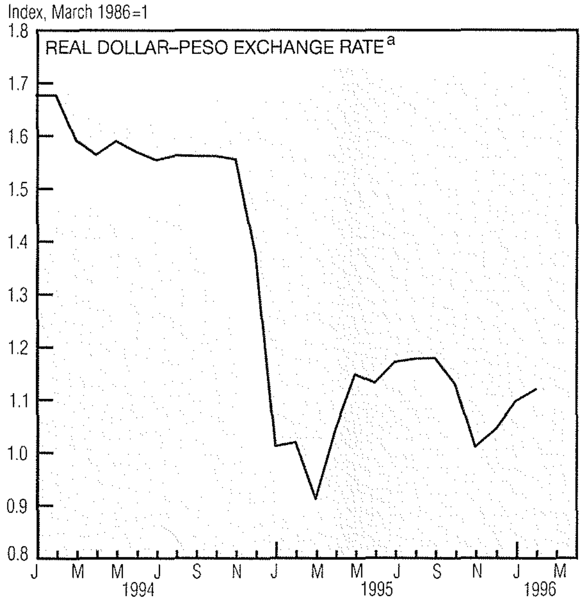
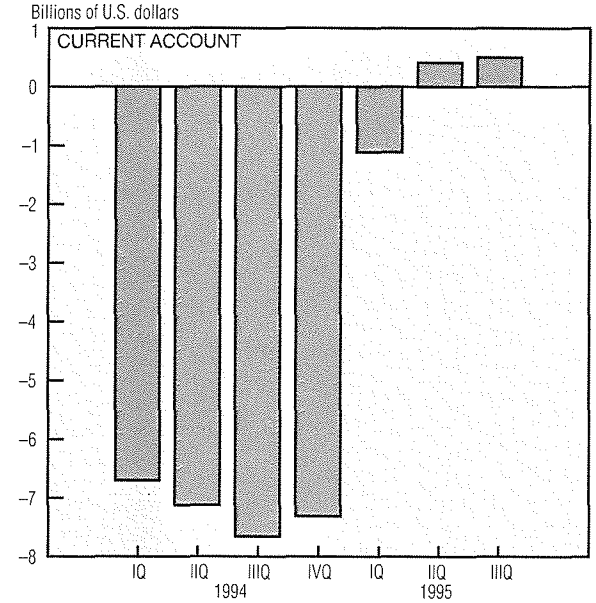
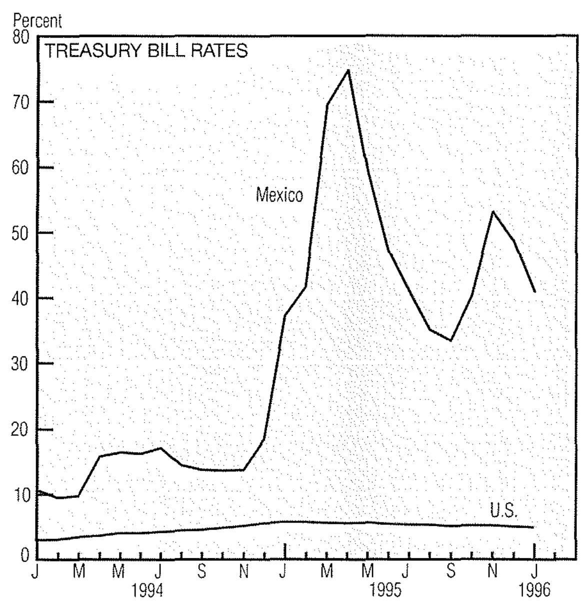
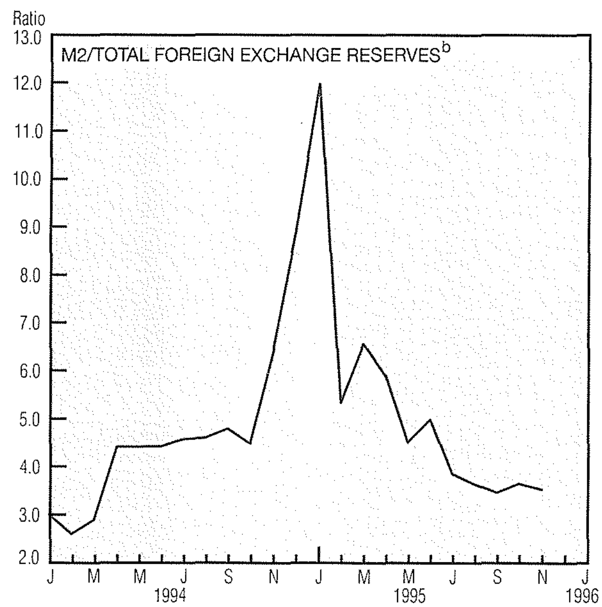
The Mexican Economy









a. Adjusted for the inflation differential between the U.S. and Mexico.
b. Foreign exchange reserves were converted to Mexican pesos using average monthly exchange rates. M2 is the sum of lines 34 and 35 in the International Monetary Fund's *International Financial Statistics.*
SOURCE: International Monetary Fund.

Macroeconomic conditions in Mexico seem to have stabilized, and concerns about growth have become focused on the condition of the banking system. The peso's real exchange rate, which combines information about the nominal exchange rate and the inflation rates in the U.S. and Mexico, was greatly reduced by the devaluation of the peso in December 1994, boosting Mexican competitiveness and exports.

However, high interest rates in Mexico, which result from capital outflows, persist. They increase the cost of efforts by the Mexican government and international financial agencies to help banks and borrowers cope with increased debt burdens and with lower domestic spending. Most observers are now confident that the banking system is recovering, but the ultimate cost to the government is unclear.

The Bank of Mexico is no longer required to intervene in defense of the peso, as it was under the previous exchange-rate regime. However, events in late 1995 demonstrated a continuing potential conflict between exchange-rate policy and the recovery of the banking system and real spending. In order to defend the peso, interest rates were increased sharply in November, further weakening the prospects for banking recovery. Investors worry that continuing problems in the banking sector may create a temptation to abandon inflation control as the guiding principle of monetary policy. Athough foreign exchange reserves need no longer be large enough to maintain the exchange rate, they must be capable of meeting capital outflows whose potential magnitudes are related to the size of monetary aggregates.