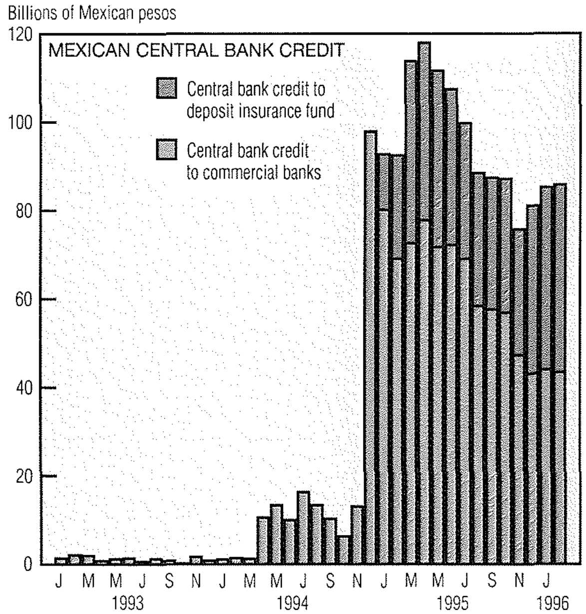
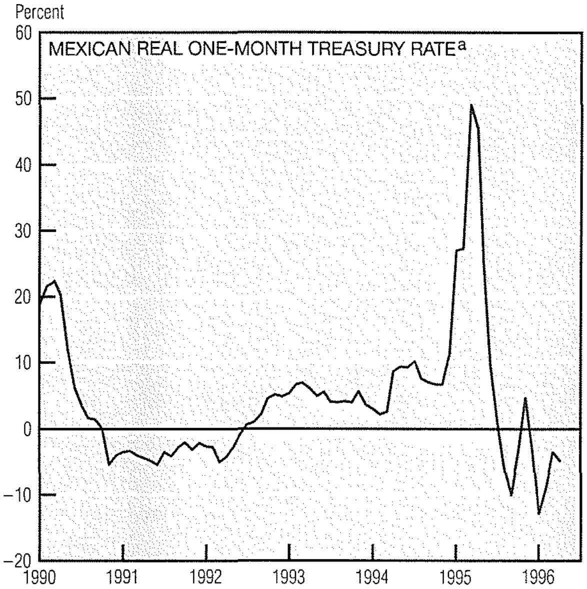
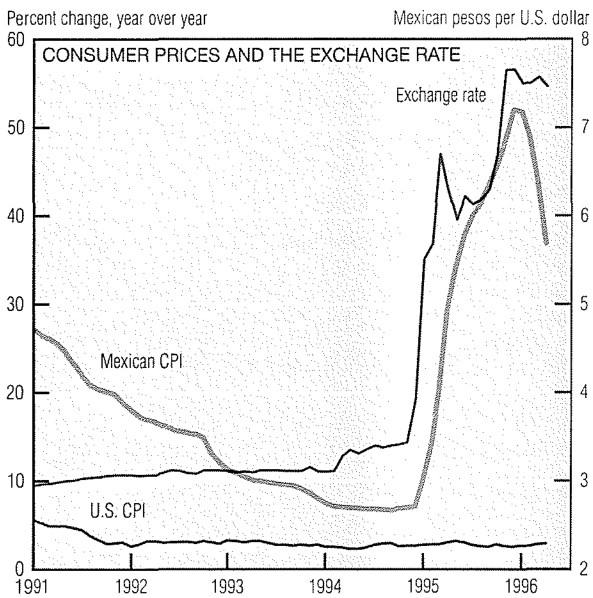
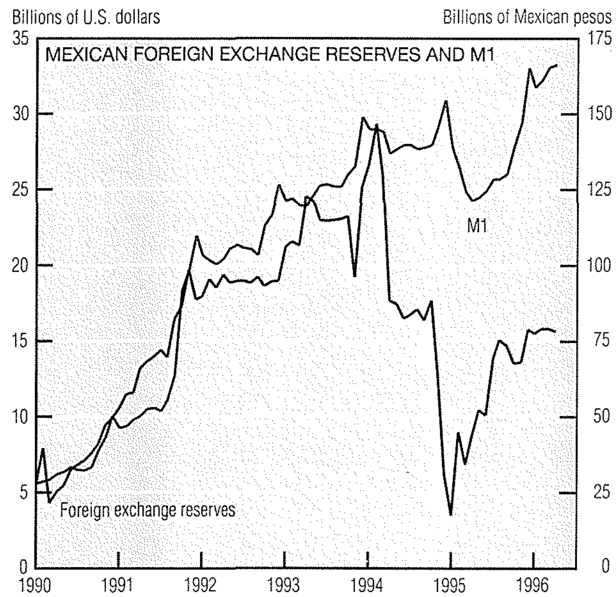
The Mexican Economy









a. One-month Treasury rate minus 12-month consumer price change.
SOURCES: DRI/McGraw-Hill; and Bank of Mexico.

Observers were surprised by first-quarter data showing that the Mexican economy shrank only 1% compared to the first quarter of 1995, but they remain concerned that this strength is limited to the export sector, which has benefited from a sharp decrease in the international value of the peso since December 1994. A continued general weakness in economic activity may be related to the burden of unpaid loans on consumers and banks.

The Mexican central bank has supported a series of programs dealing with bad-debt problems. The deposit insurance fund has been used to buy back debt from banks and to provide credit for recapitalization. Other programs include helping banks index debts to inflation and supporting debt renegotiations between banks and consumers.

Lower interest rates help consumers meet loan payments and increase their willingness to renegotiate overdue debts. However, the recent negative real interest rates enable borrowers to fund uneconomic projects. Rapid price increases since December 1994 may result partly from the weakening of the peso. Rising inflation due to central bank efforts to support banks, on the other hand, may undermine confidence in Mexican policy reforms. Any consequent loss of reserves or rise in interest rates would damage both the banking sector and the economy.