MEXICO
MINISTRY OF FINANCE AND PUBLIC CREDIT

September 8, 2004

ECONOMIC POLICY GUIDELINES AND THE FEDERATION'S EXPENDITURE DECREE PROPOSAL FOR 2005

As established by Article 74 of the Constitution, the Economic Package was delivered to Congress on September 8th.

Evolution of the Mexican Economy in 2004

The Mexican economy's dynamism has increased since manufacturing activity strengthened in the US during the second half of 2003. During the first half of 2004, total exports expanded at a rate in excess of 14 percent, which helped dissipate fears of de-linkage with the US economy.

The recovery of the manufacturing sector helped to balance the expansion, given that the rest of the economy was already behaving favorably. Moreover, during the first half of 2004, there was a shift in the contribution to economic growth by the various components of domestic demand, highlighting the expansion in total investment which outperformed consumption for the first time since 2000. In these circumstances the economy is expected to grow 4.0 percent in 2004.

The increase in economic activity has reflected on the labor market. In the first seven months of the year, the number of workers affiliated to the Social Security Institute, a measure of formal sector employment, increased by over 280 thousand, the greatest increase in the indicator in the past four years.

The public sector deficit for 2004, excluding the Voluntary Retirement Program (VRP), is expected to be 0.3 percent of GDP; this figure is consistent with the target established in the Federation's Expenditure Decree for the year. The primary surplus, defined as total revenues, minus expenditures other than financing costs is expected to represent 2.6 percent of GDP.

Budgetary revenues are projected to exceed the amount foreseen in the Federation's Revenues Law for the year by Ps. 109.5 billion. The favorable performance of this indicator is mainly attributable to high international oil prices. Non-oil related tax revenues are expected to be slightly lower than anticipated in the Revenues Law for 2004, and non-tax revenues of the Federal Government are also expected to fall below those anticipated.

Regarding programmable expenditures, excess revenues are expected to amount to Ps. 83.9 billion. The excess resources will primarily be destined to:

- Investment expenditures by PEMEX.
- Infrastructure expenditures by the States.
- Deposits in the oil stabilization fund.

The distribution of excess revenues has been carried out with strict compliance of the guidelines established in the Federation's Expenditure Decree for 2004. Additionally, programmable expenditures have been directed to social development, poverty reduction, and infrastructure provision. As a result, expenditures related to federal entities through items 33 and 25 (Ramo 33 and Ramo 25) increased an aggregate 1.2 percent in real terms. Similarly, within programmable expenditures it is important to highlight the real 4.2 percent increase in healthcare and social security expenditures during 2004.

During 2004, personnel services related expenditures are expected to decline by 0.8 percent in real annual terms. This reduction reflects the 2.1 percent real reduction in personnel services expenditures excluding those in education, healthcare, social security, and justice procurement sectors.

Non-programmable expenditures in 2004 exceed the amount stipulated in the budget decree by Ps. 21.5 billion. This is explained by higher fiscal liability payments during the previous exercise, as well as the increase in revenue sharing to federal entities.

The Public Sector Borrowing Requirements (PSBR) are expected to be 1.8 percent of GDP in 2004, including both the voluntary retirement program and the favorable impact of the note exchange of the Fobaproa Capitalization and Portfolio Acquisition Program (PCCC). Excluding the favorable impact of the PCCC notes, PSBR are equivalent to 2.7 percent of GDP[1].

[1] The exchange of the notes generates a benefit of Ps. 115.8 billion for the public Treasury, out of which Ps. 63.8 billion correspond to asset recovery and have an effect on the PSBR. The remaining Ps. 52.0 billion correspond to accounting adjustments that reduce the debt balance, but do not impact IPAB's flow of funds.

Public Sector Borrowing Requirements, 2003-2004 (% of GDP)				
	2003	2004		
		Approved	Estimate	
			w/ PCCC	w/o PCCC
I. Public Deficit excluding VRP	**0.4**	**0.3**	**0.3**	**0.3**
A. Budgetary Revenues	23.7	22.7	23.4	23.4
Oil Related	7.9	7.1	8.4	8.4
Non-oil Related	15.8	15.6	15.0	15.0
Tax	10.1	10.1	9.7	9.7
Non-Tax	1.4	1.5	1.2	1.2
PEDBC	4.3	4.1	4.1	4.1
B. Net Budgetary Expenditures	24.2	23.0	23.6	23.6
Programmable */	17.7	16.4	17.0	17.0
Non Programmable	6.4	6.6	6.6	6.6
Financing Costs	2.8	3.0	2.8	2.8
Revenues Sharing	3.3	3.4	3.4	3.4
Adefas and others	0.3	0.2	0.4	0.4
C. Non-Budgetary Deficit	-0.1	0.0	0.0	0.0
I. Public Deficit including VRP	**0.6**	**0.3**	**0.4**	**0.4**
II. Adjustments	**1.9**	**2.4**	**1.5**	**2.3**
PIDIREGAS	1.1	1.5	1.4	1.4
IPAB	0.3	0.3	-0.5	0.3
Registry Corrections	0.1	0.1	0.1	0.1
Debtor Support Programs	0.0	-0.1	-0.1	-0.1
FARAC	0.0	0.1	0.2	0.2
Financial Intermediation	0.4	0.5	0.4	0.4
III. PSBR (I+II)	**2.5**	**2.7**	**1.8**	**2.7**
Excluding Non-Recurrent Revenues	**3.2**	**3.3**	**2.3**	**3.2**

w/ with; w/o without.
VRP Voluntary retirement program.
PEDBC Public entities under direct budgetary control-

Economic Policy Guidelines for 2005

In 2005, economic policy will focus on reaching the necessary support to advance with the structural reform agenda and on consolidating macroeconomic stability.

International experience indicates that those countries that have been successful in keeping the momentum of their structural reform process, have achieved productivity growth. Successful countries have undertaken new rounds of structural reforms every time that the momentum of previous reforms on productivity has waned. Among those countries that have been successful are: Chile in Latin-American, Korea and Singapore in Asia, Ireland and Spain in Europe, as well as various OECD member such as Canada, New Zealand and Australia. These countries have successfully implemented reforms to improve, the fiscal and commercial frameworks, privatization and deregulation, labor reform, competition in the energy and telecommunications sectors, as well as decisive combat against monopolies. The results are conclusive, in 1980, GDP per capita in these countries represented 154 percent of that in Mexico, in 2003 it represented 255 percent of Mexico's per-capita GDP.[2]

The common denominator among these structural reform processes- no matter in which sector- is that they focused on increasing productivity as the key to sustainable growth, and improving income distribution.

The results experienced by these counties highlight the importance of implementing the structural reform agenda in Mexico, which comprises six priority sectors of the economy: energy, labor, fiscal, pension system, Pemex's fiscal regime, and the budgetary process.

- The energy reform focuses on improving economic competitiveness through two basic contributions by reducing energy costs, and increasing its quality.
- The labor reform seeks to promote a new labor culture which would broaden worker's development possibilities and stimulate labor productivity.
- The consensuses reached in the National Fiscal Convention clearly indicate the direction in which the tax system and fiscal coordination system must evolve in order to achieve healthy public finances that increase certainty in both revenues and expenditures. These changes will allow the government to increase the resources it channels to attend pressing social needs.
- Furthermore, the agreements reached in the National Fiscal Convention suggest the creation of a National Public Sector Worker Pension System based on individual accounts, accompanied with a guaranteed minimum pension. This system would increase equality and certainty for public workers.
- It is necessary to promote a new fiscal regime for PEMEX, which would allow the firm to compete in international markets under equal footing. Furthermore, a new fiscal regime will increase the return of investment and exploration projects, and will stimulate investment in the natural gas sector to decrease dependency on foreign countries to meet the countries natural gas needs.
- In order to carry out the Government's public policies, it is necessary to have a clear legal framework for the elaboration of the budget. Furthermore, it is desirable to establish permanent guidelines for budgetary adjustment in

[2] Source: Calculations based on the data from Heston, Summers and Aten, Penn World Tables, Version 6.1; Center for International Comparison, University of Pennsylvania, October 2002.

case a revenues shortfall is observed. Similarly, it is necessary to establish rules for the use of excess revenues, in case these are received.

The second priority of economic policy in 2005 is to ensure macroeconomic stability. Therefore, economic policy seeks to generate a better environment for the private sector to boost its investment, to generate more jobs, and improve their quality. In order to achieve this, the Government will continue to manage its public finances in a responsible manner, and to promote inflation abatement and interest rate moderation. These efforts will reduce the uncertainty related to expected investment project's returns.

Furthermore, macroeconomic stability contributes to poverty alleviation and improves income distribution. Recurrent macroeconomic and financial crises in Mexico had adverse effects on the population's well-being and in particular on the poorest segment of the population. For example, in the previous three macroeconomic crises, the real minimum wage contracted 19 percent on average. The macroeconomic stability achieved in recent years, has contributed to the recovery of real wages; the real wage has increased since 1999.

Macroeconomic recovery and the poverty alleviation programs of the Government had an important effect on the main poverty indicators as well as on income distribution.

The commitment to reduce the public sector's deficit and ultimately achieve a balanced budget, without compromising the public sector's own functions, is reaffirmed. In order to achieve macroeconomic and financial stability, this strategy strengthens the economy, and allows Mexico to be one of the emerging markets least affected by international financial volatility in 2004.

Consistent with this strategy, the public sector deficit target for 2005 is 0.1 percent of GDP. The proposed reduction in the fiscal deficit will diminish the crowding out on domestic credit markets, allow the economy to face future shocks in an orderly manner, reduce future public finance vulnerability to oil shocks, and consolidate fiscal policy credibility.

Given the importance of oil-related revenues in the Government's budget, and their volatility, there is risk that they will be lower than estimated. In case this contingency occurs, the Expenditure Decree Project contains automatic expenditure stabilizers to insure that the deficit target for the year is met. As in previous years, priority would be given to expenditures on: education, healthcare, equal opportunities, rural development, and infrastructure.

The Revenues Law for 2005 incorporates a realistic, although slightly optimistic, international oil price assumption. Furthermore, the Expenditure Decree Project has clear and transparent guidelines to distribute excess revenues. Given the transitory nature of oil-related revenues, the guidelines propose that these revenues be used for investment and savings. It is worth highlighting the experiences of Russia and Norway, which have successfully constituted important stabilization funds taking advantage of episodes where oil prices have been high. In the case of Norway, over the last 15 years an oil fund worth US $145 billion has been accumulated. Similarly, Russia created its own oils stabilization fund towards the end of 2003, and it is expected that it will approximate US $19 billion by yearend.

The consolidated budgetary public sector's revenues during the 2005 fiscal exercise are estimated at Ps. 1.7 trillion, which amounts to 21.6 percent of GDP. This figure is 1.7 percentage points of GDP lower than the figure estimated for the end of 2004. The variation is explained by:

- A decline in oil-related revenues approximating 1.1 percentage points of GDP, resulting from a decline in international oil prices.
- Non-oil related tax revenues are expected to fall by 0.1 percentage points of GDP, due to a reduction in import duties that was agreed upon in various free trade agreements.
- Non-oil non-tax revenues are expected to decline by 0.5 percentage points of GDP with respect to those projected for 2004. This decline will result from the lower operational surplus in the Central Bank, as well as the fact that no more financial asset recoveries from Brady Bond collateral are available.

In 2005, public expenditures will focus on the following objectives:

1. Establishing an expenditure level that is consistent with the amount of resources available, prioritizing strategic areas and to those that are fundamental for economic development. To achieve this end, non-investment expenditures will be rationalized and resources will be redirected to sectors that bring direct benefits to the population.

    - Non-investment expenditures decline by 2.9 percent with respect to 2004.
    - Personnel services expenditures are expected to increase by 1.6 percent in real terms during 2005.
    - The increase in personnel expenditures results from a 20.8 percent increase in personnel related expenditures requested by autonomous entities and powers, as well as a 5.4 percent increase in personnel services in universities, decentralized entities dedicated to education and healthcare, as well as research centers and public enterprises.
    - In contrast, personnel related expenditures directly carried out by the Executive will decline 1.1 percent in real terms, and personnel service related expenditures in public entities under direct budgetary control will only increase by 0.2 percent.

- Pension related expenditures will be Ps. 171.1 billion, which represents an 11.5 percent increase in real terms with respect to pension related expenditures approved for 2004.
- Operating expenses other than personnel services and pensions will fall 11.8 percent in real terms.

2. Strengthening the judicial system and the justice procurement system to safeguard the population and protect property rights.

   - To this end, Ps. 13.5 billion have been set aside for the judicial system, this amount is 22.0 percent higher than the amount approved in 2004.
   - Out of the amount mentioned above, Ps. 6.9 billion will be administered by the Ministry of Public Safety, and Ps. 6.6 billion will be destined to the National Public Safety System.
   - Furthermore, resources channeled to the public safety fund will double from their 2004 level.

3. Priority will be given to expenditure focused directly on benefiting social groups in the country's regions. Accordingly, social development expenditures and those focused on poverty alleviation will increase.

   - Social development expenditures will be Ps. 772.2 billion, 3.2 percent higher in real terms than those approved for 2004.
   - Within social expenditures it is important to highlight the 10.0 percent increase in healthcare related expenditures, mainly due to higher expenditure on the Popular Insurance that will benefit 3 million families.
   - Ps. 300.1 billion will be destined to the various aspects of education. Among these programs *Enciclomedia* will be one of the most benefited.
   - Culture related expenditures will increase by 17.3 percent in real terms.
   - Expenditures aimed at poverty alleviation will increase by 9.8 percent in real terms.
   - Indigenous communities will receive Ps. 21.4 billion; this figure is 5.4 percent higher than that approved by Congress for 2004.
   - The Ps. 32.8 billion assigned to the *Oportunidades* Program will benefit 5 million families.

4. Protecting expenditures destined to federal entities.

   - In order to achieve this, efforts will be made to increase fiscal federalism, through improvements in fiscal resource distribution and responsibility assignment between the Federal Government and federal entities and municipalities.

- Expressed as a percentage of primary expenditures, resources channeled to federal entities and municipalities will represent 35.9 percent, while the central government represents 25.1 percent. The rest corresponds to expenditures carried out by federal entities under direct budgetary control, and autonomous powers and entities, as well as liabilities from previous fiscal exercises.

5. Supporting agricultural, fishing and forestry policies in order to generate sustainable growth, employment and improvement in living conditions and income in rural communities.

    - The total amount budgeted for programs that affect rural development in the Expenditure Decree Proposal for 2005 is Ps. 125.2 billion.
    - This amount is slightly higher in real terms than the amount approved for 2004, and 10.4 percent higher in real terms than the amount included in the Budget proposal for 2004.
    - If this amount is approved, the total amount spent on the agricultural sector during the first five years of the present administration will be 32.7 percent higher, in real terms, than that spent over the previous 5 years.

6. Stimulate better infrastructure, with the purpose of accelerating economic development.

    - In 2005, budgetary resources channeled for physical capital investment will decline. However, investment carried out by the public sector will total Ps. 178.8 billion pesos, 3.0 percent higher in real terms than the amount approved for 2004.
    - Infrastructure expenditures in the road network will be Ps. 11.4 billion, 52.7 percent higher to that presented in the expenditure decree proposal for 2004, and will be complemented with joint private and public sector participation schemes.
    - In the energy sector, investment financed through PIDIREGAS will total Ps. 144.4 billion.
    - In the residential market, government projects will permit investment worth a total of Ps. 126.3 billion, 4.5 percent higher in real terms than that carried out in 2004.
    - Sustainable development related expenditures will increase by 11.7 percent with respect to that estimated for 2004.

Public debt policies will focus on generating the necessary resources to meet current obligations as well as those necessary to finance the deficit. This will be achieved under the best possible conditions in terms of cost and risk, for the medium and long terms, contributing to well functioning financial markets. Public debt administration will continue to be prudent and transparent, while it continues to diversify risk and adhere to the best international practices.

Public debt policy has permitted the reduction of public sector financing cost vulnerability to interest and exchange rate shocks; thus contributing to strengthen the macroeconomic fundamentals of the economy. To consolidate these advances, the economic package for 2005 that was presented to Congress by the Executive contemplates a minimum reduction of US $500 million in net external indebtedness in an effort to continue to strengthen the structure of public debt. Accordingly, the public sector's deficit will be wholly financed in domestic financial markets. As a result, the economic package proposes a net domestic indebtedness ceiling of Ps. 90 billion for the Federal Government.

The Federal Government's domestic debt issuance strategy continues to focus on long term fixed rate notes, while simultaneously working towards gradually eliminating the issuance of floating rate notes. The importance of the six month cetes rate as a reference rate will be heightened through increases in the amounts of these securities issued. Given current international financial market conditions, characterized by increasing interest rates, the rate at which the term and duration of domestic issuance has been increasing will decline. By the end of 2004, the average maturity of domestic debt will be greater than 1000 days; by the end of 2005 it is expected to further increase by approximately 140 days.

The external debt issuance strategy will continue to take advantage of opportunities, by substituting more expensive bonds for cheaper ones as long as these operations permit the smoothing of the amortization schedule and allow the government to increase the liquidity of its debt in international markets. Furthermore, given the improved credit rating of the county, tapping financial markets to obtain financing has become cheaper than obtaining it through official lending. Accordingly, exposure to official lending will gradually decline.

Economic Perspectives for 2005

The US economy is expected to continue to have a positive impact on domestic production during the remainder of 2004 and all of 2005. The above results are based on real annual growth expectations of 5.0 and 3.7 percent in US industrial production and GDP, respectively in 2005.

Regarding international oil prices, a reduction is expected in 2005. This results form expectations of an increase in oil supply and a moderation of global economic activity that will result in lower oil demand. Additionally, the risk premium, which explains a large part of current prices, is expected to moderate in the short term. The main factors that suggest the dispersion of the underlying risk are greater security in both Saudi Arabia and Iraq's oil facilities, the peaceful conclusion of Venezuela's referendum, and the dispersion of the fears that Russia would interrupt oil exports.

It is important to mention that Mexican oil mix prices would also decline if the expected fall in international oil prices materializes. In this manner, the high capacity utilization rate that is present in the refinery industry and the current composition of oil supply suggest that the existing spread between lighter oil and the Mexican oil mix will remain at high levels. Based on these observations, the average price for the Mexican oil mix is expected to be US $23 per barrel in 2005.

Expected real economic growth in the Mexican economy during 2005 is 3.8 percent. This forecast is supported on the expected performance of exports of goods and services, as well as higher private consumption and capital expenditures.

The public sector borrowing requirements in 2005 will be 2.1 percent of GDP, this figure implies a 0.5 percentage point of GDP reduction over the expected PSBRs for 2004, excluding the PCCC note exchange and expenditures related to the voluntary retirement program. As a result, the declining trend of the PSBR will continue, as established in the medium term economic program.

Public Sector Borrowing Requirements, 2004-2005
(% of GDP)

	2004 w/ PCCC and w/o VRP	2005	Difference
I. Traditional Public Deficit	**0.3**	**0.1**	**-0.2**
A. Budgetary Revenues	23.4	21.6	-1.7
Oil Related	8.4	7.3	-1.1
Non Oil Related	15.0	14.3	-0.6
Tax	9.7	9.6	-0.1
Non Tax	1.2	0.7	-0.5
PEDBC other than PEMEX	4.1	4.0	-0.1
B. Net Budgetary Expenditures	23.6	21.7	-1.9
Programmable	17.0	15.4	-1.6
Non Programmable	6.6	6.4	-0.3
Financing Costs	2.8	2.9	0.0
Revenue Sharing	3.4	3.3	-0.1
Adefas and others	0.4	0.2	-0.2
C. Non-Budgetary Deficit	0.0	0.0	0.0
II. Adjustments	**2.3**	**2.0**	**-0.3**
PIDIREGAS	1.4	1.0	-0.3
IPAB	0.3	0.2	-0.1
Registry Corrections	0.1	0.1	0.0
Debtor Support Programs	-0.1	0.1	0.2
FARAC	0.2	0.0	-0.2
Financial Intermediation	0.4	0.5	0.0
III. PSBR (I+II)	**2.6**	**2.1**	**-0.5**
Excluding Non-Recurrent Revenues	**3.1**	**2.2**	**-0.9**

w/ with; w/o without.
VRP Voluntary retirement program.
PEDBC Public entities under direct budgetary control-

Medium Term Economic and Public Finance Perspectives

In the medium term, a gradual deceleration of the US economy is expected, and oil prices are expected to return to historical levels.

During the period 2005-2008; the Mexican economy is expected to experience an average 4.0 percent real growth rate, similar to that foreseen in the inertial scenario of the medium term economic program. The medium term scenario is based on the assumption that the external sector will continue to be one of the main drivers of economic activity, and that domestic demand components will behave according to its historical trend.

The efforts to increase tax efficiency carried out in the past have been effective. Comparing different tax collections, as a percent of GDP, in the 1998-2000 and 2001-2004 periods yields the following results:

- Total tax revenues increased from 9.3 to 9.9 percent.
- Income tax collection went form 4.6 to 5.0 percent.
- VAT collection increased from 3.3 to 3.7.

However, meeting fiscal targets has been aided by two transitory factors:

- High oil related revenues resulting from high oil prices in the period 2001-2004, and in particular over the past two years.
- High non-recurrent revenues of the public sector over the period 2001-2004.

The medium term strategy ratifies, and extends towards 2008 the medium fiscal objectives presented in the PRONAFIDE and the Economic Policy Guidelines for 2004.

- The target of reaching a fiscal surplus by 2006, which increases slightly towards 2008.
- The PSBR will continue to decline in order to broaden the resources available to the private sector.
- Augmented public debt, measured as the historical PSBR balance, is projected to decline to about 35 percent of GDP by 2008.

Medium term fiscal pressures originate in both lower oil-related and non-recurrent revenues, as well as from higher expenditure pressures from the pension system and investment financed by the private sector.

Oil related revenues are projected to decline by about 1.9 percentage points of GDP between 2004 and 2008. Furthermore, non-recurrent revenues are projected to fall by 0.6 percentage points of GDP between the 2001-2004 average and those expected on average for 2005-2008.

On the expenditure side, in the absence of a structural reform, expenditure pressures in the public pension system will increase from 2.1 to 2.8 percent of GDP between 2004 and 2008. Additionally, fiscal pressures from investment projects financed by the private sector (previously PIDIREGAS) will double between 2004 and 2008, going from 1.1 percent of GDP in 2004 to 2.4 percent of GDP in 2008.

Final Considerations

Economic activity is expected to remain dynamic in 2005, consequently the labor market is expected to recover. The program contained in this document will help meet these objectives.

However, it must be highlighted that the growth rate achieved in 2004, and that projected for 2005 is not high enough to abate the country's economic lag. As a result, it is imperative to increase the pace of economic reform in order to attain productivity gains and increase the population's wellbeing in a decisive manner. Additionally, it is important to modify the tax structure, to increase tax revenues, to increase the efficiency of the tax structure, and to increase competitiveness. Additionally, it is important for the Government to take advantage of current high oil prices to increase its savings and investment. These measures will allow the country to face the eventual correction in oil prices efficiently.

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The economic package for 2005 does not contemplate any of the recommendations made by the National Fiscal Convention. However, the Executive sent some of the recommendations made by the Convention to Congress along with the economic package, which refer to changes in the following:

- The value added and a tax on sales.
- Income taxes.
- The Fiscal Regime of PEMEX.

ANNEX I

MACROECONOMIC FRAMEWORK, 2004-2005 e/		
	2004	**2005**
Gross Domestic Product		
Real % growth	4.0	3.8
Nominal (Billions of pesos)	7,350.4	7,934.4
GDP Deflator	4.7	4.0
Inflation		
Dec./dec.	3.9	3.0
Nominal Exchange Rate */		
Average	11.3	11.6
Interest Rates (28 day Cetes)		
Average Nominal, %	6.7	7.8
Real, %	2.9	4.8
Current Account		
Millions of Dollars	-8,887.8	-14,237.4
% of GDP	-1.4	-2.1
Fiscal Balance		
Traditional Deficit, % of GDP	0.3**	0.1
PSBR, % of GDP	2.6**	2.1
Support Variables:		
US GDP.		
Real % growth	4.4	3.7
US Industrial Production		
Real % growth	5.1	5.0
US Inflation		
Dec./dec.	2.3	2.2
Oil (Mexican oil mix)		
Average Price (US $./barrel)	29.2	23.0
Average Export Platform (mbd)	1,857	1,900
External Interest Rates ***/		
LIBOR, %	2.2	3.2
Federal Funds Rate, %	2.0	3.0

e/ Estimate.
*/ Given that the exchange rate is free floating, this figure is not a forecast, but an assumption for other calculations
**/ Does not consider either the cost of the Voluntary Retirement Program (VRP), or the revenues associated to the PCCC notes exchange
***/ End of Period.