Office Memorandum

To: The Managing Director
The Deputy Managing Director

September 30, 1985

From: C.M. Watson

Subject: Bank Debt of Selected Countries

As you requested, I attach data on the indebtedness to commercial banks of selected developing countries. These have been subdivided into three categories:

a. Market borrowers that have encountered payments difficulties.

b. Market borrowers that could potentially encounter difficulties if conditions deteriorate.

c. Countries not included in the market borrower category but which appear relevant to the present exercise. Of the 20 countries you requested, Romania appears in this category.

The data show the stock of outstanding bank claims on these countries in billions of U.S. dollars at end-December 1984. Of the sources shown, the Fund's International Banking Statistics frequently (but not invariably) provide the most comprehensive measure of cross-border claims. The BIS quarterly data provide some cross check on deficiencies in the debtor reporting component, since they are entirely derived from creditor sources. The BIS semiannual data reflect the consolidated claims of banking groups head officed in BIS reporting countries, where such claims are collected by national compilers. The final column shows the highest figure for claims of these three series.

Attachment

cc: Mr. Finch
Mr. Collins
Mr. Brown

Comparison of Bank Claims on Selected Developing Countries at end-1984

(In billions of U.S. dollars)

Country	Fund's IBS	BIS Quarterly	BIS Semiannual	Largest Recorded Claims
a. Market borrowers that have recently encountered payments strains				
Argentina	24.6	26.1	25.1	26.1
Bolivia	1.7	0.7	0.7	1.7
Brazil	93.3	76.9	65.5	93.3
Chile	16.8	13.6	13.1	16.8
Colombia	7.5 1/	7.1	6.5	7.5
Ecuador	5.6	4.9	4.6	5.6
Ivory Coast	2.1	2.6	2.7	2.7
Mexico	90.4	72.2	70.7	90.4
Nigeria	7.3	8.1	8.8	8.8
Peru	4.8 2/	5.7	4.7	5.7
Philippines	15.0	13.8	12.4	15.0
Uruguay	2.1 3/	2.0	2.0	2.1
Venezuela	23.3	25.3	26.3	26.3
Yugoslavia	15.2	9.8	9.2	15.2
	309.6	268.8	252.3	317.2
b. Market borrowers that could potentially encounter difficulties if conditions deteriorate				
Hungary	9.1	6.9	6.8	9.1
Indonesia	13.4	14.2	12.9	14.2
Korea	34.2	30.9	25.9	34.2
Malaysia	11.4	11.2	10.6	11.4
Trinidad & Tobago	0.8	0.8	0.9	0.9
	68.8	64.0	57.1	69.8
c. Countries not included among market borrowers but which appear relevant to the present exercise				
Egypt	11.6	7.0	5.9	11.6
Romania	7.6	3.2	3.1	7.6
Thailand	6.6	7.5	6.5	7.5
Turkey	12.0	5.1	4.7	12.0
	37.8	22.8	20.2	38.7
Total	416.2	355.6	329.6	425.7

Sources: International Monetary Fund, International Financial Statistics; Bank for International Settlements, International Banking Developments; and Bank for International Settlements, The Maturity Distribution of International Bank Lending.

1/ Latest available data for interbank claims are as of December 1982.
2/ Latest available data for interbank claims are as of June 1984.
3/ Latest available data for interbank claims are as of March 1984.

JOHN McCAIN
FIRST DISTRICT, ARIZONA

COMMITTEE ON INTERIOR
AND INSULAR AFFAIRS

COMMITTEE ON EDUCATION
AND LABOR

SELECT COMMITTEE ON AGING

Congress of the United States
House of Representatives
Washington, D.C. 20515

1123 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
(202) 225-2635

SUITE 151
1255 WEST BASELINE ROAD
MESA, ARIZONA 85202
(602) 897-0892

SUITE 201
411 SOUTH MILL AVENUE
TEMPE, ARIZONA 85281
(602) 261-3181

September 30, 1985

057720

ORIG: WHD
CC: ~~MD~~
DMD
MR. DALLARA
EXR
MR. COLLINS
MR. BROWN

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosiere:

Thank you for your letter seeking to clarify Mexico's relations with the International Monetary Fund. I appreciate your courtesy in doing so.

As you may know, one of my primary interests is the economic and political stability of Mexico. Its importance to the United States' long-term interests is obvious. I welcome any discussion over the role of the IMF in and with Mexico. I hope you will continue to share your thoughts with me on this subject.

Thank you again for the information.

Sincerely,

John

John McCain
Member of Congress

JM/jt

MR. Collins

WS255

U MISBT 09-24 00175

EA6113 MUN EXG ICX

IIII

MEXICO ESTABLECERA CONTACTOS PARA AYUDA INTERNACIONAL
(CON TERREMOTO)

MEXICO DF, 23 SEP (EFE).- EL MINISTRO MEXICANO DE HACIENDA, JESUS SILVA HERZOG, ESTABLECERA LO ANTES POSIBLE CONTACTOS CON LOS ORGANISMOS FINANCIEROS INTERNACIONALES QUE HAN OFRECIDO AYUDA A MEXICO TRAS LOS DOS TEMBLORES QUE AFECTARON AL PAIS LA SEMANA PASADA, SE INFORMO HOY AQUI.

EL MINISTERIO DE HACIENDA INFORMO DE QUE SILVA HERZOG, POR INSTRUCCIONES DEL PRESIDENTE MIGUEL DE LA MADRID, ESTUDIARA DE INMEDIATO ESAS OFERTAS CON LAS AUTORIDADES DEL BANCO MUNDIAL, DEL FONDO MONETARIO INTERNACIONAL (FMI) Y DEL BANCO INTERAMERICANO DE DESARROLLO (BID).

LA FUENTE AGREGO QUE EL MINISTRO TAMBIEN ENTABLARA IDENTICOS CONTACTOS CON LOS REPRESENTANTES DE LAS ENTIDADES FINANCIERAS GUBERNAMENTALES Y DE LOS BANCOS CENTRALES DE LOS PAISES ACREEDORES DE MEXICO Y DE LA BANCA INTERNACIONAL LOCALIZADA DENTRO DE ESTAS MISMAS NACIONES.

DICHO MINISTERIO ANADIO, FINALMENTE, QUE ENTRE LOS MENSAJES RECIBIDOS FIGURAN LOS DEL DIRECTOR GERENTE DEL FONDO MONETARIO INTERNACIONAL, JACQUES DE LAROSIERE. EFE

AQF/AB/J VVVV

09/24/02-02/85

RECEIVED
INTERNATIONAL
MONETARY FUND

Office Memorandum

1985 SEP 24 AM 12: 15

Mr. [illegible]
Thank you
Sept 24.85

OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director

DATE: September 24, 1985

FROM: Charles Gardner CG

SUBJECT: Washington Post Articles

This morning I spoke by telephone with Messrs. Michael Getler, Deputy Managing Editor, and Hobart Rowen, of the Washington Post to register your strong dissatisfaction with the statement on page A1 of the issue of September 21, that Mexico had been "cut off from further IMF aid," and in today's issue on page A24, referring to "the IMF's decision on the eve of the earthquake to deny Mexico $800 million in new credits...."

Mr. Getler, who is in general charge of the articles that go into the front news sections of the paper, was keenly aware of the unfavorable light in which the Fund has been cast by the association of Mexico's noncompliance with the earthquake. However, he was not himself aware of the actual nature and sequence of developments, nor of our Friday press release setting the record straight. When I explained them to him, he expressed what seemed to me to be genuine regret that the foreign editors handling these stories had not taken our press release into account. He assured me that he would speak with the responsible editors, and that future references, at least, would be accurate.

Mr. Rowen said he would drive the point home to Mr. Getler himself, and make sure that Mr. Getler follows through. Mr. Rowen notes what surely is a fact at the Washington Post and many other newspapers that departmental barriers can cause this kind of problem. Those in the financial section such as Messrs. Rowen and Mr. Rowe, who by the end of Friday were fully sensitive to our point, were not invited to review the articles coming from Mexico City through the foreign desk.

It is precisely for this reason that it has seemed such a positive and useful thing for you to take time occasionally for luncheons with Mrs. Graham that include editors and writers outside the financial department. With all the efforts that are made, I find it bewildering that such awful editing can persist.

cc: Mr. Erb
Mr. Mohammed
Mr. Collins
Mr. Brown

RECEIVED
INTERNATIONAL
MONETARY FUND
1985 SEP 23 AM 12:55
OFFICE OF
THE MANAGING DIRECTOR

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: September 23, 1985

FROM: Charles Gardner

SUBJECT: Letter to the Washington Post

Attached for your review is the draft letter you requested Friday to the Editor of the Washington Post. This does not include other staff comments, which are being solicited. Consideration should perhaps be given to having such a letter signed by Mr. Erb, since this has not previously been done by the Managing Director.

cc: Mr. Mohammed
Mr. Collins
Mr. Brown

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: September 23, 1985

FROM: Charles Gardner

SUBJECT: Letter to the Washington Post

Attached for your review is the draft letter you requested Friday to the Editor of the Washington Post. This does not include other staff comments, which are being solicited. Consideration should perhaps be given to having such a letter signed by Mr. Erb, since this has not previously been done by the Managing Director.

cc: Mr. Mohammed
Mr. Collins
Mr. Brown

DRAFT

To Mr. Benjamin Bradlee,
Editor of The Washington Post

Dear Mr. Bradlee:

The success of Mexico in working with the IMF and using its resources to ease its difficulties in adjusting its economy is lost in last Friday's doubly unfortunate story that the IMF had cut off assistance to Mexico: unfortunate because it gave the wrong impression that the IMF had taken a decision to break off its financial relations with Mexico, and unfortunate because the tragic earthquake that struck Mexico City on Thursday dominated the next morning's papers, and the appearance was given that the IMF was acting in a heartless manner in the face of tragedy.

The importance of the IMF to the many countries using its resources and technical advice to overcome their difficulties is too great to let this misapprehension stand in the public mind. The fact is that Mexico and many other countries have been able to achieve a far less onerous adjustment of their economies as a result of IMF money, and the much larger additional sums that it has catalyzed from other private and official sources.

Mexico was outstandingly successful for two and a half years in stabilizing its economy under a Fund program. In recent weeks, following statements made by the Mexican authorities to their own Congress, it has been widely known in financial circles that Mexico, as a result of a combination of developments including the weakness in world oil markets, was out of compliance with the requirements of the program. A Fund staff team had been working with the Mexican authorities in Mexico City earlier this month to assess measures that the government was taking to confront these difficulties, and it had just returned to Washington to confer at Fund headquarters about what could be done when the news appeared in the press that Mexico was out of compliance. The Fund had taken no decision at that time, nor, indeed, at any other time, to cut off resources, and was working with Mexico toward the resumption of financial support when the news broke in the newspapers.

Following the earthquake, we immediately conveyed to the Mexican authorites our readiness to resume talks, and then made known to them the possibility of using resources available through the IMF for emergency balance of payments support in the event of natural disaster, a facility that has been used in the past by a number of members facing such disasters.

Like many other heavily indebted countries, Mexico has been determined to right its economy, and restore stable economic growth, and it has found the IMF helpful in doing so. It is unhelpful both to Mexico and to other countries who wish to use the IMF in this way that the relationship between Mexico and the IMF was portrayed in such an unwarranted light.

am5m1dsb01
9/23/85 p.m.

MEXICO

The Mexican EFF program has gone off track and the likelihood that deviations can be reversed within the remaining period of the arrangement (which ends December 31, 1985) is practically nil. In any event, the situation is now further complicated by the earthquakes that hit Mexico City a few days ago (September 19-20, 1985). The damage caused by these earthquakes cannot be quantified at this stage.

Even before allowing for the impact of the earthquakes, the public sector deficit was running at the equivalent of 8 percent of GDP, compared with the 4 percent limit envisaged in the program for 1985. While the public finances were affected by factors beyond the authorities' control--the decline in the price of oil exports--there was a very sharp increase in expenditures. Also, public sector receipts from other than petroleum exports were weaker than expected, as the adjustment of the prices charged for goods and services produced by the public sector tended to lag behind the rise in domestic prices in general, and there appears to have been an intensification of tax evasion.

The expansionary stance of fiscal policy, together with a substantial utilization of the excess reserves held by commercial banks at the Bank of Mexico, led to a sharp increase in the Bank of Mexico's net domestic assets. Moreover, the growth in real terms of the broader monetary aggregates has decelerated, while the growth of deposits in commercial banks has been affected by the emergence of distortions in the domestic interest rate structure.

Exchange rate management was insufficiently flexible in the first seven months of 1985 to prevent a substantial loss of net international reserves. The strong surplus in the current account registered in 1983 and during most of 1984 virtually disappeared and private capital flight intensified. Official capital movements were practically in balance in the first half of 1985.

In an attempt to arrest the deterioration, the authorities introduced a managed float of the exchange rate in the controlled market at the end of July--following a devaluation of 17 percent--and authorized the commercial banks to operate in the parallel market through exchange houses. On the fiscal front, some additional expenditure cuts were announced in August 1985. In the trade area, a widespread liberalization from import permits was enacted in late July.

Economic activity continued to expand at a faster pace than contemplated in the program during the first half of 1985, although by midyear it seems to have come to a standstill. Inflation has not exceeded program projections by much so far, as the loss in international reserves and the lag in the adjustment in public sector prices helped cushion the impact of the prevailing excess aggregate demand pressures.

During the recent mission to Mexico, the staff reviewed with the authorities the problems encountered in implementing the program in the first part of 1985 and the policies that would be needed to restore momentum to the adjustment effort. The authorities said at that time that they were not yet prepared to indicate the kind of program that they would follow in the immediate future nor were they ready to say what kind of relationship the country would wish to have with the Fund. The mission was informed that the authorities were about to start interministerial discussions on the 1986 budget and on the general scope of adjustment policies.

The recent earthquakes may affect the authorities' perception about the urgency of the adjustment effort. It will thus be important to convey the notion that the need for reconstruction makes it all the more important to strengthen economic policies. The biggest danger of an ill-conceived reconstruction effort would be a rekindling of inflation and the abandonment of the structural reforms envisaged by the program in the fiscal and trade areas.

Under present circumstances, the Fund should indicate its willingness to assist the authorities in framing policies suitable for reconstruction needs in the context of a medium-term adjustment of the economy. We could propose assisting them in the mobilization of external assistance in collaboration with the World Bank, to support a program that ensures that the efforts to eliminate domestic inflation are intensified and that the processes of trade liberalization and the strengthening of domestic saving (through an improvement in the public finances) are continued. With understandings to this effect, the Fund would be prepared to make an immediate contribution in the form of an emergency drawing to help bolster the gross reserve position of the Bank of Mexico.

The key policies to be discussed are (a) fiscal policy, (b) monetary policy, (c) exchange rate policy, and (d) trade policy.

With regard to fiscal policy, the emphasis should be on the intensification of the process on confining the public sector deficit to a level consistent with a substantial reduction of inflation. It is quite possible that the financing of a reconstruction program may benefit from a greater influx of external capital, but it will also place greater demands on public sector savings. The strategy should therefore be to increase these savings. This could be done through a combination of the introduction of some special tax tied to the reconstruction effort, the revision of those public sector prices that have lagged and, more generally, a reconsideration of the priorities for public expenditures, with emphasis placed on reducing current expenditures as much as possible. Consideration also should be given to requiring that local governments provide a special contribution to the reconstruction program through a redirection of their participation in the federal tax receipts.

Monetary and credit policy became too loose in the last few months, and distortions have arisen in the structure of domestic interest rates. These problems need to be addressed and distortions in interest rates eliminated. Pressures are likely to arise for increasing the use of lines of credit at preferential interest rates in connection with the reconstruction efforts, and therefore care will need to be exercised to prevent new subsidies.

The exchange rate in the controlled market will have to be managed very flexibly to ensure a satisfactory overall balance of payments performance and a faster growth of nonpetroleum exports. Free access to the free exchange market should be maintained and the Bank of Mexico should refrain from intervening in that market. Given the difficulties of enforcing surrender requirements for private sector exports and the little room available for maneuvering in terms of international reserves available to the central bank, the authorities should be urged to unify the exchange market without delay. In the past, they have indicated their preoccupation that such a course of action will lead to a massive repayment of the external debt of the private sector, but the staff has argued that this need not be the case if exchange rate policy is flexible and monetary and credit policies are moderate.

On trade policy, there is the risk that there will be pressures to reverse the liberalization process that was recently introduced on the excuse that an opening of the economy cannot be afforded at a time of national disaster. It should be emphasized that the trade liberalization process can play a very important role in the reconstruction period and is crucial to promote the growth of nontraditional exports and to increase economic efficiency.

MEXICO

Area and Population	
Area	1,958,201 sq. kilometers
Population (mid-1984)	76.9 million
Annual rate of population increase (1978-84)	2.7 percent
Unemployment rate	N.A.
GDP (1984)	SDR 171 billion
	US$175 billion
	Mex$29,438 billion
GDP per capita (1984)	SDR 2,225

	1982	1983	Prel. 1984	Proj. 1985
Origin of GDP		(in percent)		
Agriculture, livestock, and fishing	8.8	9.6	9.5	...
Mining (including petroleum)	3.8	3.9	3.8	...
Manufacturing	24.1	23.6	23.9	...
Construction	5.5	4.7	4.7	...
Electricity	1.6	1.7	1.8	...
Commerce	25.4	24.2	24.0	...
Transport and communications	7.5	7.5	7.6	...
Financial services	9.8	10.6	10.5	...
Other services	13.5	14.2	14.2	...
Ratios to GDP				
Exports of goods and services 1/	13.5	14.5	15.1	13.0
Imports of goods and services 1/	-16.1	-11.9	-13.2	-13.0
Current account of the balance of payments 1/	-2.6	2.6	1.9	0.0
Central government revenues	16.3	18.6	16.9	15.7
Central government expenditures	24.8	26.2	22.0	23.1
Public sector savings	-7.9	-0.6	0.6	-1.7
Public sector overall balance (deficit -)2/	-17.8	-8.5	-6.2	-8.0
External public debt (end of year)	29.3	31.9	31.5	29.2
Gross national savings	17.8	23.9	22.2	...
Gross aggregate investment	21.2	20.3	19.9	...
Money and quasi-money (end of year)	34.3	30.0	29.4	28.6
Annual changes in selected economic indicators				
Real GDP per capita	-3.2	-7.6	0.9	0.3
Real GDP (at 1970 prices)	-0.5	-5.3	3.5	3.0
GDP at current prices	60.3	82.0	71.7	64.8
Domestic expenditures (at current prices)	51.7	69.5	76.2	...
Investment	17.5	73.5	68.4	...
Consumption	65.3	68.4	78.5	...
GDP deflator	61.1	92.2	66.0	60.0
Wholesale prices (annual averages)	56.1	107.3	70.3	65.0
Consumer prices (annual averages)	58.9	101.9	65.5	62.0
Central government revenues	63.9	107.6	56.4	52.9
Central government expenditures	69.8	92.4	44.7	72.5
Money and quasi-money	70.1	59.2	68.3	59.4
Money	61.9	41.5	55.5	23.9
Quasi-money	74.0	67.0	73.1	72.1
Net domestic credit 3/	59.9	47.2	64.2	68.0
Credit to the public sector	62.1	48.3	24.6	31.4
Credit to the private sector	-5.3	23.2	37.1	35.3
Merchandise exports (f.o.b., in U.S. dollars)	5.7	4.5	9.1	-9.9
Merchandise imports (f.o.b., in U.S. dollars)	-40.0	-41.0	32.9	19.5

Federal government finances	1982	1983	1984	1985 Budget	1985 Proj.
	(In billions of Mexican pesos)				
Revenue	1532	3181	4975	7683	7606
Expenditure	2331	4485	6488	9517	11194
Current account surplus or deficit (-)	-331	-557	-562	-142	-1893
Overall deficit (-)	-799	-1304	-1513	-1834	-3588
Public sector finances					
Current account surplus or deficit (-)	-742	-102	175	1255	-818
Overall deficit (-)	-1679	-1464	-1826	-1922	-3906

Balance of payments	1982	1983	1984	1985 Prog.	1985 Proj.
	(In billions of U.S. dollars)				
Merchandise exports (f.o.b)	22.1	23.1	25.2	25.8	22.7
Merchandise imports (f.o.b)	-14.4	-8.5	-11.3	-14.0	-13.5
Travel and border transactions (net)	0.4	0.9	1.1	0.8	0.9
Interest on public debt	-7.9	-7.4	-8.3	-7.6	-7.3
Other interest payments	-3.4	-2.9	-3.5	-2.8	-2.8
Other services and transfers (net)	-2.4	.0	0.8	-0.1	.0
Balance on current account and transfer	-5.6	5.2	4.0	2.1	0.0
Official capital (net)	6.8	4.7	2.2	0.1	-0.3
Private capital and errors and omissions (net)	-8.0	-4.4	-3.2	-1.7	-3.7
SDR allocations and gold revaluation	--	--	--	--	--
Change in official net reserves	6.8	-5.5	-3.0	-0.5	4.0

International reserve position	Dec. 1983	Aug. 1984	Dec. 1984	Aug. 1985
	(in millions of SDRs)			
Monetary authorities (net)	3353.1	5224.1	6631.2	2949.8
Monetary authorities (gross)	4908.4	7437.6	9162.9	5811.6

IMF data (as of Sept. 15,1985)	
Article VIII status	
Intervention currency	U.S. dollar at Mex$298 pesos per US$1
Quota	SDR 1,165.5 million
Fund holdings of Mexican pesos	
From Fund resources	
Credit tranche purchases	17.2 percent of quota
EFF purchases	96.4 percent of quota
CFF purchases	None
Buffer stock financing purchases	None
Oil facility purchases	None
From Supplementary and Enlarged Access resources	
Stand-by purchases	None
EFF purchases	118.3 percent of quota
Fund holdings under Enlarged Access policy	214.7 percent of quota
Total Fund holdings	231.9 percent of quota
Arrears with the Fund	None
Of which:	
CFF repurchase	None
EFF repurchase	None
Semiannual charges	None
Quarterly charges	None
EFF arrangement (Jan. 1983-Dec.1985)	
Purchases thereunder	SDR 2,502.7 million
Status of drawing rights thereunder	Inoperative
Special Drawing rights Department	
Net cumulative SDR allocation	SDR 290.0 million
Net acquisistion or utilization (-) of SDRs	SDR -289.6 million
Holdings of SDRs (as percent of allocation)	0.014 percent
Share of profits from gold sales	US$58.8 million
Gold distribution (fine ounces)	316.7 million of fine ounces

1/ In relation to GPD in U.S. dollars at 1979 exchange rate.
2/ Includes net deficit of public sector outside budget control.
3/ Changes are effective flows in relation to the unadjusted stock of liabilities to private sector at the beginning of the period.
4/ Includes as liabilities disbursements under a BIS loan and arrears on interest payments on private debt with foreign commercial banks.

Disk # 207
Index # 18
Sept. 23, 1985

Table 1. Mexico: Summary Balance of Payments, 1982-85

(In billions of U.S. dollars)

	1982	1983	Prel. 1984	1985 Prog.	1985 Rev.
Current account	-5.6	5.2	4.0	2.1	—
Trade balance	7.7	14.6	13.9	11.8	9.2
Exports, f.o.b.	22.1	23.1	25.2	25.8	22.7
Petroleum and derivatives	(16.5)	(16.0)	(16.6)	(15.8)	(14.5)
Other	(5.6)	(7.1)	(8.6)	(10.0)	(8.2)
Imports, f.o.b.	-14.4	-8.5	-11.3	-14.0	-13.5
Public sector	(-5.4)	(-4.3)	(-4.8)	(-4.5)	-4.4
Private sector	(-9.0)	(-4.2)	(-6.5)	(-9.5)	(-9.1)
Travel	0.6	1.2	1.3	1.3	1.3
Border transactions	-0.2	-0.3	-0.2	-0.5	-0.4
Factor income	-11.7	-9.6	-10.2	-9.3	-9.2
Interest on public debt	-7.9	-7.4	-8.3	-7.6	-7.3
Other interest payments	-3.4	-2.9	-3.6	-2.8	-2.8
Other	-0.4	0.7	1.7	1.1	0.9
Other services and transfers (net)	-2.0	-0.7	-0.8	-1.2	-0.9
Capital account	-1.2	0.3	-1.0	-1.6	-4.0
Official capital (net)	6.8	4.7	2.2	0.1	-0.3
Medium- and long-term	(5.6)	(16.0)	(2.0)	(...)	(-0.3)
Short-term (net)	(1.2)	(-11.3)	(0.2)	(...)	(--)
Private capital	-8.0	-4.4	-3.2	-1.7	-3.7
Long-term	(2.1)	(-2.0)	(0.4)	(...)	(-0.1)
Short-term and errors and omissions	(-10.1)	(-6.4)	(-3.6)	(...)	(-3.6)
SDR allocation and gold valuation	—	—	—	—	—
Monetary authorities (increase -)	6.8	-5.5	-3.0	-0.5	4.0
Of which: arrears	1.4	-1.1	-0.3	—	—
	(End of period)				
Memorandum items					
Net international reserves 1/	-2.0	3.5	6.5	7.0	3.0
Gross reserves in months of merchandise imports	0.1	4.9	7.8	7.5	...

Sources: Mexican authorities; and Fund staff estimates.

1/ Excludes gold and payment agreements.

am5m1dsb02
9/23/85

Note on Mexico's Medium-Term Scenario

The attached Table 2 provides the balance of payments projections for the medium term that were included in the Article IV consultation and related papers discussed by the Board in early June 1985. Since this scenario was prepared, Mexico's adjustment effort has weakened and the external environment has become more unfavorable. The widening fiscal imbalances and accommodating credit policies have put heavy pressures on the balance of payments during 1985 and the exchange rate policy was not sufficiently flexible during the first seven months of the year to prevent a substantial loss in net international reserves. The current account surplus, meanwhile, disappeared and there was an intensification of capital flight. The decrease in petroleum prices and the reduction in the volume of petroleum exports also have been important factors affecting the balance of payments results in 1985. Assuming that petroleum prices are stabilized, that foreign financing remains constrained 1/ , and that a very tight fiscal program is in place during 1986, it would be possible to envisage a return to a path which, in terms of the current account and the overall balance, would not be too far from that depicted in the attached table starting in 1987.

Mexico's balance of payments remains highly sensitive to developments in world oil prices and international interest rates. A decrease of US$1 in the world price of crude oil would increase the financing gap by US$0.6 billion at an annual rate. And an increase of one percentage point in international interest rates would increase the financing gap by about US$0.7 billion at an annual rate in the short run and by some US$0.9 billion in the medium to longer run. The extent by which these external factors will affect the balance of payments in the future is uncertain, as is the amount of foreign financing (particularly from commercial banks) likely to be available. To strengthen the chances of economic recovery and to reduce the foreign exchange constraint, Mexico needs to move decisively toward opening up the economy to foreign competition and to maintaining a flexible exchange rate policy.

1/ Borrowing from commercial banks in this medium-term scenario is nil in 1986, about US$1 billion in 1987-88, and about US$3.5 billion in 1989-90.

Disk # 207
Index # 9
Sept. 23, 1985

Table 2. Mexico: Medium-Term Balance of Payments Projections, 1985-90

(In billions of U.S. dollars)

	1985		1986		1987	1988	1989	1990
	Prog.	Rev.	Prog.	Rev.				
Current account	2.1	--	2.0	2.0	0.5	-0.2	-0.2	-0.5
Trade balance	11.8	9.2	11.1	10.3	10.2	9.4	9.5	9.7
Exports	(25.8)	(22.7)	(27.1)	(24.0)	(28.3)	(29.7)	(31.9)	(34.3)
Imports	(-14.0)	(-13.5)	(-16.1)	(-13.8)	(-18.1)	(-20.3)	(-22.4)	(-24.6)
Factor income	-9.3	-9.2	-8.6	-8.8	-9.1	-8.9	-8.8	-9.2
Of which: interest payments on public debt	(-7.6)	(-7.3)	(-7.0)	(-7.1)	(-7.2)	(-6.9)	(-6.7)	(-6.7)
Other services and transfers	-0.4	--	-0.5	0.5	-0.6	-0.7	-0.8	-1.0
Capital account	-1.6	-4.0	-0.4	-1.5	0.7	1.2	2.0	1.9
Official capital	0.1	-0.3	0.6	--	1.0	1.0	1.5	1.2
Private capital 1/	-1.7	-3.7	-1.0	-1.5	-0.3	0.2	0.5	0.7
Monetary authorities (increase -)	-0.5	4.0	-1.6	-0.5	-1.2	-1.0	-1.8	-1.4
Memorandum items								
Current account as percent of GDP								
At 1979 real exchange rate	0.9	--	0.8	0.8	0.2	-0.1	-0.1	-0.1
At current exchange rate	1.1	--	0.9	1.1	0.2	-0.1	-0.1	-0.2
Gross reserves, end of period 2/								
In billions of dollars	8.7	6.0	10.4	6.5	11.2	11.5	12.4	13.0
In months of imports	7.5	5.3	7.8	5.7	7.4	6.8	6.6	6.3

Source: Fund staff projections.

1/ Includes errors and omissions.
2/ Excludes gold and payments agreements.

9/19/85

Table 3. Mexico: External Debt Outstanding, by Maturity and Type of Lender, 1981-85

(In billions of U.S. dollars)

	1981	1982	1983	1984	Prel. June 1985
Total debt	75.0	88.8	92.4	95.7	95.2
Medium- and long-term	52.4	63.1	78.6	82.1	82.6
Short-term 1/	22.6	25.7	13.8	13.6	12.6
Public sector 2/	53.1	62.9	65.8	69.9	70.2
Medium- and long-term	42.2	50.1	65.6	69.5	69.8
Financial institutions	(31.8)	(37.0)	(50.5)	(53.3)	(53.4)
Bonds	(3.8)	(5.4)	(4.6)	(4.0)	(3.6)
International organizations	(4.0)	(4.3)	(4.4)	(4.9)	(5.2)
IMF	(--)	(0.2)	(1.3)	(2.4)	(2.7)
Bilateral 3/	(2.3)	(2.9)	(4.5)	(4.7)	(4.6)
Other	(0.3)	(0.3)	(0.3)	(0.2)	(0.3)
Short-term debt	10.7	9.3	0.2	0.4	0.4
PEMEX contracts	0.2	1.6	--	--	--
BIS and swaps	--	1.9	--	--	--
Nationalized banks 4/	7.0	7.9	8.6	8.2	7.5
Medium- and long-term	1.9	0.7	0.7	0.7	0.7
Short-term	5.1	7.2	7.9	7.5	6.8
Private sector 5/	14.9	18.0	18.0	17.6	17.5
Of which: to banks	...	...	15.4	14.5	14.5
Medium- and long-term	8.3	12.3	12.3	11.9	12.1
Short-term	6.6	5.7	5.7	5.7	5.4
Memorandum items					
Debt to banks	64.4	72.2	74.7	76.4	75.8
Public sector	(42.5)	(46.3)	(50.7)	(53.7)	(53.8)
Private sector and nationalized banks 6/	(21.9)	(25.9)	(24.0)	(22.7)	(22.0)

Sources: Data provided by the Mexican authorities; and Fund staff estimates.

1/ Includes PEMEX contracts, debt to BIS, and operations with U.S. Treasury and Federal Reserve.
2/ Includes foreign liabilities of the Bank of Mexico with IMF, BIS, U.S. Treasury, and U.S. Federal Reserve, but does not include liabilities on account of arrears, bilateral payments agreements, or outstanding letters of credit.
3/ Includes debt to the C.C.C.
4/ Owed mostly to commercial banks. Excludes letters of credit.
5/ Does not include trade-related suppliers' credits.
6/ Includes debt of all maturities.

am5mldsb02
9/23/85

Note on Mexico's Medium-Term Scenario

The attached Table 2 provides the balance of payments projections for the medium term that were included in the Article IV consultation and related papers discussed by the Board in early June 1985. Since this scenario was prepared, Mexico's adjustment effort has weakened and the external environment has become more unfavorable. The widening fiscal imbalances and accommodating credit policies have put heavy pressures on the balance of payments during 1985 and the exchange rate policy was not sufficiently flexible during the first seven months of the year to prevent a substantial loss in net international reserves. The current account surplus, meanwhile, disappeared and there was an intensification of capital flight. The decrease in petroleum prices and the reduction in the volume of petroleum exports also have been important factors affecting the balance of payments results in 1985. Assuming that petroleum prices are stabilized, that foreign financing remains constrained 1/ , and that a very tight fiscal program is in place during 1986, it would be possible to envisage a return to a path which, in terms of the current account and the overall balance, would not be too far from that depicted in the attached table starting in 1987.

Mexico's balance of payments remains highly sensitive to developments in world oil prices and international interest rates. A decrease of US$1 in the world price of crude oil would increase the financing gap by US$0.6 billion at an annual rate. And an increase of one percentage point in international interest rates would increase the financing gap by about US$0.7 billion at an annual rate in the short run and by some US$0.9 billion in the medium to longer run. The extent by which these external factors will affect the balance of payments in the future is uncertain, as is the amount of foreign financing (particularly from commercial banks) likely to be available. To strengthen the chances of economic recovery and to reduce the foreign exchange constraint, Mexico needs to move decisively toward opening up the economy to foreign competition and to maintaining a flexible exchange rate policy.

1/ Borrowing from commercial banks in this medium-term scenario is nil in 1986, about US$1 billion in 1987-88, and about US$3.5 billion in 1989-90.

Table 2. Mexico: Medium-Term Balance of Payments Projections, 1985-90

(In billions of U.S. dollars)

	1985		1986		1987	1988	1989	1990
	Prog.	Rev.	Prog.	Rev.				
Current account	2.1	--	2.0	2.0	0.5	-0.2	-0.2	-0.5
Trade balance	11.8	9.2	11.1	10.3	10.2	9.4	9.5	9.7
Exports	(25.8)	(22.7)	(27.1)	(24.0)	(28.3)	(29.7)	(31.9)	(34.3)
Imports	(-14.0)	(-13.5)	(-16.1)	(-13.8)	(-18.1)	(-20.3)	(-22.4)	(-24.6)
Factor income	-9.3	-9.2	-8.6	-8.8	-9.1	-8.9	-8.8	-9.2
Of which: interest payments on public debt	(-7.6)	(-7.3)	(-7.0)	(-7.1)	(-7.2)	(-6.9)	(-6.7)	(-6.7)
Other services and transfers	-0.4	--	-0.5	0.5	-0.6	-0.7	-0.8	-1.0
Capital account	-1.6	-4.0	-0.4	-1.5	0.7	1.2	2.0	1.9
Official capital	0.1	-0.3	0.6	--	1.0	1.0	1.5	1.2
Private capital 1/	-1.7	-3.7	-1.0	-1.5	-0.3	0.2	0.5	0.7
Monetary authorities (increase -)	-0.5	4.0	-1.6	-0.5	-1.2	-1.0	-1.8	-1.4
Memorandum items								
Current account as percent of GDP								
At 1979 real exchange rate	0.9	--	0.8	0.8	0.2	-0.1	-0.1	-0.1
At current exchange rate	1.1	--	0.9	1.1	0.2	-0.1	-0.1	-0.2
Gross reserves, end of period 2/								
In billions of dollars	8.7	6.0	10.4	6.5	11.2	11.5	12.4	13.0
In months of imports	7.5	5.3	7.8	5.7	7.4	6.8	6.6	6.3

Source: Fund staff projections.

1/ Includes errors and omissions.
2/ Excludes gold and payments agreements.

Table 3. Mexico: External Debt Outstanding, by Maturity and Type of Lender, 1981-85

(In billions of U.S. dollars)

	1981	1982	1983	1984	Prel. June 1985
Total debt	75.0	88.8	92.4	95.7	95.2
Medium- and long-term	52.4	63.1	78.6	82.1	82.6
Short-term 1/	22.6	25.7	13.8	13.6	12.6
Public sector 2/	53.1	62.9	65.8	69.9	70.2
Medium- and long-term	42.2	50.1	65.6	69.5	69.8
Financial institutions	(31.8)	(37.0)	(50.5)	(53.3)	(53.4)
Bonds	(3.8)	(5.4)	(4.6)	(4.0)	(3.6)
International organizations	(4.0)	(4.3)	(4.4)	(4.9)	(5.2)
IMF	(—)	(0.2)	(1.3)	(2.4)	(2.7)
Bilateral 3/	(2.3)	(2.9)	(4.5)	(4.7)	(4.6)
Other	(0.3)	(0.3)	(0.3)	(0.2)	(0.3)
Short-term debt	10.7	9.3	0.2	0.4	0.4
PEMEX contracts	0.2	1.6	—	—	—
BIS and swaps	—	1.9	—	—	—
Nationalized banks 4/	7.0	7.9	8.6	8.2	7.5
Medium- and long-term	1.9	0.7	0.7	0.7	0.7
Short-term	5.1	7.2	7.9	7.5	6.8
Private sector 5/	14.9	18.0	18.0	17.6	17.5
Of which: to banks	...	...	15.4	14.5	14.5
Medium- and long-term	8.3	12.3	12.3	11.9	12.1
Short-term	6.6	5.7	5.7	5.7	5.4
Memorandum items					
Debt to banks	64.4	72.2	74.7	76.4	75.8
Public sector	(42.5)	(46.3)	(50.7)	(53.7)	(53.8)
Private sector and nationalized banks 6/	(21.9)	(25.9)	(24.0)	(22.7)	(22.0)

Sources: Data provided by the Mexican authorities; and Fund staff estimates.

1/ Includes PEMEX contracts, debt to BIS, and operations with U.S. Treasury and Federal Reserve.
2/ Includes foreign liabilities of the Bank of Mexico with IMF, BIS, U.S. Treasury, and U.S. Federal Reserve, but does not include liabilities on account of arrears, bilateral payments agreements, or outstanding letters of credit.
3/ Includes debt to the C.C.C.
4/ Owed mostly to commercial banks. Excludes letters of credit.
5/ Does not include trade-related suppliers' credits.
6/ Includes debt of all maturities.

Mr de Larosiere
Mr. Sub we should go this and over
Sept 23-85
JL

RECEIVED
INTERNATIONAL MONETARY FUND
1985 SEP 21 AM 12:51
OFFICE OF THE MANAGING DIRECTOR

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 23, 1985

FROM: A. F. Mohammed

SUBJECT: The Mexican Story

In attempting to draw lessons from the disaster on the Mexican program coverage, I feel they fall into the area of: (1) pre-knowledge of news events; (2) internal communications; (3) the management of news.

(1) Although your concern that the coverage of the Mexican program nonperformance was timed with the earthquake disaster to embarrass the Fund is not easily answered, we in EXR are convinced that their appearance together is an unfortunate coincidence. The noncompliance story was a ticking time bomb which we were well aware of since the Financial Times wrote its story on August 7, 1985 (Annex 1). There was a story in El Financiero of Mexico City on August 20 which commented on the aggravation of the public sector deficit (Annex 2). The Latin American Weekly Report (Annex 3) reported a discrepancy between targets of the public sector deficit and the estimates on August 30. The major wire services and newspapers in the U.S. failed to pick up these stories, largely we suspect because many of our press regulars would have been on vacation during August, and because Mr. Rowe of the Washington Post, who covers the status of Fund programs in great detail, returned only this week from a six-week trip to Peru, Brazil, and Chile, and was out of touch with Mexican developments.

The most recent spate of news reports is connected with the data book on Mexico's Economic and Financial Statistics (Annex 4), which is dated August 30, 1985, but which, according to the Western Hemisphere Department, was made available to banks on September 16, 1985. Table 2 of the data books lays out clearly the targets and actuals on Mexico's performance criteria. This information would have taken a day or two before falling into the hands of the press.

Our first indication that this had happened came in the form of a call from Ms. S. Karen Wicher of the Wall Street Journal on the morning of Thursday, September 19 at about 10 a.m. She was making enquiries based on hard information on performance criteria which she said came from the New York banks. This enquiry clearly preceded the news of the earthquake, about which the first news flashes from the Seismic Monitoring Center in Colorado cleared the news wire at 11:00 a.m., although the enormity of the disaster did not become known until much later in the day. The same morning, Mr. Art Pine of the Wall Street Journal called me, leaving a message that he wanted to talk about Mexico, but I was unable to return his call until after lunch because of my preoccupation with the press briefing on the Annual Report. When we did talk, I explained the procedures for waivers or modifications in the event of a breakdown in the Mexican program of which he was well aware. Simultaneously, Mr. Gardner was hearing from Reuters that they were putting out on the wire their report on the suspension of IMF loans to Mexico under a by-line from Peter Torday (Annex 5). At the end of the day, Mr. Gardner was contacted by the New York Times correspondent and had some success in conveying the nature of the process of review of the Mexican program. Finally, we have tried to reconstruct with Mr. Rowe his work on the Post story. Late on the evening of Thursday, he was informed by his desk that AP Dow-Jones was carrying over the wires the version that was to be printed next morning in the Wall Street Journal and that was written by Mr. Pine. Mr. Rowe asserts that he attempted to reach Mr. Gardner at home between 9:00 and 10:00 p.m. which was the only period during the evening that Mr. Gardner and his wife were out of the house. Hence our conclusion is that the story on Mexico's nonperformance arose out of the distribution to the banks of the Mexican Secretariat of Finance document on September 16; the simultaneous appearance of the story on Friday was partly the result of competitive pressures on the various newspapers (which reaches fever pitch as between the Wall Street Journal, the New York Times, and the Washington Post) and partly the fact that the earthquake would have heightened editors' interest in the IMF angle.

Was the Reuters story spotted on [illegible] by EXR? [illegible] I suppose it had been! I would have been alerted on it off the facsimile?

(2) When the Reuters story moved at 2:23 p.m. (our time) it was transmitted on the facsimile apparatus to the Managing Director's office. I am increasingly convinced that the facsimile equipment has generated a false sense of security in us. I would like to propose that the equipment be removed and that after the Annual Meetings Mr. David Armour be required to directly call the Managing Director's Personal Assistant with items that he feels require urgent Management attention. The same procedure could be used for the Deputy Managing Director, if he wishes.

(3) Improved management of the news by us is a third major issue raised by the Mexican matter, and this incident, together with the Brazilian one in the beginning of the year, convinces me that we should be more aggressive in this respect.

In our press contacts, we at present provide guidance on a background basis to trusted journalists regarding the validity of information that they present to us on the status of programs. This serves the dual purpose of (1) keeping them coming to us and keeping our press contacts fresh, because we are a source of reliable information, and (2) giving us the opportunity to prevent a lot of misreporting, inject some perspective, and take the rough, overly-dramatic edges off developments. Our work with the New York Times and the Wall Street Journal on Thursday was effective in at least modifying the presentation of the story, and had Mr. Rowe reached us, the Washington Post story would certainly have been less troublesome.

In the larger scheme, this work throughout the debt crisis years has contributed to defusing negative developments, and modulating the crisis points. Given the sharp pressure we are under now, I think

Mr Collins

RECEIVED
INTERNATIONAL MONETARY FUND
1985 SEP 21 AM 12:51
OFFICE OF THE MANAGING DIRECTOR

→ MD 9/23

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 23, 1985

FROM: A. F. Mohammed

SUBJECT: The Mexican Story

In attempting to draw lessons from the disaster on the Mexican program coverage, I feel they fall into the area of: (1) pre-knowledge of news events; (2) internal communications; (3) the management of news.

(1) Although your concern that the coverage of the Mexican program nonperformance was timed with the earthquake disaster to embarrass the Fund is not easily answered, we in EXR are convinced that their appearance together is an unfortunate coincidence. The noncompliance story was a ticking time bomb which we were well aware of since the Financial Times wrote its story on August 7, 1985 (Annex 1). There was a story in El Financiero of Mexico City on August 20 which commented on the aggravation of the public sector deficit (Annex 2). The Latin American Weekly Report (Annex 3) reported a discrepancy between targets of the public sector deficit and the estimates on August 30. The major wire services and newspapers in the U.S. failed to pick up these stories, largely we suspect because many of our press regulars would have been on vacation during August, and because Mr. Rowe of the Washington Post, who covers the status of Fund programs in great detail, returned only this week from a six-week trip to Peru, Brazil, and Chile, and was out of touch with Mexican developments.

The most recent spate of news reports is connected with the data book on Mexico's Economic and Financial Statistics (Annex 4), which is dated August 30, 1985, but which, according to the Western Hemisphere Department, was made available to banks on September 16, 1985. Table 2 of the data books lays out clearly the targets and actuals on Mexico's performance criteria. This information would have taken a day or two before falling into the hands of the press.

Our first indication that this had happened came in the form of a call from Ms. S. Karen Wicher of the Wall Street Journal on the morning of Thursday, September 19 at about 10 a.m. She was making enquiries based on hard information on performance criteria which she said came from the New York banks. This enquiry clearly preceded the news of the earthquake, about which the first news flashes from the Seismic Monitoring Center in Colorado cleared the news wire at 11:00 a.m., although the enormity of the disaster did not become known until much later in the day. The same morning, Mr. Art Pine of the Wall Street Journal called me, leaving a message that he wanted to talk about Mexico, but I was unable to return his call until after lunch because of my preoccupation with the press briefing on the Annual Report. When we did talk, I explained the procedures for waivers or modifications in the event of a breakdown in the Mexican program of which he was well aware. Simultaneously, Mr. Gardner was hearing from Reuters that they were putting out on the wire their report on the suspension of IMF loans to Mexico under a by-line from Peter Torday (Annex 5). At the end of the day, Mr. Gardner was contacted by the New York Times correspondent and had some success in conveying the nature of the process of review of the Mexican program. Finally, we have tried to reconstruct with Mr. Rowe his work on the Post story. Late on the evening of Thursday, he was informed by his desk that AP Dow-Jones was carrying over the wires the version that was to be printed next morning in the Wall Street Journal and that was written by Mr. Pine. Mr. Rowe asserts that he attempted to reach Mr. Gardner at home between 9:00 and 10:00 p.m. which was the only period during the evening that Mr. Gardner and his wife were out of the house. Hence our conclusion is that the story on Mexico's nonperformance arose out of the distribution to the banks of the Mexican Secretariat of Finance document on September 16; the simultaneous appearance of the story on Friday was partly the result of competitive pressures on the various newspapers (which reaches fever pitch as between the Wall Street Journal, the New York Times, and the Washington Post) and partly the fact that the earthquake would have heightened editors' interest in the IMF angle.

(2) When the Reuters story moved at 2:23 p.m. (our time) it was transmitted on the facsimile apparatus to the Managing Director's office. I am increasingly convinced that the facsimile equipment has generated a false sense of security in us. I would like to propose that the equipment be removed and that after the Annual Meetings Mr. David Armour be required to directly call the Managing Director's Personal Assistant with items that he feels require urgent Management attention. The same procedure could be used for the Deputy Managing Director, if he wishes.

(3) Improved management of the news by us is a third major issue raised by the Mexican matter, and this incident, together with the Brazilian one in the beginning of the year, convinces me that we should be more aggressive in this respect.

- In our press contacts, we at present provide guidance on a background basis to trusted journalists regarding the validity of information that they present to us on the status of programs. This serves the dual purpose of (1) keeping them coming to us and keeping our press contacts fresh, because we are a source of reliable information, and (2) giving us the opportunity to prevent a lot of misreporting, inject some perspective, and take the rough, overly-dramatic edges off developments. Our work with the New York Times and the Wall Street Journal on Thursday was effective in at least modifying the presentation of the story, and had Mr. Rowe reached us, the Washington Post story would certainly have been less troublesome.

In the larger scheme, this work throughout the debt crisis years has contributed to defusing negative developments, and modulating the crisis points. Given the sharp pressure we are under now, I think we should consider being more active in these efforts. Specifically, I would recommend that Mr. Hartmann be authorized to offer information on the status of programs periodically to key trusted correspondents, on a background basis. Thus far we have assiduously avoided volunteering information, and confined ourselves to commenting on information presented to us, a policy that limits our influence on the timing with which news breaks and our ability to defuse potential crisis situations. With the freedom to feed out information on the status of programs we could affect the perception of the total situation, in which there tend at all times to be a number of programs going well, and a number in trouble. In the Mexican situation, such an approach might have prompted a series of small stories over the past several weeks, and avoided the kind of blow we experienced.

Annexes

cc: Mr. Wiesner/Mr. Beza
Mr. Collins/Mr. Brown

FINANCIAL TIMES, AUG. 7, 1985

...Scottish Secretary, who mai...

Mexico 'will not meet targets'

8-7-85

BY DAVID GARDNER IN MEXICO CITY

THE MEXICAN Government has said that it will miss by wide margins its target this year to reduce inflation and the public sector deficit, agreed with the International Monetary Fund.

Sr Francisco Suarez Davila, the Deputy Treasury Minister, told a meeting of officials from the ruling Institutional Revolutionary Party that inflation this year will be almost the same as last year's 59.2 per cent – particularly after last month's 16.7 per cent devaluation and major trade liberalisation measures – and that the public sector deficit will reach around 8 per cent of gross domestic product.

The original targets, agreed with the IMF as part of the third and last year of the austerity programme, which followed Mexico's financial collapse in 1982, were 35 per cent for inflation and 5.1 per cent for the total deficit (down from 7.6 per cent last year).

The inflation target was always unrealistic but it was hoped that a reduction of about 10 percentage points could be achieved. Inflation is currently running at an annualised 55 per cent, down from a high of 117 per cent in April 1983.

It is being fed, apart from the devaluation, by the unexpectedly vigorous recovery in domestic demand, with growth at an annualised 7 per cent during the first half against 3.5 per cent for last year, and by the dislocations being caused by spiralling domestic indebtedness.

Public finance, despite spending cuts of $3bn so far this year and more to come, have been hit by falling oil revenues, which provide 45 per cent of Mexican taxes. But at the same time, this year's switch to a more rigid system of deficit financing, with the introduction of a public sector borrowing requirement, is paradoxically fuelling the deficit.

The government has had to go to the market for extra funds – monopolising four fifths of all credit during the first half – pushing interest rates to historic highs (three months Treasury bills now stand at 75 per cent).

This has raised the cost of old and new borrowing increased the Government's interest bill, and thus forced yet more borrowing to obtain disposable funds, no longer available from external sources.

Tomorrow Nafinsa, the state development bank, is launching a Pesos 25bn ($89m) acceptances issue at an 84 per cent interest rate. Along with a Pesos 100bn Petrobond issue planned for August 19, the second of that size this year, this will not encourage optimism on the medium term outlook either for inflation or the government's growing financing needs.

EL FINANCIERO

MEXICO, D.F., MARTES 20 DE AGOSTO DE 1985 — DIRECTOR GENERAL, ROGELIO CARDENAS.
CINCUENTA PESOS — AÑO IV No. 986

El Mayor Peligro: no Crecer

Cada vez más Caro, el Costo del Financiamiento

Según BdM, este mes el CPP será de 59.06% anual, 2.06% más alto que en julio y 4% más que en junio pasado

6

Un Hecho: Sectur Pondrá en Venta la Nacional Hotelera

Asegura Enrique Rubio que Turismo ya está encaminando las gestiones para la reprivatización

18

Al Mercado, el Jueves, la Nueva Emisión de Petrobonos

La modalidad, títulos con valor nominal de 10 mil pesos para totalizar 100 mil millones

11

Imposible Evitar el Alza de Farmaquímicos

Fuentes (ANIERM) dice que los ajustes a la paridad acarrearán aumentos de precios en septiembre

19

Silva Herzog: Absurdo Pedir más Sacrificios a los Pobres

BUENOS AIRES, 19 de agosto (AP, UPI, Reuters).— La mayor amenaza que se cierne sobre México y otros países endeudados es que sus economías no puedan recuperar su ritmo dinámico de crecimiento, aseguró el secretario de Hacienda de México, Jesús Silva Herzog.

En una entrevista concedida al diario *La Nación*, el funcionario mexicano advirtió que "si en los próximos años no se logra esa recuperación, el camino se va a complicar, las poblaciones van a reclamar mayores satisfactores, se van a cansar de apretarse el cinturón".

Silva Herzog agregó que eso puede ocurrir en México, "donde la mayoría de la población es pobre, y no se le puede pedir que se ajuste el cinturón, porque muchos de ellos no tienen ni siquiera cinturón".

En sus declaraciones al diario argentino, el secretario de Hacienda de México comentó la reciente reunión sobre deuda externa que tuvo lugar en La Habana, Cuba, y dijo que las conclusiones alcanzadas no coinciden con la posición de su país.

Explicó que, sin embargo, la reunión fue de una "utilidad indiscutible y contribuye a movilizar la conciencia política en nuestros países y en las naciones industrializadas".

Junta de los 24 en Washington

Por otra parte, en Washington, los integrantes del Grupo de los 24, que aglutina a países en desarrollo de América Latina, Asia y Africa, iniciaron una reunión de dos días para afinar un proyecto de reformas al sistema financiero internacional, cuyos desajustes han tenido un efecto "devastador" sobre las naciones pobres.

El documento, que será la base de negociación del Grupo de los 24 en la próxima reunión del Fondo Monetario Internacional —que tendrá lugar en Seúl, en octubre próximo—, subraya que en los países endeudados los niveles de vida van en franco deterioro, lo mismo que sus finanzas, y que podrán cumplir con sus pagos sólo en la medida en que logren una franca recuperación.

Más en la 9 y 13

Más Ajustes: las Altas Tasas Agravan el Déficit Público

Gustavo Lomelín

Los resultados obtenidos en materia de déficit financiero y deuda interna hacen previsible el endurecimiento del programa de ajuste económico que se aplica en el país, estimaron fuentes gubernamentales.

Dijeron que la tendencia entre lo que se gasta y lo que ingresa en las arcas oficiales revela que, al final del año, el déficit público podría llegar a 7.5 por ciento en relación con el Producto Interno Bruto.

Lo anterior es consecuencia de que los niveles de las tasas de interés domésticas incrementarán el pago de intereses de la deuda interna en más de 800 mil millones de pesos adicionales.

Esto es que de un total presupuestado de dos billones 531 mil 200 millones de pesos, los réditos internos que pagará el gobierno se elevarán a 3 billones 300 mil millones de pesos, lo cual representa un fuerte desequilibrio para sus finanzas.

Por consiguiente, dijeron los informantes, habrá necesidad de continuar ajustando el gasto público, sobre todo en el sector paraestatal y en el sistema bancario.

Más en la 7

Tiende a Estabilizarse el Dólar Libre: 337, con Demanda Escasa

Jesús Guadarrama H.

El peso se comportó en forma mixta frente al dólar en la sesión cambiaria de ayer, pues mientras en el mercado controlado sufrió otra "minidevaluación" de 90 centavos, en el libre recuperó terreno y tuvo una ligera ganancia, al ubicarse en 330 a la compra y en 337 a la venta.

Expertos cambiarios comentaron que, por el lado del mercado controlado, el nuevo sistema de "flotación regulada", vigente desde el 5 del presente mes, ha flexibilizado la fijación de la paridad de la moneda mexicana con respecto a la estadounidense, pero ha significado un ajuste diario de entre 40 y 50 centavos, que resulta mayor al de 21 centavos que había con los deslizamientos.

El mercado libre, según los especialistas, va tomando su nivel real y ya hay una marcada tendencia a la estabilización, pues se ha reducido la demanda de dólares.

Más en la 6

Ante la Raquítica IE y la Insuficiencia del "Entendimiento", Proponen un Minigatt con EU

Rodolfo Benítez / Jesús Sánchez

La inversión extranjera directa ha crecido muy lentamente en los últimos seis años, y hasta el primer trimestre de 1985 los capitales foráneos acumulados hacían un total de 15 mil 251.8 millones de dólares.

Datos del Banco de México precisan que en los tres primeros meses de 1985 llegaron capitales al país por 148.4 millones de dólares, en tanto que en todo 1984 la suma total de la inversión extranjera directa fue de 391.1 millones de dólares.

Estas cifras, se señala en un documento del Centro de Información y Estudios Nacionales (CIEN), contrastan con el comportamiento de la inversión foránea en los años del "boom" petrolero, pues sólo en 1980 llegaron capitales por 3 mil 312.1 millones de dólares.

Por ramas de actividad, la inversión extranjera directa en el país presenta un descenso casi generalizado, sobre todo porque el capital foráneo que opera en México está concentrado en empresas estadounidenses, agregaron los especialistas.

A su vez, el presidente de la sección mexicana del Comité Binacional de Hombres de Negocios México-Estados Unidos, Antonio Madero Bracho, consideró que el entendimiento comercial suscrito por los dos naciones en abril pasado es insuficiente para avanzar en esa materia.

En tal circunstancia, Madero Bracho dijo que procede la creación de un "minigatt" entre México y Estados Unidos, lo que no sólo facilitaría las relaciones comerciales, sino los flujos de inversión.

Subrayó que un paso de esta naturaleza es indispensable, ya que México destina el 65 por ciento de sus exportaciones totales a Estados Unidos, y de ese país proviene el grueso de sus importaciones.

Madero Bracho dijo también que los gobiernos de México y Estados Unidos estudian la posibilidad de alcanzar un acuerdo general en materia de comercio e inversión, fin para el que se han integrado grupos de estudio que harán las propuestas a las autoridades correspondientes.

Más en la 15 y 21

ECONOMY

Gloomy mid-term balance sheet

RESULTS FALL FAR SHORT OF GOVERNMENT TARGETS

On the eve of President Miguel de la Madrid's third annual state of the union address of 1 September, Mexico's economic performance seems spotty at best. Considerable progress has been made since 1 December 1982, when the present administration took office, but the achievements pale beside the targets laid out by the government's own Plan Nacional de Desarrollo (Planade), published in May 1983, and by the *Criterios Generales de Política Económica*, submitted every year to congress by the economic cabinet:

□ **Economic growth:** The plan forecast a drop of 2-4% in 1983 (after 0.2% contraction in 1982); relative stagnation in 1984 (growth of 0 - 2.5%) and a leap to an average 5-6% in 1985-88. *Actual growth was −5.3% in 1983 and 3.5% in 1984. The economy grew at an average of 6% in the second half of 1984 and the first half of 1985.* This unexpected take-off was politically gratifying, but it also unbalanced the economy. The government was forced to 'put on the brakes' and aim for an annual 3-4% growth rate in 1985.

The rapid growth of late 1984 and early 1985 was based on a larger-than-expected government deficit and on concentrated investments in a few sectors of the economy, where temporary accelerated tax write-offs were available and subsidised credits plentiful. The automobile and construction industries —among others— grew rapidly, unlike production of basic consumer goods. After the severe production fall of 1983, the country was unprepared for such rapid expansion. The economy simply over-heated, fuelling inflation and driving up the imports bill.

□ **Inflation:** The plan ventured no specific forecast for inflation, although it did predict a reduction of the 98.8% figure registered in 1982. The yearly targets submitted to congress were 50% for 1983, 40% in 1984 and 35% in 1985. *Inflation has in fact been falling gradually, but far less than anticipated. Official figures for 1983 and 1984 were 80.8% and 59.2% respectively. During the first half of 1985, the non-annualised index topped 25% and inflation in 1985 is now estimated at 50-60%.*

Controlled prices are rising at a faster rate than the general index, in an effort by the government to stimulate production and reduce subsidies. Thus lower-income groups, who spend more of their income on basic goods, have been hardest hit by inflation.

□ **Public sector deficit:** The plan proposed a reduction of the public sector deficit from nearly 18% of GDP in 1982 to about 4% in 1985-88. Yearly targets were: 8.5% in 1983, 5.5% in 1984 and 5.1% in 1985. *The actual deficits were 8.9% and 7.1% in 1983 and 1984. Some estimates put the 1985 figure at 8%, despite spending cuts.* Analysts blame a substantial rise in local interest rates and a fall in oil revenues. Another factor, often overlooked, is the gross miscalculation of inflation levels, which has increased the outlays for government purchases.

□ **Foreign trade:** The government forecast an average trade surplus of 3.5% of GDP for 1985-88. It also predicted a 10% annual increase of Mexico's non-oil exports between 1985 and 1988. Total exports were expected to grow 12% in 1983-84 and 7-9% in 1985-88. *No specific yearly target was set for 1983, but Mexico managed a record-breaking US$13.7bn trade surplus. In 1984 a surplus of US$9.5-10bn was estimated and the actual figure was US$12.8bn. The 1985 target of US$10-12bn will not be achieved. The January-July surplus was 43.7% lower than the same period in 1984, and a surplus of US$7-8bn is estimated for the whole of 1985.*

The weakness of the international oil market is only partly responsible for the shrinking trade surplus. Non-oil exports have been falling even faster that oil exports: at 14.6% and 13.5%. Imports have been growing at 29.2% per annum over the same period.

Exporters blame the poor performance in non-oil exports on the government's failure to set a realistic exchange rate. The peso was devalued in July after months of lobbying by the private sector. Exporters point out that this contradicted the Planade's pledge to adhere to a 'realistic' exchange policy 'seeking the gradual convergence of two exchange rates and maintaining incentives for exports and import-substitution'.

□ **Salaries and employment:** The plan promised that 'increases in real salaries will match productivity increases after the initial ajustment period.' It tacitly recognised that there would be no employment gains in 1983 and 1984 but promised a growth in employment of 3.5 - 4% per year in 1985-88.

There were no real salary increases in 1983. Real wages dropped by close to 28% that year, and by an additional 4% in 1984. An 18% wage increase in June 1985 did not compensate for the 25% inflation in the first half of 1985.

Bona fide unemployment figures are difficult to come by but even the most optimistic data show *no drop in unemployment in 1983-84.* A study prepared by researchers at the Universidad Nacional Autónoma de México (UNAM) argues that *unemployment has grown; from 4% in 1981 to 8.1% in 1982, 12.6% in 1983 and 14.8% in 1984.*

In conclusion, Planade envisaged a three-phased economic recovery in 1983-88, which closely resembled the plans of former President José López Portillo. 1983 and 1984 were 'recuperation' years; 1985-86 were 'consolidation' years and 1987-88 was the take-off period.

This plan was thrown out of kilter, first, by the government's unpreparedness for the sudden burst of growth in 1984, and second, by the slump in world oil prices (though this was partly compensated by the fall in interest rates).

As Carlos Ramírez, a financial columnist, put it to us, '[The government] tried to tackle first the effects of the crisis, then its causes. As things have turned out, it has not succeeded with either.' ■

XV

ANNEX 4

MEXICO:

ECONOMIC AND FINANCIAL STATISTICS

Data Book

August 30, 1985

PREPARED BY SECRETARIA DE HACIENDA Y CREDITO PUBLICO [1]

1) Distributed to banks on September 16, 1985

Table 2

ECONOMIC POLICY TARGETS

(Billions of Pesos)

	Outstanding level as of Dec.31,1983	Cumulative change from Dec.31, 1983 1st quarter	2nd quarter	3rd quarter	4th quarter	Outstanding level as of Dec.31,1984	Cumulative change from Dec.31,1984 1st quarter	2nd quarter	3rd quarter	4th quarter	Outstanding level as of Dec.31,1985
Public sector overall deficit 1/											
Target	1500.0	400.0	770.0	1150.0	1724.0	1724.0	430.0	840.0	1240.0	1785.0	1785.0
Actual	1521.0	341.0	637.0	1047.0	2224.0	2224.0	354.0	1046.7	---	---	---
Banco de Mexico net claims on non-financial public sector 2/											
Unadjusted											
Target	3097.0	3023.0	3205.0	3397.0	3374.0	3734.0	3748.0	3895.0	3897.0	3695.0	3695.0
Actual	2839.3	2944.3	3032.8	3023.2	3722.4	3722.0	3713.1	3981.4	---	---	---
Adjusted											
Target	---	---	---	---	---	---	---	---	---	---	---
Actual	---	---	---	---	---	---	---	---	---	---	---
Banco de Mexico net domestic assets 3/											
Target	433.9	-40.0	-71.0	-113.0	-43.0	-216.4	127.0	179.0	45.0	184.0	-41.5
Actual	-173.4	-139.7	-242.5	-341.9	-52.1	-225.5	122.0	440.0	---	---	---
Public sector net external debt (US$ billions)											
Target	71.7	1.1	2.1	3.1	4.0	75.4	0.5	0.5	0.8	1.0	74.6
Actual	71.4	0.2	0.9	1.8	2.2	73.6	0.3	0.1	---	---	---
Banco de Mexico net foreign assets (US$ billions)											
Target	0.4	0.3	0.8	1.3	2.0	5.4	-1.0	-0.9	-0.1	0.5	6.9
Actual	3.4	0.9	2.0	2.6	3.0	6.4	-0.9	-1.9	---	---	---
Financial Intermediation (Effective flow) 4/											
Target	---	---	---	---	---	---	130.0	230.0	300.0	350.0	350.0
Actual	---	---	---	---	---	398.1	120.1	184.4	---	---	---
Non-financial public sector accrued and unpaid interest to Banco de Mexico 5/											
Target	---	---	---	---	---	---	314.0	314.0	214.0	77.0	568.0
Actual	---	---	---	---	---	491.0	314.0	314.0	---	---	---

192349 :PM-FUND-MEXICO URGENT
IMF LOANS TO MEXICO SUSPENDED
BY PETER TORDAY

WASHINGTON, SEPT 19, REUTER - THE INTERNATIONAL MONETARY FUND (IMF) HAS SUSPENDED 450 MILLION DOLLARS OF CRUCIAL LOANS TO MEXICO BECAUSE OF THE COUNTRY'S FAILURE TO ADHERE TO AGREED-UPON ECONOMIC REFORMS, MONETARY SOURCES SAID TODAY.

THE DEVELOPMENT COULD PUT AT RISK MEXICO'S AGREEMENT WITH ITS MAJOR CREDITOR BANKS TO STRETCH OUT LOAN REPAYMENTS OF SOME 48.7 BILLION DOLLARS OVER THE NEXT 14 YEARS.

MEXICO WAS ONCE HAILED AS THE FIRST AND MOST SUCCESSFUL EXAMPLE OF THE WESTERN STRATEGY FOR DEALING WITH THE DEBT CRISIS BUT THE LOAN CUTOFF MAY HAVE DEALT A BLOW TO IMF POLICIES, AND UNDERSCORES RECENT PLEAS OF LATIN COUNTRIES FOR A BROADER ECONOMIC AND POLITICAL SOLUTION TO THE DEBT CRISIS.

MORE

EUN269 OXA539
200046 :PM-FUND-MEXICO 2 WASHINGTON

THE WESTERN STRATEGY FOR DEALING WITH THE DEBT CRISIS IS EXPECTED TO BE A MAJOR TOPIC OF DEBATE AT NEXT MONTH'S IMF/WORLD BANK ANNUAL MEETING IN SEOUL, SOUTH KOREA.

UNDER THE STRATEGY, THE INDIVIDUAL PROBLEMS OF DEBTOR NATIONS ARE DEALT WITH SEPARATELY ON A CASE-BY-CASE BASIS.

BUT RECENTLY, LATIN NATIONS, WEARY OF AUSTERITY, BESET WITH MOUNTING UNEMPLOYMENT AND IN SOME CASES FACING SOCIAL UNREST, HAVE CALLED FOR THE INDUSTRIAL WORLD TO SHOULDER MORE OF THE BURDEN.

LATIN AMERICA OWES FOREIGN CREDITORS ABOUT 360 BILLION DOLLARS, ROUGHLY HALF THE THIRD WORLD FOREIGN DEBT TOTAL.

THE SOURCES SAID THAT UNDER IMF RULES, ONCE A COUNTRY'S ECONOMIC PERFORMANCE FALLS BEHIND THE TARGETS SET FOR IT BY THE GLOBAL LENDING AGENCY, THE FUND CANNOT CONTINUE LOAN DISBURSEMENTS.

MEXICO'S IMF PROGRAMME, UNDER WHICH ROUGHLY 900 MILLION DOLLARS COULD STILL BE PAID OUT, RUNS OUT IN DECEMBER.

BANKERS SAID THAT MEXICAN INFLATION, CURRENTLY 56 PER CENT, WAS RUNNING FAR AHEAD OF FUND TARGETS.

MORE

NNNN
EUN274 DXA554
200102 :PM-FUND-MEXICO 3 WASHINGTON

BANKERS SAID THE IMF MOVE COULD COMPLICATE A RECENTLY SIGNED AGREEMENT WITH COMMERCIAL BANKS TO STRETCH OUT ALMOST HALF OF ITS ROUGHLY 100 BILLION DOLLARS OF FOREIGN DEBT.

MEXICAN OFFICIALS RECENTLY ESTIMATED THAT THE COUNTRY WOULD NEED ABOUT 500 MILLION DOLLARS OF NEW MONEY THIS YEAR, AND BETWEEN TWO AND THREE BILLION IN 1986.

BUT THE BANKERS SAID THAT ITS DETERIORATING ECONOMY COULD MEAN ITS NEEDS ARE FAR HIGHER, POSSIBLY AS MUCH AS SEVEN BILLION DOLLARS.

THEY ALSO SAID THE COUNTRY WOULD ALMOST CERTAINLY NEED A NEW AGREEMENT ON ECONOMIC REFORMS WITH THE IMF.

BANKS HAVE BALKED AT LENDING NEW MONEY TO HEAVILY-INDEBTED COUNTRIES WHICH HAVE NOT ADOPTED IMF MEASURES FOR RESTORING ECONOMIC HEALTH.

CITIBANK, THE WORLD'S LARGEST BANK, IS EXPECTED TO TELEX MEXICO'S OTHER CREDITOR BANKS A MESSAGE FROM MEXICAN FINANCE MINISTER JESUS SILVA HERZOG, EXPLAINING HOW THE COUNTRY PLANS ...ESTORE ITS ECONOMIC HEALTH, THE BANKERS SAID.

NNNN
EUN278 DXA561
200111 :PM-FUND-MEXICO 4 WASHINGTON

IMF LOANS TO LATIN AMERICA'S OTHER BIG DEBTOR NATION, BRAZIL, WHICH OWES FOREIGNERS OVER 100 BILLION DOLLARS, WERE SUSPENDED IN FEBRUARY. THE TWO SIDES HAVE BEEN UNABLE TO FORGE A NEW AGREEMENT SINCE THEXW.

LALBZNITED NATEK HIGHLIGHT THEIR DISSATISFACTIM

EJDXOT OFFICIALS, MEXICAN PRESIDENT MIGUEL DE LA MADRID AND BRAZILIANDKFEATERAL TALKS WITH SECRETARY OF STATE GEORGE SHUL Z WHILE IN NEW YORK AT THE U.N.

REUTER

Office Memorandum

RECEIVED INTERNATIONAL MONETARY FUND

1985 SEP 21 AM 12:47

OFFICE OF THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

FROM: M. Casanegra de Jantscher

September 23, 1985

SUBJECT: Technical Assistance--Mexico

I returned to the office on September 19 from a technical assistance mission to Mexico, that lasted from the 2nd to the 18th of September. The members of the mission were Messrs. Silvani and Teijeiro (both consultants in FAD), Ms. Maria Elena Ureta (secretary), and myself. The purpose of the mission was to evaluate the structure and administration of Mexico's direct taxes. An earlier FAD mission had studied the system of domestic taxes on consumption; its report was recently sent to the authorities.

The reduction of the public sector deficit since 1982 has been achieved mainly through a decrease in government expenditure and an increase in taxes on oil production. The performance of other taxes, in particular income taxation, has been unsatisfactory. Currently, prospects for further expenditure cuts and for increases in oil revenues are not promising. Mobilization of additional tax revenues from the non-oil sector is therefore a matter of high priority.

The ratio of income taxes to GDP decreased from 5.8 percent in 1980 to 4.1 percent in 1984. As a percentage of total tax revenues, income tax collections declined from 38 percent in 1980 to 26 percent in 1984. This decline is worrisome not only because more revenue is needed but also because the burden of income taxation is, at least in principle, more equitably distributed than consumption tax burdens.

At first glance, the marked deterioration of income tax revenue is puzzling. Part of the decline can be explained by adverse economic conditions, but when the situation improved in 1984 these taxes failed to respond accordingly. The structure of Mexico's income taxes follows the generally accepted model. It even includes sophisticated elements such as capital gains taxation, a mechanism for integrating company and personal taxation, and a scheme for adjusting profits for inflation. Over the last five years considerable efforts have been made to improve income tax administration. A modern administrative structure has been established along functional lines. Much progress has been made in decentralizing tax administration. The use of computers in tax administration has expanded considerably and today Mexico has a highly developed system for processing income tax returns.

Like many other elements in Mexico's complex social and economic structure, the reality of income taxation differs from the appearance. The individual income tax is primarily collected from incomes that are subject to withholding--wages, salaries, and interest.

Income derived from professional and entrepreneurial activities composes a negligible fraction of the individual income tax base. In the case of company taxation, investment incentives and the deductibility of large nominal interest payments have greatly eroded the tax base. The current treatment of interest payments also creates an unwarranted incentive in favor of debt over equity finance.

To correct these defects, it is necessary to modify some features of the income tax laws. The tax base should be broadened, incentives for debt financing eliminated, and the current system simplified. Among the measures proposed are the repeal of special treatment for agriculture and transportation (which in practice exempt these activities from income tax), the adoption of a more consistent profits adjustment mechanism that would limit interest deductibility to "real" interest, and the reduction of the top marginal rate of the individual income tax. Taken as a whole, these measures would increase collections, facilitate tax administration, and reduce distortions in resource allocation.

For these changes to be effective, tax administration must be improved. Current methods of processing tax returns and payments are efficient, but enforcement work--particularly tax audit--is much in need of improvement.

The mission discussed its findings with the Undersecretaries for Revenue and for Finance. In more detailed form, the recommendations were spelled out in an aide-mémoire. The authorities expressed interest in our proposals and said that they hoped the report would elaborate on them. It was agreed that a working group composed of senior officials from the undersecretariats of Revenue and Finance would visit Washington to discuss our recommendations before the report is completed. It was also suggested by the Undersecretary for Finance that after the report is issued, the Mexican authorities might convoke a seminar or conference to which members of both FAD missions would be invited. On this occasion, as on others, I noticed that the officials preferred to characterize our work as cooperation from the Fund rather than technical assistance.

cc: WHD	GEN
EXR	LEG
ETR	OE
INST	RES
	Mr. Collins

INTERNATIONAL MONETARY FUND

TO : MESSAGE FOR MR. ERB

FROM: CITIBANK

(Walter Bayly, (212) 559-5556, works for Mr. Rhodes)

The Bank Advisory Group for Mexico will be meeting on Monday, Sept. 30, at 10 AM, New York, at the offices of Sherman & Sterling, at 153 E. 53rd St., 33rd Fl., Conference Room A. This meeting has been called by Mr. Angel Gurria, (Ministry of Fin.) and they asked that the IMF be invited also.

495732

MIGUEL DE LA MADRID H 95732

PRESIDENTE CONSTITUCIONAL

DE LOS ESTADOS UNIDOS MEXICANOS

RECEIVED
INTERNATIONAL
MONETARY FUND
1985 OCT 16 PM 4:56

Los Pinos, D.F., septiembre 23 de 1985.

THE ORIGINAL IS BEING TRANSLATED

ORIG: WHD
CC: MD
DMD
MR. PEREZ
ETR SEC
FAD TRE
LEG MR. COLLINS
RES MR. BROWN

SEÑOR
JACKES DE LAROSIERE
Director del
Fondo Monetario Internacional.

Estimado señor De Larosiere:

En nombre del pueblo y gobierno de México, agradezco profundamente el mensaje de solidaridad y apoyo, que con motivo de los recientes sismos ocurridos en nuestro país, envió a la Nación Mexicana.

Respecto a la asistencia de emergencia en casos de desastres naturales, que tan gentilmente nos ofrece, le comunico que mis colaboradores la están analizando.

Aprovecho esta ocasión para enviarle un cordial saludo.

RECEIVED
INTERNATIONAL
MONETARY FUND
1985 OCT 17 PM 12:10
COMMUNICATIONS
DIVISION

S.C.

INTERNATIONAL MONETARY FUND

urgent and important

TO : Mr. Mohammed

FROM: Mr. Pujol

Please provide me with any evidence (press reports, public statements etc....) that may have been made public — before the earthquake — on the fact that Mexico was not complying with the program —

I need precise references and clips.

Thank you

[signature]

Sept 22 85

-(DJ-09-20-85 1956GMT)

-IMF REPORTEDLY CONSIDERING EMERGENCY LOAN TO MEXICO IN WAKE OF EARTHQUAKE; WORLD BANK LOANS ALSO A POSSIBILITY

WASHINGTON-(DJ)--MEXICO MAY BE ELIGIBLE FOR AN EMERGENCY LOAN OF BETWEEN 300 AND 600 MILLION DLRS FROM THE INTERNATIONAL MONETARY FUND (IMF) TO HELP THE COUNTRY RECOVER FROM THE ECONOMIC EFFECTS OF A SEVERE EARTHQUAKE THAT ROCKED MEXICO CITY AND OTHER PARTS OF MEXICO THIS WEEK.

IMF OFFICIALS REPORTEDLY WERE CONSIDERING THE POSSIBILITY OF SUCH A LOAN TO MEXICO FRIDAY.

THE IMF HAS APPROVED SIMILAR CREDITS TO MEMBER COUNTRIES, EQUAL TO 25 TO 50 PC OF THEIR IMF QUOTAS OR SUBSCRIPTIONS, TO HELP THEIR ECONOMIES RECOVER FROM SEVERE NATURAL DISASTERS, SUCH AS FLOODS, HURRICANES OR EARTHQUAKES.

SUCH LOANS HAVE BEEN PROVIDED IN THE PAST UNDER THE IMF"S "COMPENSATORY-FINANCING" PROGRAM.

WORLD BANK SOURCES SAID, MEANWHILE, THAT THE BANK ALSO COULD PROVIDE LOAN TO ASSIST A MEMBER COUNTRY IN A RECONSTRUCTION EFFORT IN THE WAKE OF A NATURAL DISASTER SUCH AS MEXICO"S EARTHQUAKE.

BUT THEY SAID THE BANK CURRENTLY IS IN THE PROCESS OF TRYING TO CONTACT WORLD BANK STAFF MEMBERS WHO ARE IN MEXICO TO GET SOME ASSESSMENT OF THE SITUATION IN THAT COUNTRY.

A WORLD BANK SPOKESMAN SAID THE MEXICAN GOVERNMENT HASN"T BEEN IN TOUCH WITH THE BANK YET TO DISCUSS THE POSSIBILILITIES OF CREDITS TO HELP RESTORE ESSENTIAL SERVICES AND RECONSTRUCT BUILDINGS, ROADS AND OTHER FACILITIES DAMAGED BY THE EARTHQUAKE THAT ROCKED SOUTHWESTERN MEXICO ON THURSDAY.

-0-

-(DJ-09-20-85 2001GMT)

-(DJ-09-20-85 2152GMT)

-IMF SAYS IT HASN"T CUT-OFF LOAN DISBURSEMENTS TO MEXICO AGAINST 3.6 BILLION DLR ECONOMIC ADJUSTMENT CREDIT

WASHINGTON-(DJ)--THE INTERNATIONAL MONETARY FUND (IMF) SAID FRIDAY THAT IT HASN"T CUT OFF LOAN DISBURSEMENTS TO MEXICO AGAINST A 3.6 BILLION DLR ECONOMIC ADJUSTMENT CREDIT APPROVED IN EARLY 1983.

IN A STATEMENT COMMENTING ON EARLIER PRESS REPORTS, THE IMF SAID IT "DOESN"T CUT OFF RESOURCES" TO MEMBER COUNTRIES, BUT BORROWERS AREN"T ABLE TO MAKE DRAWINGS AGAINST IMF LOANS "WHEN THEY ARE OUT OF COMPLIANCE" WITH THE LOAN AGREEMENTS THEY HAVE NEGOTIATED WITH THE 149-NATION ORGANIZATION.

IN THE CASE OF MEXICO, THE IMF SAID, MEXICAN OFFICIALS INDICATED LAST MONTH THAT THEY WERE EXPERIENCING DIFFICULTIES IN MEETING THE ECONOMIC ADJUSTMENT "TARGETS" IN THEIR IMF LOAN AGREEMENT.

THE IMF SAID IT WILL CONTINUE DISCUSSIONS WITH THE MEXICAN GOVERNMENT ABOUT THESE PROBLEMS IN THE "NORMAL COURSE OF RELATIONS."

- -

-(DJ-09-20-85 2155GMT)

-IMF SAYS IT HASN"T CUT-OFF MEXICO- 2-

DESPITE THE IMF STATEMENT, MONETARY SOURCES SAID MEXICO CURRENTLY IS "OFF-THE-TRACK" WITH THE IMF.

MEXICAN GOVERNMENT OFFICIALS, THEY SAID, DECIDED AGAINST TRYING TO DRAW A 450 MILLION DLR INSTALMENT AGAINST THE 1983 ECONOMIC ADJUSTMENT CREDIT IN AUGUST, AND THERE ALSO COULD BE DELAYS IN MAKING THE FINAL 450 MILLION DLR DRAWING AGAINST THE IMF LOAN LATER THIS YEAR.

THE IMF NOTED THAT MEXICO HAD OBTAINED ABOUT 2.7 BILLION DLRS IN SEVERAL EARLIER INSTALMENTS AGAINST THE 3.6 BILLION DLR THREE-YEAR IMF ECONOMIC ADJUSTMENT CREDIT THAT WAS APPROVED IN JANUARY 1983.

THIS AGREEMENT IS SLATED TO EXPIRE AT THE END OF 1985.

UNDER IMF RULES, A BORROWING COUNTRY THAT FINDS ITSELF UNABLE TO CARRY OUT THE ECONOMIC ADJUSTMENTS PROMISED IN A LOAN AGREEMENT HAS THE OPTION OF ASKING THE IMF TO CANCEL SUCH AN AGREEMENT AND FOLLOW THIS UP WITH A REQUEST FOR A NEW LOAN.

BUT THIS HASN"T YET HAPPENED IN THE CASE OF MEXICO, ACCORDING TO INFORMED SOURCES.

THE IMF PRESS STATEMENT FRIDAY MADE NO REFERENCES TO THE POSSIBILITY THAT MEXICO MAY BE ELIGIBLE FOR SOME NEW FINANCIAL ASSISTANCE, IN THE FORM OF AN IMF "COMPENSATORY-FINANCING" CREDIT, TO HELP THE COUNTRY DEAL WITH EMERGENCY FINANCIAL DIFFICULTIES RELATED TO THE SEVERE EARTHQUAKE THAT HIT MEXICO ON THURSDAY.

-0-

-(DJ-09-20-85 2158GMT)

-(DJ-09-20-85 2123GMT)

-U.S. READY TO OFFER MEXICO ASSISTANCE AFTER EARTHQUAKE

WASHINGTON -(DJ)--U.S. SECRETARY OF STATE GEORGE SHULTZ IS SCHEDULED TO MEET LATER FRIDAY WITH MEXICAN AMBASSADOR JORGE ESPINOSA DE LOS REYES TO DISCUSS EMERGENCY ASSISTANCE TO MEXICO AFTER THURSDAY"S EARTHQUAKE.

MEANWHILE, TWO SENATORS INTRODUCED LEGISLATION TO PROVIDE MILLIONS OF DOLLARS IN DISASTER AID TO MEXICO. SENATOR PETE WILSON, REPUBLICAN, CALIFORNIA, CALLED FOR 75 MILLION DLRS IN ASSISTANCE, AND SENATOR LLOYD BENTSEN, DEMOCRAT, TEXAS, PROPOSED 25 MILLION DLRS.

IN ADDITION, SENATOR RICHARD LUGAR, REPUBLICAN, INDIANA, CHAIRMAN OF THE SENATE FOREIGN RELATIONS COMMITTEE, SAID THE PANEL WILL "TAKE APPROPRIATE EMERGENCY ACTION" TO HELP MEXICO AT A MEETING ALREADY SCHEDULED FOR NEXT TUESDAY.

IN MEXICO, THE CITY EMERGENCY RELIEF COUNCIL SAID A TOTAL OF 250 BUILDINGS WERE DESTROYED AND 1,000 TO 2,000 OTHERS WERE HEAVILY DAMAGED OR ON THE VERGE OF COLLAPSING.

-0-

-(DJ-09-20-85 2128GMT)

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

START ADDRESS IN THE BOX

HIS EXCELLENCY
MIGUEL DE LA MADRID
PRESIDENT OF MEXICO
PALACIO NACIONAL
06067 MEXICO CITY, MEXICO

DISPATCHED IMF
1985 SEP 20 PM 11: 58

MARK XX FOR CODE
(______) CODE

DISTRIBUTION

CC MD
DMD
MR. PEREZ
MR. ORTIZ
ETR
WHD
MR.COLLINS

START TEXT HERE

I WISH TO EXPRESS TO YOU MY DEEP SORROW FOR THE LOSS OF LIFE AND DESTRUCTION THAT RESULTED FROM YESTERDAY'S EARTHQUAKE. PLEASE BE ASSURED THAT WE STAND READY TO ASSIST YOUR COUNTRY TO THE FULLEST OF OUR ABILITY TO DO SO. WE ARE ABLE IN CERTAIN CIRCUMSTANCES TO PROVIDE EMERGENCY ASSISTANCE TO MEMBERS AFFLICTED BY NATURAL DISASTERS. TO EXAMINE THIS POSSIBILITY I AM PREPARED TO SEND A PERSONAL REPRESENTATIVE FOR DISCUSSIONS WITH YOUR OFFICIALS AS SOON AS YOU DEEM FEASIBLE.

SINCERELY YOURS,
J. DE LAROSIERE
MANAGING DIRECTOR
INTERFUND

DO NOT TYPE HERE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS ↑ TEXT MUST END HERE ↑

A

B

rPU

C TELEX NO.: CABLE ADDRESS:

D DRAFTED BY NAME (TYPE): STBEZA EXT.: 8631 DEPT.: WHD DATE: 9-20-85

E AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE): J. DE LAROSIERE (**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

F Log I3604

EC. 48 REV 1 11-18-82

G

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

INTERNATIONAL MONETARY FUND

TO :

FROM:

Mr de Larosière

A lire pour information

Sent to all EDs
+ Staff

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

START ADDRESS IN THE BOX

MR. J. SILVA-HERZOG
MINISTER OF FINANCE
MEXICO

MARK XX FOR CODE
(______) CODE

DISTRIBUTION

DO NOT TYPE HERE

START TEXT HERE

I LEARNED WITH DISMAY OF THE DISASTER WHICH HAS BEFALLEN YOUR COUNTRY, AND I WANT TO EXPRESS TO YOU, ON BEHALF OF MY COLLEAGUES AND MYSELF, OUR DEEPEST SYMPATHY AT THIS SAD TIME. PLEASE ACCEPT OUR SINCERE CONDOLENCES ON THE LOSS OF LIFE CAUSED BY THE EARTHQUAKE. BE ASSURED OF THE FUND'S READINESS TO ASSIST AND COOPERATE.

REGARDS.

J. DE LAROSIERE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.: CABLE ADDRESS:

DRAFTED BY NAME (TYPE): EXT.: 73057 DEPT.: OMD DATE: 9/20/85

AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE): ( )

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log ______

48 REV 1
8-82

SM82/71

I learned with dismay of the disaster which has befallen your country, and I want to express to you, on behalf of my colleagues and myself, our deepest sympathy at this sad time. Please accept our sincere condolences on the loss of life caused by the earthquake [~~and our best wishes for the work of reconstruction~~].

[As you begin the work of reconstruction, you may be assured ~~that the Fund will stand ready to assist, in any way within the capabilities~~ of the Fund's readiness to explore ways in which we can be of assistance.]

Be assured of the Fund's readiness to assist and cooperate.

INTERNATIONAL MONETARY FUND
WASHINGTON

MANAGING DIRECTOR

September 20. 1985

Dear Mr. Ambassador,

Further to my message of sympathy sent this morning to Mr. Silva Herzog, I would appreciate if you were kind enough to convey the enclosed telex to the President. We are endeavoring to send it by our usual means of communication but, up to now, we have not succeeded.

I would be very grateful if you would ensure that it is received by the President in view of its substantive content.

Sincerely yours

J. de Larosière

START ADDRESS IN THE BOX

MIGUEL DE LA MADRID
PRESIDENT OF MEXICO
PALACIO NACIONAL
06067 MEXICO CITY, MEXICO

MARK XX FOR CODE
(______) CODE

DISTRIBUTION

CC MD
DMD
MR. PEREZ
MR. ORTIZ
ETR
WHD
MR.COLLINS

START TEXT HERE

I WISH TO EXPRESS TO YOU MY DEEP SORROW FOR THE LOSS OF LIFE AND DESTRUCTION THAT RESULTED FROM YESTERDAY'S EARTHQUAKE. PLEASE BE ASSURED THAT WE STAND READY TO ASSIST YOUR COUNTRY TO THE FULLEST OF OUR ABILITY TO DO SO. WE ARE ABLE IN CERTAIN CIRCUMSTANCES TO PROVIDE EMERGENCY ASSISTANCE TO MEMBERS AFFLICTED BY NATURAL DISASTERS. TO EXAMINE THIS POSSIBILITY I AM PREPARED TO SEND A PERSONAL REPRESENTATIVE FOR DISCUSSIONS WITH YOUR OFFICIALS AS SOON AS YOU DEEM FEASIBLE.

SINCERELY YOURS,

J. DE LAROSIERE

MANAGING DIRECTOR

INTERFUND

DO NOT TYPE HERE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

A

B

C TELEX NO.: CABLE ADDRESS:

D DRAFTED BY NAME (TYPE): STBEZA EXT.: 8631 DEPT.: WHD DATE: 9-20-85

E AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE): J. DE LAROSIERE (**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

F Log

SEC. 48 REV 1 11-18-82

G Larosière

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

1. PLEASE KEEP SIGNATURE IN SPACE ALLOWED.
2. Use OCR-B210 sphere and set typewriter for DOUBLE SPACING - No other markings acceptable.

INTERNATIONAL MONETARY FUND

Xeropies

TO : Sent to:

FROM:

Wiesner ✓

Bezard ✓

Fisch ✓

Nols ✓

Gardner ✓

Guitian ✓

+ GV by hand.

Repico

INTERNATIONAL MONETARY FUND
WASHINGTON

MANAGING DIRECTOR

September 20, 1985

Dear Mr Ambassador,

I should appreciate it if the attached message could be conveyed to Mr. Silva Herzog.

I take this opportunity to convey to you my sincere condolences on this tragic event

Sincerely

Jacques de Larosière

DRAFT

The Executive Board of the International Monetary Fund today met in informal session to discuss emergency assistance ~~from the Fund~~ to Mexico. On September 20, 1985, the Managing Director had sent a message to the President of Mexico, Miguel de la Madrid, that referred to the possibility of Fund financial assistance in the aftermath of the recent earthquake.

At their meeting, Executive Directors indicated they would look favorably upon a request from Mexico for such assistance and would be prepared to give it prompt consideration when received. Assistance in the order of ~~SDR 291 million~~ $300 mn was mentioned.

The proposed use of Fund resources would be in line with emergency assistance offered by the Fund in the past to member countries suffering from natural disasters.

INTERNATIONAL MONETARY FUND

→ MD 9/18

September 18, 1985

Mr. Collins:

The attached memorandum is of relevance in the context of the debriefing of the mission to Mexico.

Attachment

Manuel Guitián

Office Memorandum

INTERNATIONAL MONETARY FUND

1985 SEP 18 PM 3:00

OFFICE OF THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

September 18, 1985

FROM: Manuel Guitián *MG*

SUBJECT: Mexico - Staff Report

You will have seen in the debriefing on the mission to Mexico the views of the authorities on the issuance of a staff report to the Executive Board on the situation and the status under the extended arrangement. The purpose of this note is to outline the reasons why the staff thinks it is important to proceed with a report.

First, the deterioration in Mexico's situation raises an important question concerning our responsibilities for providing information to the Executive Board. The issue is not different from the one that arose in late 1981 when our reporting on a rapidly worsening situation in Mexico was delayed on several occasions by the unwillingness of the Mexican authorities to complete the Article IV consultations through successive postponements of the conclusions of the discussions. The delay did not serve Mexico or us well and we should avoid falling into a similar trap this time.

Second, we believe that a report from us is in the best of Mexico's interest. This country pioneered a willingness to go relatively public on its economic policies and in many respects, benefitted in the process from it. It would be damaging to Mexico's credibility to clam up when the situation turns sour, since lack of reporting cannot but fuel the worse type of speculation.

Third, on our part, we are being generally called upon by the membership at this stage to expand both the scope and the frequency of our reporting on members' economies, in particular on those with characteristics of systemic scope such as Mexico. This was made particularly clear in some recent discussions such as that on Argentina where concern was expressed about long information lags in cases where reviews cannot be completed and the program veers off track. We fear that shying away from reporting in such an important and visible case as Mexico will impair our ability to fulfill it in the future. In this context, we doubt that an informal briefing to Directors would be sufficient.

Fourth, the Mexican authorities have made public that they are experiencing difficulties and that there will be a need for new money on a significant scale in the years to come which, most likely, can only be forthcoming on a concerted basis. This contrasts with the expectation under the extended arrangement that toward its end, Mexico would be resuming normal access to capital markets that consequently was a premise for the exercise of enhanced surveillance envisaged for Mexico from 1986 on in the context of the MYRA. Lack of a report on Mexico in these circumstances is likely to prove counterproductive.

There are some precedents of reports issued to the Board even though a review could not be completed or was not explicitly called for. One example is Brazil where a staff report on the review of the extended arrangement was issued last February 1985 for the information of the Board (EBS/85/37, 2/14/85); another instance is Panama where in the absence of a formal review clause, a procedure was developed to issue a staff report to the Board for information to keep Directors current on the country's performance under a series of stand-by arrangements.

We think the issue at stake should not be decided solely on the basis of precedents, because its resolution will affect our future scope for action in reporting to the Board in this and other cases. Therefore, we believe that there are grounds in this case either to set a precedent concerning incomplete reviews or to invoke the consultation clause under the extended arrangement.

cc: Mr. Finch
Mr. Wiesner
Mr. Collins/Mr. Brown

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 17, 1985

FROM: J. P. Pujol

SUBJECT: Mission to Mexico--August 12-September 5, 1985

The mission that recently visited Mexico City reviewed Mexico's performance under the program for the third year of the extended arrangement approved in December 1982. The mission found that the program had strayed off track; four out of the seven criteria that had been set out to monitor performance under the program were not being observed as of the end of June (Table 1), and the likelihood that this situation can be reversed within the remaining period of the arrangement (which ends December 31, 1985) is practically nil.

The mission met with the Secretary of Finance, Mr. Silva Herzog, and the Director General of the Bank of Mexico, Mr. Miguel Mancera. Other meetings were held with the Under Secretaries of Finance, of Federal Government Revenues, of Budget and Planning, of the National Banking System, and of External Trade, and also with high-ranking officials in the Federal Government, the central bank, and the major public enterprises. The Alternate Executive Director for Mexico, Mr. Ortiz, participated in the main policy discussions.

At the request of the authorities, the mission prepared a note containing its preliminary views on the problems encountered in the instrumentation of the program and an outline of the policies needed to correct them. The mission argued in favor of the adoption without delay of economic policies aimed at bringing inflation down very quickly.

In his concluding remarks, Mr. Silva Herzog indicated that the authorities were conscious of the recent deterioration in Mexico's economic and financial situation and that they were discussing internally the courses of action to redress the situation in the context of the preparation of the 1986 budget. In these circumstances, he was not yet prepared to indicate what the precise relationship between the Fund and Mexico might be in the immediate future. He said that the note left by the mission would be most useful in the context of their internal discussions and that he would be reviewing it with his colleagues. He hoped to get back to us within a couple of weeks, perhaps in a visit to Washington prior to the Annual Meetings. He expected that by that time a course of action would have been decided.

The mission informed the authorities that the staff would prepare a paper to report to the Fund's Executive Board about recent developments under the program, in line with the commitment under the arrangement for a midpoint consultation with the Fund. The Under Secretary of Finance, Mr. Francisco Suárez, expressed the authorities' preference that the presentation of a paper to the Board be held in abeyance until the authorities had completed the formulation of their plans. He said that although a number of important measures had been taken in recent weeks, they were still working on the preparation of a comprehensive program for next year. Although he had no objection to the staff's briefing of Directors on an informal and individual basis, he preferred that a formal presentation be delayed somewhat. He pointed out that in other similar cases, the Fund staff had been willing to hold the presentation to the Board until a program with the Fund had been fully articulated. He also argued that, from a domestic point of view, their internal discussions on any new program would be made more difficult if a document were to be circulated prior to the presentation to Congress of their 1986 budget, since it might appear that the program was being dictated from abroad and this would weaken the Government's hand. The mission replied that, although it understood the authorities' concerns, it felt that it was extremely important to keep the Board informed of developments, especially in cases of such great interest as Mexico. Executive Directors had insisted on the timeliness of reporting on ongoing programs. Nonetheless, the mission said that it would convey the authorities' preoccupations about the timing of a Board paper to the management of the Fund.

1. <u>Recent developments and performance under the program</u>

As had been indicated in the briefing, performance in the first half of the year was weaker than programmed. The public sector deficit exceeded the limit established under the program by some Mex$208 billion--25 percent--and preliminary results for July and August indicate that the fiscal gap widened even more in those two months. Although this deviation from the fiscal policies of the program reflects in part the weaker than projected petroleum receipts in the period May-July 1985 as a result of the drop in world oil prices, there was a general weakening of overall public sector receipts and a very sharp rise in expenditures--particularly in the category of current transfers--which accounts for a very important portion of the outrun in the fiscal deficit.

The growth in real terms of the broader monetary aggregates decelerated during the first eight months of the year despite the sharp increase in the Bank of Mexico net domestic assets. The behavior of the Bank of Mexico credit reflects to a significant extent the impact of the large borrowing requirements of the public sector. The ceilings on both the net domestic assets of the Bank of Mexico and the net credit to the nonfinancial public sector were exceeded by wide margins at midyear. Moreover, the expansion of the total net domestic credit of the Bank of Mexico reflects a substantial use of the excess reserves that commercial banks were holding at the beginning of the program period. These resources, together with the issuance of bankers' acceptances not subject to reserve requirements, allowed banks to expand credit to the private sector beyond that projected in the program, even in the face of a somewhat lower than projected growth in deposit liabilities. The rate of growth of deposits in commercial banks was affected by the emergence of an interest rate differential in favor of treasury bills and other financial instruments not subject to controls. In contrast to the experience of 1983 and 1984, during the first semester of 1985 interest rates paid on time and saving deposits by commercial banks lagged behind those paid on instruments that are market determined.

The performance of the balance of payments has been very weak this year. During the first eight months of 1985 net international reserves declined by US$3.3 billion, substantially at variance with the program's objective. The strong surplus in the current account that had been observed in 1983 and most of 1984 disappeared during the first half of 1985, although there is the suspicion that this development reflects in part an intensification of the underinvoicing of exports and over-invoicing of imports attendant to the widening of the exchange rate differentials between the two exchange markets. According to customs records, nonpetroleum exports fell by almost 3 percent in the year ended June 1985 compared with the same period of the previous year, while imports rose by 35 percent; private imports showed a 54 percent rate of growth during this period. At the same time, the capital account displayed large net outflows of private capital in the first half of 1985, while official capital flows remained practically in balance, notwithstanding the postponement of the US$950 million prepayment to commercial banks until October 1985.

Given the widening imbalances in the public finances and the substantial expansion in net domestic assets of the financial system, exchange rate management was not sufficiently flexible to protect the balance of payments during the first part of 1985. The real effective exchange rate of the Mexican peso 1/ appreciated by almost 8 percent during the first quarter of the year. Even though the appreciation of the real effective exchange rate virtually came to an end in the second quarter of the year, by the end of June 1985 there were clear indications that the current rate was out of line. The loss in international reserves, which amounted to US$0.9 billion in the first quarter of 1985, rose to US$1.1 billion in the second quarter and to US$1.3 billion in the month of July. The differential between the exchange rate quotations in the controlled market and the parallel market began to widen in the second quarter of the year. This differential reached 45 percent by early July, after having been at 11-22 percent during the first 4 1/2 months of the year. On July 10, 1985 the authorities allowed commercial banks to start operating in the parallel market; on July 24 they devalued the peso in the controlled market by 17 percent; and on August 5 they abandoned the system of preannouncing the daily

---

1/ The real effective exchange rate of the Mexican peso described here is calculated as a trade-weighted index involving eight partner countries. Prices are taken from line 63 of the IFS (wholesale price index) for the trading partners and line 64 (consumer price index) for Mexico.

rate of depreciation in the controlled market for one month ahead and adopted instead a managed float. Following the end-July devaluation the real exchange rate for the peso stood at about the average real exchange rate prevailing in 1984. With the adoption of these measures, the drain on international reserves stopped and there was even some recovery of the reserve position in the latter part of August.

On July 25, 1985 Mexico announced a significant liberalization of imports from quantitative restrictions. The requirement for prior import permits was eliminated for the equivalent of 37 percent of total imports, bringing the total value of imports free from permits to 61 percent. This may be compared with the commitment made under the program for the third year of the extended arrangement to raise imports free from permits to between 35 and 45 percent. At the same time, the import tariff schedule was modified, with a view to reducing the number of tariff categories and improving its structure. The new import tariff schedule is to have nine rates ranging from zero to 50 percent. In general, the tariff increases with the degree of processing of the product; products that are produced domestically tend to have higher rates. The process of realigning the tariff schedule has not been entirely completed yet and a few items still remain in the tariff category of 100 percent. Steps also were taken to make the scheme that gives exporters automatic access to import permits (DIMEX) more liberal by reducing the percentage of import items excluded from this scheme from 28 percent to 21 percent, and by lowering the minimum import tariff applicable to imports under the DIMEX scheme from 25 percent to 10 percent. As a result of these measures and of other steps taken in the first half of 1985, the dispersion of the tariff schedule has been reduced and the weighted tariff (weighted by imports of 1984) has increased from 8.6 percent in 1984 to 12.4 percent in July 1985.

During the first half of 1985 economic activity continued to expand at a faster pace than contemplated in the program, although by midyear the rate of growth of activity seemed to have come to a standstill. Inflation, on the other hand, did not exceed by much what had been assumed under the program for the first half of 1985. Inflationary pressures were cushioned during this period by the loss of international reserves and by some lags in the adjustment of public sector prices.

2. Policy discussions

As indicated above, the authorities were not prepared at this stage to spell out in detail their plans for the future, but rather the discussions focussed on the problems encountered in the instrumentation of the program and on possible courses of action to correct the situation. The authorities asked the mission to prepare alternative macroeconomic scenarios simulating different policy strategies. The mission concentrated on two scenarios. The first one assumed that very strong corrective actions were implemented starting September 1985 with the aim of bringing inflation down to the level prevailing in Mexico's main trading partners by the end of 1986. The second scenario assumed that current trends continued unabated through the end of this year and that an attempt was made to bring inflation down to 40 percent in 1986. In both of these scenarios the mission made the assumption that the net availability of foreign resources to finance the budget would be practically nil, since any foreign financing available would probably be needed to shore up the international reserve position of the country. As a consequence, the fiscal adjustment required in either case would be quite demanding. The authorities indicated that they would want to raise some US$2 to US$3 billion in net financing abroad in 1986 (as much as US$5 1/2 billion on a gross basis), but at this time it did not seem that this could be done through voluntary lending operations. They pointed out that the steps taken by bank regulators abroad to tighten the rules about bank lending were hampering their efforts in this regard.

a. Fiscal policy

The mission emphasized that the deviations that have taken place in the fiscal performance disclosed weaknesses in both revenue collections and expenditure controls. On the revenue side, taxpayers seemed to be benefitting to too large an extent from measures originally designed to protect them from the impact of the crisis; in addition, there appeared to have been an intensification of tax evasion, particularly with respect to the value added tax. As a result, tax revenues have declined as a proportion to GDP, even recently when economic activity was showing a very strong recovery. Furthermore, during the first part of 1985 adjustments in public sector prices had lagged behind the rate of inflation, and the prices of tradable goods produced by the public sector had not been adjusted after the July devaluation.

With regard to public sector outlays, there had been a very sharp increase in central government current transfers; current transfers going outside the consolidated public sector rose in real terms by over 70 percent in the first half of 1985 compared with the same period of 1984. In addition, there had been large increases in real terms in capital expenditures and in wages and salaries. As already noted, the preliminary information for July and August indicated a further significant weakening of the public finances, much beyond what could be explained by the fall in petroleum export receipts.

A continuation of these trends, the mission argued, would put very heavy pressure on domestic prices in the latter part of the year, particularly since the authorities no longer could afford to rely on a large drawdown in international reserves. In the absence of further fiscal measures, the public sector's economic deficit could easily exceed 8 percent of GDP in 1985, compared with a program ceiling of 4.1 percent (Table 2). The mission, therefore, urged the authorities to take immediate remedial action to forestall the realization of a deficit as large as the one that seemed to be in the offing. Special emphasis was placed on the prompt correction of public sector prices as a measure that could bring about a quick reduction in the deficit, to be followed by the implementation of additional expenditure cuts to ensure the permanence of the deficit reduction.

Although the authorities seemed to have no major disagreement with the staff on the prognosis of the fiscal situation, they expressed some concern about the possible impact of large price adjustments in the public sector on the price level in general and on wages in particular. They indicated that so far they had managed to avoid the granting of any special wage awards following the large depreciation of the peso that took place in late July, but they feared that a new round of increases in public sector prices might trigger such a demand from the labor unions. Nonetheless, the authorities did not completely rule out large public sector price adjustments in the context of an overall policy package for next year.

b. Monetary policy

In the discussions in this area the mission pointed out that, in addition to the growth in borrowing requirements of the public sector, there had been a large expansion in credit to the private sector. This development was particularly disturbing since the Bank of Mexico had undertaken open market sales and changes in the reserve requirement regime applicable to the banks to absorb excess liquidity. These operations apparently were insufficient, and the resulting expansion of credit to the private sector had contributed to the pressures on the international reserve position of the Bank of Mexico. In light of these results, the mission wondered whether it was necessary to review the system of calculating reserve requirements by commercial banks and in general to carry out a more agile policy of monetary regulation than had been the case in the recent past.

The authorities were in broad agreement about the missions' assessment of overall credit developments, particularly with regard to the role played by the public sector borrowing requirements in the excessive expansion of credit by the central bank. They felt, however, that there was no need for changing the methodology for calculating reserve requirements and that the mission had an incorrect perception about the banks' ability to withdraw funds from the central bank. Reserve requirements were calculated on an average daily basis, and thus on any one day the banks did not have to hold the full amount of required reserves at the central bank. Consequently, it could occur that while on an end-of-period basis the deposits of commercial banks at the central bank might show a large decline, on an average basis this may not be true. They emphasized that the operations of monetary regulations that were carried out had prevented the situation from becoming even worse but that, given the size of the public sector deficit, there was little that the central bank could do to neutralize the excess liquidity.

In the discussion of interest rate policy, the staff indicated its concern over the differential between the interest rates paid on treasury bills (and other instruments with market-determined rates) and the rates paid on bank deposits, which are regulated by the central bank. The authorities agreed that the widening of interest rate differentials had contributed to a slower real rate of growth of bank deposits, reducing their profit margins. However, the authorities were of the view that the commercial banks were in a very strong position and could support the present situation for some time without serious risks. They felt that bank rates ought to be adjusted gradually and that the rates paid on treasury bills were likely to come down as the speculation about the exchange rate subsided.

The mission also raised questions about the substantial increase in credit operations at subsidized rates by development banks and official trust funds. The authorities said that steps were being taken to adjust the rates charged by these entities upwardly in line with the commitments made to the World Bank in this area of policy.

c. Exchange rate policy

The mission discussed with the authorities the new exchange rate policy followed since early August. The authorities said that their objective consisted on halting the loss in reserves and that they were prepared to engage in sufficient flexibility in the management of the exchange rate policy to prevent such a loss. The mission noted that, under the current exchange arrangements, such an objective seemed to imply that the exchange rate would have to adjust as much as needed to prevent any loss in reserves and that the authorities would have to refrain from intervening in the free market.

The mission questioned the authorities on their intentions with respect to the unification of the exchange market. The mission pressed for an early unification of the two exchange markets, arguing that the central bank's ability to maintain a differential between the two rates had decreased substantially with the loss of international reserves that had taken place and the fall in petroleum export prices. The mission argued, moreover, that the maintenance of the differential between the two markets results in an incentive to divert foreign exchange away from the controlled market and introduces inefficiencies and distortions in the allocation of resources. However, the authorities maintained that, if unification were to take place in the immediate future, there would be great pressures for an accelerated repayment of the private external debt outstanding and that the economy would not be in a position to honor such payments. The mission noted that pressures for repayment of the private external debt would depend on the degree of flexibility in the management of the exchange rate and on the general stance of credit policy.

d. Commercial policy

Concerning commercial policy, the mission indicated that while it is too soon to assess the impact of the recent measures on the flows of trade and overall economic efficiency, it is clear that the impact will depend on how effectively and firmly the latest trade measures are implemented in practice. The mission expressed concern about the establishment of official reference prices for certain tariff categories and the discussions on the need for antidumping legislation. These mechanisms could set back the opening of the economy; the mission noted that in some cases the official prices that had been established are well above world prices.

As regards the prospects for further trade liberalization, the authorities acknowledged that there was still much to be done in this area, but they indicated that they wanted to leave this possibility open for future bilateral negotiations with their main trading partners. In the meantime, they felt that they needed to consolidate the steps already taken. They also noted the importance, from their standpoint, of backing the trade liberalization measures with external financial support; the World Bank is examining the possibility of a credit in support of this effort.

As you probably know, Mexico has started to reconsider the possibility of joining the GATT and the issue is expected to be discussed in the Mexican Congress later this year.

3. Other issues

The authorities raised with the mission the possibility of access to a compensatory financing on account of the decline in export receipts arising from the fall in oil export volume during several months of 1985. The mission reminded the authorities of the requirement of collaboration with the Fund in the context of a compensatory financing operation. The mission provided the authorities with a list of the information required for consideration of a CFF operation, and the authorities said that such information would be gathered and sent to Washington as soon as possible.

Attachments

cc: Mr. Finch
Mr. Habermeier
Mr. Nicoletopoulos
Mr. Tanzi
Mr. Wiesner
Mr. Collins

Table 1. Mexico: Extended Arrangement--Quantitative Performance Criteria for the Third Program Year

	1984	1985					
		Targets and Ceilings					
		Jan.-Mar.		Apr.-June			
	Dec.	Prog.	Actual	Prog.	Actual	July-Sept.	Oct.-Dec.
(In billions of Mexican pesos)							
Nonfinancial public sector cumulative deficit 1/ 2/	1,826	430	354	840	1,047	1,240	1,785
Unpaid interest accrued to the Bank of Mexico on claims on the non-financial public sector	491	805	801	805	805	705	568
Net credit to the nonfinancial public sector by the monetary authorities 3/							
Unadjusted	3,740	3,748	3,713	3,895	3,981	3,897	3,695
Adjusted 4/		3,958		4,426	6/	4,676	4,902
Cumulative changes in financial intermediation (effective flow)	414	130	9	230	185	300	350
Cumulative changes in net domestic assets of the monetary authorities (effective flow) 5/	-53	127	122	179	439	45	184
(In millions of U.S. dollars)							
Cumulative net foreign borrowing by the public sector 1/	2,189	500	300	500	43	800	1,000
Cumulative change in net international reserves of the monetary authorities 1/	2,990	-1,000	-867	-900	-1,927	-100	500

Sources: Mexican authorities; and Fund staff estimates.

1/ Limit tested at end of each period.
2/ Effective flows of financing measured on cash basis.
3/ Effective stocks calculated by adding effective flows to nominal stock outstanding as of the end of 1984.
4/ Ceiling can be adjusted upwards by an amount equivalent to the commercial banks' lending to the nonfinancial public sector resulting from implementing mandatory portfolio requirements. The counterpart of this adjustment would be a downward adjustment of the mandatory portfolio requirements on commercial banks by the same amount as the upward adjustment of the Bank of Mexico's lending to the nonfinancial public sector allowed under the program.
5/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the monetary authorities.
6/ Upward adjustment in ceiling is not applicable because the counterpart measure of reducing the mandatory portfolio requirements on commercial banks was not undertaken (see footnote 4).

Table 2. Mexico: Summary Public Sector Operations

	1984 Rev.	1985 Prog.	1985 Scenarios A 1/	1985 Scenarios B 2/
(In billions of Mexican pesos)				
Overall economic deficit	-1,826	-1,785	-3,147	-3,906
Public sector receipts	9,416	13,745	14,320	14,220
Petroleum exports	2,780	3,541	3,675	3,743
Other PEMEX receipts	1,000	1,577	1,466	1,386
Other public enterprises	1,697	2,632	2,799	2,752
Federal Government	3,247	4,922	5,043	5,011
Social security	633	988	1,257	1,257
Federal District	59	85	80	70
Public sector outlays	11,242	15,530	17,467	18,126
Wages and salaries	1,918	2,588	3,025	3,025
Interest payments	3,099	4,468	5,248	5,697
Current transfers	531	696	1,165	1,245
Revenue sharing	643	960	959	953
Other expenditure	2,608	3,163	3,480	3,528
Capital expenditure	1,999	3,088	3,000	3,088
Floating debt (ADEFAS)	444	567	590	590
(In percent of GDP)				
Overall economic deficit	-6.2	-4.1	-6.5	-8.0
Public sector receipts	32.0	31.6	29.8	29.3
Petroleum exports	9.4	8.1	7.6	7.7
Other PEMEX receipts	3.4	3.6	3.0	2.9
Other public enterprises	5.8	6.0	5.8	5.7
Federal Government	11.0	11.3	10.5	10.3
Social security	2.2	2.3	2.6	2.6
Federal District	0.2	0.2	0.2	0.1
Public sector outlays	38.2	35.7	36.3	37.4
Wages and salaries	6.5	5.9	6.3	6.2
Interest payments	10.5	10.3	10.9	11.7
Current transfers	1.8	1.6	2.4	2.6
Revenue sharing	2.2	2.2	2.0	2.0
Other expenditure	8.9	7.3	7.2	7.3
Capital expenditure	6.8	7.1	6.2	6.4
Floating debt (ADEFAS)	1.5	1.3	1.2	1.2
Memorandum items				
GDP (in billions of Mexican pesos)	29,438	43,510	48,069	48,525
Inflation (period average in percent)	66	51	59	62

Sources: Secretariat of Finance and Public Credit; Secretariat of Planning and Budget; and Fund staff estimates.

1/ Assumes increases in public sector prices and other adjustment measures in the period September-December 1985.

2/ Projection on the basis of ongoing trends observed through August 1985.

WHD-85/5173
Translated by J. Merry
Edited by WHD

September 5, 1985

Memorandum on the Evolution of the Economic Program

Introduction

The Mexican authorities' economic program, following a major adjustment in 1983, began to lose momentum from mid-1984 and has lost considerable ground in recent months. At this time, the authorities find themselves in quite a critical situation, and unless resolute action is taken, the gains achieved by the program heretofore are likely to be forfeited. A deterioration in both the internal and the external situation accentuates the urgent need to adopt decisions on the course to be pursued.

This memorandum describes events up to the first few months of the current year and discusses possible courses of action for future economic policy with a view to the resumption of the adjustment process and attainment of the program's original objectives.

1. Objectives of the Economic Program

The economic program adopted by the authorities at end-1982 had as primary objectives the restoration of medium-term viability of the balance of payments--reducing dependence on external financing--and the elimination of inflation, so as to restore a sound base for the growth of activity and employment. The strategy proposed for strengthening the balance of payments included a large-scale effort to restore competitiveness in the economy through a permanent change in the relative prices of tradeable goods, achieved through a flexible exchange rate policy; a simplification of the exchange system; and the rationalization of trade policy. The authorities sought to restructure the external debt--both public and private--and to eliminate payments arrears vis-à-vis foreign creditors, in order to re-establish Mexico's access to international capital markets which had been interrupted in consequence of the 1982 exchange crisis.

The cornerstone of the adjustment process is a significant reduction in the size of the deficit accompanied by an increase in the savings of the public sector. This action was considered essential in order to eliminate the pressures exerted by the public finances on domestic prices and the balance of payments. In 1983 measures were taken to increase public sector revenues, but the adjustment strategy was based mainly on expenditure cutbacks--especially cuts in current expenditure. In view of the magnitude of the disequilibrium observed, a thorough revision was proposed of the public sector's direct participation in activities not essential for the achievement of its economic and social objectives. Initially, an important part of the expenditure reduction was derived from the elimination of exchange losses generated at end-1982 and of the large subsidies that the public sector granted to various sectors of the economy. It was hoped that price adjustments for public sector goods and services would not only help reduce the deficit but would also improve the structure of relative domestic prices and so lead to greater efficiency in the allocation of resources.

2. Results obtained so far in the implementation of the program

The firm management of the economic program throughout 1983 and for much of 1984 brought about a substantial turnaround in the country's economic conditions. The balance of payments swung from an overall deficit of almost US$7 billion in 1982 to a surplus of US$5.5 billion in 1983 and US$3 billion in 1984. This improvement was generated by large-scale import substitution in response to the change in relative prices and a very significant reduction in outflows of private capital. Also, toward the end of 1983 and early in 1984 the growth rate of nonpetroleum exports increased vigorously. There was a considerable deceleration of inflation between end-1982 and mid-1984; during this period the monthly growth rate of prices decreased from approximately 11 percent to about 3 percent. The rates of growth in economic activity and employment, from being strongly negative in late 1982 and early 1983, became highly positive in 1984. The recovery in economic activity was determined by the growth of nonpetroleum exports and the increase of private investment.

However, in 1984 the ratio of the deficit (including accrued unpaid interest) to GDP remained at a level similar to that of the previous year, instead of continuing strongly downward as programmed. Toward the end of 1984 there was a discernible weakening in the adjustment effort, reflected in a relaxation of the fiscal and monetary policies. With the activation of the contingency reserve in the second half of the year, programmable public sector expenditure ceased to fall in real terms, and on the other hand revenues suffered erosion. In consequence, the public sector deficit increased significantly in the latter part of the year. A heavy demand for credit by the public sector compounded the demand from the private sector, which was at the height of its recovery process. Given the growth of financial resources in real terms, by the end of 1984 it was no longer possible for monetary policy to entirely offset the growing pressure on prices and the balance of payments exerted by the demand for credit.

With the added factor of a certain concentration of amortization of foreign debt, these financial developments started to be reflected in the level of international reserves since December 1984. It was aggravated by intensified outflows of private capital induced by a climate of uncertainty regarding the behavior of the international petroleum market and the conduct of economic policy as a whole. The lag in the adjustment of domestic interest rates, and the erosion of the economy's competitiveness in relation to levels which existed in late 1983, combined to undermine the balance of payments situation.

In the light of these events, the 1985 budget did not bring about any important rectification of the trends implicit in the public finances at the end of the previous year. From the commencement of budget execution, the behavior of the different fiscal variables clearly pointed towards financing needs that were incompatible with the objectives of reducing inflation and maintaining an adequate level of international reserves. This made it necessary to modify the economic policy from as early as February-March 1985. For this purpose new measures were designed to cut spending which, it was hoped, would change the seasonal deficit pattern. Likewise, a restrictive monetary policy was programmed, and consideration was given to the need for an even more flexible exchange policy to protect the balance of payments.

The behavior of the economy in the first six months of 1985 has been marked by a series of uneven developments. On the one hand, economic activity and employment have continued to grow more dynamically than expected, although there are now indications of a deceleration. The public sector deficit has exceeded the amounts programmed for the first half of the year--both in terms of economic deficit and under the somewhat broader concept of financing requirements to cover financial intermediation operations. It should be added that the deviation intensified considerably in July and August. Although during the latter period the public sector deficit was affected by the reduction in oil export revenues, the main cause of the slippages noted derives from a pronounced acceleration of nonfinancial expenditures, especially transfers. The behavior of the monetary variables has been influenced by excessive growth in the Bank of Mexico's domestic credit and a management of interest rates that has stimulated the direct attraction of financial resources by the public sector. A marked deceleration is observed in the real rate of growth of financial resources, with a change in the structure of the broadest financial aggregate toward more liquid resources and instruments not subject to reserve requirements. These financial developments, coupled with an additional appreciation of the real exchange rate, contributed to a substantial deterioration in the balance of payments. Between November 1984 and July 1985 net international reserves declined by US$3.6 billion. Inflation, while higher than originally projected in the budget, did not greatly exceed that projected in the program, because most of the demand pressure was reflected in the balance of payments results.

3. Impact of the recent economic measures and possible course of action for the future

In view of the situation described above, in recent weeks a series of new measures has been adopted in the fiscal, monetary, exchange, and trade areas, designed to change the underlying trends, reverse the deterioration noted, and restore the confidence of the public.

We believe the measures adopted are important and aimed in the right direction. However, greater efforts are required to correct the present situation, particularly in the fiscal area. In view of the changes that have occurred on the international scene--both in the petroleum market and in conditions for access to capital markets--and the uncertainty manifested by the various economic agents, the authorities have no alternative but to resume the adjustment program; not to do so could cause a resurgence of the exchange crisis, a further onset of inflation, and a drop in the level of activity. In fact, the sooner the adjustment is resumed and accomplished, the more robust and lasting the result will be in terms of future economic growth. An attempt to implement a very gradual adjustment policy would intensify the risks of failure and increase the efforts required on the economic and social fronts. The experience of late 1984 and early 1985 shows how easily ground may be lost with a policy that attempts to distribute gradually the costs of adjustment over time.

In this context, the question arises as to which should be the policy guidelines to be put into effect immediately with a view to attaining the economic program's objectives as quickly as possible.

a. Fiscal policy

In the fiscal area, as noted earlier, a deceleration of the adjustment process is perceptible from mid-1984. Despite the recovery in economic activity, the Federal Government's uncommitted revenues have diminished. This is due in part to the granting of incentives to business--such as accelerated depreciation--and the extension of the zero rate regime to a variety of products in the value-added tax. There are also indications of increased tax evasion, particularly as regards the value-added tax, owing to abuses in the system governing small taxpayers. Furthermore, available Federal revenue has also been affected in recent years by a large increase in the revenues earmarked for state and local governments. These are all areas in which changes could be made that would result in strengthening tax receipts.

With regard to the revenue of the parastatal institutions, while an important endeavor was made to update prices of goods and services provided by the public sector in 1983 and 1984, the process was attenuated during 1985. Insofar as the inflation rate has exceeded the original budget projections, many prices for public sector goods and services are out of date. The same may be said of the preferential interest rates applicable to credits granted by the development banks and official trust funds. It is therefore necessary to have a more flexible policy for the revision of prices and preferential interest rates, in order to avoid further fiscal gaps and new distortions in relative prices.

With regard to expenditures, since mid-1984 a marked acceleration has been noted in the rate of increase of "programmable" expenditure. Federal Government transfers have grown particularly strong--not only transfers to the rest of the public sector but even more so those going outside the consolidated public sector. The Federal Government's current transfers increased by 170 percent in the first half of 1985 compared with the same period in 1984, and their proliferation has been such that the number of recipients is very large. Other spending items which also showed considerable growth in real terms from January to June 1985 are investment in capital goods, capital transfers, and wages and salaries. Any fiscal adjustment strategy adopted in the near future will need to include very substantial cutbacks in "programmable" expenditures, over and above those already announced during the course of this year. In view of the magnitude of the cuts required and the associated budget control difficulties, the cuts should be made by programs, and this entails substantial changes in sectoral policies.

Interest expenditure, on the other hand, has not occasioned wide deviations in total spending in the first half of 1985, since it shows a growth in nominal terms of only 35 percent on a cash basis and 30 percent on an accrual basis compared with the same period in 1984. Interest payments in the second half of 1985 will certainly exceed those of the first half, but their magnitude will depend on the inflation profile and the corrective measures adopted in monetary and fiscal policies. It may be noted that, while interest on domestic debt represents an important share of total public sector expenditure, that sector continues to pay an actual rate of interest that is negative in real terms on its overall domestic debt; only in the placement of government securities (CETES) has the real rate of interest become highly positive in recent months. Public sector interest payments as a share of GDP have decreased from the equivalent of more than 12-1/2 percent in 1983 to less than 10-1/2 percent in 1985, and would tend to decrease more than proportionally if inflation were to decelerate considerably.

Although the fiscal results for the first half of 1985 differ from those projected in the fiscal program, they would not seem at first sight to lead to a totally unmanageable situation if the additional spending cuts mentioned above are taken into account. But the deficit observed in July and August (months for which revenue expenditure information is still incomplete) indicates the existence of a much larger fiscal deficit which, if not tackled very soon, would result in financing needs for the year that might amount to Mex$4 billion. If a deficit of this magnitude were to materialize it would exert tremendous pressures on the domestic inflation rate and the exchange rate. In the present situation of the Mexican economy, financing a deficit of this size would result in a serious rekindling of inflation, possibly to more than 70 percent.

In terms of fiscal policy strategy for the immediate future, therefore, two important questions must be resolved. First, what can be done between now and the end of the year to ensure that a fiscal deficit of this magnitude does not arise? Second, what guidelines should be observed for fiscal policy in the preparation of the 1986 budget?

With regard to the first question, while a series of budget cutback measures has indeed been adopted in the course of the year, there is no precise estimate of the extent to which these cuts can have a significant impact on the traditional seasonality of the deficit--which normally has resulted in a very heavy growth of financing needs in the last quarter of the calendar year. The spending cuts announced since the beginning of the year are considerable in amount, but it is not clear how much they represent an effective decrease in the rate of expenditure to be effected, and how much they represent a diminution of the potential spending authorized in the budget. Also unknown is to what extent these cuts affect only the execution of this year's budget but have a lesser impact on future years. Furthermore, the July and August deficit figures would seem to indicate that there have been other increases in spending which have more than offset the cuts actually implemented. There is no doubt that the rekindling of inflation and the prevailing uncertainty have increased the nominal interest payments on domestic debt over and above those programmed. This factor, together with the deterioration in oil revenue, has increased the deficit, but the impact of these variables is not sufficient to explain the fiscal deterioration observed. It would therefore appear that the programmable expenditure being executed has continued to accelerate in recent months, and that the delay in adjusting controlled prices and preferential interest rates is generating increasingly large subsidies which are heavily burdening the financing needs of the public sector.

Without a doubt, immediate additional spending cuts can and must be considered in the context of any adjustment program, both for the coming year and for the remaining months of this year. But taking into account the mechanics of implementation and the lags in expenditure, the impact of most cuts to be introduced in the next three months would not become apparent until the coming year. This being so, the brunt of the short-term impact would need to be borne by the correction of controlled prices and by other measures of an administrative type that help reinforce tax revenue immediately. It is true that sizable adjustments in public prices will tend to affect the price index, but the resulting inflation would be corrective. On the other hand, if these adjustments were not made inflation would swell up again in any event on account of the size of the deficit to be financed.

As regards the guidelines for the 1986 budget, the availability of noninflationary resources considerably restricts the size of the financiable deficit. To obtain a really substantial reduction in inflation next year, the deficit should not exceed more than 2 to 2-1/2 percent of GDP. This would mean a deficit for 1986 which in nominal terms would probably be less than half that expected for 1985.

In view of the current balance of payments situation and the prevailing uncertainty on the oil market, available external resources should be used to reconstitute the international reserve position. If a sizable reduction of inflation is to be obtained next year, a bold fiscal policy is required, one that brings the major adjustment measures into play from the beginning of the program.

The alternative to the strategy outlined above would be one in which inflation is reduced over a longer period through spending cuts that initially would seem less important, and by moderate increases in the prices for public services. There are at least four objections to this gradualist approach. First, its credibility would be doubtful in light of the experience of the last year and a half. Secondly, the risks of failure or deviation would be greater in the event of any exogenous disturbances materializing during its implementation. Thirdly, the extent of nonfinancial expenditure in real terms would be less in a situation of a slower reduction of inflation. Fourthly, the efforts required on the social and political fronts would probably be greater with a slower progress in the fight against inflation.

b. Monetary and credit policy

The Bank of Mexico's credit has increased too strongly since the end of 1984. Although this expansion of credit reflects to a large extent the slippage in the fiscal deficit, at the same time there is a large element of excessive growth of credit to the private sector. Against such a strong expansion of overall credit, exchange and interest rate measures were inadequate to induce greater financial saving and avert a considerable loss of international reserves in the first seven months of the year.

These developments raise doubts about the efficacy of the measures adopted with regard to monetary regulation and the reserve requirements. From mid-March this year the Bank of Mexico undertook certain monetary regulation operations with a view to reducing the volume of credit in the system so as to arrest the loss of reserves that had begun in December 1984. These operations were planned on the basis of a projected public sector deficit that was much smaller than that actually executed. The results obtained by the regulatory measures were more than offset by the larger deficit and a net withdrawal of banks' resources held in the Central Bank. The withdrawal occurred despite the measures taken to freeze the banks' supplementary reserve deposits as of December 1984. Consequently, and in the absence of complementary measures to control credit and changes in the exchange rate, the loss of reserves continued at an accelerated pace.

A scheme was recently established for channeling funds captured by the banks into purchases of government securities for the equivalent of 70 percent of the marginal funds attracted, which leaves only about 15 percent of such marginal funds available for lending to the private sector. If continued for long, this scheme entails a "crowding out" of the private sector that will have negative effects on the level of activity. In a situation of a very large fiscal deficit, inasmuch as the Central Bank has to honor the Treasury's overdrafts, the growth of credit will be dictated by the size of the deficit, and the Bank of Mexico will be powerless to counter it.

In the implementation of interest rate policy, contrary to the situation prevailing in 1983 and much of 1984, distortions have been generated by the spread that has appeared between banks' deposit rates and the CETES rate. This spread has affected the structure of financial saving, decreasing the funds attracted by banks and reducing the role of the commercial banks in the financial intermediation process. The pressure derived from a higher deficit which makes increasingly large placements of government paper obligatory has also contributed to pressures on the lending rates charged by banks in their unrestricted portfolio as they try to balance the yields of their overall portfolio. In this situation, it would be advisable to re-examine the interest rate policy, either with a view to liberalizing the banks' deposit rates, or to make those rates more readily adjustable in line with the rates for other financial instruments. An increase in the deposit rates, in itself, would not necessarily lead to a large increment in interest payments on the domestic public debt, if that increase were to engender a substantial expansion in the growth of the real financial resources of the economy. In any case, the re-examination of the interest rate policy should take place in conjunction with a bold anti-inflationary program. We believe that the response in terms of private saving would result in lower real rates of interest within a relatively short period.

Another factor that has contributed to the distortion of capital market operations has been the rapid growth of credit operations, at a preferential rate, of official trusts and development banks. These operations--apart from generating large-scale subsidies whose total amount is hard to identify a priori, and which have to be financed directly or indirectly by the Treasury--produce distortions in the allocation of financial resources. At times of credit restriction, users normally seek out the cheapest source of credit. But the real cost of "financial intermediation" is not accurately measured, and it is doubtful whether the distribution of financial resources resulting from this activity is consistent with the objectives of efficiency and growth. We think it would be in order to evaluate these activities in depth within the global context of economic and fiscal policy, and that the interest rates applicable under these programs should be related to the real cost of the resources. In any case, the total amount of the resources and subsidies involved in these activities should be determined in the context of the overall budget exercise.

c. Exchange policy

In the face of the developments described above, exchange policy did not appropriately protect the balance of payments in the first half of 1985. There was an appreciation of the real exchange rate and a substantial loss of reserves. The exchange policy was recently modified to make it more flexible, to assure free access to the exchange market, and to more than compensate for the competitiveness lost since the beginning of the year. All of these measures are important and aimed in the right direction. Nevertheless distortions continue to exist in the exchange system.

The existence of a spread between the exchange rates of the two exchange markets partly reflects uncertainty on the part of the public regarding economic policy. This differential is an incentive to evade the surrender requirements to the controlled market and introduces inefficiencies and distortions in the allocation of resources. Maintaining a dual market implies that when the spread tends to widen the Central Bank is ready to support the exchange rate on the controlled market by using the foreign currency surplus of the public sector or its international reserves. Recently the foreign currency surplus of the public sector has been affected by the fall in international petroleum prices, and the international reserves have decreased, thus reducing the central bank's ability to intervene. Moreover, aggregate demand pressure continues and it is not expected to decrease in the short run. Under these circumstances it will be necessary to seek an early unification of the two markets, without restrictions as to access, allowing the exchange rate to adjust freely.

It has been argued that these circumstances might induce an acceleration in the repayment of the external private debt. However, the extent of this repayment will depend on how flexible the management of the exchange rate is, and on the degree of liquidity in the economy. The stability and level of the exchange rate, in these circumstances, will depend on the quality of supporting economic policies. The exchange rate policy cannot be a substitute for the correction of the internal imbalances, hence the urgent need to resolve the fiscal problem and to control credit policy.

d. Commercial policy

Progress in implementing the original objectives of trade policy was slow through the end of 1984. It has been recognized that the lack of progress in this area contributed to prevent a faster reduction in the rate of inflation and scaled down the recovery in economic activity and the growth of exports. However, a series of measures taken in recent months mark an important change in this trend. These measures, which include the restructuring of the import tariff schedule, the elimination of the requirement of prior permits for a large proportion of imports, and the introduction of DIMEX, represent key steps for attaining the structural reform objectives contemplated in the program. The trade liberalization process is an extremely important instrument for achieving greater efficiency in the Mexican economy and the sustained growth of nonpetroleum exports--a matter which is becoming increasingly urgent because of the uncertainty surrounding petroleum exports. It is not possible yet to make a quantitative assessment of the impact of the recent trade liberalization measures. This, however, will largely depend on the effective implementation of the measures. In particular, it will be necessary to make sure that the setting of official prices, the modification in the tariff schedule, and the antidumping measures do not invalidate, in a concealed form, the opening up of trade.

Undoubtedly this process will need to be intensified and consolidated. The rationalization of trade policy should seek to reduce the dispersion in the tariff rates and to continue advancing in the process of reducing effective protection with a view to eliminating distortions that may still exist. Likewise, it would be advisable to extend the exemption from import permits to final products and to repeal the external financing requirements for capital imports, as this requirement introduces an unnecessary rigidity in the investment process. Another area that should be carefully reviewed is the public sector procurement program; the guidelines that prevail in this area introduce an element of excessive protection which may result in the generation of new inefficiencies and distortions in the economy resulting, at the same time, in higher costs for the public sector.

e. Evolution of wages, salaries, and employment

During 1983 the moderate increases in wages and salaries made a very important contribution to the adjustment process and to the maintenance of the level of employment. However, in 1984 and the first half of 1985 the increases in minimum wages aimed at restoring the loss in purchasing power of the immediately preceding period. The problem with wage increases of this kind is that they introduce a certain rigidity in the price system and are liable to erode gains in competitiveness achieved through the exchange rate policy. Certainly the only protection that can be given to the purchasing power of wages is that of controlling inflation and thereby attacking the causes of internal imbalances that cause it. But any wage system whose aim is to index wages to prices, whether by more frequent increases in nominal wages or by means of other more formal indexing systems, tends to create rigidities in the reduction of inflation and to hamper the adjustment process. Given the importance of reducing inflation as quickly as possible, wage adjustments need to be made with a view to the future and have to be consistent with the desired goals with respect to inflation and employment.

Conclusion

The foregoing analysis identifies the main problems found in implementing the economic program, and provides certain guidelines on possible courses of action for economic policy in the immediate future for the achievement of the initial objectives of the program. There is no doubt that the efforts made have been substantial and the results significant; it is thus important for this effort not to vanish. Therefore, the adjustment process should be strengthened and rapid action taken to avoid greater damage.

The main problem continues to be the need for fiscal adjustment, and this could only be achieved with an in-depth structural reform of public expenditure. In the absence of this reform, all other measures will be insufficient to reduce the basic imbalances. Without a doubt, cuts in public spending should be accompanied by appropriate tax, monetary, exchange, and trade policies. However, most of the weight of the adjustment will have to fall upon the rationalization of public sector activities. Only thus will it be possible to lay the foundations of sound and sustained growth.

Mr. [illegible]
Mr. Wiener
Mr. [illegible]
Finch
JV

REMARKS BY JESUS SILVA HERZOG, SECRETARY OF FINANCE OF MEXICO, AT THE SIGNING CEREMONY OF THE RESTRUCTURING ARRANGEMENT OF MEXICAN EXTERNAL PUBLIC DEBT. NEW YORK, AUGUST 29th, 1985.

LADIES AND GENTLEMEN,

WE ARE HERER THIS MORNING TO MARK THE SIGNING OF MULTIYEAR RESTRUCTURING AGREEMENTS FOR APPROXIMATELY 20 BILLION DOLLARS OF THE MEXICAN PUBLIC SECTOR DEBT MATURING FROM 1985 TO 1990. THIS SIGNING WILL LEAD TO THE CONCLUSION OF A COMPLEX PACKAGE DESIGNED TO ESTABLISH AN ADEQUATE PROFILE MORE IN LINE WITH MEXICO'S FUTURE DEBT SERVICING CAPACITY. TOGETHER WE HAVE SHOWN THAT THROUGH MUTUAL COOPERATION WE CAN ACHIEVE A GREAT DEAL IN MOVING TOWARDS THE SOLUTION OF THE DEBT PROBLEMS. IN THIS RESPECT, I EXTEND OUR APPRECIATION TO THE INTERNATIONAL BANKING COMMUNITY.

WE HAVE INDEED COME A LONG WAY SINCE AUGUST 1982, WHEN MEXICO'S EXTERNAL FINANCES REACHED A CRITICAL STAGE AND WHEN PESSIMISM ABOUNDED IN EVERY SPHERE. STARTING FROM THE INITIAL STEPS OF SHORT-TERM RENEWALS AND [redacted] PARTIAL RESCHEDULINGS OF PRINCIPAL PAYMENTS, WE HAVE NOW PERCEIVED THE WISDOM AND THE NECESSITY OF A LONGER-TERM APPROACH TO THE DEBT PROFILE OF MEXICO AND OTHER DEVELOPING COUNTRIES.

INITIALLY, THE DEBT CRISIS TENDED TO BE PERCEIVED AS ESSENTIALLY A CASH FLOW PROBLEM, HENCE SUSCEPTIBLE TO SOLUTION THROUGH COOPERATION BETWEEN THE BORROWING COUNTRY AND ITS LENDERS, PARTICULARLY INTERNATIONAL COMMERCIAL BANKS.

THE SUBSEQUENT MULTIPLICATION OF DEBT RESCHEDULINGS BY AN INCREASING NUMBER OF DEVELOPING COUNTRIES SINCE 1982, HOWEVER, IS CLEAR EVIDENCE THAT WE ARE FACED WITH A SYSTEMIC PROBLEM FAR BEYOND CIRCUMSTANCES PECULIAR TO ANY INDIVIDUAL DEVELOPING COUNTRY OR ITS ECONOMIC MANAGEMENT.

IN THE WAKE OF THIS REALITY, IT WAS NECESSARY FOR MEXICO TO ADJUST ITS ECONOMY TO THE CHANGING INTERNATIONAL ENVIRONMENT. IN THIS RESPECT, SINCE THE BEGINNING OF HIS ADMINISTRATION, [redacted] PRESIDENT DE LA MADRID, [redacted] HAS SHOWN A RELENTLESS POLITICAL WILL TO PURSUE THE NECESSARY ECONOMIC MEASURES TO STABILIZE OUR ECONOMY. RESULTS SO FAR OBTAINED ATTEST TO THAT FACT. THUS, SINCE EARLY 1983 WE HAVE TAKEN DRASTIC MEASURES IN ORDER TO SIGNIFICANTLY REDUCE THE FISCAL DEFICIT, TO BALANCE THE CURRENT ACCOUNT – WHICH HAS IN FACT SWUNG TO SUBSTANTIAL SURPLUS IN 1983 and 1984 – AND BRING DOWN INFLATION TO AROUND HALF THE LEVELS PREVAILING IN 1982,

A FEW DAYS AGO, IN A FURTHER EFFORT TO CONTAIN FISCAL AND INFLATIONARY PRESSURES IN THE CONTEXT OF HIGHER DOMESTIC INTEREST RATES AND LOWER THAN EXPECTED EXPORT REVENUES, THE GOVERNMENT [redacted] ANNOUNCED A SERIES OF COMPLEMENTARY MEASURES AIMED AT THE REDUCTION OF GOVERNMENTAL ADMINISTRATIVE AND PERSONNEL COSTS, A MORE REALISTIC MANAGEMENT OF THE EXCHANGE RATE IN ORDER TO [redacted] ENCOURAGE THE GROWTH OF THE EXPORT SECTOR, AND THE LIBERALIZATION OF TRADE THROUGH THE SUBSTITUTION OF TARIFFS FOR THE PRESENT CUMBERSOME SYSTEM OF IMPORT PERMITS. ONE OF THE MAIN THRUSTS OF THIS NEW MACROECONOMIC POLICY, IS THE STRUCTURAL REDIRECTION OF THE MEXICAN ECONOMY FROM A TRADITIONAL PATTERN OF IMPORT SUBSTITUTION TOWARDS A SUSTAINED EFFORT OF EXPORT PROMOTION. INCREASED EXPORTS, SEEN AS INCREASED DEMAND FOR OUR INDUSTRIAL APPARATUS WILL ALLOW THE FINANCING OF INCREASED IMPORTS AND PROVIDE FOR AN ENHANCED CREDIT STANDING IN THE INTERNATIONAL CREDIT MARKETS.

BUT UNDERLYING ALL THESE MEASURES IS THE VITAL OBJECTIVE FOR THE MEXICAN ECONOMY TO RESUME ITS PATH OF SOUND AND SUSTAINED GROWTH IN THE FUTURE. WE CANNOT CONTINUE TO REQUEST SACRIFICES FROM THE MEXICAN PEOPLE WITHOUT OFFERING IN EXCHANGE A BETTER FUTURE FOR THEM.

FOR ECONOMIC, SOCIAL , POLITICAL AND ETHICAL REASONS, WE MUST HAVE GROWTH. WE MUST THEREFORE FOCUS ON THE NOTION OF GROWING OUT OF OUR DEBT PROBLEMS; WE MUST GROW TO BE ABLE TO SERVICE OUR DEBT;

AS MENTIONED, WE ARE TAKING ALL THE NECESSARY STEPS IN ORDER TO FOSTER AN EXPORT ORIENTED ECONOMY, BUT WE MUST ALSO RECOGNIZE THAT A NUMBER OF FACTORS IN THE INTERNATIONAL ARENA CONTINUE TO MILITATE AGAINST SUCH EFFORTS BY MEXICO AND OTHER DEVELOPING COUNTRIES.

AMONG THESE, WE SEE SIGNS OF A SLOWDOWN IN THE U.S. ECENOMY WHICH WILL ADVERSELY AFFECT OUR EXPORT PROSPECTS; WE CONTINUE TO SEE A HIGH U.S. BUDGET DEFICIT THAT IS CAUSING VERY HIGH REAL INTEREST RATES; THE RESLUTING STRENGTH OF THE U.S. DOLLAR CONTINUES TO AFFECT THE DOLLAR PRICE OFINTERNATIONALLY TRADED COMMODITIES AND HAS GIVEN RISE TO THE HIGHEST TRADE DEFICIT IN U.S. HISTORY; THIS IN TURN IS NOW CREATING DEMANDS FOR INCREASED PROTECTION FOR THE DOMESTIC INDUSTRIES OF THIS COUNTRY. ON THE OTHER HAND, WE ARE STILL CONSTRAINED BY THE LIMITED AVAILABILITY AND ACCESS TO MULTILATERAL AND BILATERAL SOURCES OF FUNDS - WHICH CANNOT FILL THE VACUUM LEFT BY THE INTERNATIONAL BANKING COMMUNITY. AS TO THE BANKS THEMSELVES, NOT ONLY ARE THEY NOW PROVIDING NEW MONEY ON A VOLUNTARY BASIS, BUT SOME OF THEM SEEM TO BE TRYING TO REDUCE THEIR PRESENT EXPOSURE TO LATIN AMERICA BY THE MOST IMAGINATIVE MEANS.

FURTHERMORE, THE REGULATORY ENVIRONMENT PLACES AN ADDITIONAL CONSTRAINT ON THE REACTIVATION OF MUCH NEEDED NEW CREDIT FLOWS. WE MUST SEEK A MORE FLEXIBLE REGULATORY ENVIRONMENT WHICH WILL PERMIT A RENEWED FLOW OF FUNDS COMPATIBLE WITH OUR NEW DEVELOPMENT NEEDS.

AS WE LOOK TO THE FUTURE, WE CANNOT - AND MUST NOT - ALLOW HAPHAZARD CIRCUMSTANCES TO DICTATE THE EXTENT OF NEW MONEY FLOWS; WE MUST PLAN, ORGANIZW AND ENSURE THAT SUCH NEEDED FLOWS ARE READILY AVAILABLE. FOR THAT, A CONCERTED ACTION IS A NECESSARY REQUIREMENT IN SUPPORT OF THE ECONOMIC EFFORTS BE DEVELOPING COUNTRIES. THINGS WILL NOT HAPPEN BY THEMSELVES: WE MUST MAKE THEM HAPPEN.

THIS SHOULD NOT OBSCURE THE FACT, THAT MEXICO AND ITS LENDERS - PARTICULARLY THE COMMERCIAL BANKS - HAVE MADE SUBSTANTIAL PROGRESS IN STEERING AWAY FROM THE CRISIS ATMOSPHERE THAT SURROUNDED US AT THE END OF 1982.

YET WE MUST ALSO EXPRESS OUR CONVICTION THAT A DURABLE AND SUSTAINABLE SOLUTION OT THE PROBLEMS CONFRONTING THE EXTERNAL FINANCES OF MEXICO AND OTHER LATIN AMERICAN COUNTRIES RESIDES NOT MERELY IN AGGANGEMENTS BETWEEN DEBTOR COUNTRIES AND BANK CREDITORS BUT IN A MORE COMPREHENSIVE APPROACH TO THE INTERRELATED CONCEPTS OF TRADE, FINANCIAL AND ECONOMIC RELATIONSHIPS WITH THE MAJOR INDUSTRIAL COUNTRIES.

IN ORDER TO FIND THE BEST SOLUTIONS, WE MUST WORK MORE TO NARROW THE GAP WHICH EXISTS TODAY WITH RESPECT TO THE DIAGNOSIS OF THE SITUATION.

MOST OECD COUNTRIES ARE TELLING IS THAT THE DEBT PROBLEM CAN BE SOLVED BY THEIR GROWTH, OUR ADJUSTMENT AND OPEN BORDERS.

WE BELIEVE THESE CONDITIONS ARE NOT OCCURING AND FURTHERMORE, ARE NOT SUFFICIENT. MORE FACTORS HAVE TO BE LOOKED AT. THE WHOLE QUESTION OF TRADE HAS TO BE REEXAMINED BOTH IN THE PRICE OF OUR EXPORTS AS WELL AS IN THEIR ACCESS TO FOREIGN MARKETS. THE CRITICAL AREA OF THE RESUMPTION OF CREDIT FLOWS TO DEVELOPING COUNTRIES ALSO HAS TO BE FOCUSED ON WITH RENEWED INTEREST. FORMULAE WHICH INSURE THAT WE CAN RESUME AND MAINTAIN ADEQUATE GROWTH LEVELS AND SERVICE OUR DEBT HAVE YET TO BE AGREED UPON.

THE SIGNING OF A MULTIYEAR RESTRUCTURING AGREEMENT IS AN IMPORTANT STEP FORWARD. THIS TYPE OF AGREEMENT IS PREDICATED UPON TWO FUNDAMENTAL PRINCIPLES: FULL PAYMENT OF INTEREST AND NEW NET MONEY FLOWS. HOWEVER, IF ONE OF THE ASSUMPTIONS DOES NOT HOLD, NEITHER WILL THE OTHER.

WITH BANK CREDIT FLOWS MOVING AWAY RATHER THAN RETURNING, COUNTRIES CANNOT BE EXPECTED TO PAY THEIR FULL INTEREST BILL AND GROW AT NECESSARY LEVELS. SOMETHING HAS TO GIVE AND GROWTH HAS ALREADY TAKEN THE BRUNT OF THE BURDEN IN THE LAST THREE YEARS.

IN SOME COUNTRIES, EXISTING REGULATIONS EVEN PENALIZE NEW CREDIT ALLOCTIONS TO OUR AREA BY THE IMPOSITION OF STIFF AFTER-TAX RESERVE REQUIREMENTS OR THE CATEGORIZATION OF NEW LOANS IN WAYS THAT SUGGEST THEY CAN NOT BE CARRIED AT FACE VALUE. THIS IS INCONSISTENT WITH OUR EARLIER ASSUMPTIONS OF HOW THE WORLD WOULD BE.

T

THE RECENT RENEWED INTEREST IN THE DEBT MATTER IS NOT ACCIDENTAL. WE ARE TALKING ABOUT THE POTENTIALLY MOST EXPLOSIVE DEVELOPMENT ISSUE OF OUR TIMES. IN INDUSTRIAL COUNTRIES, IT MAY BE SEEN AS A PURELY FINANCIAL OR ECONOMIC ISSUE. IN DEBTOR COUNTRIES, IT IS SEEN AS A SERIOUS POLITICAL AND SOCIAL ISSUE. WHEN REAL INCOME IS FALLING OR JOBS ARE LOST, WHILE REAL TRANSFER OF RESOURCES ARE NEGATIVE, DEBT BECOMES A CRITICAL MATTER IN WHICH LONG TERM GAINS ARE NOT NECESSARILY BALANCED WITH SHORT TERM SACRIFICES.

WE HAVE REPEATEDLY STATED THAT RESTRUCTURING OUR PRINCIPAL PAYMENTS IS A VERY IMPORTANT STEP, BUT NOT THE SOLUTION TO THE DEBT CRISIS. WE MUST GO THROUGH THE NECESSARY STAGES BEFORE THE CONSENSUS IS CREATED THAT WILL ALLOW FURTHER PROGRESS ON THE ISSUE. WE HAVE ALSO WARNED REPREATEDLY AGAINST THE CREEPING SENSE OF COMPLACENCY THAT THESE EVENTS CREATE, ESPECIALLY IN OFFICIAL SPHERES IN DEVELOPED COUNTRIES.

TODAY WE MARK THE END OF A STAGE, BUT ALL ENDS MARK THE BEGINNING OF A NEW EFFORT.

IN THIS NEW EFFORT, COOPERATION BETWEEN BANKS AND DEBTORS WILL NO LONGER BE ENOUGH. IT WILL NOT YIELD THE RIGHT COMBINATION OF GROWTH AND DEBT SERVICING CAPACITY. THE REGULATORS AND THE GOVERNMENTS MUST NOW PLAY AN ACTIVE ROLE.

WE MUST SEEK MORE EFFICIENT, MORE AUTOMATIC, LESS DISCRETIONARY ARRANGEMENTS. MULTIYEAR RESTRUCTURINGS SHOULD BE COUPLED EITHER WITH THE AVAILABILITY OF NEW MONEY ON A VOLUNTARY BASIS OR, IN ITS ABSENCE, WITH MULTIYEAR NEW MONEY COMMITMENTS BY LENDERS.

OTHER AVENUES TO BE EXPLORED, DEPENDING ON THE SPECIFIC CIRCUMSTANCES OF EACH COUNTRY, ARE THE PARTIAL CAPITALIZATION OF INTEREST PAYMENTS IN ACCORDANCE WITH PREVIOUSLY AGREED-UPON MACROECONOMIC GOALS. THE DISCUSSIONS ABOUT MULTILATERAL FIANACIAL INSTITUTIONS NOT ONLY AS PROVIDERS OF CREDIT WITH ENLARGED CAPITAL BASES, BUT ALSO AS GUARANTORS OF COMMERCIAL LOANS THROUGH A MORE FLEXIBLE USE IF THEIR GEARING RATIOS.

THIS IS OUR BLUEPRINT FOR FUTURE ACTION. WE HOPE AND EXPECT WE CAN CONTINUE TO SEEK THESE SOLUTIONS IN A CONCERTED FASHION, AS WE HAVE IN THE PAST.

THE SENSE OF URGENCY IS CLEARLY THERE. THE NON-CONFRONTATIONAL PATH IS OBVIOUSLY THE MOST PRODUCTIVE AND FRUITFUL. IT IS THE PATH WE MUST FOLLOW.

John: Nothing ambiguous about this statement.

Mc

SPECIAL DELIVERY CABLE

MD says WO

PDE 8/26/85

RECEIVED
IMF CABLE ROOM

197677 FUND UT

674929

1985 AUG 24 AM 8: 07

ORIG: MD
CC: DMD
MR. PEREZ
WHD
EXR
MR. S.COLLINS

ZCZC 0043
TMACS 23-00030.28
TLX 3 197677:0028/FUND
ATT INTENATIONAL MONETARY FUND
JACQUES DE LAROSIERE, MANAGING DIRECTOR
RICHARD ERB, DEPUTY MANAGING DIRECTOR
BT

JESUS SILVA HERZOG, MINISTER OF FINANCE AND PUBLIC CREDIT, REQUESTS THE PLEASURE OF YOUR COMPANY AT A RECEPTION TO CELEBRATE THE SIGNING OF DOCUMENTATION TO IMPLEMENT THE LAST PORTION OF THE FINANCING PRINCIPLES FOR THE UNITED MEXICAN STATES ON THURSDAY, AUGUST 29, 1985 FROM 7:00 P.M. TO 9:00 P.M. AT THE RACQUET AND TENNIS CLUB, LOCATED AT 370 PARK AVENUE (BETWEEN 52ND AND 53RD STREET) SECOND FLOOR.

REGARDS,

MEXICAN MINISTRY OF FINANCE AND PUBLIC CREDIT

2201 EDT 08/23/85
NNNN

197677 FUND UT
MMMMM
2217 08/23
VIA TRT
?

Time: 22:17 08/23/85 ???
Connect Time : 171 seconds

INCOMING CABLE/TELEX

DRAFT TELEX 8/28/85

MR. JESUS SILVA HERZOG
MINISTER OF FINANCE AND PUBLIC CREDIT
MINISTRY OF FINANCE
MEXICO

THANK YOU FOR YOUR TELEX OF AUGUST 24 INVITING THE MANAGING DIRECTOR TO A RECEPTION ON THURSDAY, AUGUST 29. THE MANAGING DIRECTOR REGRETS THAT DUE TO OTHER ENGAGEMENTS HE WILL NOT BE ABLE TO ACCEPT YOUR KIND INVITATION.

REGARDS.

RICHARD D. ERB
Acting ~~DEPUTY~~ MANAGING DIRECTOR
INTERFUND

START ADDRESS IN THE BOX

MR. ALFRED MUDGE
SHEARMAN & STERLING/CITICORP CENTER
153 EAST 53RD STREET
NEW YORK, NEW YORK

5112

MARK XX FOR CODE
(______) CODE

DO NOT TYPE HERE

DISTRIBUTION

CC: MD
DMD
MR. PEREZ
MR. ORTIZ
ETR
LEG
WHD
MR. COLLINS

START TEXT HERE

TO: THE BANKS PARTY TO

(A) THE 1983 USDOLLARS 5 BILLION CREDIT AGREEMENT

AND

(B) THE 1984 USDOLLARS 3.8 BILLION CREDIT AGREEMENT FOR THE UNITED MEXICAN STATES

FROM: RICHARD D. ERB, ACTING MANAGING DIRECTOR
INTERNATIONAL MONETARY FUND

I REFER TO THE TELEXES DATED FEBRUARY 18, 1983 AND APRIL 9, 1984 WHICH THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND SENT TO THE BANKS TO BE PARTY TO THE 1983 USDOLLARS 5 BILLION CREDIT AGREEMENT AND THE 1984 USDOLLARS 3.8 BILLION CREDIT AGREEMENT FOR THE UNITED MEXICAN STATES AS BORROWER. BOTH TELEXES SUMMARIZED THE PHASING OF THE PURCHASE (DISBURSEMENT) SCHEDULE FOR MEXICO UNDER THE EXTENDED ARRANGEMENT FOR MEXICO APPROVED BY THE EXECUTIVE BOARD OF THE INTERNATIONAL MONETARY FUND ON DECEMBER 23, 1982. BOTH TELEXES INDICATED THAT THE PHASING OF THE PURCHASES IN 1985 WAS TENTATIVE AND THE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.: 126698 WU — CABLE ADDRESS:

DRAFTED BY NAME (TYPE): STBEZA:cl — EXT.: 8631 — DEPT.: WHD — DATE: 23AUGUST85

AUTHORIZED BY NAME (TYPE): MR. BEZA — AUTHORIZED BY NAME (TYPE): MR. ERB — ( )

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log ______

SEC 48 REV 1 11-18-82

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

1 PLEASE KEEP SIGNATURE IN SPACE ALLOWED.
2 Use OCR-B210 sphere and set typewriter for DOUBLE SPACING - No other markings acceptable

START ADDRESS IN THE BOX

NEW YORK

PAGE 2

MARK XX FOR CODE

(______) CODE

DISTRIBUTION

START TEXT HERE

TELEX OF APRIL 9, 1984 SPECIFICALLY INDICATED THAT THE PHASING OF THE PURCHASES IN THE THIRD YEAR OF THE EXTENDED ARRANGEMENT WOULD BE DETERMINED IN THE CONTEXT OF THE REVIEW OF MEXICO'S ECONOMIC PROGRAM FOR THE THIRD YEAR OF THE EXTENDED ARRANGEMENT.

I WISH TO INFORM YOU THAT AT THE MEETING OF THE EXECUTIVE BOARD ON JUNE 7, 1985 THE PHASING OF THE PURCHASES IN THE THIRD YEAR OF THE EXTENDED ARRANGEMENT WAS DETERMINED AS FOLLOWS:

SDR 295.8 MILLION ON JUNE 7, 1985

SDR 302.6 MILLION ON AUGUST 20, 1985

SDR 302.6 MILLION ON NOVEMBER 20, 1985

SDR 302.7 MILLION ON FEBRUARY 20, 1986

REGARDS,

RICHARD D. ERB

ACTING MANAGING DIRECTOR

INTERFUND

DO NOT TYPE HERE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS TEXT MUST END HERE

TELEX NO.: CABLE ADDRESS:

DRAFTED BY NAME (TYPE): EXT.: DEPT.: DATE:

AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE):

(**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log ______

SEC. 48 REV 1 11-18-82

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

1 PLEASE KEEP SIGNATURE IN SPACE ALLOWED.

2. Use OCR-B210 sphere and set typewriter for DOUBLE SPACING - No other markings acceptable

RECEIVED
INTERNATIONAL
MONETARY FUND

1985 AUG -8 PM 5:09

OFFICE OF
THE MANAGING DIRECTOR

Office Memorandum

TO: The Acting Managing Director DATE: August 7, 1985

FROM: Eduardo Wiesner and Manuel Guitián

SUBJECT: Mexico: Draft of Information Notice on Modifications of Exchange and Trade System

Attached for your consideration and approval is a draft of a note informing the Board of recent modifications in Mexico's exchange and trade system. No Board action is requested at this time.

In addition to ourselves, this note has been reviewed by the following Departments:

Exchange and Trade Relations:	Mr. Quirk
Legal:	Mr. Ogoola
Western Hemisphere Department:	Mr. Beza

Attachment

cc: The Managing Director (o/r)
Mr. Nicoletopoulos
Mr. Collins

sp5mex1
8/7/85

INTERNATIONAL MONETARY FUND

MEXICO

Modifications of Exchange and Trade System

Prepared by the Western Hemisphere Department and
the Exchange and Trade Relations Department

(In consultation with the Legal Department)

E.W. MG

Approved by E. Wiesner and Manuel Guitián

August --, 1985

The Mexican authorities have informed the Fund about a number of measures that have been adopted recently, several of which involve modifications to the exchange and trade system. These measures are summarized below.

1. Exchange system

On July 11, 1985 the so-called "free" exchange market was abolished. Up to that date, three exchange rates 1/ had been in effect in Mexico: (1) a controlled rate, at which about 80 percent of Mexico's external transactions were conducted, 2/ (2) an officially set "free

---

1/ Several other special rates had been introduced in December 1982 involving forward cover contracts for the settlement of specified medium- and long-term obligations abroad but the transactions eligible to benefit from those rates have now been concluded (EBS/85/123, 5/13/85, p.39, footnote 1).

2/ Operations channeled through the controlled exchange market include: all merchandise export receipts in excess of Mex$200,000; payments for virtually all imports; payments by in-bond industries for wages, salaries, rent and the purchase of Mexican goods and services, other than real estate; royalties for the use of foreign technology; payments of principal and interest on registered debt by the public and private sectors; payments for the Mexican foreign service and contributions to international organizations; and other transactions specifically authorized by the Secretariat of Finance and the Bank of Mexico.

market" rate that was managed by the commercial banks and that covered transactions not authorized through the controlled market (access to this market has been subject to limitations from time to time), and (3) a parallel market rate. The parallel market rate gained official recognition on June 5, 1985, (Buff Statement 85/99); on that date, the authorities announced new rules for the operation of exchange houses and commercial banks were authorized to operate in the parallel market through exchange houses. Under the new regime announced on July 11, 1985, purchases and sales of foreign exchange for transactions other than those conducted at the controlled market rate are to take place at the parallel market rate.

From March 6, 1985 through July 11, 1985 the exchange rate of the Mexican peso in terms of the U.S. dollar in both the controlled and the "free market" had been depreciated in relation to the U.S. dollar by Mex$0.21 per day. The rate in the parallel market fluctuated freely in response to market forces. On July 10, 1985 the mid-point exchange rate of the Mexican peso vis-a-vis the U.S. dollar was Mex$230.1 per U.S. dollar in the controlled market, Mex$248.7 per U.S. dollar in the "free market," and Mex$317 per U.S. dollar in the parallel market.

The exchange rate in the controlled market continued to be depreciated in relation to the U.S. dollar by Mex$0.21 per day in the period from July 11, 1985 to July 24, 1985. On July 25, 1985 the authorities announced a 17 percent devaluation, moving the mid-point rate in the controlled market from Mex$232.8 to Mex$279.7 per U.S.

dollar. On that date the average rate in the parallel market dropped from Mex$366 per U.S. dollar to Mex$356 per U.S. dollar. The value of the peso continued to be adjusted by Mex$0.21 per U.S. dollar a day until August 4, 1985.

On August 5, 1985 a new system of managed floating for the controlled market came into effect. Under this system, the exchange rate is to undergo daily unspecified adjustments, not necessarily equal in amount, which will be made on the basis of, inter alia, the following factors: (a) the demand and supply for foreign exchange in the controlled market; (b) the objective of obtaining adequate levels of international reserves; (c) the movements of domestic and foreign prices; and (d) movements in other exchange rate relationships. Parties eligible to utilize the controlled market can choose to complete the transaction at a retail rate, agreed between those parties and the financial institutions authorized to operate in this market, or at the "equilibrium exchange rate" of the day. An "equilibrium exchange rate" will be determined for the controlled market each day at a fixing session at the Bank of Mexico, where representatives of the various financial institutions operating in this market will exchange bids for purchases and sales of foreign exchange; the Bank of Mexico also may submit bids in these sessions. For transactions exceeding US$50,000, the parties concerned may make completion of the transaction contingent on the equilibrium exchange rate achieving a particular minimum or maximum value. Offices and agencies of the public administration must carry out foreign exchange transactions directly with the Bank of Mexico at average exchange rates, corresponding to specific periods, calculated on the basis of the "controlled market equilibrium exchange rate." On August 5, the "controlled market equilibrium exchange rate" was Mex$282.30 per U.S. dollar, the average retail rate was Mex$282 per U.S. dollar, and the spread between the exchange rates in the controlled market and the parallel rate was about 22 percent.

The changes in the exchange system referred to above involve modifications of the multiple currency practices described in EBS/85/123, and discussed by the Executive Board on June 7, 1985 at the time of the last Article IV consultations and the approval of the program for the third year of the extended arrangement for Mexico. The modifications to Mexico's multiple currency practices fall within the purview of paragraph 4(e)(ii) of the extended arrangement for Mexico approved by the Fund on December 23, 1982, as amended, and are thus subject to approval by the Executive Board under Article VIII.

2. Trade system

On July 25, 1985 the Mexican authorities announced that the process of eliminating import permits, and their replacement by protection through tariffs, was being accelerated. The requirement for import permits is being abolished for 3,604 items (representing some 37 percent of the value of 1984 imports), thereby raising the total number of items free from import permit to 7,159 (61 percent of total 1984 imports). Thus, the proportion of total imports free from import permit will now exceed the 35 to 45 percent that had been envisaged for end-1985 in the letter of intent describing the economic program for the third year of the extended arrangement (EBS/85/70, p.8, paragraph 19). With this change, 909 items will remain subject to import permit, involving mainly: agricultural food products; industrial products subject to special manufacturing agreements; raw materials for the pharmaceutical industry; final products in the computer, telecommunications and tool industries; and some 333 items considered nonessential.

A new import tariff structure is being introduced with nine rates ranging from zero to 50 percent, with most imports subject to duties in the range of 25 to 40 percent. The rates applicable to 1,980 tariff items are being revised, with the zero rate being reserved mostly for agricultural inputs such as seeds and fertilizers; a 5 percent rate applies to machinery and equipment imported in component form; a 10 percent rate applies to raw materials and capital goods for which there is no local manufacture; a 15 percent rate applies to intermediate products for which there are many stages of processing; a 20 percent rate applies to goods that have close substitutes produced in the domestic market; a 25 percent rate applies to intermediate goods which are locally produced and have a high local value added, such as steel; a 30 percent rate applies to spare parts and unassembled machinery that are locally produced as well; a 40 percent rate applies to final goods and intermediate agricultural products; and a 50 percent rate applies to nonpriority final consumer goods.

Steps are being taken to liberalize the operation of the DIMEX, a scheme that provides exporters automatic access to import permits for a value equivalent to 30 percent of their exports. The number of items excluded from access to the scheme is being reduced, from 943 (representing some 28 percent of 1984 imports) to 537 items (representing about 21 percent of 1984 imports), and the minimum import tariff rate applicable to imports under DIMEX is being lowered from 25 percent to 10 percent.

3. Other policy actions

On July 25, the authorities took measures to reduce current expenditures of the Central Government, including the elimination of 15 units at the level of undersecretariat of state and at least 50 at the level of directorates-general, a freeze in salaries for high government officials and reductions in various other expenditure categories. Instructions have been given to public sector enterprises to reduce their operating expenditures to an extent at least comparable to that undertaken by the central administration. The authorities estimate that these spending cuts will yield some Mex$150 million (equivalent to 0.3 percent of GDP) in savings to the budget during the remainder of this fiscal year.

4. Staff Appraisal

At the conclusion of the 1985 Article IV consultations with Mexico, the Executive Board urged the authorities to exercise greater flexibility in the management of the exchange rate policy and to unify the exchange system as quickly as possible (SUR/85/69). In the view of the staff, the recent modifications of the multiple exchange rate system by Mexico represent a step in the right direction and constitute a simplification of that system. They involve an effective depreciation of the peso and provide an indication of the authorities' intention to manage the controlled rate flexibly, and thus should facilitate the process of exchange rate unification. The staff also welcomes the measures taken to accelerate the process of phasing out import licenses and liberalizing imports.

The effect of the policy measures described above will be discussed with the Mexican authorities during the forthcoming staff visit to Mexico that is scheduled to review progress under the extended arrangement. In the meantime, no action by the Executive Board is being recommended.

Office Memorandum

TO: The Managing Director

DATE: August 2, 1985

FROM: E. Wiesner E. W.

SUBJECT: Mexico - Briefing for EFF Review Mission

Please find attached for your consideration the briefing for an EFF mission to Mexico.

This briefing has been reviewed by the following departments:

Exchange and Trade Relations:	Mr. Guitián
Fiscal Affairs:	Mr. Yandle
Legal:	Mr. Ogoola
Treasurer's:	Mr. Leddy
Western Hemisphere:	Messrs. Beza, Linde and myself

Mr. Pujol's last day in the office will be August 6, 1985.

Attachment

cc: The Deputy Managing Director (o/r)
Mr. Collins

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Briefing for Mission to Mexico

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

E.W. MG

Approved by Eduardo Wiesner and Manuel Guitián

August 2, 1985

A staff mission consisting of Messrs. Pujol (Head-WHD), Duran-Downing (ETR), Gil-Diaz, Jaramillo-Vallejo, Valdivieso (all WHD), and Ms. Lanio (Secretary-WHD) will visit Mexico City for two-three weeks to review Mexico's performance under its EFF arrangement over the first six months of this year. An advance team will travel to Mexico City on Monday, August 5, 1985, and Mr. Pujol will join them during the course of the week. This review constitutes a performance criteria under the arrangement that was scheduled to be completed by September 30, 1985.

On December 23, 1982 (EBM/82/168) the Fund approved Mexico's request for use of Fund resources in an amount equivalent to SDR 3,611.2 million (310 percent of the current quota), of which SDR 200.6 million represented a first credit tranche purchase and the remainder was to be available under an extended arrangement covering the three-year period through December 1985. The program for the third year of the arrangement was approved in conjunction with the conclusion of the discussions for the 1985 Article IV consultation by the Executive Board on June 7, 1985 (EBM/85/91) following extensive negotiations that began in November 1984 and were concluded in May 1985. Total purchases to date amount to SDR 2,703.4 million (Table 1 and Attachment I). Under the current arrangement three drawings (of SDR 907.9 million) would be available in August and November 1985 and February 1986; as is indicated below, there are serious questions whether performance will permit these drawings.

I. Background

1. Recent developments

As has been reported previously, Mexico's economic performance was strong during 1983 and much of 1984. However, slippages in performance began to emerge during the second half of 1984 as demand policies were relaxed. The overall public sector deficit, which had been implemented in line with the program during most of 1984, exceeded the target in the latter part of last year, mostly reflecting increased current expenditures (including higher than expected domestic interest outlays). The higher public sector deficit was financed by the domestic banking system at a time when demand for credit by the private sector accelerated.

Because of the deviations in demand policy and the award of relatively high minimum wage adjustments, inflation was higher in 1984 than had been envisaged under the program. In the light of these developments, the policy of maintaining two official exchange markets with a daily depreciation rate of Mex$0.13 per U.S. dollar a day became increasingly inadequate. In early December 1984 the pace of daily depreciation of the peso vis-a-vis the U.S. dollar was increased to Mex$0.17, and in early March to Mex$0.21.

Because of the weakening of policy and performance, the negotiation of the program for 1985 took many months. It was completed only after steps were taken by the authorities to reduce public sector expenditures, to tighten credit policies, and to raise the pace of currency depreciation. The public finances continued to be the cornerstone of the adjustment process under the new program, with the overall public sector deficit scheduled to decline by 2 percentage points of GDP, to 4.1 percent of GDP. It was envisaged that such a deficit could be financed with little or no use of foreign financing, on the basis of a projected inflation rate of around 40-45 percent. Economic activity was expected to continue to expand with real GDP rising by 3 1/2 percent, and the balance of payments was projected to strengthen during the year for a cumulative increase of net international reserves of US$500 million.

Performance in the first half of the year was weaker than programmed. Although the public sector's finances during the first few months of the year appeared to be improving as a consequence of the measures adopted in February and March, significant deviations from the end of June limit are now expected. Weaker than projected petroleum receipts, higher current expenditures and heavy domestic debt service payments more than offset the reduction of interest payments on the external debt, and have resulted in increased recourse to domestic financing. The information available indicates that at least two other quantitative performance criteria for end-June 1985--the net domestic assets of the Bank of Mexico and net international reserves--have not been met (Table 2). The net domestic assets rose sharply in June, reflecting in part the borrowing requirement of the public sector that emerged when petroleum export receipts dropped.

Interest rates have been raised substantially since March 1985, despite a deceleration of inflation. For the twelve months ending June 1985, the inflation rate was 53.7 percent, some 6 points below the rate observed in the twelve-month period ending December 1984. By end-June of 1985, three-month deposit rates reached an annual rate of 73 percent, while the yields of Treasury bills had risen to 78 percent. Thus, returns in savings instruments have become highly positive in real terms and the differentials with comparable rates in the United States moved in Mexico's favor; lending rates in the banking system also have been raised sharply. However, the increases in rates were not sufficient to offset fears of an exchange rate change.

The weakening of the balance of payments has been particularly marked this year. For the period January-June, the Bank of Mexico's net international reserves declined by almost US$1.9 billion, compared with a cumulative loss of no more than US$0.9 billion established under the arrangement. This decline in international reserves has taken place even though interest payments abroad were lower than projected and Mexico did not repay US$0.95 billion to commercial banks in the first half of the year as had been anticipated in the program. This repayment has now been scheduled, in agreement with the banks, in two tranches for October 1985.

External payments developments have reflected a continued reduction of the trade surplus and a resumption of capital flight. Total export earnings for the first half of 1985 declined by almost 10 percent from the same period of 1984. Oil export receipts were affected adversely by downward adjustments in crude oil prices and reductions in volume, crude oil export volume is reported to have declined in June to one-half its customary level, while nonpetroleum export receipts were affected adversely by the erosion of competitiveness through the first quarter of 1985, the recovery of domestic demand, and increased under-reporting due to persistent deviations between the parallel market rate and the official market rates. (During the first half of 1985 the differential between the "free market" rate and the parallel market rate widened significantly, reaching 30 percent toward the end of the period.) Imports continued to grow vigorously in the first half of 1985, reflecting the growth of domestic demand and the appreciation of the peso. Relaxation of import licensing restraints contributed to the growth of private sector imports.

During the first six months of the year, net repayments of official capital were somewhat smaller than those projected in the program, mainly because of the postponement of the repayment to commercial banks mentioned above. Other sources of capital fell short of the original estimates, however, reflecting delays in the disbursement of loans from multilateral institutions and the effects of cuts in the domestic public sector investment program. Private capital outflows increased substantially, notwithstanding the rises in interest rates referred to above.

Data on economic activity are limited, but there are signs of a slowdown of economic activity. Manufacturing activity, which on a 12-month basis had been growing at about 9 percent in December 1984, decelerated to about 4 1/2 percent in May, and a further drop is projected in the months ahead.

2. Latest policy actions

The realization that the fiscal situation was off-track and that the balance of payments was deteriorating rapidly led the authorities to take a number of measures recently to reduce public sector expenditures and bolster the balance of payments. Cuts in Central Government were announced, commercial bank reserve requirements were raised, the free market exchange rate was abolished, and the peso in the controlled market was devalued. Steps also were taken to accelerate the process of trade liberalization.

In the fiscal area, last week the Government announced a number of steps to cut current expenditures of the Central Government, including the elimination of 15 undersecretariats and 50 directorates, a freeze in salaries for high government officials, and reductions in various other expenditures categories. These spending cuts are expected to yield some Mex$150 billion (0.3 percent of GDP) in savings to the budget in the remainder of this year. No increases are planned in tax rates at this time but expenditure cuts are being readied in the state enterprises, and the prices of public sector goods and services are to be adjusted soon. The measures put in place thus far would go only a small way in bringing fiscal performance back to the path that had been indicated in the 1985 program, and thus much remains to be done in strengthening the position of the enterprise sector and in reducing outlays in the Central Government.

On June 5, 1985, the parallel market was officially recognized by authorizing commercial banks to operate in it, and on July 10, 1985, the authorities announced the elimination of the "free market" rate by shifting transactions to the freely fluctuating parallel market. Moreover, on July 24, the authorities devalued the peso in the controlled market by 17 percent and announced that starting August 5, the system whereby the exchange rate in that market vis-a-vis the U.S. dollar was depreciated by Mex$0.21 per day would be abandoned. Instead, a new system of managed floating would be instituted, where the daily adjustment would vary taking into account the demand and supply in the controlled market, the performance of international reserves, the relative positions of different foreign currencies, and domestic and foreign price developments.

In the area of commercial policy, the process of substituting import permits for tariffs had been proceeding at a very slow pace; it is estimated that by the end of June 1985 only about 25 percent of the value of 1984 imports had been freed from controls compared to a level of about 18 percent at the beginning of the year, and very few imports had come under the recently enacted scheme that gives exporters automatic access to import permits (DIMEX). On July 25, 1985, however, the authorities announced that the process of moving away from the use of import permits and relying on protection through tariffs was being accelerated. The requirement for import permits is being dropped for an additional 37 percent of total imports, bringing the total value of imports free from permit to over 60 percent (compared with the commitment made under the program for the third year of the EFF to raise imports free from permits to between 35 and 45 percent of total imports before the end of 1985). The tariff rates applicable to some 1,980 tariff items are also being modified to bring them within the new tariff structure, which has nine rates ranging from zero to 50 percent. With respect to the DIMEX, steps were taken to make access to this scheme more liberal by lowering the number of items excluded from it--from the equivalent of 28 percent of total 1984 imports to 21 percent--and by lowering the minimum import tariff rate applicable to imports under DIMEX, from 25 percent to 10 percent.

II. Policy discussions

As just indicated, the authorities have started to take actions intended to regain the momentum of the adjustment effort. However, the deviations from the existing program that have been identified or projected by the authorities appear to be very large, and there are serious doubts whether the program can be brought back on track before the extended arrangement ends in December 1985. The mission will ascertain the extent of these deviations and assess how far the measures in place, and those planned, go in redressing the situation. Should the mission conclude that the program as currently formulated cannot be brought back on track within the remainder of the arrangement, it will be prepared to to examine with the authorities, if they so wish, whether policies might be developed to support a new program, perhaps a standby arrangement for 12 to 18 months.

A new program would need to ensure the reestablishment of the main thrust of the policies and objectives of the existing EFF; in particular, it would concentrate on corrective actions in those policy areas which were subject to difficulties in the current arrangement. Any new program would have to place great emphasis on prior actions that would provide assurances that the adjustment effort would be carried through. At present, the situation in Mexico is a fluid one requiring a careful assessment of the depth of the imbalance and its trends. Consequently, the mission will indicate to the authorities that any discussions on the outline of a new program cannot be more than exploratory at this stage, and that the staff will require further consultations at headquarters before negotiation of a new arrangement can proceed.

As the authorities have stressed themselves, any new program will need to have as its objectives a sustained reduction of inflation, a strengthening of savings and capital formation, improvements in the efficiency with which resources are used, and the attainment of external balance. The policy areas that will need to be discussed for these purposes as well as for the conduct of the mandatory review are the following:

1. Public sector policies

Given the very low levels of available net foreign financing and the undue pressure that public sector borrowing requirements have been exerting upon scarce domestic resources, the mission will stress that the public sector deficit will have to be reduced very sharply; if inflation is to be limited to no more than 20 percent in 1986, the deficit would need to be reduced to about 2-3 percent of GDP; current indications are that this would involve a reduction in the deficit of some 5 percentage points of GDP for 1985 to 1986. On the side of expenditure, the mission will stress the need for a sharp cutback of remaining subsidies and transfers, the streamlining of the enterprise sector, including the closing or sale of some enterprises, and a significant strengthening of expenditure controls. In this connection, the extent of the budgetary support to financial intermediation operations conducted on behalf of the public sector also will be reviewed. On the revenue side, the adequacy of public sector prices will be reassessed, particularly in the light of the adjustment of the exchange rate, and the efforts to strengthen tax administration will be examined.

2. Monetary and credit policy

The mission will investigate the reasons for the large recent expansion in domestic credit; in this connection, the mission will review the capacity of the financial system to meet credit demands in light of the expected growth of domestic financial savings. The mission will impress on the authorities the need for monetary and credit policy to respond more quickly to changes in the economic situation, including through greater reliance on open market operations and a speedier adjustment of deposit interest rates to market conditions. The mission will take the position that credit policy in a a new financial program will need to be framed in such a way as to ensure avoidance of a crowding-out of the private sector and an adequate defense of the international reserve position.

3. Wage policy

The adjustments in minimum wages in 1984 and the first half of 1985 contributed to the maintenance of cost pressures and hampered the scaling down of inflationary expectations. The staff will emphasize the need for a strict approach in this area to prevent erosion of the gain in competitiveness attained with the latest devaluation. Given the importance of reducing inflation rapidly, the mission will argue that wage policy will need to be forward-looking and consistent with the objective of reducing inflation.

4. Exchange rate policy

The recent devaluation of the peso in the controlled market and the elimination of the "free market" are undoubtedly steps in the right direction, and should provide the basis for an improvement in balance of payments performance. Nevertheless, the mission will need to discuss in detail with the authorities their plans for administration of the managed float for the controlled market and the means for assuring external competitiveness. In this context, the mission will point out that the overall foreign exchange surplus of the public sector transactions has now practically disappeared and, therefore, the authorities are likely to have little room to manage such a float. Given the difficulties of enforcing surrender requirements for private sector exports, there would seem to be no alternative to an early unification of the markets (in the context of a floating exchange rate arrangement such as that which characterizes the parallel market). The mission will point out that any new arrangement with the Fund would have as a precondition actual unification or a firm understanding on a well specified time path for the prompt unification of the markets. It might be recalled that at the time of the last Article IV consultation, there was strong support in the Board for the lack of approval of Mexico's multiple currency practices because of Mexico's failure to agree to such a timetable.

5. Trade policy

The mission will review the actions taken recently on this front with a view to assess their effects on the balance of payments and overall economic efficiency. In this context, the implications for exchange rate policy of the acceleration of the trade liberalization process will be assessed. The role of the DIMEX scheme within the general trade policy framework also will be discussed. The mission will seek to map out with the authorities the further steps to be taken in moving away from import permits, and it will examine with them how tariff reduction might be expected to be complemented.

III. Relations with IBRD

The IBRD was in the process of "graduating" Mexico from its lending program just prior to the 1982 crisis, but a major effort is now being made to expand the Bank's role in Mexico and the Mexican authorities now seem eager to obtain Bank financing and technical assistance in a number of areas. IBRD lending operations in Mexico have in the past covered a wide range of sectors, including infrastructure, agriculture, manufacturing, mining, regional development, and municipal. Net disbursements from the IBRD amounted to US$511 million in 1984 and are expected to reach US$580 million in 1985.

As regards the thrust of the IBRD's involvement in Mexico, it is noteworthy that the Bank has become active in the study and design of trade liberalization in Mexico, and has provided a great deal of technical assistance to the authorities in this area. The Bank is currently giving consideration to the possibility of supporting Mexico's program of trade liberalization through financed assistance. The IBRD's current work program on Mexico includes (in addition to its efforts in the trade field), investigations relating to the reform of the financial sector, the management of public sector investment, the functioning of labor markets, and agricultural development.

The lending program of the Bank that may be expected to follow from those investigations include support for specific public sector investment projects, lines of credit for exports and other activities, and certain sector-wide development programs. Cofinancing with commercial banks is also being explored by the Bank as a means of mobilizing private capital in the years ahead, although in the past this approach has not been favored by the Mexican authorities, who have preferred to maintain their own direct relations with foreign commercial banks. The Mexican authorities have expressed some interest in having the Bank assist them in examining the operations of particular public sector enterprises and to evaluate investment plans in certain sectors; the staff will encourage the authorities to seek such assistance from the Bank in connection with their plans for cutting public spending and public sector involvement in the economy.

IV. Completion of the review

If the authorities are not in a position to develop policies to support a new program, or if this process is likely to be a length one, the timing of the completion of the review would be an issue. Given the importance of this case, it would be inadvisable to delay in reporting to Executive Directors. Accordingly, the mission will inform the Mexican authorities that we would report to Executive Directors on the findings or the mission even if the review (which is a performance criterion) cannot be completed formally.

Attachments

cc: Mr. Finch
Mr. Habermeier
Mr. Nicoletopoulous
Mr. Tanzi
Mr. Wiesner

ATTACHMENT I

Fund Relations with Mexico
(As of June 30, 1985)

I. Membership Status

(a) Member since December 31, 1945
(b) Status - Article VIII

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 1,165.5 million

(b) Total Fund holdings of Mexican pesos: SDR 3,868.9 million or 331.9 percent of quota

(c) Fund credit: SDR 2,703.3 million or 231.9 percent of quota
Of which: SDR 200.6 million or 17.2 percent of quota under credit tranche
SDR 1,123.6 million or 96.4 percent of quota under EFF
SDR 1,379.2 million or 118.3 percent of quota under EAR

(d) Reserve tranche position: None

(e) Current Operational Budget: Not applicable

(f) Lending to the Fund: Not applicable

III. Current Stand-By or Extended Arrangement and Special Facilities

(a) Current extended arrangement
(i) Duration from January 1, 1983 to December 31, 1985
(ii) Amount: SDR 3,410.6 million
(iii) Utilization: SDR 2,503.1 million
(iv) Undrawn balance: SDR 907.5 million.

(b) Previous extended arrangement
(i) Duration: 1977 to 1979
(ii) Amount: SDR 518 million
(iii) Utilization: SDR 100 million

(c) Special facilities: CFF
(i) Year approved: 1976
(ii) Amount: SDR 185 million

IV. SDR Department

(a) Net cumulative allocation: SDR 290 million
(b) Holdings: SDR 0.36 million, or the equivalent of 0.13 percent of net cumulative allocations
(c) Current Designation Plan: not applicable

V. Administered Accounts (amounts)

(a) Trust Fund Loans: Not applicable
(b) SFF Subsidy Account: Not applicable

B. Nonfinancial Relations

VI. Exchange rate arrangement: Between December 20, 1982 and July 10, 1985 two official foreign exchange markets were operative in Mexico: a controlled market covering specified transactions amounting to about 80 percent of trade and payments transactions, and a "free market." In addition, a parallel market existed where the rate was established by market forces. The exchange rates in the official markets were set by the authorities, who preannounced the rates for periods of four weeks. At first only the controlled market was allowed to depreciate at a pace of Mex$0.13 per U.S. dollar a day. Since September 23, 1983 the exchange rates in both the controlled and the "free" markets began to depreciate at the same daily amount, initially by Mex$0.13, and subsequently by Mex$0.17 since December 6, 1984, and by Mex$0.21 since March 6, 1985. The parallel market gained official recognition on June 5, 1985, when the authorities authorized commercial banks to operate in that market. Starting July 10, 1985 the authorities abolished the "free market;" foreign exchange operations other than those authorized in the controlled market are to take place in the parallel market. On July 10, 1985 the mid-point exchange rate of the Mexican peso vis-a-vis the U.S. dollar was Mex$230.1 per U.S. dollar in the controlled market, Mex$248.7 per U.S. dollar in the "free market," and Mex$317 per U.S. dollar in the parallel market. The exchange rate in the controlled market continued to be depreciated by Mex$0.21 per day from July 11, 1985 to July 24, 1985, when the rate experienced a 17 percent depreciation. The authorities have announced that the rate in the controlled market would continue to be adjusted by Mex$0.21 per U.S. dollar a day until August 5, 1985 when a new system of daily "floating" would be introduced.

VII. Last Article IV consultation and review under EFF: The last Article IV consultation and discussions of the 1985 program were completed by the Executive Board on June 7, 1985 (EBM/85/91). The relevant supporting documents were SM/85/123, Cor. 1, 5/13/85 and SM/85/148, Cor. 1, 5/23/85. For consultation purposes Mexico is on the 12-month cycle.

VIII. Technical Assistance: At the request of the Mexican authorities, during 1985 two technical teams from the Fiscal Affairs Department are providing technical assistance in the fields of direct and indirect taxation.

ATTACHMENT II

Mexico: Selected Economic and Financial Indicators

	1982	1983	1984 Prog.1/	1984 Prel.	1985 Prog.
(Annual percentage changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	-0.5	-5.3	1.0	3.5	3.5
GDP deflator	61.1	92.2	50.0	66.0	43.0-48.0
Consumer prices (end of period)	98.9	80.8	40.0	59.2	35.0-45.0
Overall public sector					
Receipts	73.1	106.8	59.0	59.8	44.5
Outlays	80.9	62.5	47.0	52.8	38.2
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	5.7	4.5	8.1	9.1	2.4
Export volume	(19.6)	(5.7)	(6.0)	(7.4)	(4.6)
Import, f.o.b.	-40.0	-41.0	64.7	32.9	23.9
Import volume	(-43.7)	(-44.6)	(56.1)	(32.5)	(21.5)
Terms of trade (deterioration -)	-17.0	-1.3	-3.4	1.3	-4.0
Nominal effective exchange rate (appreciation -)2/					
Average	101.3	138.4	...	37.2	...
End of period	261.6	46.9	...	31.5	...
Real effective exchange rate (appreciation -)2/					
Average	30.5	19.4	—	-14.9	—
End of period	86.3	-17.3	...	-16.0	...
Money and credit					
Domestic credit (net)3/	58.9	47.2	36.3	64.0	50.8
Public sector 3/	(62.7)	(28.2)	(16.6)	(19.8)	(22.0)
Private sector 3/	(-5.3)	(23.2)	(21.9)	(37.8)	(28.8)
Money and quasi-money (M3)	70.1	59.2	43.3	71.1	46.7
Velocity (GDP relative to M4)	2.7	3.1	3.8	3.2	3.3
Interest rate (annual rate, one-year term deposits)4/	50.0	47.4	44.0	39.6	40.0
(In percent of GDP)					
Overall public sector savings	-7.9	-0.6	2.6	0.1	2.9
Overall public sector deficit (-)	-17.8	-8.5	-5.5	-6.2	-4.1
Domestic financing	(14.1)	(5.0)	(3.1)	(4.9)	(4.1)
Foreign financing	(3.7)	(3.5)	(2.4)	(1.3)	(—)
Gross domestic investment	21.2	20.3	19.0	19.9	22.0
Gross national savings	17.8	23.9	18.4	22.2	23.1
BOP-current account (deficit -)	-3.4	3.6	-0.6	2.3	1.1
At 1979 exchange rate	(-2.3)	(2.6)	(-0.5)	(1.9)	(0.9)
External public debt 5/					
Inclusive of Fund credit	38.3	43.6	38.9	35.1	31.5
At 1979 exchange rate	(29.3)	(30.9)	(30.0)	(28.7)	(26.9)
Interest payments on external public debt 6/	4.7	5.0	4.7	4.5	3.5
At 1979 exchange rate	(3.6)	(3.6)	(3.6)	(3.7)	(3.0)
(In percent of export of goods and services)					
Debt service 7/					
Before rescheduling	44.6	50.2	42.8	45.4	54.6
After rescheduling	40.1	33.2	32.2	33.6	44.5
(In billions of U.S. dollars)					
Overall balance of payments	-6.8	5.5	2.0	3.0	0.5
Gross official reserves (months of merchandise imports)8/	0.1	4.9	4.7	7.8	7.5

Sources: Bank of Mexico; Secretariat of Programming and Budget; and Fund staff estimates.

1/ Annual changes and ratios to GDP in column "Prog. 1984" are those projected at the time of program inception.
2/ Indices of effective exchange rate measured in terms of local currency per unit of foreign exchange.
3/ Changes are effective flows adjusted for exchange rate changes in relation to total liabilities to the private sector at the beginning of the period.
4/ Maximum authorized rate at the end of the period net of withholding tax; excludes compounding.
5/ Includes short term debt, but net of gross international reserves.
6/ Interest paid on external public debt, net of interest earned on gross international reserves.
7/ Includes debt service on Fund credit.
8/ Excluding gold and payments agreements.

Table 1. Mexico: The IMF Position (December 31, 1982-December 31, 1985)1/

	Transactions in 1982 2/	Transactions in 1983	Transactions in 1984	Transactions During Third Program Year: Actual May-July	Projected Aug.-Oct.	Projected Nov.-Dec.	Projected Jan.-Feb.3/	Total
	(In millions of SDRs)							
Purchases	200.6	1,003.2	1,203.8	295.8	302.6	302.6	302.7	1,203.7
Ordinary resources	200.6	501.6	601.9	20.0	—	—	—	20.0
First credit tranche	(200.6)	(—)	(—)	(—)	(—)	(—)	(—)	(—)
Extended arrangement	(—)	(501.6)	(601.9)	(20.0)	(—)	(—)	(—)	(20.0)
Borrowed resources	—	501.6	601.9	275.8	302.6	302.6	302.7	1,183.7
Repurchases	—	—	—	—	—	—	—	—
Total credit outstanding (end of period)	200.6	1,203.8	2,407.6	2,703.4	3,006.0	3,308.6	3,611.3	3,611.3
	(In percent of quota)							
Purchases	17.2	86.1	103.3	25.4	26.0	26.0	26.0	103.3
Total credit outstanding (end of period)	17.2	103.3	206.6	231.9	257.9	283.9	309.8	309.8

Source: International Monetary Fund.

1/ Partials may not add up to totals because of rounding.
2/ There were no purchases outstanding prior to December 1982. For more details on the transactions with the Fund, see Appendix I.
3/ Last purchase is expected to take place at the beginning of 1986 on the basis of performance through December 31, 1985.

Table 2. Mexico: Extended Arrangement--Quantitative Performance Criteria for the Third Program Year

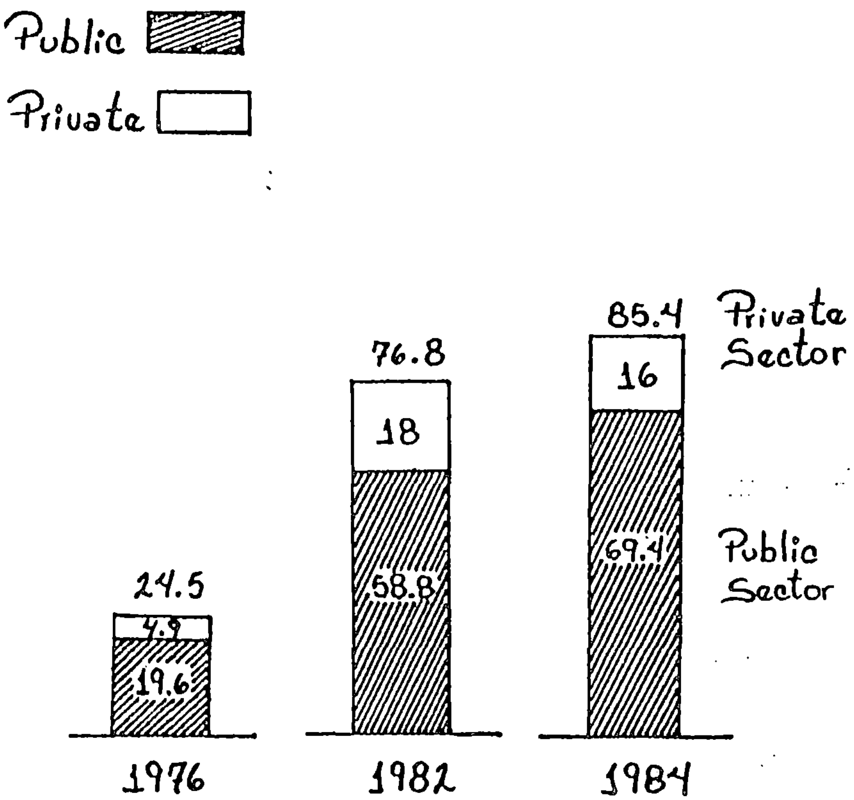
	1984 Dec.	1985 Targets and Ceilings Jan.-Mar. Prog.	Jan.-Mar. Actual	Apr.-June Prog.	Apr.-June Actual	July-Sept.	Oct.-Dec.
(In billions of Mexican pesos)							
Nonfinancial public sector cumulative deficit 1/ 2/	1,826	430	345	840	...	1,240	1,785
Unpaid interest accrued to the Bank of Mexico on claims on the non-financial public sector	491	805	801	805	...	705	568
Net credit to the nonfinancial public sector by the monetary authorities 3/							
Unadjusted	3,740	3,748	3,713	3,895	...	3,897	3,695
Adjusted 4/		3,958		4,426	...	4,676	4,902
Cumulative changes in financial intermediation (effective flow)	414	130	105	230	...	300	350
Cumulative changes in net domestic assets of the monetary authorities (effective flow) 5/	-53	127	122	179	440	45	184
(In millions of U.S. dollars)							
Cumulative net foreign borrowing by the public sector 1/	2,189	500	300	500	...	800	1,000
Cumulative change in net international reserves of the monetary authorities 1/	2,990	-1,000	-867	-900	-1,927	-100	500

Sources: Mexican authorities; and Fund staff estimates.

1/ Limit tested at end of each period.
2/ Effective flows of financing measured on cash basis.
3/ Effective stocks calculated by adding effective flows to nominal stock outstanding as of the end of 1984.
4/ Ceiling can be adjusted upwards by an amount equivalent to the commercial banks' lending to the nonfinancial public sector resulting from implementing mandatory portfolio requirements. The counterpart of this adjustment would be a downward adjustment of the mandatory portfolio requirements on commercial banks by the same amount as the upward adjustment of the Bank of Mexico's lending to the nonfinancial public sector allowed under the program.
5/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the monetary authorities.

- MEXICO -

External Debt



Source: Secretaría de Hacienda y Crédito Público.

THE FALSE AUSTERITY POLICIES OF THE MEXICAN GOVERNMENT

By

Luis Pazos

Instituto de la Integración Iberoamericana

Camelia No. 329
Col. Florida
México 20, D.F.
C.P. 01050

Julio, 1985

In Mexico, as in many other Latin American countries, austerity policies have been adopted superficially to comply with the recommendations of the International Monetary Fund (IMF).

On paper the Mexican government shows numbers which indicate a reduction in the budget deficit, superavit in the trade balance and a descending tendency of inflation.

But for us, the so-called austerity policies adopted by the Mexican government are superficial. The corrections achieved are transitory and their objective is mainly to carry out the obligations acquired with the International Monetary Fund and not to attain lasting solutions.

The semi-austere policies applied by the government are the same as taking a medicine partially--it doesn't cure the illness but does disturb the stomach.

NOTE: Lecture given by Luis Pazos in the Mexican Forum at The Center for Strategic & International Studies of Georgetown University. Washington, D.C. 6/3/85.

Althought the Mexican Gvoernment lowered the rate of its investments and expenditures in some sectors, it has continued since 1983 with the same--or even bigger--bureaucratic body which characterized the previous government.

During the administration of President Echeverria at the beginning of the 70's, a new problem begins to appear: Inflation.

This problems obeys the government's neo-keynesian policies which pursue the encouragement of economic growth through larger public expense, sustained by the emission of paper money.

Such policies result in artificial booms, such as the high economic growth in '73, '74 and part of '75, causing , however, a crisis in '76. In order to meet that crisis, it was necessary to request the aid of the International Monetary Fund and to devaluate the Mexican Peso in that year by almost 60%.

In 1977, the new government, headed by President López Portillo, started its programs following the agreement with the International Monetary Fund, which forced the administration to moderate both the government's expenses and its deficit. The International Monetary Fund policies lowered inflation in '77 and part of '78.

In '78, in view of the high oil prices, the Mexican government is again able to recieve credits from the private international banks and pays the IMF in advance, freeing itself of the obligation to correct the loss of equilibrium in the public finances.

From that moment, the government applies once more expansive public expense policies and maintains an almost fixed exchange rate to the dollar, without taking into account the disparity of inflation between the two countries.

The excessive foreign debt of 1980, '81 and the beginning of '82 is, to a great extent, due to mistaken exchange rate policies.

In 1981, Mexico had the highest foreign currency income from oil export, but nevertheless asked for foreign credits amounting to more than 19 thousand millions of dollars.

These loans were not used for new investment but to support the Mexican peso which was overvalued by nearly 50% with the sole purpose of keeping up the image of the president who maintained that a president who devaluated the currency was devaluating himself politically.

In other words, a great part of the Mexican foreign debt is the product of the pride of a president who refused to take realistic economic measures and used the foreign loans to keep a fictitious dollar price with the theoretical purpose of ending his term without devaluating the currency.

1979, '80 and part of '81 are marked by great economic growth and the creation of thousands of jobs, backed by a great supply of cash emissions in order to increase the public expense and investment which, at the same time, stimulate private investment.

This artificial growth led to a crisis in 1982 which was characterized by a 100% inflation, low economic growth and an unemployment rate which nullified the jobs previously created through an inflationary process, and a rise in the exchange rate from 26 pesos per dollar in December 1981 to 148 in December 1982.

Together with the fictitious exchange rate policies and the expansive public expense, a tendency towards socialist policies begins to take hold in the Mexican economy.

In Mexico, the inflation served to finance an excessive growth of government. The public expense in 1970 was 26% of the Gross Domestic Product. In 1976, the last year of President Echeverria's administration, it was 35% and in 1982 it was more than 50% of the Gross Domestic Product.

In 1970, there were 86 state companies; in '76 there were 760 and in '82 they added up to more than 1,000.

There are some investigators who think that Mexico's economic problems are due to demographic growth. Nevertheless, the problem of our country lies in bureaucratic growth. From 1975 to 1983 the population grew by 25% whereas the bureaucracy in government and state firms grew by 85%.

Some politicians blam^ the crisis on factors outside control of the Mexican government.

That is not true. The flight of capitals, the rnational decrease in the oil price and the high interest s of external credits were factors which made the internal is worse, but they did not cause it.

The crisis in Mexico has been caused by a dispropor- ıal increase in bureaucracy and the government body. This gerated bureaucratic growth has also obeyed socialist tical criteria which have given new dimensions to the ic sector and have gradually limited the private sector.

In 1982, President Lopez Portillo's government, ıout declaring itself formally socialist, put into practice ly all the policies recommended by the programs of the ıunist and socialist parties in Mexico.

The state expropriation of the banks, the trade unions banks and the exchange control were demands of the Mexican nunist parties.

The socialist policies of the Mexican government which ninated in 1982 in the arbitrary and unconstitutional bank opiation caused the flight of capitals which deteriorated situation in Mexico.

Under these conditions and in this situation, and nitted again to the International Monetary Fund to correct instabilities in the balance of payments and the public finances, the new government of President De la Madrid came into power in 1982. In its first year (1983), in accordance with the International Monetary Fund, some irregularities in the government economic policies were corrected.

From a public sector deficit as percentage of Gross Domestic Product of nearly 18% in 1982, President De la Madrid's administration was able to reduce it in 1983 to 8.3% and in 1984, to 7.4%, although this did not meet the goal of the International Monetary Fund to reduce it to 5.5 or 6.5% of the Gross Domestic Product.

In 1983 and 1984, superavits in the trade balance are obtained and inflation is reduced from 100% in 1982 to 60% in 1984.

Nevertheless, these numbers do not mean there was austerity in the public finances. The only real austerity was in industry, commerce, and private consumption.

In other words the austerity has been practiced by the working people, not by the Government.

The corrections made by the government in 1983 and '84 tried to carry out what was established by the International Monetary Fund and not to correct really the internal irregularities derived from excessive public expenditures.

The mistake made by the International Monetary Fund is to ask the underdeveloped countries to reduce the budget deficit, without considering that this can be done by increasing taxes and incomes and not just by reducing expenses.

In Mexico, as in many other Latin American countries, the budget deficits were reduced by increasing taxes, prices and services offered by the public sector without reducing the size of government.

In other words, the main problem of our economy, which is the excessive size of the public sector, is not attacked. Moreover, the cost of reduction of the budget deficit is paid by the people through higher taxes and higher prices for government services.

In 1983, the year in which there was, theoretically, a greater government austerity, the cabinet was enlarged and added a new Secretary of State together with 10 undersecretaries and 28 general divisions. In one sole year, the present administration created more government offices than those created by the previous administration in six years.

Bureaucracy did not become smaller in 1983 but grew by 281,000 more bureaucrats.

The salaries for ministers, under ministers, Directors and high level bureaucrats increased two and three times above the price-raise in 1983 and 1984, whereas the salaries for the low level bureaucrats and the workers did not keep pace with inflation.

The growth of the public sector at the same time as the reduction of the budget deficit was possible thanks to the increase in the prices of gasoline, electricity, telephone and other services provided by the government, plus higher taxes.

The sales-tax was raised by the Mexican government to 15%, more than double what it is in the United States.

In spite of the fact that the fiscal income is low in Mexico in relation to the Gross Internal Product, due to the high taxes which produce fiscal evasion and stop reinvestment, we have one of the highest impositive levels in the world; definitely higher than in the U.S.A.

Although the recommendations of the International Monetary Fund are generally correct, they open the door to the implementation of policies such as the increase of taxes, which obstruct economic growth and consolidate socialist policies.

But in spite of the increase in taxes, the instruments to finance the budget deficit, which are the emission of money and government bonds, and the lending of funds by the commercial banks, now owned by the state, to the government, have grown to record-levels in 1984 and the first months of 1985.

In December 1984 the monetary growth was 63% over the same period of the previous year. That level of money increase is higher than in 1982, the year in which the crisis broke out.

The banks, now monopolized by the government, have stopped fulfilling their function as intermediaries between savings and business and have concentrated, fundamentally on financing the government.

In 1984, more than 60% of the funds of the banking system were used to finance the expenses and debts of the public sector and not for productive investments.

In one year (April 1984 to 1985), the Treasury Bonds in circulation which are the same as the Treasury Bills in the United States, have doubled in number.

The payment of the internal debt absorbed more than 38% of the total public expense in 1984. And if we add to it the payment of amortization and interests of the foreign debt, nearly 45% of the budget from the public sector is only to pay debts.

Even if Mexico seems to be a good example in the eyes of the International Monetary Fund and various financial circles, the government is not carrying out real austerity programs and has not actually reduced the size of the public sector. Many of the data presented to the International Monetary Fund are contrived to give a distorted impression of the Mexican reality.

Proof of this is that financing for the public sector is still requiring in 1985 great emissions of money, greater than in previous years, and which stimulate higher levels of inflation, much above those estimated by the international banking organisms and the Mexican government.

The government Treasury bonds, which are not backed up by an additional production, because they are used to pay normal expenses, are also a promise of future money emissions, to pay for the interests and capital of those same bonds.

The foreign debt has been renegotiated to a longer term, but it is still growing. In the first two years of the present administration the public foreign debt increased by 10.5 millions of dollars (198384).

If we add to all this the fact that most of the Mexicans' savings deposited in the state banks are used to finance public expenses and not productive investments, it is difficult to think in terms of a real economic recovery.

On the other hand, the policies of the present administration make the economic crisis even worse and make the expectation of a recovery far away. Mexican businessmen are discouraged by the clear tendency towards centralization policies and economic socialization under state plans.

The government of President De la Madrid legalized the unconstituional, arbitrary and unpopular bank expropiation, done by President Lopez Portillo with the aim of making himself famous and blaming the private bankers for all his errors and squanderings.

Many of us hoped that President De la Madrid would give back the banks to the private sector, but not only did he not do it, but incorporated to a constitutional level the monopoly of the banks by the government. He also raised state planning to a constitutional level, which is the main element of socialist economy. He also introduced in the Mexican Constitution an article (Art. 25) in which one of its paragraphs was copied almost literally from the Cuban Constitution (Art. 16). In this paragraph almost unlimited powers are given to the government to interfere in all the private economic activities.

The present economic policies of the Mexican government, if we analyze the "National Plan of Development", the document that holds the government programs, are more socialist than those of Felipe Gonzalez in Spain or those of Mitterrand in France. And yet the Mexican government does not call itself socialist, because that would make it even more unpopular.

All these facts have created uncertainty and discontent among businessmen who see in the present government a continuation of the two previous ones.

The defeat, in various elections, of the political party in power (PRI), most of them not officially recognized, show the growing criticism of the Mexican people towards the gradual saocialization of the economy.

The recently announced selling of some State firms does not show any fundamental change in the socialist tendencies because their importance in the public finances is very small. Many of these companies will be sold to the so-called social sector, a name which the Marxist and now also the Mexican Constitution assigns to the business run by the leaders of the worker's trade unions. The French Communist Party asked for the same thing.

In conclusion, the relative corrections achieved by the Mexican government in the last two years in what concerns the arranging of the public finances, have been based on a greater inflationary pressure which has made the workers poorer, because their salaries have not kept up with inflation levels. the increase of taxes and inflation have contributed to decapitalize business, decreasing profits and in some cases producing losses and bankruptcies.

The only things which have grown above inflation in the last two years are taxes and the salaries of the high bureaucracy.

The Mexican government has not made any sacrifice in recent years and continues the same centralizing and socialist tendencies as in the previous administrations.

The crisis in Mexico is not only economic, but political because the group in power has no limit whatsoever. Economic corrections require political changes.

In reality there is no balance or division of powers in

Mexico, the legislative and judicial powers are controlled almost absolutely by the executive power.

The Constitution is violated or changed at the whim of the president in turn.

In the United States, in 196 years the Constitution has undertaken only 26 modifications. In Mexico, in 68 years the Constitution has had 316 changes. Only in the first two years of De la Madrid's administration it suffered 33 modifications, more than in 196 years in the United States.

And what makes it more serious is that the majority of these changes create uncertainty about the property rights and freedom of the citizens, and give each day more power to the government.

Under the present economic, legal and political system there is no trace of a solid and lasting recovery, for apart from the fact that there is no real austerity in public finances, there are no adequate laws or political institutions to favour a lasting economic and social recovery.

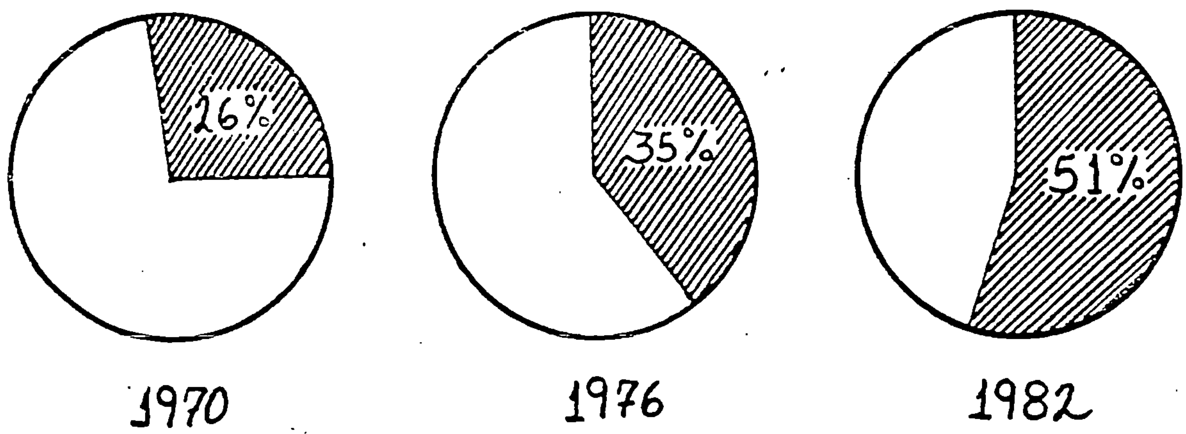
Mexico is a rich country, with sufficient natural and human resources to be able to pay its foreign debt, stop inflation, unemployment and overcome underdevelopment, but nevertheless, in order to be able to achieve this, a change in the present economic policies is essential.

If in Mexico the doors to foreign investment were opened, if the banks were given back to their previous owners, if private property in farming was guaranteed, if taxes went down and if the Constitution were modified in such a way as to guarantee property and freedom in the economic sphere, and if the elections were respected, without having to wait for remote increases in the price of oil or having to beg longer terms for the foreign debt, we could become a powerful nation.

Unfortunately, these economic modifications imply leaving aside the socialist tendency in the economy, which if it has been a drawback for the majority of Mexicans, has been the means for a small group of power hungry politicians to concentrate greater influence and greater wealth.

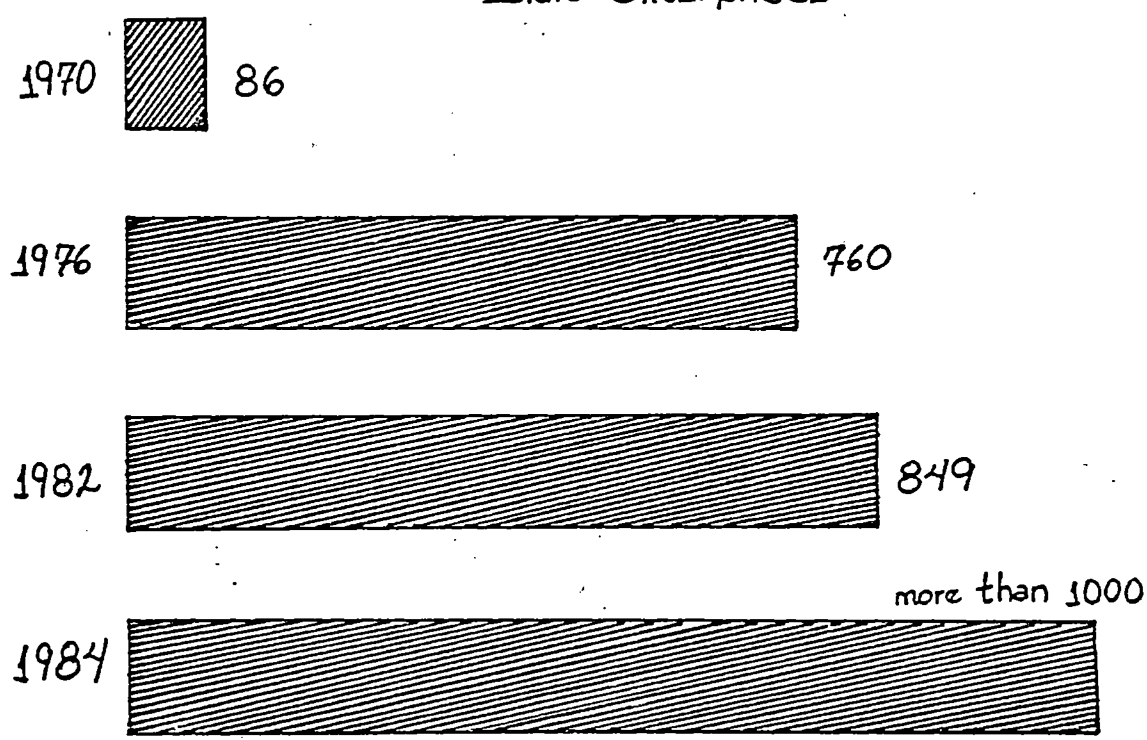
The economic future in Mexico is tied to a change in the political system. If this change goes towards democracy and free enterprise, it will be possible to overcome our economic problems. If, on the other hand, the tendency toward central planning, socialization and party dictatorship continues, no program from the International Monetary Fund or renegotiation of the debt or foreign aid will be able to solve our problems.

MEXICO
Public Expenses
as a Percentage
Gross Domestic Product



Source: Banco de México.

Mexico's
State Enterprises



Source: Diario Oficial, 1984, proper calculation.

MEXICO

1975 - 1983

25%

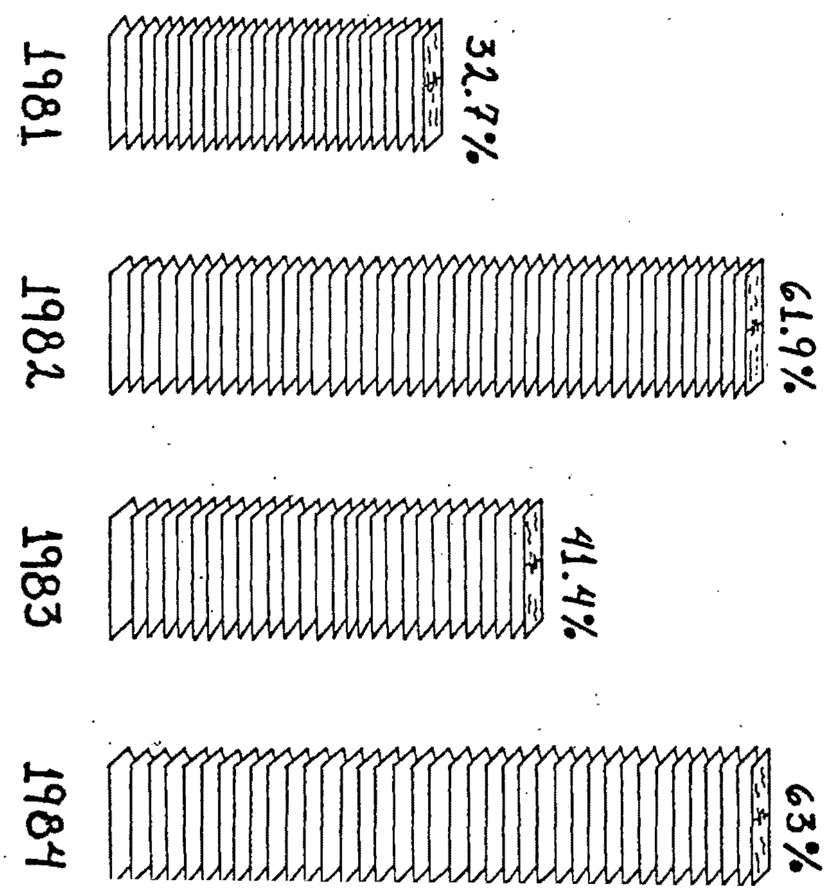
Population growth

85%

Bureaucracy growth

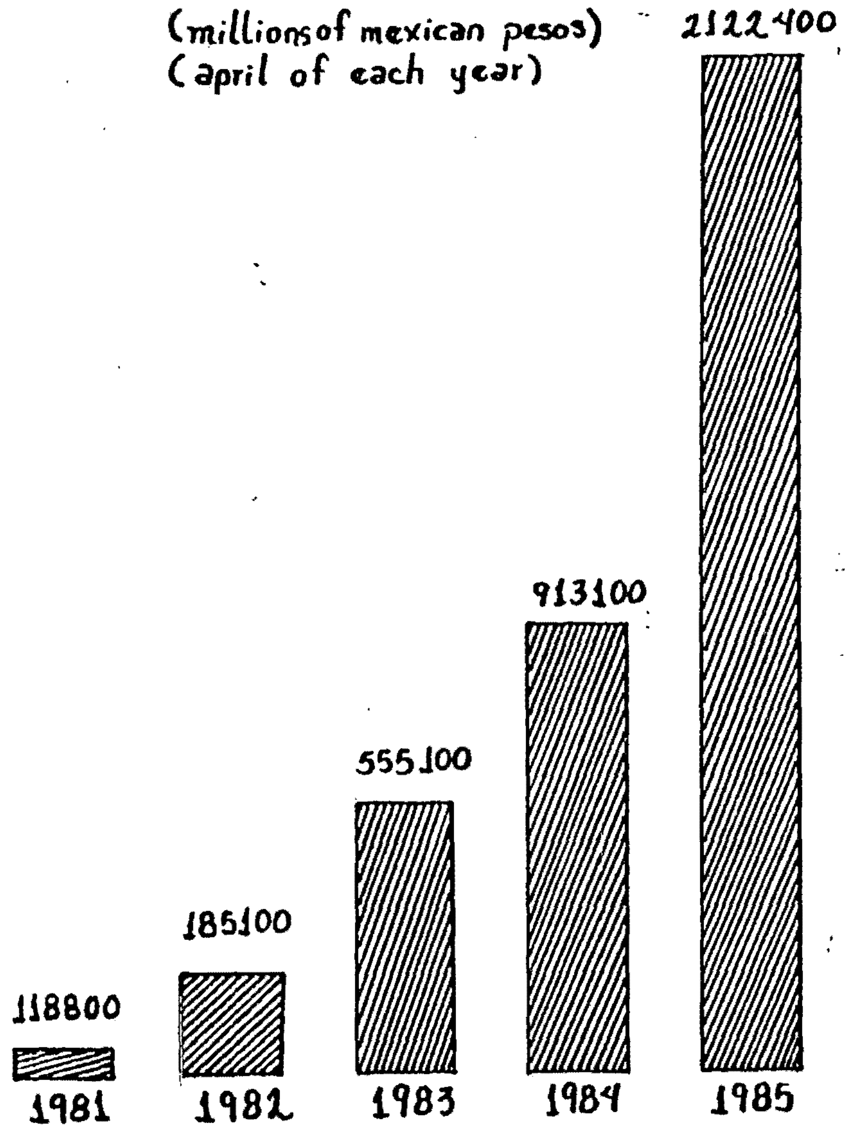
Source: Instituto Nacional de Estadística, Geografía e Informática (S.P.P.)

Monetary Growth (M1)

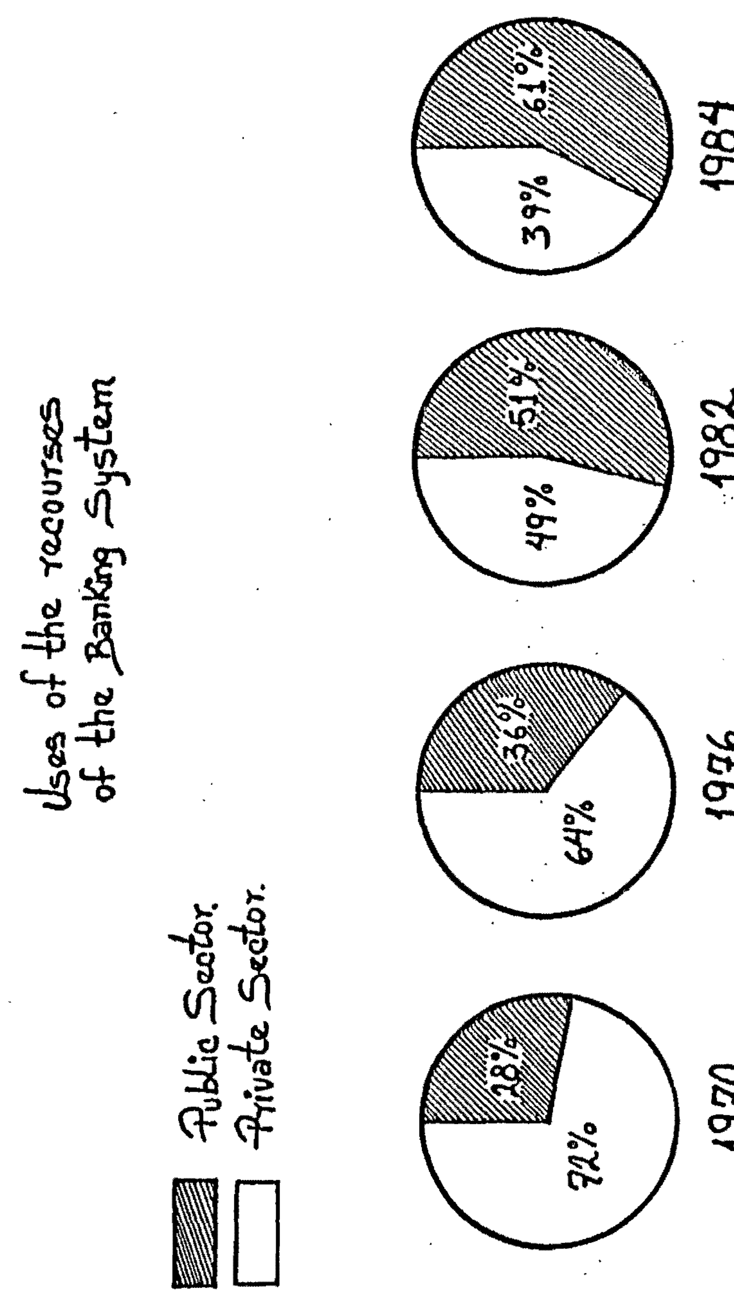


Source: Banco de México. december of each year.

Government
Bonds in Circulation
(millions of mexican pesos)
(april of each year)



Source: BANXICO.



Source: Banco de México

Description of

The Journal of Economic Growth

Summary and Introduction

The Economic Policy Division of the Chamber of Commerce of the United States intends to develop, produce and distribute the Journal of Economic Growth, a quarterly publication devoted to free market solutions to economic growth, job creation and the alleviation of poverty in developing nations. Each edition of the Journal will include four to six essays by prominent economists, sociologists, political scientists and other appropriate individuals from the U.S. and abroad. Essays will be written in easily understandable, non-technical language and will emphasize the free market/limited government approach to economic growth and development and compare it to the statist and interventionist efforts that are now common in these countries. Where appropriate, case studies will be used to the extent that they illustrate general principles of market-oriented development strategies and have applicability to other nations. Intended readership would include opinion-makers, public officials, businessmen and women, business associations, academics, students, and prominent individuals in developing countries.

Initial funding by foundations would be used to develop the first edition of the Journal, publish it in two languages -- English and Spanish --, distribute it through a sample mailing to target audiences in several nations, and assess reaction by surveying initial audience as well as other appropriate individuals and experts. Outcome of assessment would be used to determine the future course of the Journal.

Background

Frequent discussions with individuals from other countries and a casual reading of the foreign press suggest that there is a limited understanding of the free market, growth-oriented policies that have been successfully reintroduced in the U.S. and consistently practiced in some East Asian nations over the past decade or two. These policies -- with their emphasis on economic freedom, democratic institutions, limited government, low taxes, free market solutions, strong legal guarantees of property rights and incentives for entrepreneurial creativity -- are not well understood abroad, particularly in the developing countries. Even with the highly publicized implementation of these policies in the U.S. and Japan, and their apparent success in generating growth and jobs, there is still a great deal of misunderstanding about what these policies are and what they can lead to.

Reasons for this misunderstanding are due to a variety of factors. An absence of accurate information as well as distortions by the popular media, unintentional or not, explains some of it. The tradition of aggressive state intervention, whether deliberately founded on socialist principles and state capitalism, or simply reflecting a natural drift toward government solutions, may also explain a part of it. In this case, free market/limited government solutions pose a threat to existing arrangements in both the public and private sectors. In still other cases, these policies may be deemed inappropriate, even when understood, in the mistaken belief that they are applicable only under a unique set of circumstances which are seldom found in developing nations. Finally, perhaps the greatest obstacle to the consideration and implementation of these policies is the traditional teachings of development economics which emphasize central planning and significant state involvement.

Purpose

The essays published in the Journal will directly confront these misunderstandings and obstacles, and demonstrate that policies that rely on free market/limited government principles are superior to alternative proposals in achieving development, growth and wealth creation. In doing so, the Journal will strive to be eminently readable, provocative and aggressive in its advocacy of these principles and their application to the political and economic problems of developing countries. The objective of the Journal is to provide the proponents of free market/limited government views with facts and ideas that can be used by them in their efforts to influence and formulate public policy.

Description of Journal

The Journal will be edited and published by the Economic Policy Division (EPD) of the U.S. Chamber of Commerce through the

National Chamber Foundation. The EPD's long-established tradition of aggressive advocacy of free market/limited government solutions makes it uniquely qualified to develop the Journal and serve as editor and publisher. With a professional staff of fourteen, including five economists with doctoral degrees, the EPD specializes in economic analysis of the U.S. and world economy from a free market perspective. At present, the staff of EPD write, edit and publish the Economic Outlook, a monthly journal of opinion focusing on U. S. economic policy, forecasting and basic economic analysis. The Outlook is widely-read by public officials and opinion makers, and is frequently quoted in major publications. Articles in the Outlook are often reprinted in other publications.

Published in the form of a 20 to 24 page newsletter, the Journal will consist of four to six articles by prominent authors. The Journal may also publish existing articles where appropriate. To the greatest extent possible, efforts will be made to publish authors who are citizens of developing countries. EPD staff will select authors, approve articles and suggest editorial changes where appropriate.

In order to broaden appeal, the Journal will also include several pages of timely data on international business conditions and country economic performance. Focus will emphasize economic trends in developing countries, which are often neglected in the major business and economic publications. Data presented will include trade patterns between nations, per capita income growth, changes in employment, level of government taxation and spending, industrial production, capital investment and other indicators of economic health.

The complete text of the Journal will be translated into Spanish and two versions of the Journal -- one in English and one in Spanish -- will be printed and distributed to the target mailing list in designated countries. A cover letter from the editor/publisher will accompany the Journal to announce its purpose and note that a questionnaire soliciting their reaction to the Journal will be mailed in a week. Three thousand Journals will be printed, evenly split between English and Spanish.

To achieve the broadest dissemination, the Journal will maintain a liberal reprint policy to encourage local newspapers, magazines and publications of business associations to reproduce articles for distribution to their own readers.

The initial mailing list will consist of public officials, journalists, academics, businessmen and women, and business-oriented associations such as Chambers of Commerce, industry associations and employers organizations.

Designated countries for the first edition will be selected Spanish-speaking countries in Central and South America, English-speaking countries in the Caribbean, Southeast Asia and African countries where the educated classes are fluent in English. India and Spain are also potential recipients of the first edition of the Journal . Once the Journal is made permanant, distribution will be extended to a broader spectrum of nations in other languages.

Goals

Readers should find the Journal a useful source of ideas and arguments that have direct application to their own public policy interests. Those already inclined toward the principles of open market, free enterprise systems should be able to utilize the ideas and arguments presented in the Journal to advance the cause of free enterprise or deter government encroachment. For those who are seeking new approaches to growth and development, the Journal will present a strong argument and intellectual support in favor of free enterprise.

For release on delivery
10:00 A.M., E.D.T.
July 30, 1985

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on International Development Institutions and Finance

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 30, 1985

I appreciate your invitation to appear before this Subcommittee to discuss the multilateral development institutions and their role with respect to the debt and growth problems in the developing countries. Over the years I have had some opportunity to observe the Bretton Woods institutions -- the International Monetary Fund and the World Bank -- and to a much lesser degree the regional development banks. All these institutions, in my judgment, have important ongoing roles to play in safeguarding international stability and in promoting sound growth in the world economy.

In the process, they necessarily have to adapt their programs and approaches to new circumstances as they emerge. That is not an easy task for large institutions, and particularly for those that must operate within the framework of a wide international consensus. At the same time, it is the fact that these institutions are international, with memberships drawn from all nations other than the USSR and most of its satellites, that provides a sense of cohesion and political legitimacy essential to the success of their efforts -- efforts that seem to me very much in accord with the larger interests of the United States.

I believe the constructive response of these institutions to the severe debt and adjustment problems that emerged in the early 1980s illustrates these points. In the initial stages of the international debt crisis, the Fund played an essential and, in key respects, an innovative role. It worked with borrowing countries to develop strong adjustment programs that could command international support. Concurrently, it helped coordinate an unprecedented international cooperative effort to provide sufficient external funds to meet immediate needs and to support the countries' adjustment efforts.

The World Bank and regional lending institutions, geared toward a longer-range perspective and project lending, could not, in the circumstances, at first respond so forcibly. Indeed, borrowing countries cut back on some investment projects that could have received World Bank support.

Now, many of the borrowing countries are or should be moving into a second stage, looking beyond the immediate need for budgetary and monetary adjustments to the essential need to sustain growth within the constraints of servicing existing debt and the less ready availability of private credit. In that context, the role of the World Bank and the regional development lending institutions is likely to become much more critical. The need for innovative approaches and even closer cooperation with the Fund seems to me evident.

There is a natural division of labor between the two Bretton Woods institutions that must be respected. The Fund is concerned with monetary stability, with balance-of-payments equilibrium, and with the broad economic policies necessary to support that equilibrium. The Bank is concerned with longer-term development and projects and policies designed to support that development in particular sectors of the economy.

These are valid distinctions. Essentially the roles are complementary, not competitive. But in practice, both institutions serve as sources of finance, as purveyors of policy analysis and advice to their members, and as forums for economic consultations among governments. In specific areas, those functions can overlap, and should be coordinated. Management of the "debt problem" provides apt illustrations.

First Responses to the International Debt Problem

Beginning in 1982, many foreign borrowers, principally in Latin America but also in other areas of the world, experienced an abrupt curtailment of their access to new loans from the private market. The Fund responded by assisting in the design of stabilization programs to help restore confidence and external balance. It also provided temporary financial assistance to many of the most troubled borrowers. In one perspective, that kind of work is a normal part of the Fund's business. But it has been without precedent in scope and challenge. More or less simultaneous negotiations have been required with a large number of member countries in a highly charged atmosphere. Not only were the fortunes of particular countries at stake, but also the performance of the world economy and financial system as a whole.

In that situation, the Fund became involved to an unusual degree in consultations with the borrowing countries' commercial bank and official creditors. Those lenders clearly recognized that individual, uncoordinated responses to the crisis could not serve their mutual interest in orderly adjustment and servicing of loans. Restructuring of old debt and some new private credit would typically be necessary to provide enough time for the adjustment process to be effective. By working with the Fund, lenders could both be better assured that appropriate adjustment programs were undertaken and financial needs appropriately assessed. From the viewpoint of the Fund, orderly refinancing of outstanding debt and the provision of new private credit, substantially supplementing its own resources, provided essential financial support during the period of economic adjustment.

With its traditional emphasis on investment planning and project lending, the World Bank was not in a position to react as quickly as the IMF to the immediate adjustment needs of the major borrowing countries. Nor were borrowing countries -- faced with overwhelming short-term needs to cut back on budget deficits, to bring monetary expansion under control, and to adjust exchange rates -- able to give priority attention to long-term development and investment programs. Instead, cutbacks in overall investment and consumption expenditures by governments became unavoidable. In these circumstances, both existing and new investment projects assisted by the World Bank and other donors tended to slow down rather than increase.

Even in the "crisis" stage, however, there have been clear opportunities for mutually supportive approaches by the Fund and the Bank.

In advising countries about "adjustment" programs, the Fund is always concerned with measures that should help promote economic efficiency and long-term development. Flexible pricing policies, more open and less discriminatory trade practices, and appropriate exchange rates are normal parts of Fund-sponsored programs. Such approaches are consistent with, and typically crucial to, long-term growth. At the same time, the Bank was, in fact, able to increase or speed up its disbursements of funds to several of the countries affected by the debt crisis.

That response was assisted by the capability the World Bank had developed in 1979 for nonproject lending through so-called "structural adjustment loans" (SALs). The Bank's new commitments for SALs and broadly similar "sectoral adjustment loans" expanded from less than $1/2 billion in FY 1980 to more than $2-1/2 billion in FY 1984, before declining somewhat in the fiscal year just ended.

The SALs and sectoral adjustment loans have the advantage of being fast-disbursing, so that they can have an immediate effect on short-term balance-of-payments financing requirements. At the same time, they are strongly linked to policy actions, designed to promote economic efficiency in particular sectors and to support growth. The recipient government, in effect, commits itself to changes in specific policies that will be sustained over time and which are expected to have a material positive impact on the effectiveness of its investment expenditures and on the growth of the economy.

There is, by now, a record of accomplishment by these kinds of programs in some countries. For example, Turkey has undertaken a series of major reforms, including major steps toward import liberalization, decontrol of interest rates, and reform of state economic enterprises with the support of the World Bank.

These efforts of the Bank overlap with those of the Fund in two respects. The quick-disbursing Bank loans help provide the necessary external financing for the borrowing countries. And, at a sectoral or "micro" level, the policies supported by the Bank should reinforce and undergird the efforts of the Fund to promote economic efficiency and competitiveness.

The recent efforts by the Fund and the Bank in Colombia exemplify these relationships, and could have implications for future cooperation. While that country has not requested or received IMF financial assistance, it has kept the Fund fully informed in developing its economic program. Just last Friday, the Fund, in turn, agreed to monitor progress in implementing the economic adjustment program, which, in the judgment of the Fund, is broadly appropriate to the needs of Colombia. Meanwhile, the World Bank is a major lender to the country, both for specific projects and for sectoral adjustment. The size of that lending program has been facilitated by the efforts of Colombia to implement suitable adjustment measures. The staffs of both institutions will work together in assessing Colombia's progress.

Looking Ahead

The particular circumstances in Colombia are unique, and the arrangements in that country do not necessarily provide a precise prototype for others. However, all the heavily indebted countries in Latin America and elsewhere need to move from a situation of endemic financial crisis to another stage in development, looking toward what is necessary to sustain growth. As they do so, the particular skills and resources of the World Bank become increasingly relevant. Heavy reliance on the shorter-term tools of the IMF should then be phased down and out.

Clearly, either or both of these institutions can only play a supporting role in the economic development of a country. The borrowing countries themselves must maintain a disciplined budgetary and financial environment, enabling them to consolidate the essential gains they have made in achieving better balance in their external accounts and to respect the tight constraints that still prevail with respect to their access to external finance. I believe they will also have to encourage more open and competitive economies, able to sell into world markets as well as to increase their productivity. They will need well-conceived investment programs. More generally, they will need to encourage economic efficiency and well-functioning markets in agriculture, industry, and finance. These are the kinds of things the World Bank and its affiliate, the IFC, working especially with the private sector, can support, but not impose.

Internal reform is critical in circumstances in which access to new foreign bank and trade credits seems bound to remain limited for the time being. The hope occasionally expressed for really major increases in long-term official lending on concessional terms to the middle-income developing countries does not appear politically realistic. Moreover, I doubt that industrial countries are prepared to ease substantially debt burdens by taking over and writing off existing debt to private lenders. Nor do such approaches seem to me essential if well-conceived adjustments efforts are maintained.

In time, renewed confidence could end capital flight and induce repatriation of capital by the citizens of the borrowing countries themselves as well as fresh flows from abroad. That process would be immensely helpful and the best possible evidence of success. But it is, of course, dependent upon a sense of sustained economic performance.

The implication of these conditions is that it is too early for the major borrowers to <u>plan</u> on significant net private inflows of capital. Imports will not be able to grow over time at a rate substantially exceeding the growth in exports. But that is <u>not</u> a recipe for stagnation, so long as exports in fact grow.

One of the lessons of experience is that rapid growth in developing countries, without excessive dependence on new debt, must go hand in hand with participation in international trade. That is why a competitive and relatively open economy is so important. This is a theme that the World Bank has stressed in its structural and sectoral adjustment lending.

Without doubt, there will be more opportunities for working with borrowing countries to help encourage the process. In some countries, for instance, there are urgent needs to improve the efficiency and effectiveness of agriculture, of transport, and of domestic financial markets and institutions. Review of the structure, operation, and performance of state enterprises is sorely needed, including the possibility of greater private participation and incentives in some cases. Structural distortions that hamper or discourage sectors of the economy that potentially could become the most dynamic and efficient need to be eliminated. That in turn may require import liberalization so that companies that have high export potential can in fact make use of the most rational and efficient production techniques. Much of this seems to be recognized, for instance, in the latest steps announced by Mexico only last week, in conjunction with actions to reinforce budgetary discipline and to adjust exchange rates.

In all these areas, there should be potential opportunities for constructive World Bank collaboration, both in consultation as to the design of programs and in financing, dependent on effective implementation. That official financing will not only help the borrowing countries to cover external needs during a period when private financing is so slack, but also encourage some resumption of private lending, through so-called co-financing or otherwise.

You are aware that the World Bank now has under development a proposed Multilateral Investment Guarantee Agency (or MIGA). MIGA would be designed to enhance prospects for foreign direct investment by providing guarantees against noncommercial (i.e., currency transfer and expropriation) risks. Here in the United States the Overseas Private Investment Corporation has offered such guarantees to U.S. investors in many countries for over 20 years, with a considerable measure of success. Some other countries have comparable programs. But, properly structured, I believe wider availability of such guarantees on a multilateral basis could help improve the climate for direct investment in the developing countries.

None of this suggests to me that the major focus of the World Bank on project lending will not or should not continue. The inherent discipline in project lending -- the need to relate a loan to tangible projected returns -- is important. But it also is quite possible that, as a matter of relative priority, heavily capital-intensive, long lead-time projects, with returns deferred far into the future, could give way to areas where more effective use of the existing capital stock is emphasized, with quicker and more evident returns.

I will not pretend to an expertise in these areas that I do not possess. But certain broad conclusions do seem to me valid.

-- In the World Bank Group and the regional lending institutions the world has an enormously valuable resource. That resource lies not just in their technical skills and financial resources. As <u>international</u> institutions, they are in a uniquely advantageous position for working constructively with developing countries in the common interest.

-- The role of those institutions will be more important -- indeed potentially crucial -- in Latin America and elswhere if those countries are to be able to restore strong and sustained growth in the wake of the debt crisis.

-- The development institutions can only be effective as they build on the stabilization efforts of the countries themselves -- the effort that has been so strongly supported by the IMF.

-- As that implies, the efforts of the IMF and the World Bank in heavily indebted countries have become increasingly intertwined, and the need for close cooperation and operating relationships between the institutions has greatly increased.

-- The entire effort deserves the continued strong support of the United States, including, as and when the need is demonstrated, financial backing in the form of capital increases.

Perhaps I need not emphasize at length that the success of all these efforts is also fundamentally dependent on prosperous, growing economies in the industrialized world. Here and elsewhere, we must maintain reasonably open markets for what others can produce more efficiently and economically. The developing countries, in turn, can again become the most promising and most rapidly expanding markets for our products, as they were during much of the 1960s and 1970s. Flourishing two-way trade will be both the means for recovery and growth and a measure of our success.

****

Office Memorandum

July 30, 1985

MEMORANDUM FOR FILES:

SUBJECT: Minutes of Telephone Conversation with Mr. Francisco Suarez, Mexico's Undersecretary of Finance, on Thursday, July 25, 1985

Mr. Suarez called to inform us about the new economic measures being implemented by the Mexican authorities. Measures were taken in the following areas:

1. Exchange rate: As of July 25th, the rate for the peso in the controlled market was adjusted from Mex$233 per U.S. dollars to Mex$280 per U.S. dollar. The peso in the controlled market would continue to be adjusted by Mex$0.21 per U.S. dollar a day until August 5, when a new system of "floating" for the controlled market would be introduced. The criteria to be applied in conducting the controlled float were still being worked out, but it was noted that the following would be taken into account: (a) export performance, (b) the behavior of international reserves, (c) the differential vis-a-vis the parallel market, and (d) domestic inflation. Yesterday the spread between the controlled market rate and the parallel market rate was 20-25 percent. We emphasized to Mr. Suarez the limited scope for subsidizing imports and private transfers in present circumstances, and the advisability of moving to a unified rate.

2. Trade system: The process of moving away from the use of import permits, and relying on protection through tariffs, is being accelerated and intensified. The requirement for import permits is being eliminated for an additional 37 percent of total imports, bringing the total value of imports free from permits to more than 60 percent (this may be compared with the commitment made under the program for the third year of the EFF to raise imports free from permits to between 35 and 45 percent of total imports before the end of 1985). The new import tariff schedule will have nine rates ranging from zero to 50 percent (0, 5, 10, 15, 20, 25, 35, 40 and 50), with most import categories falling between 25 and 40 percent. It was indicated that tariff rates might be revised downward in the future, in light of the experience with the new schedule; the enactment of antidumping legislation was expected to help in this connection. As regards the generalized export drawback scheme (DIMEX), we were informed that steps had been taken to make it more liberal; the percentage of import items excluded from this scheme is being lowered from 28 percent to 21 percent and the minimum import tariff rate applicable to imports under the scheme is being lowered from 25 percent to 10 percent.

3. Fiscal policy: The Government announced a number of steps to cut current expenditures of the Central Government, including the elimination of 15 undersecretariats and 50 directorates, a freeze in salaries for high government officials, and reductions in various other expenditures categories. The President announced that he would take a 10 percent cut in his salary. These spending cuts are expected to yield some Mex$150 billion (0.3 percent of GDP) in savings to the budget in the remainder of this year. No increases are planned in tax rates at this time but expenditure cuts are being readied in the state enterprises, and the prices of certain public sector goods and services are to be adjusted soon.

Mr. Suarez indicated that the public sector deficit for July had been very high, partly reflecting the fall in petroleum export receipts. After the lowering of petroleum export prices earlier this month, sales volumes had returned to normal, he said, and this would be reflected in receipts in August. He went on to emphazise, however, that major action still had to be taken to curb the public sector deficit. Without remedial measures the public sector deficit recently had been projected by Mexican officials to reach Mex$3.7 billion (close to 8 percent of GDP) this year. This projection took into account the adverse effects on the budget of the drop in petroleum export volume and prices, the negative repercussions of interest rates and inflation higher than originally forecast, and the favorable effects of the reduction in foreign interest rates. (The combined effect of these factors would not seem to be sufficient, however, to explain the difference between the public sector deficit envisaged in the program and the latest official projection, which is a matter that will need to be addressed by the forthcoming staff mission to Mexico.) Earlier this month the authorities had raised reserve requirements sharply to provide financing for the public sector.

S. T. Beza
J. P. Pujol

cc: Managing Director
Deputy Managing Director
Mr. Wiesner
Mr. Guitian
Mr. Collins

RECEIVED
INTERNATIONAL
MONETARY FUND

1985 JUN 24 PM 3:38

OFFICE OF
THE MANAGING DIRECTOR

Office Memorandum

Mr. V.H.
A slightly more mild version approved
J.
June 24.85

June 24, 1985

To: The Managing Director

From: Leo Van Houtven

Subject: Summing Up--1985 Article IV Consultation with México

Mr. Ortiz has requested the deletion of the last sentence of the first incomplete paragraph on page 2. We have told him that reference to capital outflow and the adequacy of interest rate policies was made specifically by Mr. Dallara and suggested that perhaps the original words "doubts were expressed" could be changed to "some doubt was expressed." Mr. Ortiz came back reiterating his preference for deletion, but otherwise he insisted that we should insert the clause "one Director expressed doubt." You know that we generally try to avoid "one Director" clauses. Moreover, such an insertion would weaken the strength of the United States' voice in the Board. Since Mr. Ortiz does not dispute the basic veracity of the statement, I suggest that you insist on maintaining the sentence with the mild softening referred to above.

yes With regard to the DIMEX scheme, Mr. Ortiz has pointed out that some Directors had noted the positive aspects of this scheme as a transitional feature. The record supports the reference of that type, which I believe can be added without us having to draw the specific attention of the Board to that addition.

May I have your reaction please.

Attachment

cc: Deputy Managing Director
Mr. Wiesner/Mr. Beza
Mr. Collins

→ MD 6/24

L. Collins

Office Memorandum

June 24, 1985

To: The Managing Director

From: Leo Van Houtven

Subject: Summing Up--1985 Article IV Consultation with Mexico

Mr. Ortiz has requested the deletion of the last sentence of the first incomplete paragraph on page 2. We have told him that reference to capital outflow and the adequacy of interest rate policies was made specifically by Mr. Dallara and suggested that perhaps the original words "doubts were expressed" could be changed to "some doubt was expressed." Mr. Ortiz came back reitterating his preference for deletion, but otherwise he insisted that we should insert the clause "one Director expressed doubt." You know that we generally try to avoid "one Director" clauses. Moreover, such an insertion would weaken the strength of the United States' voice in the Board. Since Mr. Ortiz does not dispute the basic veracity of the statement, I suggest that you insist on maintaining the sentence with the mild softening referred to above.

With regard to the DIMEX scheme, Mr. Ortiz has pointed out that some Directors had noted the positive aspects of this scheme as a transitional feature. The record supports the reference of that type, which I believe can be added without us having to draw the specific attention of the Board to that addition.

May I have your reaction please.

Attachment

cc: Deputy Managing Director
Mr. Wiesner/Mr. Beza
Mr. Collins

The Chairman's Summing Up at the Conclusion of the 1985
[redacted] Article IV Consultation with Mexico
Executive Board Meeting 85/92 - June 7, 1985

Executive Directors expressed in general their broad agreement with the thrust of the appraisal in the staff report for the Article IV consultation with Mexico.

Directors warmly commended the authorities on the remarkable gains that Mexico had made in recovering from the 1981-82 crisis. This had involved determination and political courage. While slippages had occurred in the program during 1984, Directors noted that the authorities had shown readiness to swiftly correct policies to deal with deviations from the programmed path and to adopt further measures in support of the adjustment effort. On the whole, economic performance had improved in 1984 and financial imbalances had been reduced further, but Directors expressed concern about certain developments since late in the year.

Directors welcomed the indications that economic recovery had started. They observed, however, that the adjustment effort was not yet completed, that it was proving very difficult to slow inflation, that the Mexican peso had appreciated significantly in real effective terms, and that Mexico's net international reserve position had deteriorated in recent months. Directors expressed some concern that the adjustment effort had been relaxed in the second half of 1984, and emphasized that the momentum of adjustment had to be regained in order to consolidate earlier gains in restoring confidence and to set the stage for sustained growth. In this context, Directors noted the more favorable development of consumer prices in May 1985, but added that the minimum wage settlements which had taken place in 1985 were likely to add to the difficulty of reducing inflation. Directors also regretted that progress in the implementation of structural adjustments in the exchange and trade areas had been slower than anticipated.

Directors noted that the 1985 program called for a further strengthening of the public finances, mainly through reductions in current expenditure. They welcomed the additional cuts decided in February-March 1985 and the decision not to activate the contingency reserve authorized in the budget, and regarded the 1985 fiscal target as appropriate. The cutback in the size of the public sector deficit was seen as essential in the effort to slow inflation, while the steps taken to prepare tax reforms, to strengthen the finances of public enterprises, and to scale down the public sector's involvement in various economic activities could be expected to contribute to a better use of the economy's resources in the medium term.

In the course of 1984, monetary policy had become too accommodative, many Directors observed. They therefore welcomed the recent marked tightening of monetary and credit policies. The introduction of monetary regulation bonds and the increase in domestic interest rates were expected to improve the control over demand growth and to encourage domestic savings. However, Directors were uncertain whether enough had been done in this area. Concern was expressed about the overruns in the operations of financial intermediation by development banks and official trust funds. Given the momentum of demand expansion, Directors emphasized that the authorities would be well advised to take additional measures in this area should demand continue to grow rapidly and domestic financial savings

change? (doubts were)

prove weaker than expected. In view of the continued outflow of private capital, some doubt was expressed regarding the adequacy of interest rate policies.

Directors noted that since the arrangement is already in its third year, it was important that the authorities move forcefully to implement the needed structural changes; therefore, they welcomed the adoption of a series of supply-side measures to complement demand management policies. Directors expressed disappointment about the slow pace of import liberalization, but noted the recent decision to accelerate trade liberalization and to deal with problems in the structure of protection. In this context, they took note of the approval of the DIMEX scheme,

deleted

which had positive aspects as a transitional feature but of course should not be considered as a substitute for trade liberalization. Directors generally urged the authorities to move more aggressively in this area with a view to raising economic efficiency in general and to improving the conditions for the growth of non-oil exports, which was seen by Directors to be crucial for the maintenance of a sustainable external position in the medium term.

Directors recognized that steps had been taken in December 1984 and March 1985 to improve the international competitiveness of the Mexican economy, but they were concerned that policy in this area was not sufficiently flexible, particularly in view of the insufficient exposure of public and private enterprises to the stimulus of foreign competition, the recent weak performance of non-oil exports, and the continuation of high rates of inflation. Directors noted with concern recent developments in private capital outflows, the drop in official international reserves, and widening of the differential between rates in the controlled and in the parallel exchange markets. Directors urged the authorities to monitor developments in the exchange rate area very closely to facilitate timely action to assure the maintenance of external competitiveness and the protection of the overall balance of payments. Directors stressed the distortions and confidence-reducing effects arising from the continued existence of multiple exchange markets, and urged the authorities to unify the exchange system as quickly as possible.

Directors welcomed the signing of the multiyear restructuring of the public sector external debt with commercial banks. This, together with the reduced reliance on net external borrowing by the public sector and the progress made toward adjustment, had significantly improved Mexico's capacity to manage its external debt. Directors stressed the importance of both pursuing appropriate demand management and exchange rate policies and implementing structural reforms to facilitate Mexico's return to international capital markets and sustained economic growth. In this context the enhanced Article IV consultations in 1986 should contribute to the process of normalization of Mexican access to financial markets.

It is expected that the next Article IV consultation with Mexico will be held on the standard 12-month cycle.

'RNATIONAL MONETARY FUND

→ Mr. Mohammed

Please see the Managing Director's additional (pencilled) remarks.

6/24

Stephen P. Collins

RECEIVED
INTERNATIONAL
MONETARY FUND

Office Memorandum

1985 JUN 17 PM 6 40

OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

DATE: June 1[?], 1985

FROM: A.F. Mohammed

SUBJECT: The Managing Director's Visit to Mexico

Your forthcoming visit to Mexico (July 23-25, 1985), is likely to attract wide media coverage. To minimize any inconvenience or encumbrance upon your activities, it would be helpful if the media has an opportunity to cover the visit in as informed and well-documented a manner as possible.

Mr. Rafael Resendiz, Director of Communications at Mexico's Ministry of Finance, visited our Information Office recently. From him, we learned that your press conference scheduled at President de la Madrid's residence in Mexico City on Thursday, July 25, 1985, will mainly attract coverage by the political media normally covering Los Pinos whereas the more specialized economic media will be present in force in Guadalajara over the weekend (July 20-21, 1985), prior to the Second Annual Bankers' Convention (July 22-24, 1985). Mr. Resendiz expects great interest, even pressure, on the part of the economic media to gain access to you in Guadalajara, and expressed the view, with which I concur, that it would be useful to (a) have a Fund representative hold a background press briefing, perhaps on Sunday, July 21, in order to provide general information on the Fund, as well as to make relevant publications available to the media; and (b) for you to offer to meet the press on Wednesday, June 24, prior to delivery of your speech to the convention, perhaps at a breakfast session. This would not be a news event as you would not wish to announce anything to the press except what you are going to say in your speech. Reporters could be told that they are being provided with an opportunity to meet with you. An embargoed text of your address would also be made available, in Spanish, at that time. This contact with the economic media would reduce pressure for individual access to you while in Guadalajara.

If you agree, I would send Mr. Hernan Puentes, our Senior Information Officer, to conduct the background press briefing prior to your arrival in Guadalajara and to work with Mr. Resendiz on the organization and handling of the proposed press breakfast meeting. Mr. Puentes will be able, on the basis of his earlier contacts, to provide you with a list of questions that he expects to be asked. We will also prepare possible questions and suggested responses for your press conference in Mexico City, which will be conducted by the Mexican government's media representatives in the presence of Mr. Silva-Herzog, and which is expected to last about 30 minutes.

yes

Mr. Wiesner has no difficulty with this proposal.

cc: Mr. Wiesner

External Relations

Mr. Erb
Mr. Mohammed

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: June 17, 1985

JN June 17-85

FROM: A.F. Mohammed

SUBJECT: The Managing Director's Visit to Mexico

Your forthcoming visit to Mexico (July 23-25, 1985), is likely to attract wide media coverage. To minimize any inconvenience or encumbrance upon your activities, it would be helpful if the media has an opportunity to cover the visit in as informed and well-documented a manner as possible.

Mr. Rafael Resendiz, Director of Communications at Mexico's Ministry of Finance, visited our Information Office recently. From him, we learned that your press conference scheduled at President de la Madrid's residence in Mexico City on Thursday, July 25, 1985, will mainly attract coverage by the political media normally covering Los Pinos whereas the more specialized economic media will be present in force in Guadalajara over the weekend (July 20-21, 1985), prior to the Second Annual Bankers' Convention (July 22-24, 1985). Mr. Resendiz expects great interest, even pressure, on the part of the economic media to gain access to you in Guadalajara, and expressed the view, with which I concur, that it would be useful to (a) have a Fund representative hold a background press briefing, perhaps on Sunday, July 21, in order to provide general information on the Fund, as well as to make relevant publications available to the media; and (b) for you to offer to meet the press on Wednesday, June 24, prior to delivery of your speech to the convention, perhaps at a breakfast session. This would not be a news event as you would not wish to announce anything to the press except what you are going to say in your speech. Reporters could be told that they are being provided with an opportunity to meet with you. An embargoed text of your address would also be made available, in Spanish, at that time. This contact with the economic media would reduce pressure for individual access to you while in Guadalajara.

I am uncomfortable with the press suggestions. This is a busy [illegible]. no

If you agree, I would send Mr. Hernan Puentes, our Senior Information Officer, to conduct the background press briefing prior to your arrival in Guadalajara and to work with Mr. Resendiz on the organization and handling of the proposed press breakfast meeting. Mr. Puentes will be able, on the basis of his earlier contacts, to provide you with a list of questions that he expects to be asked. We will also prepare possible questions and suggested responses for your press conference in Mexico City, which will be conducted by the Mexican government's media representatives in the presence of Mr. Silva-Herzog, and which is expected to last about 30 minutes.

yes →

Mr. Wiesner has no difficulty with this proposal.

cc: Mr. Wiesner

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: June 7, 1985

FROM: J. Pujol

SUBJECT: Mexico - 1985 Article IV Consultation and Discussion on the Extended Arrangement

Attached is copy of the staff opening statement of the Executive Board discussion of the Article IV consultation and the extended arrangement for Mexico.

Attachment

cc: Mr. Wiesner (o/r)
Mr. Van Houtven
Mr. Collins

sl JP-6/7/85
Draft

In the papers circulated to the Executive Board on Mexico's program for the third year of the extended arrangement, the staff had commented on developments during 1984 and the early months of 1985 on the basis of the information gathered by the missions that visited Mexico City in late 1984 and early 1985. At the time the papers were finalized we had not yet received all the figures for the end of March 1985. We have, over recent days, received additional information from the Mexican authorities concerning the performance in the early months of this year and would like to bring it to the attention of the Board.

This information shows that all performance criteria were met in the first quarter of this year. With respect to the deficit of the nonfinancial public sector, it reached Mex$416 billion in the period January-March 1985, thus remaining under the limit of Mex$430 billion established for the first quarter of the year. The interest accrued to the Bank of Mexico on claims on the nonfinancial public sector reached Mex$801 billion as of the end of March 1985, which was under the limit of Mex$805 billion established under the program. Net credit to the nonfinancial public sector from the monetary authorities reached Mex$3,713 billion at the end of March 1985, compared with the limit of Mex$3,748 billion established under the program. The operations of financial intermediation of the development banks and official trust funds amounted to Mex$120 billion, which was under the ceiling of Mex$130 billion. Net domestic assets of the monetary authorities expanded by Mex$122 billion, compared with the limit of Mex$127 billion established in the program. During the first quarter of 1985 the cumulative net foreign borrowing of the public sector amounted to US$300 million, which was well within the limit of the US$500 million established in the program, while international reserves dropped by US$867 million, compared with the US$1,000 million reduction allowed for under the program.

As was pointed out by Mr. Ortiz's statement, preliminary information for the first few months of the year indicate that the rate of growth of economic activity continues to be quite strong, although it has slowed somewhat since the last quarter of 1984. The rate of inflation has decelerated further, as consumer prices are estimated to have increased by 2.4 percent in May, compared with 3 percent in April and an average of 5 percent a month in the first quarter of the year. The recent increase in minimum wages referred to in Mr. Ortiz's statement brings the increase for 1985 to 53 percent, compared with 56 percent during 1984. The data shows that the balance of payments has been weaker than expected and official reserves--although still very substantial--are somewhat below their level at the end of the first quarter of 1985 and net domestic credit of the Bank of Mexico, which is subject to continuous testing, has been running close to its quarterly ceiling. Quotations in the parallel market have varied widely in the first few months of this year, with the differential vis-a-vis the controlled market fluctuating between 11 and 30 perent, with the most recent quotations showing a differential of a little more than 20 percent.

INCOMING CABLE/TELEX

Rcv: @1IM/3.08515 Line: 3

RCA JUN 06 1610
248331 IMF UR

662325

RECEIVED
IMF CABLE ROOM
1985 JUN -6 PM 4:22

ORIG: WHD
CC: MD
DMD
MR. PEREZ
ETR
FAD
LEG
RES
SEC
EXR
MR. S. COLLINS

248331 IMF UR

1777313 SHDCME
TLX.NO. 8881
14:11 P.M.
MEXICO, D.F., JUNIO 6, 1985.

Mr. Beza
Mr. Collins
Mr. Hansz
Please prepare an answer on this two
say I prefer [illegible]
[illegible]
June 7.85

MR. STERIE T. BEZA
ASSOCIATE DIRECTOR
INTERNATIONAL MONETARY FUND

C.C. MR. GUILLERMO ORTIZ

ON BEHALF OF SECRETARY SILVA-HERZOG, I WOULD LIKE TO CONFIRM THE INVITATION EXTENDED TO MR. DE LA ROSSIERE TO COME TO MEXICO IN AN OFFICIAL VISIT IN WHICH HE WOULD BE HAVING AN INTERVIEW WITH PRESIDENT MIGUEL DE LA MADRID AND WOULD BE ADDRESSING THE SECOND ANNUAL BANKERS CONVERTION.

I PROPOSE TO YOU THE FOLLOWING TENTATIVE PROGRAM AND WOULD BE IN TOUCH WITH YOU OVER THESE ARRANGEMENTS AND YOUR SUGESTIONS:

TUESDAY JULY 22ND

	FLIGHT WASHINGTON-GUADALAJARA

WEDNESDAY JULY 23RD

10:30	ATTENDANCE TO THE CLOSING SESSION OF THE SECOND ANNUAL BANKERS CONVENTION (SEGUNDA REUNION NACIONAL DE LA BANCA). PLACE: DEGOLLADO -- THEATRE. 20-MINUTE ADDRESS. THEME: INTERNATIONAL FINANCIAL SITUATION.
14:30	LUNCH WITH MEXICAN BANKERS AND GUADALAJARA BUSINESSMEN. 20 PERSONS. CAMINO REAL HOTEL (GUADALAJARA CITY).
17:00	FLIGHT TO MEXICO CITY.
18:00	ARRIVAL IN MEXICO CITY.

19:00	ACCOMMODATION AT CAMINO REAL HOTEL (MEXICO CITY).
21.00	DINNER AT MR. SILVA-HERZOG'S HOUSE WITH A LIMITED GROUP (APPROXIMATELY 15 PERSONS).

THURSDAY JULY 24TH

10:00	INTERVIEW WITH PRESIDENT MIGUEL DE LA MADRID AT LOS PINOS RESIDENCE.
10:30	PRESS CONFERENCE IN THE PRESIDENT'S RESIDENCE. (LOS PINOS).
11:00	MEETING WITH A GROUP OF BUSINESSMEN OF THE PRIVATE SECTOR.
11:30	MEETING WITH A GROUP OF THE WORKING SECTOR.
14:00	LUNCH OFFERED BY THE GENERAL DIRECTOR OF THE BANK OF MEXICO.
17:00	RETURN TO WASHINGTON (ONE STOP IN DALLAS).

FRANCISCO SUAREZ
UNDERSECRETARY OF FINANCE OF MEXICO

(GRF)

248331 IMF UR

1777313 SHDCME

Time: 16:17 06/06/85 ???
Connect Time : 418 seconds

INCOMING CABLE/TELEX

→ MW 6/6

Mr. Collins

Office Memorandum

To: The Managing Director
The Deputy Managing Director

June 5, 1985

From: S.T. Beza STB

Subject: Mexico--Visit of Mr. Mancera

Mr. Miguel Mancera, Governor of the Bank of Mexico, will be meeting with us tomorrow. He will be accompanied by Mr. Buira, Director for International Organizations at the Bank of Mexico.

Recent developments and policies

A Mexican team headed by Mr. Gurria, Director General for Public Credit at the Ministry of Finance, visited Washington late last week to review with the staff developments under the program. The comments presented in this note incorporate the results of those discussions.

Preliminary information for the first few months of the year indicate that the rate of growth of economic activity continues to be quite strong, although it has slowed somewhat since the last quarter of 1984, when it is estimated that real GDP was expanding at an annual rate of about 6 1/2 to 7 percent. The rate of inflation also has decelerated; in April and May consumer prices are estimated to have risen by around 3 percent a month (an annual rate of about 43 percent), compared with an average of 5 percent a month in the first quarter of the year. However, the performance of the balance of payments has been weaker than expected. Non-oil exports have declined in the first few months of the year, compared with the same period a year ago, while imports have continued to expand at a relatively rapid pace. The result has been that the surplus in the current account of the balance of payments has narrowed significantly. More importantly, there appears to have been a sharp increase in private capital outflows since the beginning of the year; very recently, capital outflows appear to have been influenced by uncertainties in respect of oil prices.

These capital outflows have led to losses in official reserves and have given rise to wide fluctuations of the parallel market exchange rate. The differential between the parallel and the controlled market rate has varied between 11 percent and 30 percent during the first five months of the year. The most recent differential is somewhat over 20 percent. (You might recall that it had been agreed with the authorities that a sustained deviation in excess of 20 percent would give rise to consultations with the staff.) The real effective exchange rate is estimated to have shown an appreciation of about 1 1/2 percent from end-February 1985 to end-April.

The net international reserves of the Bank of Mexico experienced a drop of US$867 million in the first quarter of the year, and in the next seven weeks (through May 24) they fell by another US$400 million. Although all the performance criteria under the program for end-March were observed (Table 1) and the net domestic asset ceiling was being respected as of May 24, 1985, the margin under this last-mentioned ceiling was practically nil as of that date; the ceiling on the net domestic assets of the Bank of Mexico is a continuous ceiling, with readings available on a weekly basis. As matters now stand, the Bank of Mexico will have to make a substantial effort during the month of June to meet the end-June target for international reserves and to remain within the ceiling on its net domestic assets; indeed, if the repayment of a credit (from 1984) to foreign commercial banks is made in June rather than July, there will be virtually no chance of meeting the end-June balance of payments target.

From the data available it would appear that the problem that has emerged in respect of the ceiling on the net domestic assets of the Bank of Mexico did not originate in credit to the public sector. As regards other credit operations, it may be recalled that the Bank of Mexico was to place monetary regulation bonds in March and April. The placement in March (three quarters of the total) took place as scheduled but the April tranche was delayed until end-May. The placement of bonds in March raised deposit rates by 7 to 8 percentage points, to 66 percent at an annual rate. Bank deposit rates were not changed again until this week when they were raised to 70 percent, but treasury bill rates in the weekly auctions continued to rise throughout the period (from some 63 percent in mid-March to 80 percent this week). The growth of deposit liabilities in commercial banks has lagged in relation the projection, perhaps reflecting pressures from capital flight.

The data available on the public finances show that the public sector deficit remained within its ceiling in the first quarter of 1985. This was followed by a relatively high deficit in April, but the latest indications are that the deficit was reduced in May. We were informed by Mr. Gurria that during the month of May instructions were given to reduce public sector expenditures by another Mex$200 billion (about 0.4 percent of GDP) to help counter the effects of a possible decline in petroleum export prices. The authorities appear to expect a drop of about US$1.50 to US$2 a barrel in the average price of petroleum exports. Such a fall in petroleum prices would result in a loss of public sector revenue of about US$850 to US$1,100 million, which however would be more than offset on a full-year basis by the recent reduction in foreign interest rates; however, because of the lags in the reduction of interest rate charges for outstanding credits, it is possible that the net effect of these two forces would produce negative effects in 1985.

Other policy developments discussed with the Mexican team included: the approval of the DIMEX program, whereby local exporters will be allowed to import without permit a value equivalent to 30 percent of their export proceeds (which is a smaller percentage than the 40 percent mentioned in the letter of intent); a further liberalization equivalent to 2 percent of total imports (this last installment raised the total of liberalized imports to 25 percent, compared with a target range of 35 to 45 percent by the end of 1985); and the mid-year award of an 18 percent increase in minimum wages. The staff has emphasized to Mexican officials that the wage action will affect adversely the chances of reducing inflation from nearly 60 percent during 1984 to the range of 40-45 percent being sought this year; with the latest change in minimum wages their increase for 1985 is 53 percent, compared with 56 percent last year.

Today the authorities authorized the establishment of exchange houses that will be permitted to operate in the parallel market. Banks will be able to set up exchange houses, and thus will be allowed to operate in the parallel market. This would seem to be a move to implement the liberalization of the exchange system that Mr. Mancera discussed with us when he was here in late March. However, the method chose seems to be less open than we had expected on the basis of the conversations we had had with him.

Issues for discussion

We are concerned that all aspects of the financial program continue to be experiencing difficulties, but the most pressing problems seem to be in the areas of exchange rate policy and credit policy; this is not to say that fiscal policy is not without its difficulties, but measures continue to be taken in this area (as was noted above) and there is still a reasonable chance that the authorities will comply with the midyear limit. In contrast, a major reversal of recent trends will be needed in credit from the Bank of Mexico and net official reserves to accomplish the aims of the program.

It seems clear that exchange rate policy needs to be made much more flexible to reverse the drain of reserves, and this needs to be backed up by a more aggressive policy of credit restraint (including further increases in interest rates). We might ask Mr. Mancera how the latest change in exchange arrangements might be utilized to achieve a greater flexibility of the exchange rate; however, far bolder steps toward a flexible system may well be necessary. As for the management of credit policy, private demand seems to be still quite strong, and it may take a significant reduction in the rate of increase of credit to bring the growth of domestic demand down to a more sustainable rate.

Another issue to be discussed with Mr. Mancera is in the area of commercial policy (Mr. Mancera was the author of the DIMEX scheme). We might review with him the progress made so far in the process of trade liberalization, the timetable for the implementation of the new tariff structure for rest of the year, and the operational implications of the new DIMEX scheme, both domestically and in the context of the new trade agreement with the United States.

We will need to prepare an opening statement for the staff for Friday's meeting on Mexico, taking into account information received from the visiting Mexican team and the discussion with Mr. Mancera. The latest information is disconcerting, and the additional material we present to Directors will undoubtedly make the discussion of Mexico's policies even more critical than it would have been on the basis of the staff reports issued a little more than three weeks ago.

Attachment

cc: Mr. Wiesner (on return)
Mr. Guitian
Mr. Collins

Table . Mexico: Summary of Performance under the 1985 Program

	January-March Program	January-March Actual	Excess(+) Margin(-)
	(In billions of pesos)		
Nonfinancial public sector cumulative deficit 1/ 2/	430	416	-14
Unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector	805	801	-4
Net credit to the nonfinancial public sector by the monetary authorities 3/			
Unadjusted	3748	3713	-35
Adjusted 4/	3958		
Cumulative changes in financial intermediation (effective flow)	130	120	-10
Cumulative changes in net domestic assets of the monetary authorities (effective flows) 5/	127	122	-5
	(In millions of U.S. dollars)		
Cumulative net foreign borrowing by the public sector 1/	500	300	-200
Cumulative change in net international reserves of the monetary authorities 1/	-1000	-867	-133

Sources: Mexican authorities; and Fund Staff.

1/ Limit tested at end of each period.
2/ Effective flows of financing measured on cash basis.
3/ Effective stocks calculated by adding effective flows to nominal stocks outstanding as of the end of 1984.
4/ Ceiling can be adjusted upwards by an amount equivalent to the commercial banks' lending to the nonfinancial public sector resulting from implementing mandatory portfolio requirements.
The counterpart of this adjustement would be a downward adjustment of the mandatory portfolio on the commercial banks by the same amount as the upward adjustment of the Bank of Mexico's lending to the nonfinancial public sector allowed under the program.
5/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the monetary authorities.

Office Memorandum

MAY 7 1985

TO :	The Managing Director The Deputy Managing Director
DATE:	May 7, 1985
FROM :	E. Wiesner E.W.
SUBJECT :	Mexico--Staff Report for the 1985 Article IV Consultation and Use of Fund Resources Under the Extended Arrangement--Program for the Third Year

Attached for your approval is the draft of the staff report on the 1985 Article IV consultation with Mexico and the presentation of the program for the third year of the extended arrangement.

This note has been reviewed by the following departments:

Exchange and Trade Relations	- Mr. Guitian
Fiscal Affairs	- Mr. Yandle
Legal	- Mr. Nicoletopoulos and Mr. Ogoola
Treasurer's	- Mr. Leddy
Western Hemisphere	- Messrs. Beza, Caiola, van Beek and myself

Attachment

cc: Mr. Collins

a significant downward tendency, seem to have stabilized at around 3 to 3 1/2 percent a month in the second half of the year. Furthermore, prices experienced an acceleration in December 1984–January 1985 that went beyond that expected from seasonal factors taking into account the adjustment of controlled prices. Accordingly, in February 1985 the authorities decided to forego activation of the contingency deficit reserve and to reinforce the public finances to ensure that the 1985 overall economic deficit would be kept within Mex$1,785 billion (the equivalent of 4.1 percent of GDP).

The authorities explained that receipts of the public sector in 1985 would be affected by the decline in international petroleum prices. However, in local currency terms, the drop in the dollar value of petroleum exports would tend to be somewhat offset by the faster rate of depreciation of the peso adopted in December 1984 and March 1985. Nevertheless, the authorities were aware that there was a need for strengthening the administration of existing taxes and for adjusting the prices of public sector goods and services, to compensate for some of the loss of public sector revenue resulting from the fall in petroleum exports.

The authorities pointed out that substantial adjustments had taken place in the prices of public goods and services in 1983 and 1984, and a large part of the lag in prices accumulated in previous years had now been erased. In 1985 they intend to continue adjusting public sector prices to compensate for inflation, as well to reduce or eliminate operating losses of the state enterprises, but they indicated that the adjustments to be made in 1985 would be relatively smaller than in the

The authorities have reiterated their commitment to exercise flexibility in the management of the exchange rate policy, and in December 1984 and March 1985 they raised the pace of the daily depreciation. They have noted that the current rate of depreciation would be consistent with the maintenance of the present real effective exchange rate if their goal of reducing inflation during 1985 is achieved and the behavior of foreign exchange markets and inflation abroad conforms to current projections. The staff is concerned that the margin for maneuver on this front has become very thin, particularly in the context of the authorities' intention to open the economy on the import side. For these reasons, the staff would urge the authorities to monitor developments in the exchange rate area very closely to facilitate timely action to assure external competitiveness.

you could say a word on the intention of the authorities to tune their ext'l policies in a way that will be consistent with attainment of the BoP target (for viability) over the program period

The dual exchange market was introduced as a transitory measure by the authorities, and they have reiterated their intention of eventually returning to a unified exchange market. However, the authorities are not prepared at this time to commit themselves to the elimination of the existing multiple currency practices before the expiration of the current extended arrangement on December 31, 1985. While exceptional conditions may still prevail, the staff would note that the existing limitations on access to the free market have encouraged the development of an informal parallel market, giving rise to certain distortions and risking unfavorable effects on confidence. Although the spread between the rates in the controlled and free market has narrowed over the past two years, the spread between these two markets and the parallel market rate has been significant in recent months.

→MD [illegible]

M. Collins

Office Memorandum

To: The Managing Director
The Deputy Managing Director

May 3, 1985

From: C. A. Aguirre

Subject: Technical Assistance Mission to Mexico

I returned to the office today from a technical assistance mission to Mexico, which took place April 8-30. The mission comprised, in addition to myself, Mr. Shome, Mr. Kondratiuk (an Argentine member of the panel of fiscal experts), and Mrs. Handford (secretary). As requested by the Mexican authorities, this mission was to evaluate the structure and administration of the federal domestic taxes on consumption. A second mission will visit Mexico in the summer to study the remaining federal taxes.

Extensive discussions were held with a number of government officials responsible for tax policy and administration, including the Under Secretary for Revenue, and, following arrangements made by the authorities, with representatives of the private sector. In addition, two state revenue administrations (the Federal District and the State of Mexico) were visited to ascertain the efficiency of their operations in connection with the administration of the value-added tax (VAT). The last day of the visit the mission was received by the Secretary and Under Secretary for Finance and Public Credit to discuss its preliminary conclusions.

Collections from domestic taxes on consumption, including the VAT, excises, and a tax on the production of the Mexican oil company (PEMEX) for domestic consumption, have been approximately 50 percent of total tax revenue in 1983 and 1984. The VAT and excises contributed around 19 percent and 14 percent of total tax revenue, respectively, while the remaining was accounted for by the production tax on PEMEX. In the case of the VAT, collections in recent years do not seem to have responded as expected, particularly after the rate increase that took place in January 1983. In trying to explain the disappointing performance of VAT collections, the mission tried to ascertain the validity of a number of arguments relating to exogenous factors that have been advanced. After observing production, and supply and demand patterns in the Mexican economy in recent years, it was concluded that both the effort to increase exports and the contraction and change in the composition of imports resulted in a decrease of domestic consumption which, in turn, pressed the VAT base downward.

With a view to determining the importance of endogenous factors, the mission also attempted to estimate the probable base of the VAT for 1983 on the basis of published national accounts. The design of the Mexican VAT includes zero rating (exports and agriculture, including its inputs) and exemptions (construction and rental of housing, books, passenger transport, interest, a large part of medical services, education, and other activities such as public administration which are usually exempted). There is a standard rate of 15 percent and a reduced rate of 6 percent, the latter applying to medicines and most food products as well as to transactions that take place within 20 kilometers of the borders with neighboring countries. This unusual treatment of a geographical area as a separate tax zone was introduced so that tax rates would not be much higher than sales tax rates prevailing in the U.S. states bordering Mexico, thus not encouraging purchases in the United States by Mexican residents in the border zone. There is also a symbolic tax rate of 20 percent, which was introduced in 1983 and applies to very few goods and services that are unimportant in terms of revenue. Highly tentative results, arrived at before receiving all the statistical information that was requested, would indicate that: (a) the taxable base of the VAT would be approximately 50 percent of the GDP plus imports; and (b) actual collections from the VAT would be slightly less than half of the potential VAT revenue. The mission expects to be able to refine these estimates on the basis of additional data to be received soon from the Mexican authorities and to incorporate the revised calculations in the final report.

The mission did not find major problems in the design of the VAT, although there may be some merit in limiting somewhat the extent of zero rating currently in effect to avoid the administrative problems created by a large number of refunds. Regarding administration, however, there are some identifiable shortcomings. The major one is the overlapping authority of the Federal Government and the states (there are 31 states plus the Federal District) for administering the tax, a situation which is recognized by the authorities as being clearly undesirable but which has deep institutional and political roots in Mexico, dating back to the introduction of VAT in 1980 as a replacement to a turnover tax that was entirely administered by the states. Another serious difficulty is the legal and administrative treatment of the so-called "minor" taxpayers, a category which includes many taxpayers who are no longer "minor" but benefit unduly from being defined as such and pay little tax. Recognizing the importance of political factors in the decision to establish a dual administration for the VAT, the mission recommended that a study of the feasibility of transferring all the administrative functions to the Federal Government be undertaken, at least in the case of the Federal District, which enjoys much less political autonomy than the states and collects more than 40 percent of total VAT revenue. Moreover, the mission also recommended that the current system of revenue sharing be changed in order to give more weight to the collection effort of the states in determining their shares of federal revenue (see below). As regards "minor" taxpayers, the mission is of the view that the legal set-up needs to be substantially overhauled so as to eradicate the abuses currently prevailing.

With respect to excises, it is worthwhile to note that the Mexican system relies heavily on a tax on gasoline that amounted to almost 10 percent of total tax revenue in 1984. In general, the system is well designed and administered. The mission had, however, two observations to make. In the first place, tax coverage in the case of most taxable products has been extended to include the wholesale stage. Thus, the tax is now multistage and a credit system, similar to that of the VAT, has been adopted to avoid cascading. This was done to prevent manufacturers from underpricing their sales to related companies engaged in distribution activities, a practice that became common after most rates were made ad valorem in 1980. Although the new system has enhanced the revenue potential of the tax by increasing its base with the value added by the wholesalers, it has also increased considerably the number of taxpayers and forced the authorities to introduce a withholding system which is not free from administrative complexity. The mission would favor a return to a more conventional, single stage, type of excise system, which includes only manufacturers and importers in the tax coverage. To avoid underpricing, it would be necessary either to include adequate provisions against it in the law, or use a system of administered prices to which the ad valorem rates would apply. This system would allow the use of simple control procedures, similar to those that are in force where specific rates apply but without the disadvantages of the latter. Tax rates would have to be adjusted, of course, to avoid revenue losses in those cases where the tax base becomes smaller as a result of excluding the value added by distribution activities. The second observation of the mission relates to the list of taxable goods and services. At present, this is rather limited, a fact that probably reflects an overreaction against the proliferation of excises that prevailed before 1980. If revenue needs dictate it, however, the list could easily be expanded to include products such as luxury goods, electrical appliances, and tires.

As mentioned above, the states play an important role in the administration of the VAT. Despite this, there is currently very little in the formula used to determine the share of each state in federal revenue that rewards its effort to increase VAT collections. Moreover, the ratio of state tax revenues to state shares in federal revenue averages barely more than one fourth, making evident the dependency of the states on revenue sharing to carry out their programs. Assuming that current institutional arrangements regarding dual administration of certain federal taxes by the Federal Government and the states cannot be altered substantially, the mission recommended a change in the formula currently in effect by means of introducing a factor that would encourage the states to improve significantly their collection effort. One way of achieving this would be to break down, by state, the budget estimate of federal taxes administered by the states and then consider the excess or shortfall generated by each state as a proxy for its administrative effort. Assignment of a substantial part of this excess or shortfall to the state that generated it could work as a powerful incentive to maximize the states' efforts.

As usual, a final report will be prepared and submitted to the authorities in due course.

cc: WHD
EXR
ETR
INST
GEN
LEG
OE
RES
Mr. Collins

bcc: Mr. Tanzi
Mr. Tait
Mr. Latham