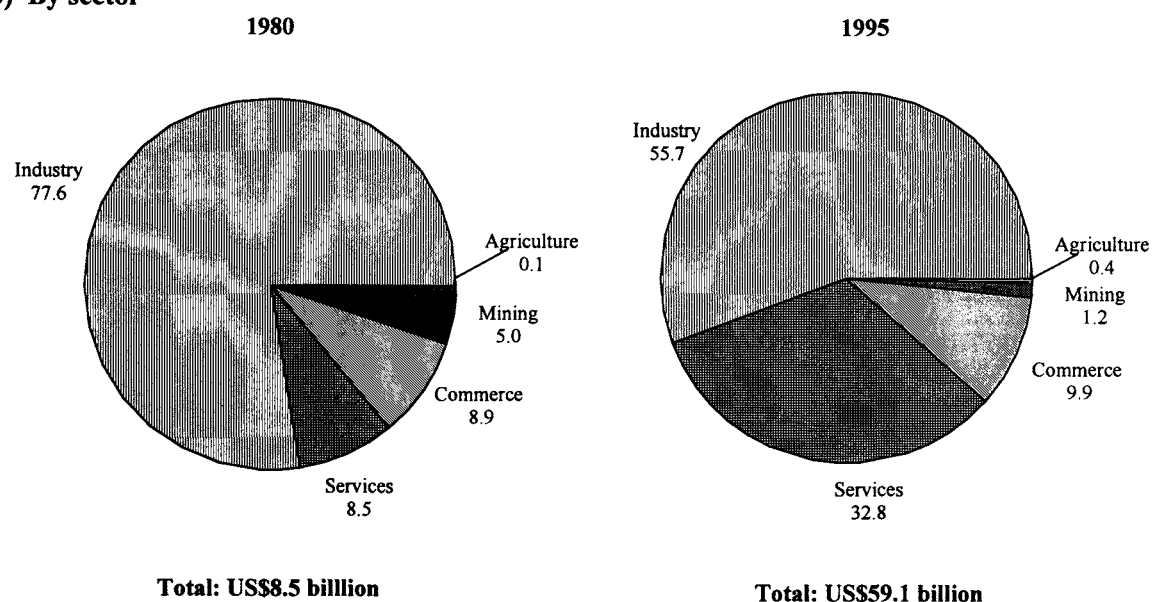
23. As a result of foreign borrowing to combat the effects of the financial crisis, Mexico's total external debt soared by US\$29 billion to US\$118 billion (equivalent to 59 per cent of GDP) in the 12 months up to the end of 1995. Part of the debt increase reflects the Government's substitution of debt denominated in domestic currency for debt in U.S. dollars (public short-term external debt accounted for US\$22 billion at end-1994). In 1996, the Government started to refinance the public debt at longer maturities and lower cost, but according to the OECD (1996b) repayments will still weigh heavily on the capital account in the short term.

Chart I.2
Stock of foreign direct investment in Mexico, 1980 and 1995
(Per cent)

(a) By country of origin



(b) By sector



Source: INEGI (1996); Government data for 1994 and 1995.

24. Balance-of-payments developments allowed the gross international reserves to increase to US\$18 billion at end-1996, equivalent to 2.1 months of goods and non-factor services imports, and to US\$22 by end-May 1997.

(3) Composition and Direction of Trade

25. The large currency depreciation in the aftermath of the December 1994 crisis resulted in a substantial increase in exports: overall exports of merchandise and non-factor services increased from US\$61 billion in 1993 to US\$107 billion in 1996 (32 per cent of GDP). Although slowing down in 1996, exports are continuing to drive growth (growth in current U.S. dollars of 25.3 per cent in 1995 and 19.7 per cent in 1996).

26. A full description of long-term trends in Mexico's merchandise trade by country and product is not possible, since data before 1992 exclude trade by the *maquiladora* industries, the free-trade zones concentrated along the border with the United States (Chapter IV).¹⁷ The *maquiladoras*' production is concentrated in processing manufacturing inputs, raw materials, components, parts, etc. into final products for re-export to the United States.

(i) Composition of merchandise trade

27. Since the trade liberalization initiated in the mid-1980s, Mexican exports have successfully diversified away from oil, with manufacturing exports growing at an impressive pace. Between 1992 and 1995 the value of manufacturing exports almost doubled, accounting for 78 per cent of merchandise export earnings in 1995 compared with 71 per cent in 1992 (Table AI.3). This expansion has been driven by the machinery and transport equipment sub-sector, notably the automotive industry. Data for the first three quarters of 1996 indicate a continued good performance of the sub-sector as well as of the automotive industry. Growth in manufacturing has been accompanied by increased productivity; between 1992 and 1996 average productivity per manufacturing worker rose by more than 50 per cent.¹⁸

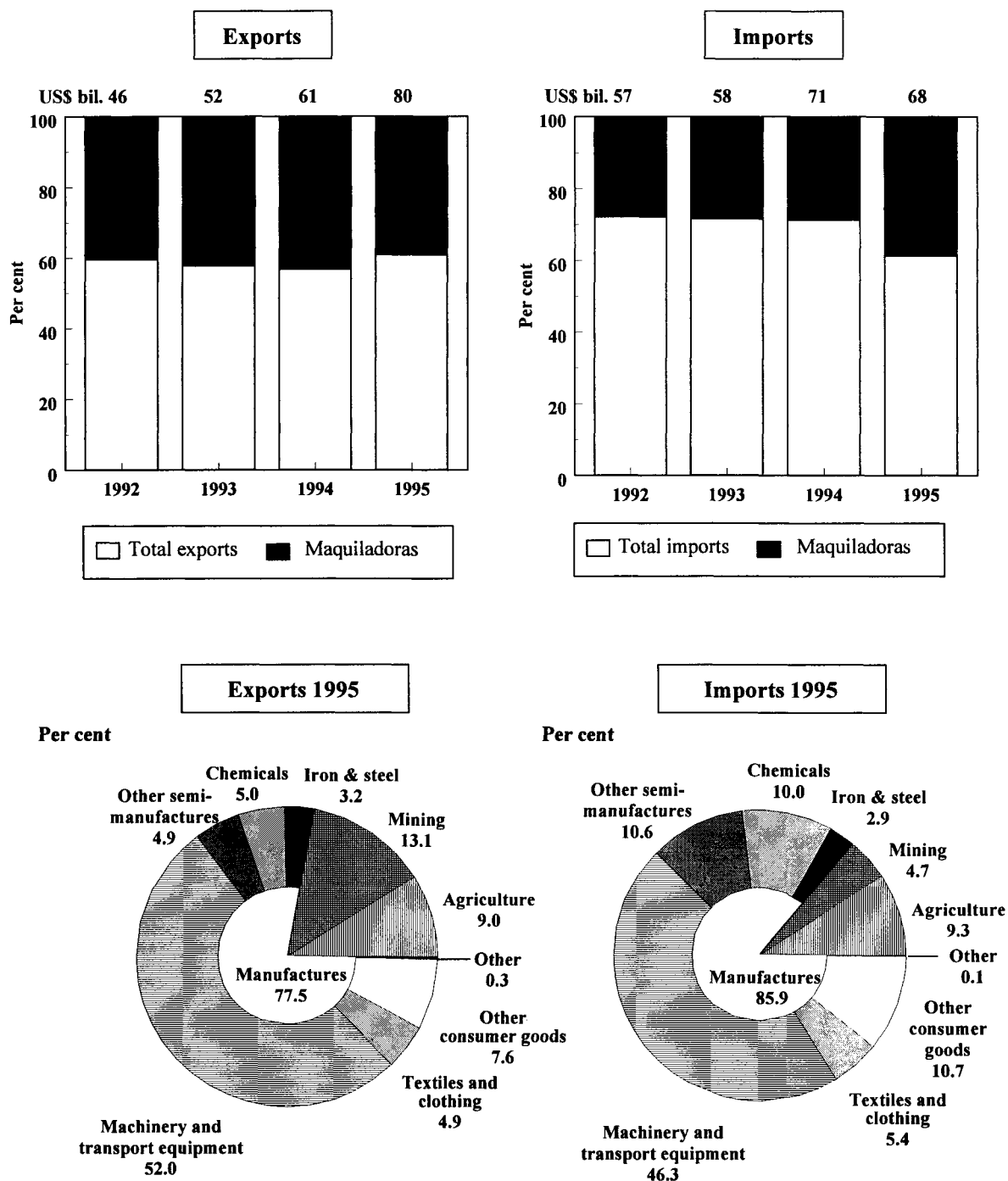
28. Manufacturing dominates merchandise imports, amounting to 86 per cent of merchandise imports in 1995, of which machinery and transport equipment (54 per cent of manufacturing imports) are the most important items (Chart I.3 and Table AI.4). Imports of agricultural goods have continued to decrease during the 1990s from 12 per cent of merchandise imports to 1992 to 9 per cent in 1995.

29. Mexico's strong dependence on imported intermediated goods has meant that export growth has led to increased imports. In 1995, although total merchandise imports contracted by almost 9 per cent, intermediate goods expressed in U.S. dollars (and as a share of total) continued to increase (Chart I.3 and Table I.5). As the economic recovery began in 1996, imports soared from US\$72 billion to US\$89 billion, with the value of intermediate goods growing strongly and capital goods rebounding after the decline in 1995.

¹⁷Traditionally data on *maquiladora* industries have been included in the invisibles account, with net appearing under the heading of transformation services. Since 1992, however, the *maquiladoras*' imports and exports have been included with merchandise trade flows.

¹⁸Banco de México (1997).

Chart I.3
Composition of Mexico's merchandise trade, 1992-95



Note: Trade in gold is excluded.

Source: Government of Mexico.

Table I.5
Merchandise trade, 1992-97
 (US\$ million and per cent)

	1992	1993	1994	1995	1996	Jan-Apr 1997
Imports (US\$ billion)	62.1	65.4	79.3	72.4	89.5	23.5
Consumer goods (per cent)	12.5	12.0	12.0	7.4	7.4	7.5
Intermediate goods (per cent)	68.9	71.1	71.2	80.6	80.4	79.5
Capital goods (per cent)	18.6	16.9	16.8	12.0	12.2	13.0
Exports (US\$ billion)	46.2	51.9	60.9	79.5	96.0	24.9
Consumer goods (per cent)	24.8	27.5	28.4	29.2	29.6	29.1
Intermediate goods (per cent)	62.7	59.0	57.1	55.5	53.3	53.7
Capital goods (per cent)	12.4	13.5	14.6	15.2	17.1	17.2

Source: Government of Mexico.

Trade by *maquiladoras*

30. In 1995 exports by the *maquiladoras* increased at a slower pace than non-*maquiladora* exports, reversing the pattern of many years; preliminary data for 1996 show the same trend. This change in relative performance may be explained by the re-orientation of domestic firms towards the world market as domestic demand dropped sharply in 1995. Total exports by the *maquiladoras* increased from about US\$19 billion (or 40 per cent of total exports) in 1992 to US\$31 billion (or 39 per cent of total exports) in 1995 (Chart I.3 and Table AI.5). As noted above, exports by the *maquiladoras* are almost exclusively manufacturing products (99 per cent in 1995). In 1995, the most important export items were: office machines and telecommunications equipment (30 per cent), other electrical machines (29 per cent), and automotive products (7 per cent).

31. In tandem with increased exports, *maquiladoras* imports have increased in value from about US\$16 billion in 1992 to US\$26 billion in 1995 (Table AI.6); they also account for an increasing share of imports, rising from 28 per cent in 1992 to 39 per cent in 1995 (Chart I.3). *Maquiladoras* imports are heavily focused on manufacturing (81 per cent in 1995), of which machinery and transport equipment (47 per cent of *maquiladoras* imports in 1995) dominate.

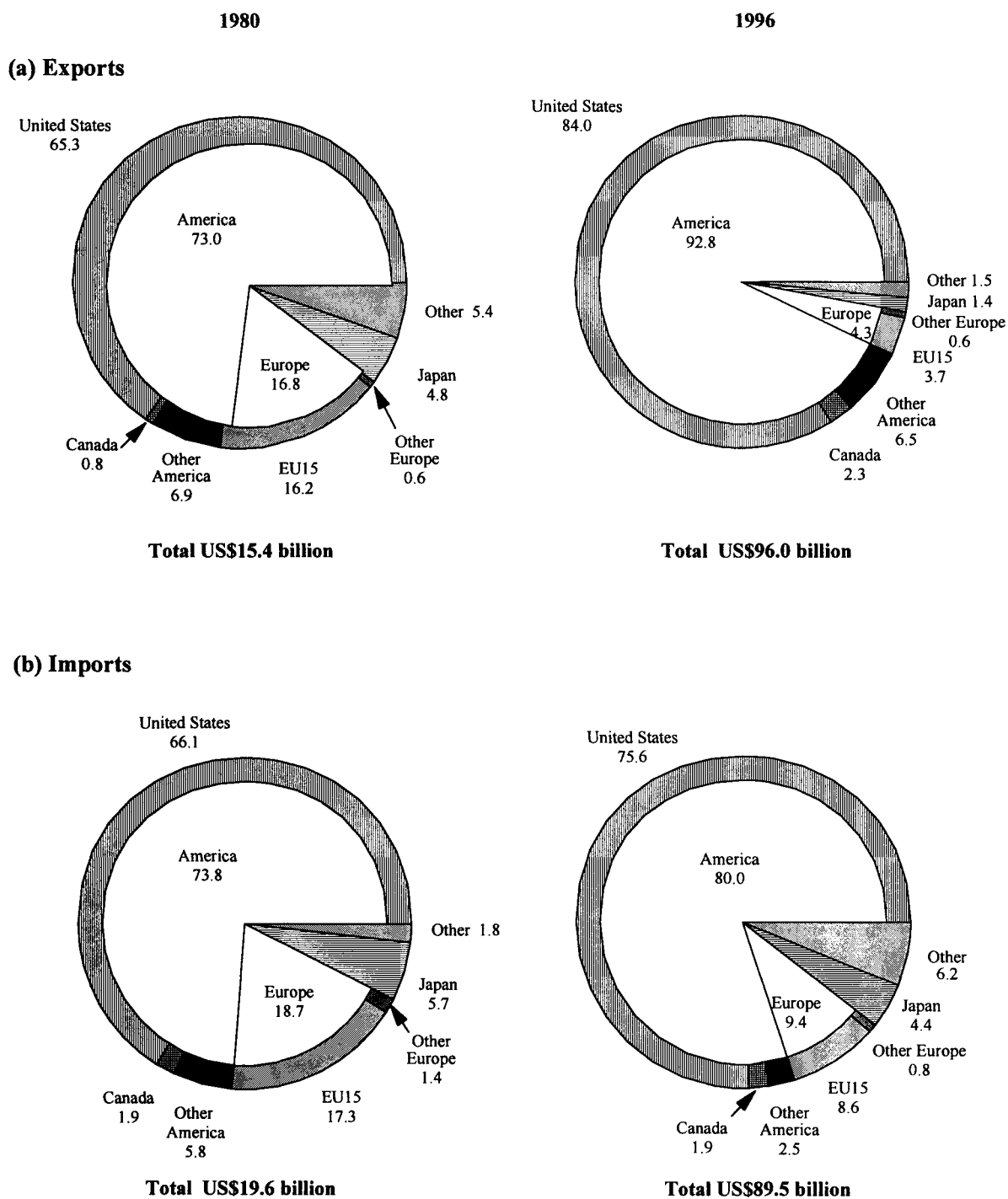
(ii) Direction of merchandise trade

32. The United States takes over 80 per cent of Mexico's exports, and overall trade between the United States and Mexico has surged since the completion of the NAFTA. This trend is likely to continue as tariffs and non-tariff barriers are further lowered within the framework of NAFTA. Mexico is also likely to benefit from the agreements reached in the field of services and investment. In addition, the growth of Mexican exports to the United States has benefited from the strong growth of the U.S. economy during the 1990s (Chart I.4 and Table AI.7). Exports to Canada have also performed well, albeit at much lower levels, while the share of exports destined for the EU has decreased from 7 per cent of total exports in 1992 to 4 per cent in 1996.

33. On the import side, the picture is similar; the United States' share of Mexico's imports has increased steadily since 1992, reaching about three-quarters in 1996 (Chart I.4 and Table AI.8). Over the same period, the share of imports from the EU has fallen from 11 per cent in 1992 to 9 per cent in 1996, while East Asia has continued to take about 10 per cent of the market.

Chart I.4
Merchandise trade by main origin and destination, 1980 and 1996

(Per cent)



Note: Data for 1980 excludes trade by maquiladoras.

Source: UNSTAT, Comtrade database; and Government of Mexico.

(iii) Trade in services

34. Mexico has a substantial, but declining deficit on its trade in services. Net receipts on services account improved from an annual average deficit of 4.5 per cent of GDP between 1980 and 1992 to a deficit of 3.9 per cent in 1996 (equivalent to US\$13.0 billion).¹⁹

35. Net receipts for non-factor services improved from an annual average deficit of 0.5 per cent of GDP between 1980 and 1992 to a surplus of 0.2 per cent of GDP in 1996. Gross receipts, which averaged 2.7 per cent of GDP between 1980 and 1992, rose slightly to reach 3.2 per cent of GDP in 1996. Tourism accounted for about 64 per cent of total receipts in 1996. Payments for non-factor services, which averaged 3.3 per cent of GDP from 1980 to 1992, fell to about 3.1 per cent of GDP in 1996, reflecting the slowdown in Mexican travelling; this fall was compensated in 1996 by increased freight and insurance costs as imports surged. Interest payments, amounting to some US\$13.5 billion in 1996, heavily dominate payments of factor services, and are about twice the receipts from tourism.

(4) Outlook

36. Under the effects of the stabilization programme, pressures on financial markets seem to have eased. Short-term nominal interest rates have decreased from a peak of about 80 per cent during the crisis to 19 per cent (the annual rate on 28-day cetes Treasury-bill) and inflation is showing signs of falling. Mexico's access to international capital markets has improved, while the index of the stock market has increased. The current level of gross international reserves (US\$22 billion at end-May 1997) is getting close to that prior to the peso crisis (US\$29 billion). Moreover, the increase of 11 per cent in construction in 1996, bodes well for future growth based on domestic demand.

37. However, the economy has not fully recovered from the financial crisis, and the situation of the banking sector remains a major concern. A collapse of the banking system has been averted, but the crisis has left behind a highly fragile system. It is not clear to what extent the sector can support a fast growing economy. The high share of non-performing loans (notably mortgage loans) may also call for additional government resources. Fiscal consolidation may also be threatened by the cost of the reform of the pension and health insurance system, and the projected sharp increase in debt-servicing payments in the near future. The Government may be forced to keep interest rates high to protect against further peso weakening and inflation, thereby discouraging investment. A risk factor on the external front is the evolution of the world market price of oil, which, following substantial increases in 1995 and 1996, is projected to decrease in the short term.²⁰

38. Within the framework of its current fiscal and monetary stance, the Government is strongly committed to continuing with structural reforms, which will enhance outward and private-sector orientation. The introduction of individual pension savings accounts may contribute to higher savings as well as a deepening of financial markets. The Government's recent initiative to present a medium-term plan (until year 2000) may also contribute to a more stable and predictable policy framework.²¹

¹⁹Instituto Nacional de Estadística Geográfica e Informática (1996) and Banco de México's Web-site.

²⁰The IMF (1997), page 159, projects the price of oil expressed in U.S. dollars to fall by 3.6 per cent in 1997 and 6.7 per cent in 1998.

²¹The Pronafide (*Programa Nacional de Financiamiento del Desarrollo*) was presented by President Zedillo in June 1997.