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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/117

3:00 p.m., July 30, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	S. Kolb, Temporary
B. de Maulde	
A. Donoso	
	D. C. Templeman, Temporary
	T. Alhaimus
H. Fujino	T. Yamashita
	I. R. Panday, Temporary
R. K. Joyce	
	H. A. Arias, Temporary
	G. Grosche
	N. Coumbis
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	
A. R. G. Prowse	
	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	A. Linda
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

Central Banking Department: S. P. Leite. Exchange and Trade Relations Department: M. Guitián, Deputy Director; N. Kirmani, P. Neuhaus. Fiscal Affairs Department: M. Katz, P. R. Rado. Legal Department: G. P. Nicoletopoulos, Director; J. K. Oh. Middle Eastern Department: S. Thayanithy. Research Department: W. C. Hood, Economic Counsellor and Director; J. Artus, D. Folkerts-Landau. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; R. A. Elson, J. Gil-Diaz, C. M. Loser, J. P. Pujol, S. J. Stephens. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. El-Khouri, L. Ionescu, W. Moerke, G. E. L. Nguyen, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, M. Camara, Chen J., H. Kobayashi, M. Lundsager, E. Olsen, E. Portas, M. Rasyid, D. J. Robinson, J. E. Rodríguez, Shao Z., A. J. Tregilgas, A. Yasseri.

1. MEXICO - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Mexico (SM/84/155, 7/2/84; and Cor. 1, 7/24/84). They also had before them a report on recent economic developments in Mexico (SM/84/165, 7/16/84).

Mr. Senior made the following statement:

My authorities are in general agreement with the staff appraisal. Therefore, I shall limit my remarks to some elements of the performance of the economy during the first months of this year and to various aspects of the policies embodied in the 1984 stabilization program.

Before commenting on these two main areas, let me stress the significance of the adjustment effort undertaken in 1983. The staff describes in great detail the considerable improvement of the Mexican economy during the first year of the extended arrangement; thus, there is no need to dwell on it. Suffice it to say that the firm implementation of a wide range of the demand and structural policy measures embodied in the initial adjustment effort has led to a remarkable turnaround of the economy. Policy actions interacted in a coherent and articulated manner to arrest the serious internal and external imbalances of 1982. As a result, by the end of 1983 the impressive improvement of the balance of payments was accompanied by significant progress in abating inflationary pressures. Central to these developments was the more than halving of the public sector deficit that was aided by the determined implementation of monetary, price, income, and exchange rate policies.

In 1984, the program aims at a substantial deceleration of inflation and a moderate economic recovery while maintaining a strong balance of payments position. All of the program's performance criteria have been fully met, and all payments arrears have been eliminated. However, the economy remains depressed, and unemployment is rising. It is becoming apparent that unless a moderate recovery in activity takes place, the adjustment effort may not be sustainable.

The rate of inflation has continued to decline; prices increased during the second quarter of 1984 at an annual rate of 55 percent, compared with 67 percent in the 12 months ended in June 1984 and 81 percent in the year ended December 1983. This favorable trend is expected to continue, particularly since most increases in public sector prices and tariffs for 1984 have already been introduced. These price adjustments explain the lower than expected deceleration of inflation during the first semester and the sharp reduction expected for the second semester.

In the real sector, an important feature is the appearance of some signs of a reversal in the falling trend in production. The manufacturing sector registered a growth rate of 2.2 percent in the 12 months ended in May, but still remains well below mid-1981 levels. Prospects for agricultural production are favorable, and a growth rate of 4-5 percent is expected. Most services also show a positive trend, particularly those related to the external sector.

Despite the sharp rise in imports of 31 percent, the balance of payments has continued to strengthen beyond expectations. The trade surplus is now greater than that for the corresponding period of 1983, largely as a result of the very strong performance of non-oil exports which increased by 42 percent. It is important to note that currently, the sum of non-oil exports plus net tourism revenues--at US$370 million a month--is virtually equal to total merchandise imports. Thus, the proceeds from oil exports and other revenue items have allowed for a further increase in imports, despite the heavy burden of interest payments on external debt. Net international reserves have continued to increase rapidly; by mid-July, the annual target for reserves--US$2 billion--has been exceeded.

During the first few months of the year, public finances have continued to improve, with the public sector deficit falling by about 40 percent in real terms. Mainly as a result of the comprehensive set of revenue measures adopted and of the somewhat improved level of economic activity, receipts have increased at a faster rate than contemplated in the program. Furthermore, it is expected that the recent price increases of gasoline, sugar, and edible oil, together with the price increases at the beginning of the year, will further strengthen public revenues in the remainder of 1984. According to the latest information, public revenues increased by about 70 percent in the first semester of this year. Public sector expenditures have been strictly controlled according to the program, growing at a lower rate than inflation. Continued emphasis has been placed on eliminating low-priority programs and reducing government involvement in certain sectors. It should be noted that the sale of shares of nonbanking enterprises owned by commercial banks--including insurance, brokerage, leasing, and other nonbanking intermediaries--has almost been completed. In addition, my authorities have established an interministerial committee to determine which other public enterprises will be sold to the private sector. In fact, some public enterprises are already in the process of being offered for sale.

My authorities remain committed to attaining the original target for the public sector deficit of 5.5 percent of GDP by the end of 1984. The attainment of this objective, however, is made more difficult by the impact that higher external and domestic interest rates impose on the budget since higher interest payments imply a more restrictive fiscal adjustment.

My authorities intend to activate the contingent expenditure provision contained in the 1984 budget. The main reason for this decision is to offset the adverse impact of the rise in international interest rates, which is estimated to be of the order of US$1.1 billion on account of external interest payments only. The impact of interest payments on the budget is much greater when account is taken of the rise in interest payments to service domestic debt. The increases in interest rates have an adverse effect on economic activity, since the additional debt service absorbs a greater share of public expenditure that otherwise would have been channeled to productive and labor-intensive investment, contributing to the creation of employment. Furthermore, higher international interest rates have pushed domestic interest rates up from the lower levels that would otherwise have been warranted, given the decelerating trend of domestic inflation. Thus, the purpose of activating the contingent expenditure provision is to offset these unfavorable effects.

Activating the contingent expenditure provision does not add to inflationary pressures. Its monetary impact is neutralized by the increased outflow in the form of higher interest rate payments abroad, avoiding pressures on domestic demand and, thus, on inflation. Moreover, the prevailing level of deposits in the financial system will allow the activation of the contingent expenditure provision to be financed with domestic savings.

The restrictive stance of fiscal policy has been accompanied by a prudent management of monetary and credit policies, resulting in a favorable evolution of the financial and monetary variables in the first six months of the year. The strong growth of financial savings in commercial banks on the order of 75 percent has in turn allowed an expansion of domestic credit to the private sector, reflecting a gradual restoration of confidence. Instrumental to this development have been the realistic interest rate policy pursued and the noninflationary financing of the public sector deficit. Since mid-May, interest rates have again become positive in real terms. Credit by the Banco de México to the public sector has also declined in real terms. The annual growth rate of the money supply of 58 percent in the 12 months ended in June is below the rise in prices and largely reflects the increase in international reserves. Moreover, there has been an increase in the demand for money induced by lower inflationary expectations.

Structural measures adopted in the nationalized banking system have improved its efficiency and thus enhanced its intermediation role, as reflected not only by the strong growth of financial savings mentioned above, but also by the substantial reduction in the spread between borrowing and lending rates, while increasing profits. The reduction in the number of banks and the improvement in the structure of charges have also contributed to this end. More recently, the authorities have reduced financial subsidies on loans provided by development banks and official trust funds, by increasing lending rates and linking them to the average cost of funds. It is expected that financial subsidies will decline further as inflation continues to fall, since remaining subsidy rates are fixed in nominal terms.

My authorities will continue considering measures to increase the efficiency of the financial system so as to allocate resources better. To this effect, a number of banking reforms will be submitted to Congress for consideration later this year, including an amendment to the charter of the central bank that would limit the maximum amount of credit the Banco de México may provide to the public sector.

Price policy has remained consistent with the objectives of the 1984 economic program. The reduction of subsidies and the elimination of numerous price controls in 1983 have resulted in the need for smaller corrective price adjustment in the current year. Nevertheless, prices and subsidies have continued to be adjusted to encourage production and investment. Last May, the authorities increased agricultural support prices and those of some consumer goods. To protect low-income groups, price controls will continue to focus primarily on basic consumer goods, which have the greatest impact on the welfare of the poorest wage earners.

With regard to wage policy, my authorities strongly hold the view that labor unions have been responsible and cooperative, thereby making possible successful wage negotiations.

Directors may remember the dramatic real wage decline in 1983, which represented a cut in minimum real wages of more than 20 percent. I cannot recall a similar cut in wages in any other country without social unrest. Once this drastic adjustment has been made, requirements of social cohesiveness and, indeed, the political viability of the program itself call for avoiding a further deterioration in the purchasing power of wages. Thus, the authorities' intention has been to maintain the current purchasing power of real wages. The 1984 wage negotiations, however, could result in a further small fall in average real wages.

That social and political considerations do not figure in the staff report does not mean they are not important. Social and political constraints are as real and as important as economic ones, and they should not be judged lightly. My authorities have instructed me to stress that the adjustment achieved in Mexico has touched on the verge of social tolerance and, therefore, extreme care must be exercised in assessing as sensitive an issue as wage policy.

After the substantial depreciation of the peso in 1982 and 1983, exchange rate policy has been managed flexibly so as to strengthen the balance of payments, eliminate arrears, and rebuild reserves. Despite this, from time to time questions arise whether the current pace of depreciation is adequate. It should be recalled that, following a large devaluation, domestic prices unavoidably increase faster than external prices for a time. This was the case following the 1954 Mexican devaluation when, particularly in the subequent two years, domestic prices rose faster than external prices. This did not prevent the maintenance of a fixed exchange rate until 1976 at a satisfactory level of competitiveness, as shown by the growth of exports of manufactures that prevailed during most of this period.

More than by statistical studies based on questionable assumptions and theoretical shortcomings, the competitiveness of an exchange rate is to be assessed by looking at the balance of payments results and prospects. In 1984, the high competitiveness of the peso has been reflected in the great dynamism of import substitution and in the strong growth of non-oil exports. These encouraging developments have, in turn, resulted in a substantial increase in international reserves. Thus, the external sector of the economy is clearly responding to the flexible management of the exchange rate, making the peso highly competitive. Nevertheless, the authorities will follow closely balance of payments developments and, if needed, will review current exchange rate policies.

Second, the small parallel market that appeared last March has almost been eliminated. The differential between the free and the parallel market rates has been reduced from 10 percent to less than 2 percent. It is clear that the appearance of this market was a temporary development caused by factors other than domestic economic policies, particularly the uncertainty following the increases in international interest rates. A flexible exchange rate policy combined with the expected deceleration of inflation in the second half of the year will consolidate the competitive gains already achieved while keeping under control the pressures in the parallel market.

Third, my authorities remain committed to the eventual unification of the dual exchange market. Nonetheless, the current exchange arrangement will be maintained for the time being, so as to guarantee orderly conditions in the capital account.

My authorities are committed to a policy of import liberalization. They recognize its benefits for resource allocation and its contribution to the fight against inflation. Liberalization of imports increases the supply of goods and limits monopolistic and oligopolistic practices. The authorities have devised a gradual and pragmatic strategy to avoid an adverse impact on economic activity. Liberalization has proceeded in accordance with this strategy, as stated at the beginning of the 1984 program. The elimination of licenses has continued this year, as seen by the approval of import permits on the order of US$7.3 billion as of June 1984. Notwithstanding this action, the number of unused import permits has remained high. It should be noted that the 31 percent increase in overall imports this year is composed of an 11 percent increase in public sector imports and a 72 percent rise in private sector imports, a rate that can hardly be termed restrictive if consideration is given to the low level of economic activity. The trade system will continue to be revised, with a view to rationalizing its structure and decreasing its restrictions. A recently announced decision to exempt a further 800 tariff items from import licensing requirements will become effective in the coming weeks, as the new import duties are established. Moreover, the life of existing import permits has now been extended from six to nine months. These measures should be seen as part of the programmed revision of the trade system.

Substantial progress has been made in restructuring the private external debt and in reducing reliance on external borrowing. As mentioned before, with the support of the facility for the coverage of foreign exchange risks (FICORCA), all remaining arrears of the private sector were eliminated last March, improving Mexico's creditworthiness. In strict adherence to the program, the net foreign borrowing requirement of the public sector has been drastically reduced. Last April, a credit of US$3.8 billion was agreed with commercial banks on substantially better terms than last year's. Net borrowing in the first six months of this year amounted to only US$1 billion. Financing will continue to be provided mainly by domestic savings, foreign borrowing serving as a supplementary source.

Essential to attaining Mexico's goals of adequate rates of economic growth and price stability in the medium term are an orderly rescheduling of maturities falling due in the rest of the decade and the country's return to normal access to international capital markets. Equally important is a lowering of international interest rates and a stronger expansion of foreign trade. Prospects for the first two are encouraging. The first round of negotiations between the Mexican authorities and commercial banks for the rescheduling of maturities falling due in 1985-90 has already begun. The multiyear rescheduling aims at a viable debt service burden and a balance of payments position in the medium term consistent with adequate rates of economic growth.

To that end, it is necessary to attain a more balanced structure of payments of principal, avoiding any bunching of maturities. The terms of this rescheduling should reflect the improved creditworthiness achieved by Mexico and contribute to the prompt normalization of its access to international capital markets.

In contrast to these developments, trends in international interest rates and world trade are now, even more than before, a cause for concern. If trade protectionism and high levels of interest rates do not subside, they would endanger Mexico's progress toward attaining its medium-term goals.

In sum, the economic program for 1984 is consolidating the gains of the adjustment initiated by the current administration in December 1982. Substantial progress has been achieved in strengthening the balance of payments, lowering the inflation rate, and re-establishing the basis for sustained economic growth and price stability in the medium term. The authorities have clearly expressed their commitment to continuing the adjustment envisaged over the remainder of the program with the same firm determination as they have shown so far.

Mr. Arias stated that the Mexican authorities deserved the respect of the Executive Board for their courage and determination in implementing the adjustment program, and for making heavy sacrifices. The main objective of the 1984 economic program--to continue adjustment, while resuming growth and avoiding any rekindling of inflation--was obviously a challenge. The program was thus far on track: all performance criteria had been observed, in some cases with substantial margins.

In the fiscal area, public sector savings had increased by about 5.8 percent of GDP between 1982 and 1983 and were expected to reach a positive level in 1984, Mr. Arias noted. Progress had also been made in the monetary area with a further reduction in the spread between deposit and lending rates and a return to positive real interest rates. The real growth of the broadest monetary aggregates indicated increased confidence in the Government's success in reducing inflation. Mr. Senior had appropriately stressed the contribution of the labor unions to that outcome. He, himself, fully agreed that the adjustment achieved by Mexico had touched on the limits of social tolerance.

On the external side, Mr. Arias went on, the improvement in the current account balance in the first quarter of 1984 reflected the appropriateness of the exchange rate adjustment. Significant success had also been achieved in narrowing the spread between the exchange rates, a move toward unifying them. He could support the authorities' intention to maintain a free market as a safety valve.

Mexico had undoubtedly regained the confidence of the international financial community and had successfully negotiated a US$3.8 billion loan under more favorable terms and conditions, Mr. Arias said. He welcomed Mr. Senior's statement that the prospects for an orderly rescheduling of maturities and a return to a policy of borrowing more voluntarily by Mexico were encouraging. He shared Mr. Senior's concerns about the trends of international interest rates and world trade. Finally, the Mexican authorities had successfully carried out their economic program, and he could support the proposed decisions.

Mr. Wicks stated that he endorsed the staff's appraisal and supported the proposed decision. In the first 18 months of the extended arrangement, the Mexican authorities had turned their economy around. Perhaps the most significant proof of that success was the commercial banks' agreement to negotiate a multiyear rescheduling, in which the Managing Director had played a central role.

With external consolidation well advanced, the focus of attention should turn to the domestic economy, Mr. Wicks remarked. He was particularly encouraged to note that the trough of the recession seemed to have passed. While there was some way to go before the per capita income levels of 1981 were regained, the recent increase in employment, the recovery in industrial output--especially in the tradable sector--and, the improvement in business confidence were welcome signs of revival.

In order to sustain that recovery, it would, however, be important for the authorities to make further progress on inflation, Mr. Wicks considered. While he appreciated the social and political difficulties involved and noted the substantial drop in real income over the past few years, success on the inflation front was likely to require continued firm wage restraint. It would also be important to press ahead with structural reforms, particularly unification of the exchange market, phasing out of price controls, firmer control over the parastatals, development of new sources of revenue, and replacement of import restrictions by a tariff system. Among those measures, he attached particular importance to tariff reform, which would raise revenue and domestic savings, promote competition, restrain inflation, and improve allocative efficiency in general. Even though some structural improvements had been made, he was sorry that the timetable for reform had slipped and urged the authorities to give high priority to regaining lost time.

More generally, he hoped that future structural reforms would be directed toward developing the private sector, a crucial issue that had not been addressed in the staff paper, Mr. Wicks continued. Could the staff comment on the reactions of domestic and foreign investors to the recent modifications in the Foreign Investment Law, as well as on the prospects for further direct investment?

As for fiscal policy, the reduction in the fiscal deficit by 9.5 percent of GDP in 1983 had been most impressive, Mr. Wicks remarked. He noted, in particular, the substantial improvement in the operating balance of PEMEX, the state oil company, the increase in federal government revenue of 2.2 percent of GDP, and the diminution of exchange losses. However, despite a reduction in capital expenditure and commendable wage restraint, federal government current expenditure had continued to grow as a percentage of GDP, owing to the sharp increase in interest payments and rising subsidies and current transfers. The authorities' intention to reduce subsidies substantially in 1984, particularly in the public enterprise sector, was therefore welcome. While the public sector price increases announced earlier in 1984 had been appropriate, he was concerned about the authorities' decision to postpone a number of other price adjustments. As Table 14 in SM/84/165 showed, the financial position of the state enterprises other than PEMEX remained difficult, and operating expenditure, though projected to improve, would still exceed revenues by one third in 1984. He hoped that the authorities could make further progress.

The rising international interest rates, while admittedly a matter of concern to the authorities, further reinforced the need to reduce domestic inflation, both to restrain nominal domestic interest rates and to avoid the necessity for a faster devaluation of the peso and, consequently larger domestic counterparts to foreign interest payments, Mr. Wicks continued. He noted from Mr. Senior's statement that, as a result of increased interest payments, the authorities had decided to activate the contingency reserve. There was a strong case for seeking to offset the adverse effects of high international interest rates by action elsewhere in the budget, but he could appreciate the circumstances in which the decision to activate the reserve had been made.

On monetary policy, he endorsed the staff view that further improvements in the structure of interest rates were needed to reduce financial subsidies, Mr. Wicks went on. He welcomed the authorities' recent agreement on that issue with the World Bank. The substantial overshooting of the lending limit by the development banks and trust funds was a cause for concern, even though it had been offset elsewhere and efforts had been made to reduce the concessionality implicit in such lending. A major objective of the lending ceiling had been to limit subsidies provided in that way.

He was encouraged to see that interest rates had again become positive in real terms and strongly urged the authorities to ensure that they would remain so, Mr. Wicks commented. What was the staff's view on the extent to which the reappearance of negative real rates in the first quarter of 1984 might have been a factor explaining the increase in the errors and omissions item? Could the staff or Mr. Senior provide any further details on the development of nonbank financial markets?

The authorities should be congratulated for the encouraging progress on the external side, especially the continuing impressive performance of nontraditional exports, the elimination of arrears, and the $3.3 billion increase in reserves forecast for 1984, Mr. Wicks said. In view of that improvement, it was hard to argue with the authorities' contention that the current rate of depreciation of the peso was not yet having an adverse effect on the external position. Nevertheless, the existence of a third, informal exchange market offering a discount on the free market rate was a cause for concern, although he was glad to hear from Mr. Senior that that market had been almost eliminated. However, as domestic activity recovered, imports were likely to rise, and exports might be diverted to the domestic market. He therefore encouraged the authorities to continue to keep a close watch on the exchange rate.

In sum, the consolidation of the external accounts was on track, Mr. Wicks considered, but the medium-term prospects served to emphasize the magnitude of the task in hand. Increasingly, such consolidation required the control of inflation and the implementation of structural reforms. He hoped that, by the time of the next Executive Board discussion of the Mexican economy, progress would have been made in that direction.

Mr. de Maulde indicated his general agreement with the staff report and the proposed decision. He agreed with Mr. Senior that in the future the staff should give more emphasis in its papers to the social and political constraints in a country and the domestic impact of high international interest rates. However, it was essential to focus staff reports on economic and financial matters, rather than overburden them with too many peripheral considerations.

In the conduct of economic policy the main difficulty facing governments was the detection of the precise moment when the economy had improved sufficiently that short-term adjustment measures could be replaced by more general adjustment measures aimed at raising the standard of living of the population, Mr. de Maulde considered. Mexico's comprehensive stabilization program was gradually being transformed into a recovery program. Mexico should receive the full support of the international financial community, as it had proved clearly that Fund programs need not lead to perpetual restraint. The positive steps taken, at the Managing Director's initiative, by the commercial banks to renegotiate Mexico's external debt on a multiyear basis were most welcome.

The adjustment program was largely on track, Mr. de Maulde observed, but increased attention should be given to reducing inflation further. The behavior of prices during the first half of 1984 was a cause for concern. Even though a sharp reduction in inflation was expected for the second half of 1984, the projected target of limiting inflation to 40 percent would be exceeded. The authorities should take action to avoid any further deviation from the inflation target and to reduce inflationary expectations. He agreed with Mr. Wicks that wage negotiations would continue to be of critical importance in that regard.

On the financial aspects of the program, he broadly agreed with the staff recommendations, Mr. de Maulde continued. Monetary and credit policy should remain cautious, and positive real interest rates should be maintained so as to generate savings.

The authorities' determination to implement a restrictive fiscal policy despite adverse developments was commendable, Mr. de Maulde remarked. The main burden of adjustment would be borne by public finances, with a projected reduction of the deficit to 5.5 percent of GDP. Could the staff indicate the eventual inflationary impact if the contingency expenditure reserve were activated?

On the external side, Mexico's previous balance of payments performance had been impressive, and there was no reason to question the ambitious targets for the remainder of the year, Mr. de Maulde considered. The staff had expressed some concern about the exchange rate policy, but he was confident that the authorities stood ready to take any timely countermeasures that might be necessary in case of a loss in competitiveness. He welcomed the authorities' intention to return as soon as possible to a unified exchange system. Had the staff discussed any precise schedule with them?

Mexico was entering a new phase of adjustment, and he agreed with the authorities that it was important to resume economic growth in order to cope with the annual population increase of 2.7 percent, Mr. de Maulde said. The reorganization of the economy was well under way, and the most obvious imbalances had been eliminated. Nevertheless, some weaknesses remained and called for further correction. Together with adjustment action, recovery measures should be implemented only with caution and with a clear awareness of their impact, particularly on the rate of inflation. The main economic partners of Mexico could contribute to the country's recovery by abstaining from raising new trade barriers and by lowering their interest rates.

Mr. Coumbis remarked that the spectacular results achieved by the Mexican authorities with respect to public policy and the balance of payments in 1983 had been analyzed fully at EBM/84/35 and EBM/84/36 (3/2/84). Mexico was complying with all quantitative performance criteria for the first quarter of 1984, and most targets had been met with substantial margins. The balance of payments position continued to be strong, and net international reserves had increased by about $1 billion during January-May 1984. Mexico's creditworthiness had improved considerably, and in April 1984 Mexico had been granted a US$3.8 billion loan, with favorable terms, by a group of 500 commercial banks.

There were, however, a few areas of concern, which indicated that the authorities must continue pursuing adjustment with vigor and determination, Mr. Coumbis stated. First, although inflation had decelerated from 100 percent in 1982 to 80 percent in 1983, the rate of inflation for the 12-month period ended May 1984 had been reduced only to 67 percent compared with the 1984 target of 40 percent. The authorities considered that a rate of inflation of 50 percent at end-1984 would be more realistic than the targeted 40 percent, but recent evidence suggested that inflation in 1984 would probably be even higher than 50 percent. The staff attributed that unfavorable development to the public sector price adjustments, a low rate of import liberalization, and the 30 percent increase in minimum wages in December 1983.

Second, after real minimum wages had declined by about 17 percent in 1983, Mr. Coumbis noted, the authorities were planning to accept wage increases in 1984 that would result in a cumulative increase of minimum wages of about 56 percent, in order to maintain the average purchasing power of 1983 minimum wages. While that increase was perhaps necessary to appease social unrest, it was a serious constraint in the effort to decrease inflation.

Third, developments in output and employment had not been encouraging in 1983, Mr. Coumbis said. Output had contracted sharply in the second half of 1982 and the first half of 1983; as a result, about 300,000 workers had been laid off, and real GDP had declined by 4.7 percent in 1983. The Mexican authorities were confronted with the problem of fighting inflation, while encouraging a sustainable growth of real GDP, which was expected to increase by 1 percent in 1984. However, developments with respect to wages in 1984 indicated that the authorities' room for maneuver was diminishing because of social constraints.

In his statement, Mr. Senior had indicated that the authorities were planning to use the contingency reserve to offset the adverse impact on the economy of the rise in international interest rates, Mr. Coumbis observed. He could understand the authorities' view, but, as the rate of inflation was still high and the policy options in the fight against inflation were limited, he would suggest that the authorities postpone the use of that reserve until later in the year, when there was some indication that the rate of inflation might reach the 40 percent target.

The revised medium-term balance of payments projections were optimistic, even more so than Scenario B in Supplement 1 to EBS/84/1 (1/27/84), which had suggested that the achievement of an equilibrium current account position in 1988 would be consistent with more restrained aggregate demand policies and a more aggressive exchange rate policy, Mr. Coumbis noted. The projections in SM/84/155 had been revised in the light of recent developments and prospects for foreign borrowing, but the major macroeconomic assumptions made in the earlier papers had been maintained. Could the staff explain in greater detail why recent developments justified a revision of forecasts for the entire period 1985-90? Recent developments, particularly with respect to imports, were associated with special factors that would not prevail for the whole of that period.

He welcomed the fact that Mexico had maintained close links with the World Bank during implementation of the adjustment program, Mr. Coumbis said. The Bank operations had covered major sectors of economic activity, including project and program lending, and the staff had also assisted Mexico in evaluating its current public investment program. The Bank's involvement in Mexico's development plan and its close cooperation with the Fund were important for the successful implementation of the adjustment program. Finally, he urged the authorities to review the tariff structure, to act promptly to dismantle the dual exchange system, and to replace the import licensing system by a comprehensive import tariff.

Mr. Nimatallah indicated his agreement with the staff's analysis and his support for the proposed decision. Considerable progress had been made in 1983 in reducing the internal and external imbalances in the Mexican economy. The rate of inflation had declined; the fiscal deficit had been sharply reduced; the balance of payments had strengthened considerably; and Mexico's relations with its creditors had been generally normalized. He commended the authorities on those achievements, which had resulted from serious and determined adjustment efforts, and the Fund for its role in supporting the authorities.

Developments thus far in 1984 indicated that further progress had been made in lowering inflation, reducing the fiscal deficit, and strengthening the balance of payments and reserve positions, Mr. Nimatallah commented. After a decline in economic activity over the past two years, it was particularly encouraging to see a resumption of growth in 1984.

Mexico would continue to face a difficult external payments situation, owing to large debt repayments to be made over the coming years, Mr. Nimatallah went on. Although a sustained recovery in the world economy should be helpful to Mexico, the achievement of a sustainable external position in the medium term would depend mainly on the continued pursuit of vigorous adjustment efforts by the authorities.

The fight against inflation was beginning to show gradual results, but much remained to be done, Mr. Nimatallah considered. Priority should be given to the objective of controlling the unacceptably high rate of inflation. Success in that area would help to reduce the social and political pressures for granting large wage increases, improve the competitiveness of exports--thereby reducing the pressure on the exchange rate and improving the balance of payments--and increase credit to the private sector, which would, in turn, enhance the growth prospects of the economy.

Several policies would have to be pursued simultaneously if significant progress were to be made in the fight against inflation, Mr. Nimatallah said. First, the fiscal deficit should be kept under control in order to reduce the need for external and domestic bank financing of the deficit, thereby limiting the pressure on the external debt ratio and inflation. He noted from Mr. Senior's statement that the authorities intended to activate the contingency expenditure provision in the budget. While the staff considered such action inadvisable in view of the present rate of inflation, the authorities' view that activation of the reserve would not be inflationary was perhaps understandable, given the takeoff of the recovery and the possible strain on liquidity created by interest payments on debt. On the other hand, the staff's apprehension could be warranted unless the authorities made substantial gains in controlling inflation. Could Mr. Senior and the staff elaborate on the question of the contingency expenditure provision? He thought that the program for the second year of the extended arrangement had been based on the assumption that an understanding would be reached between the authorities and the Fund on the contingency reserve.

Second, wage policy should be supportive of efforts to fight inflation, Mr. Nimatallah continued. Considerable political and social difficulties were associated with the issue of wage settlements, but wage restraint was essential to the objective of controlling inflation. The minimum wage had been increased by 20 percent in June, bringing the cumulative increase in the minimum wage to 56 percent in 1984, a development that hindered the achievement of the inflation target.

Third, in light of the resumption of economic growth and the substantial improvement in the balance of payments and reserve positions, import policies should be liberalized further, Mr. Nimatallah remarked. A more liberal import policy would help to increase economic efficiency, reduce the cost of domestic production, allow businesses to acquire the necessary inputs to enhance their growth prospects, and, in general, improve the allocation of resources. Those benefits would contribute to the success of the fight against inflation.

The complex exchange system introduced in late 1982 had been necessitated by the unusually difficult financial situation facing Mexico at that time, Mr. Nimatallah commented. Since then, considerable progress had been made in simplifying the exchange system and narrowing the spread between the controlled and the free-market rates. The authorities were to be commended on their pursuit of a flexible exchange rate policy. Nevertheless, he shared the staff's concern about the emergence of an informal exchange market--where the U.S. dollar had a premium over the free-market rate--which he hoped would prove a temporary phenomenon, as the authorities believed it to be. In any event, he welcomed their intention to keep developments in the exchange markets under review and to consider alternatives to present policies if necessary. Their commitment to eventual unification of the exchange markets was appropriate.

Finally, the seriousness of the authorities' commitment to adjustment had convinced the commercial banks to start discussions with the authorities on a forward-looking approach to debt restructuring, Mr. Nimatallah noted. He hoped the authorities would achieve favorable results from those discussions and would continue with their adjustment efforts.

Mr. Templeman welcomed the opportunity to stand back from the immediate questions related to targets and performance criteria under the extended arrangement in order to survey the present state of Mexico's economic adjustment effort. Remarkable progress had been made in reducing the fiscal deficit, strengthening the balance of payments, and managing foreign debt; less progress had been made in restoring noninflationary growth. To some extent, the successes had been the result of corrections of obvious distortions in previous economic policies. He did not underrate the courage required to have brought that change about, but it seemed likely that further progress might be more difficult. Moreover, the progress achieved to date had occurred in an economic environment characterized by a large number of restrictive devices such as import licensing, price controls, and subsidized credit. The true test of present policies would occur only when economic recovery led to a revival of domestic demand and to potential pressures on the prices of labor, capital, and foreign exchange, and when the restrictive devices had been significantly reduced.

It had been clear from the start of the adjustment program that, with a public sector deficit equal to nearly 15 percent of GDP in 1981 and nearly 18 percent of GDP in 1982, the restoration of fiscal balance would be a key to success, Mr. Templeman remarked. In fact, that ratio had been cut by 9.4 percentage points in 1983, and a further cut of 2.9 percentage points, to 5.5 percent of GDP was expected for 1984. A further reduction to the targeted 3.5 percent of GDP in 1985 would present a serious challenge. Cuts in expenditures relative to GDP had been greater than revenue increases, and cuts in current expenditures had been greater than cuts in capital outlays. Wage restraint in the public sector had also been an important component of fiscal adjustment. Current transfers and subsidies relative to GDP had declined steadily from their 1980 peak. Capital expenditures were expected to recover somewhat in 1984. A strengthening of the financial position of public enterprises had helped to reduce the fiscal deficit, and the petroleum sector had made an increasing contribution to revenues. The achievement of the 1984 target ratio of revenue to GDP would represent an interruption in the previous rise in the tax burden.

As to the future, Mr. Templeman requested the staff or Mr. Senior to give some indication of the Mexican authorities' plans for further reducing the fiscal deficit beyond 1984. As a number of the more obvious distortions--the exchange rate losses and unrealistic prices for some public sector goods and services--had been eliminated, additional measures affecting revenue and expenditure might be more difficult to implement. He noted with interest the staff's suggestion that customs tariffs should be substituted for the import licensing system and that the array of tax exemptions should be reviewed. Such a shift to a pricing mechanism from an administrative mechanism could increase revenues and lead to a more efficient allocation of resources. However, continued public wage restraint was a sine qua non for further deficit reductions. On the other hand, the recent freeze on the prices of some public services and the intent to activate the contingency fund later in 1984 might be inconsistent with the aim of reducing the deficit.

The better than expected balance of payments position was a bright spot in the adjustment program and partly reflected the rapid growth of Mexico's export markets, Mr. Templeman observed. The sharp turnaround in the current account balance and the prospect for virtual balance in the medium term were also highly encouraging developments, which largely explained Mexico's improved creditworthiness and the prospect of a multi-year rescheduling with the commercial banks. However, continued close cooperation with Mexico's official and private foreign creditors would be necessary over the medium term. On the import side, although a sharp decline in imports had been a major factor in the improvement of the trade accounts, the extremely high import levels of 1980 and 1981 should not be viewed as a reasonable base. Also, a continued expansion of non-oil exports was essential, in view of the likelihood of relatively slow growth in oil exports.

On the exchange rate system, it would be premature to conclude that Mexican goods and services were not internationally competitive because of the real effective appreciation of the peso during 1983, Mr. Templeman continued. Export performance had been good; in view of both relative unit labor costs and relative price movements, the exchange rate did not appear to be overvalued. But, the continued appreciation of the exchange rate and failure to decelerate the rate of inflation would increasingly raise doubts about exchange rate policy. Although pressure on the peso in parallel markets appeared to have subsided somewhat, the differential between the so-called free-market rate and the rate in offshore markets and exchange houses in Mexico City continued to be perceptible. Furthermore, the errors and omissions item in the balance of payments had totaled more than minus $1 billion in the first quarter of 1984, compared with only minus $400 million in 1983. That those factors suggested some lack of confidence in the peso should not be ignored by the Mexican authorities, notwithstanding the impressive export performance and reserve accumulation during the first quarter of the year.

He could understand the authorities' desire to try to maintain both the real effective exchange rate and real interest rates at appropriate levels through a reduction in inflation rather than through increases in nominal exchange and interest rates, Mr. Templeman said. However, if inflation did not decelerate, too long a delay in adjusting nominal rates would be risky. He was concerned about the continuation of the multiple exchange rate system and about de facto limits on access to the free market. The authorities' commitment to exchange rate unification seemed vague, and failure to allow the free market to play a more important role would certainly lead to an expansion of the parallel market across the border.

Concerning trade policies, Mr. Templeman went on, he agreed with the staff's analysis of Mexico's import regime, particularly its assessment of the impact of continued import restrictions on inflation, fiscal revenues, and general economic efficiency. He strongly concurred with the staff's recommendation that the authorities should not delay comprehensive reform of the trade system. Although Mexico had suspended its main subsidy program--and he strongly supported that decision--it still relied to some extent on other forms of subsidies, notably on export credit. The Mexican authorities should move rapidly to eliminate such subsidies, as their use, currently or in the future, was not in line with the Government's stated intentions to rely more on market forces and to avoid costly expenditure programs.

In the key areas of growth and inflation, Mr. Templeman welcomed the signs of economic recovery. While Mexico's successful adjustment offered a certain margin for economic recovery to occur without the re-emergence of balance of payments and stronger inflationary pressures, the margin was narrow. Public savings were expected to amount to 2.5 percent of GDP in 1984, compared with negative savings of nearly 7 percent of GDP in 1982, and financial savings seemed to be growing. He was therefore somewhat puzzled by the projected decline in the national savings rate in

1984; a recovery of savings and investment would be crucial to sustain growth. On the inflation front, he shared the authorities' disappointment about the large overshooting of the 1983 target, a development that underlined the importance of continued wage restraint, particularly if a wage-price cycle were to be avoided and if inflationary expectations were to improve. He encouraged the dismantling of measures that served to repress rather than reduce inflation, including price controls in some areas and the slow rate of import liberalization.

Foreign direct investment could play an important role in long-term economic growth, Mr. Templeman considered. The authorities' stated intention to encourage greater inflows of foreign direct investment had not been accompanied by systematic improvements in the environment for such investment. Indeed, recent decrees in the automotive, pharmaceutical, and computer sectors had added new restrictions, and he understood that similar restrictive decrees were being contemplated in other sectors of great interest to potential foreign investors. He hoped that the authorities would address other economic policies that had distortive effects, including local content, export performance, and equity participation requirements for foreign investors, as reflected in recent sectoral decrees.

Finally, concerning monetary developments, the sharp reduction of the public sector deficit had reduced the danger that the Government would pre-empt available credit, an important consideration given that economic recovery should lead to a revival of private credit demand, Mr. Templeman commented. Still, broad money had grown more rapidly than expected in 1983, and velocity was expected to continue rising in 1984. The staff stated that the increase in nominal interest rates in May had restored real positive rates. However, Chart 5 of SM/84/155 indicated that rates were slightly negative. What were real interest rates at present? Positive real interest rates were important in restoring savings levels, allocating capital efficiently, and avoiding the capital outflow problems of the past. In addition, the continued availability of subsidized credit for industrial promotion, agricultural restructuring, and export promotion raised questions about efficient allocation of resources.

Mr. Joyce commended the Mexican authorities for the decisive steps taken to correct the domestic and external imbalances in their economy. He agreed with the staff that Mexico had made remarkable progress in the past 18 months in overcoming the serious crisis of late 1982. Mexico provided an example of what could be achieved in a relatively short period of time if the authorities determined to carry out a well-defined program of adjustment.

The economy had continued to make substantial progress, in the first quarter of 1984, Mr. Joyce observed. While the world economic recovery, and particularly the recovery in the United States, had helped Mexico, much of the country's improvement had clearly been a result of the adjustment measures taken by the authorities. Drastic cuts in the public sector budget deficit had made a major contribution to adjustment.

There was a need to maintain domestic and international confidence in the economy, Mr. Joyce stated. It was important, therefore, that there be no relaxation in fiscal and monetary policy. Indeed, the continued strong inflationary pressures, as evidenced by a projected inflation rate of about 50 percent for 1984, as well as the continuous need to service the large external debt, suggested that high priority should be given to a determined attack on structural rigidities and distortions in order to improve the supply capacity of the economy.

He urged the authorities to resist the temptation to use expansionary short-run demand measures to raise output, Mr. Joyce went on. At best, the beneficial effects on output would be temporary and the progress already made toward reducing the inflation rate could be compromised. He therefore agreed with the staff that it would be inappropriate at present to use the contingency reserve, but he noted from Mr. Senior's statement that the authorities intended to activate that reserve. What were the staff's views on Mr. Senior's comments? In his own view, the release of those contingent funds could unleash excessive demand pressures. Moreover, activation of the contingency provision at present, when inflation remained high and when a recovery in output was apparently under way, could be interpreted by the market as a significant weakening in the authorities' resolve to continue the fight against inflation. He was not sure how long it would take to activate the contingency provision, but its effects, particularly on revenues as distinct from expenditures, might not be felt until 1985 in which event the achievement of the target for the public sector deficit of 5.5 percent of GDP would be jeopardized. Although sympathetic to the plight of the Mexican authorities with respect to rising interest rates, he urged them to delay use of the contingency reserve.

While the Mexican authorities had made significant progress in implementing adjustment measures, a number of areas would require close monitoring, Mr. Joyce considered. First, success in dealing with inflation would be a key to determining the degree to which further progress could be achieved in the overall adjustment program in 1984. The latest data indicated that inflation had risen by 3.6 percent in June, resulting in an annual rate that was virtually unchanged at 67.1 percent. Efforts at reducing inflation had been less successful than expected, in part, because of the corrective price adjustments made by the authorities. As price adjustments were expected to be less of a factor in the second half of the year, inflation might decelerate in coming months. Nevertheless, he was concerned about the possible adverse impact that the recent high wage increases would have on labor costs and inflationary expectations. He urged the authorities to exercise care in future wage negotiations to ensure that wage settlements were consistent with the goal of reducing inflation.

Second, as excess demand pressures had not disappeared from the Mexican economy, tight control over public sector expenditure remained essential, Mr. Joyce stated. In particular, there could be no slippage in meeting the first target of achieving a public sector deficit of

5.5 percent of GDP. Substantial support toward that goal had come from the revenue side through price adjustments on goods and services provided by public sector enterprises and improved revenue collection. The replacement of the existing import permit system with a comprehensive tariff system would contribute to increasing revenues. Only by strengthening the revenue base through such measures would the authorities provide extra room in the public sector budget for the capital expenditure necessary to improve the economy's productive capacity.

Third, he welcomed the restoration of positive real interest rates through rate adjustments and a reduction in financial subsidies, Mr. Joyce continued. Unless private sector financial savings were encouraged by a reduction in inflationary expectations and realistic interest rates, the plan to rely less on foreign savings in financing the public sector deficit, a key element in the economic adjustment program, could become increasingly difficult to implement.

Fourth, while the continuing strength of the trade account reflected the economy's underlying competitiveness, the real effective exchange rate had been appreciating recently, a development that should be monitored closely, Mr. Joyce stated. While he welcomed the authorities' commitment to making necessary adjustments to the exchange rate if necessary, he shared the staff's concern that the maintenance of broad import restrictions and controlled access to the free market through administrative measures was unlikely to restore confidence in the peso. He urged the authorities to liberalize imports further and reduce the restrictions on currency transactions. Such initiatives would help to restore more normal external trade flows and financial relationships. For example, the $10 billion improvement in the balance of payments capital account in 1983 had been due to the virtual disappearance of speculative outflows, giving an indication of the benefits that could result from measures enhancing confidence in the trade and payments system, including the elimination of multiple exchange rates.

Fifth, the medium-term projections of the balance of payments and public sector debt in Tables 9 and 10 of SM/84/155 clearly indicated that successful management of the debt situation would depend on the maintenance of a strong trade surplus, a restructuring of debt, a reduction in net borrowing requirements, and the provision of sufficient financing, Mr. Joyce noted. Given the forecast of total external public debt in excess of $77 billion by the end of 1990, the authorities would have to pay close attention to the management of debt over the long term. They must also ensure that borrowed funds were directed toward productive sectors of the economy.

Finally, recent internal and external developments indicated a much improved outlook for the Mexican economy, Mr. Joyce said. He agreed with the staff and Mr. Senior that there had been significant progress; economic activity was picking up, external arrears had been eliminated, the profile of public and private sector debt had been significantly improved through debt restructuring, and net foreign borrowing by the public sector had been reduced. Those developments, together with improved borrowing terms and an offer by the commercial banks to reschedule on a multiyear basis, attested to the improved standing of Mexico. The Managing Director deserved much of the credit for initiating the proposal for multiyear rescheduling by the commercial banks. Mexico was a good place to start such an approach to rescheduling. The willingness of some major commercial banks to increase their net exposure and move from involuntary to voluntary lending also indicated the renewed confidence of the commercial banks in the Mexican economy.

In sum, if the authorities could consolidate the progress made so far, remain flexible in making necessary policy adjustments, and take advantage of the improved international confidence, there could be a sustainable economic recovery, Mr. Joyce said. The time had come for the authorities not only to begin building on the successes already achieved but also to pay greater attention to establishing a longer-term framework of sustainable growth. The shifting of gears, which must be smooth and well programmed, was vital if Mexico was to effect the transition from a world of financial crises to one that offered hope for continued progress and development.

Mr. Grosche indicated broad agreement with the staff appraisal and support for the proposed decision. Developments in 1984 had been broadly positive, and the authorities were to be commended for their firm adjustment policies. He hoped they would continue to be successful in maintaining a social consensus, which was crucial for further progress.

Less satisfactory had been the authorities' efforts to reduce inflation, Mr. Grosche noted. It appeared that the inflation rate would exceed the 1984 target by a substantial margin, owing partly to the adjustments in public sector prices and tariffs. Nevertheless, it was appropriate that the authorities had made the reduction in inflation one of their central policy objectives. Wage policy and import liberalization could be supportive of that objective.

Wages should be adjusted only very cautiously, Mr. Grosche considered. Although the authorities might be correct that, considering the substantial real reduction of wages in 1983, a targeted cumulative increase of 56 percent for 1984 would be consistent with an inflation rate of less than 50 percent, that target would not be an ambitious one. Moreover, it could be thought that the authorities were aiming at an inflation rate of 56 percent, given their intention to maintain the current purchasing power of real wages. He agreed with the staff that great care needed to be exercised with respect to future wage adjustments.

He was concerned that progress toward import liberalization had been limited, Mr. Grosche stated. The staff had put forward convincing arguments that faster liberalization could help to control inflation and reduce distortions in the economy. He was not concerned so much about the level of imports in 1984, which was projected to increase substantially, but more about the structure of imports, as Mexico's industrial sector remained dependent on imports. Many problems arose from the present restrictive trade system. He therefore urged the authorities to complete the envisaged comprehensive reform of the system of trade protection as soon as possible.

Additional fiscal revenues would be generated if the system of import permits were replaced by a comprehensive tariff system, and the deficit could be reduced further, Mr. Grosche went on. The staff had advised against the use of the contingency reserve, as it would indicate an easing of the authorities' fiscal stance. As he understood it, use of the reserve would not lead automatically to an increase in the overall public sector deficit, as targeted for 1984. Given that the envisaged reduction of the public sector deficit from 8.4 percent of GDP in 1983 to about 5.5 percent in 1984 seemed appropriate, he could understand the authorities' view that the contingent expenditure reserve should be used to offset the adverse impact of the rise in international interest rates. Furthermore, he would be interested in hearing the staff's views on Mr. Senior's statement that activating the contingency reserve would not have an inflationary impact.

He urged the authorities to continue pursuing a prudent monetary policy, Mr. Grosche commented. He welcomed, in particular, the increase of interest rates to positive levels announced in mid-May.

There were a number of ingredients necessary for a favorable outcome in the medium term, Mr. Grosche remarked. First, strong adjustment policies should be continued: the success attained thus far had been encouraging and should be broadened by appropriate structural reform. Second, external debt should be rescheduled on favorable terms, and developments in that respect seemed promising. A third ingredient would be normal access by Mexico to international capital markets, a factor that would depend to a significant extent on the first two ingredients that he had mentioned. Fourth, Mexico's medium-term outlook was dependent on developments in its main export markets and the degree of protectionism against its products. Finally, Mexico's successful adjustment was dependent on a reduction in international interest rates, a point on which he hoped the staff's projections in Table 10 of SM/84/155 were not too optimistic.

Mr. Polak remarked that economic adjustment in Mexico had been most impressive on the balance of payments side, and recent indications were even more positive than they had been at the Executive Board's previous discussion of Mexico. However, success must also be achieved in terms of activity, employment, and inflation. Activity was no longer declining on a year-to-year basis. In the staff report, he would rather have seen an ordinary index of industrial production than a year-to-year comparison, as it would have given some idea of turning points and recent rates of change. In situations where the question of turning points was so important, the staff should make a greater effort to appraise the underlying rate of industrial production or inflation, as the case might be. Comparisons with the situation 12 months earlier did not always efficiently demonstrate developments in the more recent past. In his view, the turning point in industrial production in Mexico had taken place in about September 1983, one year after the financial crisis. The fact that GDP might currently be increasing at about 4-5 percent per annum gave hope that the recession phase of the adjustment process might be over, and that production and employment would keep rising, provided that confidence was maintained.

The picture with respect to inflation was less reassuring and, incidentally, for the same statistical reasons, less clear, Mr. Polak went on. If the effect of the increase in controlled prices on the inflation rate for the first months of 1984 were eliminated, inflation would be approximately in line with the authorities' target of 40 percent, a considerable improvement. However, much progress was needed to reach the low inflation rate that had been characteristic of the northern Latin American countries in the past. Did the staff share his view that the current underlying rate of inflation was about 40 percent? The authorities should pursue a cautious wage policy and make rapid progress on trade liberalization.

With respect to the balance of payments, the 1984 forecast of imports had been reduced from the forecast in EBS/84/1 (1/3/84), Mr. Polak noted. He was glad that the forecast for imports had been scaled down to 50 percent, as he had thought that a 65 percent increase in imports had been slightly high. Equally welcome was the upward revision of non-oil exports, estimated to be more than one third above their 1983 level. The increase in the errors and omissions item was the one black spot in the balance of payments. That item had amounted to $8 billion in 1981, $10 billion in 1982, and had declined to $400 million in 1983, but in the first quarter of 1984 had increased once again to $1 billion. Newspapers seemed to indicate that there was a brisk buying of dollars in Mexico, a development that raised the question whether expectations with respect to the exchange rate were consistent with the current rate of depreciation. The rate of depreciation of 13 centavos a day was equivalent to 33 percent per annum, and represented a declining undervaluation, even if inflation were reduced to 40 percent. There was undoubtedly some room for a decline in the undervaluation. The base period 1978-82 used by the staff to measure an appropriate exchange rate was not entirely satisfactory, as between 1980 and 1982 the peso had been overvalued. The question was whether the market was confident that inflation would decline sufficiently and rapidly enough so that the exchange rate would not become too overvalued. The increase in the errors and omissions item was an ominous indication of market perceptions. The authorities' intention to monitor the exchange rate closely was not enough to ensure the necessary correction of the rate at the right time. By having selected a fixed daily rate of depreciation, the authorities had put themselves in a position where either a steep devaluation or a higher daily rate would be taken as a signal of some degree of failure. In retrospect, Mexico should have followed the Brazilian example of depreciating the exchange rate without committing itself to a fixed daily or weekly rate.

Nevertheless, in the circumstances, he agreed that Mexico could stick to the present rate of depreciation, Mr. Polak said. A positive sign in that connection was that the spread between the financial rate in Mexico and the free rate on the other side of the border had narrowed recently. However, if the process of depreciation were to remain adequate, the authorities would have to pursue appropriate policies in other areas. He did not include, among those measures, a further decline in real wages. There had been a dramatic real wage decline in 1983, and the political viability of the program currently called for stabilization of real wages, and perhaps some increase. Among the measures that did need to be taken so that the exchange rate policy would remain adequate was a tightening of monetary policy. The action already taken by the authorities in that area had caused real interest rates to reach positive levels, a development likely to have a direct effect on the demand for and supply of foreign exchange.

Second, the authorities must pursue a strong fiscal policy, Mr. Polak considered. There had been some slippages, especially with respect to expenditure on public sector enterprises, a constant pressure point in the Mexican economy.

Third, trade liberalization was called for, Mr. Polak continued. In 1983, he had welcomed the authorities' indication that they were prepared for speedy action, but their plan to replace import restrictions by tariffs had been delayed, and substantial liberalization was taking place only with respect to products not produced by Mexico. The prevailing degree of protection undoubtedly had some impact on inflation and was a matter for serious concern. Mexico had a long history of protectionism, even in the years of its most enlightened economic management. Broad protectionist measures of all sorts--such as restrictions of a discretionary nature and arbitrary trade restrictions--were both a natural response to an overvalued exchange rate and a dangerous indicator that the authorities themselves were not sufficiently confident in the current and prospective exchange rate for the peso.

The liberalization of trade was a major policy issue crucial to the entire program, and it should be recognized as such, Mr. Polak said. The authorities should take courageous steps toward trade liberalization, bearing in mind that the level of reserves was sufficient to take the burden off some associated risks.

As to the activation of the contingent expenditure reserve, only one of the two preconditions that the authorities had set themselves for activation had been fulfilled, Mr. Polak remarked. The precondition that noninflationary resources should be available had been fulfilled, but the other--that there should be evidence that economic activity was not recovering--had not been. He did not share Mr. Senior's view that the impact of activating the contingency reserve would be borne entirely by domestic savings. There would also be an impact on foreign exchange. He recognized that foreign exchange receipts had been above expectations and that, therefore, some setback could be accepted. However, activation could also be interpreted as evidence that the trade account was performing so much above expectations that Mexico would be able to stand some rise in world interest rates, a message that he was sure Mexico did not want to give. He agreed with the staff that it would be wiser not to activate the contingency reserve. In conclusion, he generally endorsed the policy approach followed by the authorities and was confident that further progress would be made toward a successful outcome.

Mr. Yamashita indicated his support for the staff appraisal and the proposed decision. The Mexican authorities should be commended for the notable economic and financial progress made thus far under the Fund-supported adjustment program. The public sector deficit had been reduced; the external position had been strengthened; the inflation rate had declined, although at a somewhat slower pace than originally expected. It was encouraging to note that the strong adjustment efforts by the authorities had greatly enhanced Mexico's creditworthiness, as indicated in the improved terms of borrowing from a group of foreign commercial banks.

Notwithstanding those favorable developments, the economy was not free of sources of concern, Mr. Yamashita went on. Price movements in the early months of 1984 had threatened the achievement of the inflation target of 40 percent for the year. Although the higher than expected inflation rate reflected, in part, essential price adjustments of public sector services and goods, the slower pace of import liberalization and the wage increases had been contributing factors. Obviously, further adjustment was called for if Mexico were to return to a path of sustained economic growth with stability.

On fiscal policy, the steadfast reduction in the public sector deficit should remain the key element of adjustment efforts, Mr. Yamashita continued. He commended the authorities for their firm commitment to reducing the fiscal deficit to 5.5 percent of GDP in 1984, despite the recent rise in domestic and external interest rates. It was reassuring that the deficit for the first quarter of 1984 had been well below target, reflecting both expenditure restraint and favorable revenue performance.

On the revenue side, he welcomed the price adjustments introduced earlier in the year, affecting petroleum products, electricity, and telephone services, Mr. Yamashita said. He endorsed the staff's suggestion that the conversion of the import licensing system to a comprehensive tariff scheme would not only contribute to enhancing efficiency in resource allocation, but also provide a new source of revenue.

On the expenditure side, adjustment should come mainly from a curtailment of current expenditures and transfers, while leaving room for a moderate real increase in high-priority capital expenditure, Mr. Yamashita considered. Although total expenditure had been contained within the program target, he noted the recent rapid increase in operating expenditures of the public enterprises. Could the staff provide further background on that development? Fortunately, the authorities were revising the expenditure plan to eliminate low-priority programs. The sale of some public enterprises in order to reduce the size of the public sector was also a step in the right direction. Regarding the contingency expenditure reserve included in the 1984 budget, it could be argued that the rise in interest rates and the continuous sluggishness in economic activity justified the activation of the reserves. Like Mr. de Maulde, he would be interested in the staff's comments on the interesting argument put forward by Mr. Senior in that respect.

As for monetary policy, developments with regard to credit had been encouraging, Mr. Yamashita observed. Credit to the private sector had grown rapidly in the first quarter of 1984, while the total credit expansion had been well within target. One of the most important monetary objectives should be the maintenance of positive real interest rates, which were indispensable for stimulating domestic savings and discouraging capital flight. Although there might be some argument for lowering interest rates in order to permit a recovery of private investment, any attempt to bring down interest rates ahead of actual inflation would undermine much-needed growth in financial savings.

A cumulative wage increase of 56 percent for 1984 seemed to have been unavoidable, given the significant decline in real wages during 1983, Mr. Yamashita remarked. Great care needed to be exercised with respect to future wage adjustments, if inflationary expectations were to be brought down completely.

On the external side, a continued flexible exchange rate policy was essential for maintaining competitiveness, Mr. Yamashita stated. The recent real appreciation of the peso in terms of relative prices gave rise to questions on the adequacy of the current daily adjustment system. He noted the authorities' view that a deceleration of inflation in coming months would prevent further losses in competitiveness. However, the present pace of adjustment--equivalent to an annual rate of about 33 percent--appeared likely to maintain competitiveness at the point reached at the end of 1983 only if domestic inflation could be contained within the original targets. In view of the present high rate of inflation, he agreed with the staff that the authorities should monitor the current and capital accounts closely and be prepared to take prompt action as necessary. Thus, the authorities' intention to keep a close watch on developments in that area was welcome.

Another source of concern was the relatively slow pace of import liberalization, Mr. Yamashita said. At present, import and foreign exchange permits were required for most import items. The maintenance of import protection would have an adverse impact on domestic prices. The replacement of the licensing system by a tariff system at an early date would contribute substantially to alleviating current problems. In conclusion, with perseverance and steadfast implementation of adjustment policies by the authorities, a resumption of sustained noninflationary economic growth would be well within reach.

Mr. Mtei stated that he agreed with the staff appraisal and could support the proposed decision. He joined other Directors in applauding the efforts of the Mexican authorities to stabilize their economy over the past 18 months. It was encouraging that they were committed to continuing adjustment in order to consolidate the gains made thus far. The Fund had played a constructive role in Mexico's adjustment. The decision of the commercial banks to consider multiyear debt relief for Mexico was welcome, as it would give the country breathing space to strengthen its external payments position. He hoped that that type of initiative would, in due course, apply to other developing countries similarly placed.

Since Mexico's economic crisis in 1982, substantial progress had been made on several fronts, Mr. Mtei observed. The budget deficit relative to GDP had been cut by 9 percentage points in 1983, and a further decline was expected in the current year. Inflation had been declining in the past six months, reflecting demand restraint and the pursuit of a cautious incomes policy. Domestic savings had taken a turn for the better, a significant development for a country once highly dependent on external resources. In addition, the balance of payments position had been improved dramatically: in 1983, Mexico had been able to rebuild its international reserves and to repay a large part of the arrears that had accumulated in 1982. In general, Mexico's creditworthiness had improved.

The program for 1984 was appropriate, Mr. Mtei considered. Efforts aimed at improving tax administration and steps taken to make public enterprises more self-sufficient should further strengthen the Government's financial position. The authorities' commitment to maintaining a flexible exchange rate policy and their intention to unify the exchange market when conditions permitted was welcome.

However, there were a number of developments that gave cause for some concern, Mr. Mtei went on. Real per capita GDP had fallen by 7 percent in 1983, after a drop of 2.2 percent the previous year. Based on the projection for growth in 1984 of 1 percent, a further decline in per capita GDP would occur. If the standard of living in Mexico were improve, particularly in the face of a high population growth, the need for an early resumption of economic growth could not go unheeded. Interest payments and other transfers remained a burden on the economy. Debt service was expected to be high, even until the end of the decade, posing a constraint on Mexico's development potential. The decline in private capital formation from 18.4 percent of GDP in 1979 to 9.6 percent in 1983 imposed a further constraint on growth. Unemployment was expected to remain a major problem in the near future, given the steady rise in the population of working age.

It might be difficult from a practical viewpoint for the authorities to hold wages down if inflation were not brought under control, Mr. Mtei considered. Despite relatively large nominal increases in wages in recent years, real wages had generally declined since 1981.

The balance of payments outcome over the medium term would depend on whether Mexico was able to expand its exports sufficiently and on the terms of debt relief to be negotiated with the country's creditors, Mr. Mtei commented. With respect to exports, he hoped that the protectionist barriers in Mexico's trading partners would be reduced in due course. On the issue of growth, the projection of an increase of 5 percent in real GDP in 1985-90 might be optimistic. In conclusion, the Mexican experience demonstrated that benefits could accrue to a country if prudent policies were forcefully and consistently implemented. However, much remained to be done to deal with the longer-term issues of growth, employment, and inflation.

Mr. Prowse remarked that he agreed with the staff appraisal and supported the proposed decision relating to Mexico's exchange measures. The staff recommended approval of that decision on the grounds that the authorities regarded the multiple currency practices as transitory. Could the staff indicate what it had intended when recommending approval of the decision in "the circumstances of Mexico"? It was important to clarify those circumstances, given the frequency with which multiple currency practices arose. Nevertheless, he could support the proposed decision.

Mexico had made remarkable progress in recovering from the financial crisis, Mr. Prowse considered. Furthermore, the performance criteria of the first year of the extended arrangement and those for the first quarter of 1984 had been observed. Policies had remained on track, so much so that the commercial banks had agreed to negotiate a multiyear debt rescheduling. He acknowledged the Managing Director's important contribution in that rescheduling arrangement. Mexico provided a good place to start a multiyear approach to debt rescheduling, but that approach should not be reserved only for those countries that had made great progress: those countries having the most difficulty in making progress might need the benefits that could derive from multiyear rescheduling.

The problem of inflation should not be emphasized too heavily, although further progress was necessary, Mr. Prowse commented. He was concerned about the growth in the real economy and, in particular, about gross domestic investment, which was at about 16.5 percent of GDP compared with a target of 22.7 percent.

Further action, especially on the structural side, was called for if Mexico were to return to the path of sustained economic growth with stability, Mr. Prowse went on. No early adjustment to the current monetary and fiscal policies would be necessary. In that respect, he fully agreed with the staff that the authorities should forgo the use of the contingency expenditure reserve. Experience demonstrated that increased spending by the Central Government would not be helpful in alleviating the larger demand for foreign resources arising from the increase in interest rates. Furthermore, from a theoretical viewpoint, it would be unwise to use the contingency reserve.

He was not arguing that there should be any further tightening of overall macroeconomic policy, Mr. Prowse stated, and he recognized that there were social constraints on the extent to which stabilization could be pursued in the short term. To re-establish viable economic growth, the Mexican authorities must implement with firmness those policies that had recently been relaxed. They should take action to introduce some of the important fundamental structural and institutional reforms, the need for which was clearly indicated by the sluggishness of the economy. For example, while price regulation had been reduced since 1982, price controls continued over 17 basic products that were being indirectly subsidized by the Government. Such controls did not help those sections of the population most in need, and they did not provide incentives to producers. The level of subsidies, although increasing to 1.3 percent of GDP in 1983 after being halved in 1982, was not high by the standards of many countries. However, he was worried about the recent increase, and urged the authorities to reverse the trend, not only to help reduce the budget deficit but also to improve efficiency and increase incentives to producers.

In 1983, there had been a large decline in manufacturing output, attributable in part to the lack of availability of certain intermediate goods that were restricted by commercial policy, Mr. Prowse noted. Moreover, delays in liberalizing protectionist measures and restoring more normal levels of imports, even though they had increased rapidly, could affect export competitiveness by fostering a higher exchange rate than would otherwise be the case. Action to liberalize and rationalize the trade system was overdue. He recognized that the import system was less restrictive than it had been in 1982, but import liberalization appeared to have been confined to goods not locally produced, thus increasing protection for local industry.

While the Government's efforts to encourage local procurement by the public sector was understandable, it had adverse affects not only on the budget but also on efficiency, Mr. Prowse remarked. The formalization of the automatic denial of import permits for 1,850 items in early 1984 had sought to protect selected domestic activities, as well as to discourage consumption of luxury items. As a matter of priority, the import licensing system should be replaced with a tariff system. As the authorities themselves recognized the need for such reform, why had they delayed action on that front until at least the second half of the year?

The question of foreign investment policy had not been discussed fully in the staff papers, Mr. Prowse noted. For at least ten years, foreign investment regulations had tended to restrict foreign ownership of all Mexican companies to a maximum of 49 percent. He thought that the Government had recently decided to open the door to foreign ownership by identifying 34 priority industries in which majority participation by foreigners would be permitted.

On public enterprise policy, Mr. Prowse continued, the staff seemed to have suggested that performance of the public enterprises had perhaps been allowed to slip. Table 14 of SM/84/165 showed that the operating expenditure of public enterprises had increased substantially in real terms in 1983. After the authorities had taken brave action to implement a more efficient pricing policy in 1983 and early 1984, they had decided in mid-June to suspend until the end of the year the monthly adjustment of liquid gas prices for home consumption and residential electricity tariffs, and to roll back previously announced increases in telephone charges. In addition, some prices for public sector services had been frozen. The staff had indicated that the authorities were aware of the importance of containing the growth of expenditure by public enterprises. Could the staff provide any details about the plans for revising expenditure in the public enterprises? Should the Executive Board urge the authorities to renew their commitment to implementing an appropriate pricing policy in the public sector?

The authorities hoped to reduce the size of the public sector, as well as to moderate the rate of growth of expenditure in that sector, Mr. Prowse noted. They had started to sell some public enterprises, and he wondered how that progressive privatization was proceeding. Was it restricted to the sale of enterprises owned by the nationalized commercial banks, and were there any estimates of the likely effects of privatization?

As to wages, the minimum wage award of 20 percent announced in June 1984 yielded a cumulative annual increase of 56 percent during a period when the target rate of inflation was about 40-50 percent, a development that indicated a strong increase in real wages, Mr. Prowse went on. Whatever the expectations had been, he was concerned that real wages might be on an increasing trend. He agreed with the staff that any relaxation in wage policy could be damaging to the economy, as it would generate expectations of further wage increases and would also stimulate inflation.

Finally, on the most difficult issue of all, that of the exchange rate, it was his understanding that there had been a cumulative rate of depreciation for the first four months of 1984, Mr. Prowse remarked. He was not sure, on the basis of movements in relative prices, that a real effective appreciation of about 7 percent could be justified. Recent movement in the rate was sufficient to warrant a careful discussion of exchange rate developments. On the one hand, Mr. Senior had indicated that the margin between the official and the unofficial rates had almost disappeared. On the other hand, there was a strong demand for dollars in the unofficial market. He had difficulty in accepting, from a theoretical viewpoint, the programmed adjustment of the exchange rate. Furthermore, he was not convinced that the present effective rate was satisfactory, because it was lower than the rate prevailing in 1978-82. As Mr. Polak had noted, for some years during that period there had been a clear overvaluation in the real exchange rate. The surplus in the current account at present did not necessarily imply that the present rate was highly competitive; the balance of payments situation was a result of import control and the entire structure of restraint, as well as of the exchange rate. There was a case for reviewing the exchange rate system, and for considering whether a new system or further adjustment ought to be associated with a significant step forward toward a more liberal, rationalized trade system.

Mr. Tvedt commented that he was impressed by the authorities' progress in recent years in correcting the severe imbalances in the Mexican economy. Especially noteworthy was the improvement in the balance of payments and the public sector deficit, which had been reduced by one half in 1983 and was expected to be reduced further in 1984. That success had demonstrated the authorities' willingness to carry out firm adjustment in spite of the hardships involved.

The recovery in the second half of 1983 seemed more firmly rooted, Mr. Tvedt considered, but there was still some way to go before medium-term economic viability was achieved. The medium-term debt service projections indicated that serious constraints on the balance of payments would continue, although he hoped that the multiyear rescheduling of commercial bank debt would ease the situation and allow for a higher level of imports.

A dark spot in the Mexican economy was on the inflation front, Mr. Tvedt said. Although the increase in prices had continued to abate, the recent rise had been faster than previously envisaged. The present system of frequent adjustments of minimum wages gave cause for concern, as it fueled inflation from the cost side and might exacerbate inflationary expectations. Although he understood the difficult social and political constraints faced by the Mexican authorities, slippages in wage policy might undermine the stabilization effort.

The authorities had achieved some success in improving the structural aspects of the economy, but further action was needed, Mr. Tvedt considered. Structural policies together with appropriate financial and exchange rate policies might promote a shift of resources toward the traded goods sector; such a development was a prerequisite for a sustainable increase in the prosperity and welfare of the Mexican population. In conclusion, he could support the proposed decision.

Mr. Donoso commended the Mexican authorities for their firm determination in correcting the internal and external imbalances of the economy in the past 18 months. The deficit of the nonfinancial public sector had been reduced from 17.8 percent of GDP in 1982 to 8.4 percent of GDP in 1983, and was expected to be reduced further to 5.5 percent of GDP in 1984. Net credit creation by the Banco of México had been consistent with the accumulation of international reserves of $678 million in 1983--compared with induced losses of $387 million in 1982--given that real balances had been declining at least until mid-1983. Furthermore, average real minimum wages had been reduced by about 17 percent between 1982 and 1983.

The exchange rate had been depreciated by 27 percent in real terms by the end of 1983 from the average of 1978-82 in terms of relative prices, Mr. Donoso observed. The depreciation appeared greater if measured in terms of unit labor costs. Those figures reflected a dramatic change of policy intended to bring about a sustainable position in the external accounts, reduce the rate of inflation, and re-establish conditions for growth.

Impressive results had been achieved on many fronts, Mr. Donoso observed. The trade surplus had almost doubled between 1982 and 1983, from $7.7 billion to $14.5 billion. The current account had registered a surplus of $5.5 billion in 1983, following a deficit of $5.5 billion in the previous year. Although a great part of that improvement had been brought about by a reduction in imports, to which direct restrictions had been applied, the increase in non-oil exports had also been important. The improvement in the external accounts appeared sustainable, even if import restrictions were relaxed. Capital outflows had been controlled through appropriate monetary policy.

With respect to inflation, the monthly rate of increase in the consumer price index had decelerated, although it was still high, Mr. Donoso observed. The restoration of confidence and realistic interest rates had facilitated the growth in financial savings, which, in turn, had allowed for a rapid increase of credit to the private sector. Although the economy was depressed and the adjustment efforts had proved costly, signs of an upturn in economic activity should make management of the economy easier in the future.

On policies to consolidate the success thus far and to facilitate growth, Mr. Donoso agreed with the staff on the need to maintain all efforts aimed at reducing the rate of inflation in order to stabilize the financial system and thereby increase the availability of domestic financing. The elimination of the current account deficit was an important achievement, but, without foreign financing, recovery would be dependent upon domestic savings channeled through the financial system. Appropriate interest rates and price stability were therefore crucial to speed up recovery at the present stage.

Equally important were steps to control the deficit of the nonfinancial public sector, because without foreign financing that deficit would absorb resources otherwise available to the private sector and because resources should be used as efficiently as possible, Mr. Donoso went on. The authorities should pursue an appropriate policy to enhance the role of the private sector.

With respect to activation of the contingency reserve for fiscal expenditures, he encouraged the authorities to act cautiously, Mr. Donoso said. However, the strong performance of the current account during the first half of 1984 seemed to indicate that there was little danger in activating the reserve, and he would tend to support the authorities' decision, especially as they had proved their strong commitment to economic stability. It appeared that those expenditures could be financed without endangering the achievement of the external objectives.

He attached the greatest importance to monitoring exchange rate developments and labor costs closely so as to ensure that competitiveness was maintained, Mr. Donoso remarked. The information provided by the staff seemed to indicate that competitiveness was adequate at present. However, an opinion on the appropriateness of relative prices could not be formulated without considering the authorities' plans and objectives regarding trade liberalization. A flexible exchange policy should be pursued if the authorities were to eliminate restrictions on imports, so that excessive reliance on demand restraint could be avoided and the favorable external account position maintained.

In retrospect, it could be concluded that the import restrictions and multiple exchange system had minimized the cost of adjustment, while enabling a noticeable improvement in the external accounts during the first stage of the adjustment program, Mr. Donoso observed. Through those measures, the authorities had avoided excessive reliance on new financing, and Mexico's relations with the international financial community had therefore improved. He urged the authorities to give high priority to liberalizing exchange restrictions in order to avoid a misallocation of resources. As noted by the staff, the substitution of tariffs for existing restrictions would strengthen the fiscal finances. He commended the authorities for their achievements and supported the staff's views on fiscal, monetary, exchange rate, and wage policies.

Mexico had successfully recovered from the financial crisis of 1982, Mr. Donoso considered, and the authorities had corrected policies in many fundamental areas. Economic growth had been initiated, but progress toward internal and external balance should be maintained, and controls and restrictions leading to an inefficient allocation of resources should be eliminated.

Finally, he was concerned about high international interest rates and continued protectionism in Mexico's trading partners, Mr. Donoso said. High interest rates represented an added burden on Mexico, which depended on a moderate recovery in activity. Many other debtor countries presented a still more fragile situation, as current account deficits would remain even after economic adjustment. High interest rates and protectionism reduced the prospects of recovery for debtor countries, and weakened the international financial system by exacerbating the debt problem. In conclusion, he could support the proposed decision.

Mr. Malhotra recalled that Mexico's payments situation in mid-1982 had set off an international alarm. However, perceptions of the international financial community had changed over a relatively short period, and Mexico had shown what could be achieved if national authorities were willing to pursue strong adjustment policies in a determined fashion. The Fund had also played a crucial role at a difficult time, and it continued to provide assistance to resolve Mexico's medium-term problems.

Remarkable progress had been made in 1983, as many Directors had noted, Mr. Malhotra continued. Developments thus far in 1984 had been generally positive, although the decline in inflation had been smaller than was desirable. Fiscal and monetary policies had been appropriate, and the balance of payments position appeared to have strengthened more than envisaged.

On the contingency expenditure reserve, Mr. Malhotra inquired whether the authorities intended to keep the overall budget deficit within 5.5 percent of GDP. Assuming that they did, and that the economy, despite some improvements, remained depressed, he could see little difficulty in activating the contingency expenditure reserve. However, it was not always possible to ensure that expenditures activated in midyear were implemented in the optimal fashion. The 1985 target for the overall budget deficit had not yet been set, but if the authorities were satisfied that those additional expenditures could be implemented and were unlikely to undermine the targets for 1985, they would be right in activating the contingency reserve.

While inflation was not on target at present, the latest developments noted by Mr. Senior were encouraging, Mr. Malhotra considered. The high inflation rate was related to developments in the real sector; there was some pressure on inflation from the supply side. Did the authorities consider that the activation of the contingency expenditure reserve would relieve the supply constraints? If so, the impact of activation of the reserve on inflation might be beneficial. Moreover, did the staff or Mr. Senior consider that an increase in GDP of 1 percent was feasible? According to the staff report, agricultural production was projected to increase by 3-4 percent, but agriculture contributed only 10 percent to GDP. The manufacturing sector contributed about 24 percent to GDP, and was projected to increase by only about 2 percent.

The authorities were faced with the task of stimulating the economy, Mr. Malhotra noted. Although fiscal stimulus was generally not looked upon with favor, in some important cases such deficits had brought about major economic improvements. The Fund should not always take a negative view of fiscal stimulus; if implemented efficiently, it could be helpful.

Real wages had declined by 20 percent in 1983, Mr. Malhotra observed. A further cut in real wages would be counterproductive. Cooperation between the trade unions and the authorities had been an important factor in the success of the adjustment effort, which had taken place in an atmosphere of peace and stability. While Mr. Senior had indicated that the 1984 wage negotiations could result in a further fall in average real wages, the staff considered that a wage award of 20 percent would result in a cumulative increase of 56 percent for the year, a figure inconsistent with the inflation rate target of 50 percent. What was the explanation for the difference of opinion between the staff and the authorities? He thought that the staff had added the 30 percent wage adjustment at the beginning of the year to the 20 percent adjustment agreed to at midyear, and had then added 6 percent, which was 20 percent of 30 percent. If the staff took into account the lag of six months between the agreement and the granting of the wage increase, there might not have been a real increase in wages. In his view, real wages should be maintained.

The staff considered that further corrections should be made in the exchange rate, Mr. Malhotra noted. He urged the authorities to keep the exchange rate policy under close review so that Mexico's competitiveness could be maintained.

The likely multiyear debt rescheduling represented a vote of confidence by the financial community in the adjustment effort of the authorities, Mr. Malhotra considered. Furthermore, that forward-looking approach to debt rescheduling provided hope for many other countries, which also needed to regain the confidence of the international financial community by pursuing their own adjustment policies. He appreciated the crucial role played by the Fund, especially by the Managing Director, in promoting the multiyear rescheduling arrangement.

As for the medium-term outlook, the authorities were faced with the task of resuming economic growth while maintaining adjustment on course, Mr. Malhotra noted. In that connection, the volume and efficiency of future investments, particularly in the public sector, would be crucial. He agreed to the proposed decision.

Mr. Kabbaj stated that the remarkable performance of the Mexican economy under the extended arrangement was encouraging. All performance criteria for the first year of the program had been observed. The performance criteria for the first quarter of 1984 had also been met, and the general aim was to consolidate the gains made thus far and to set the stage for a resumption of moderate economic growth and increased employment. The turnaround in the balance of payments had come about principally from the sizable reduction in imports and the curtailment in development investments. Growth and unemployment had inevitably been affected by the adjustment policy.

The Government had been determined to reduce the fiscal deficit to manageable proportions in 1983, Mr. Kabbaj observed. It had been essential to tackle the problem directly because of the repercussions of the large budget deficit on key sectors of the economy. In the first quarter of 1984, domestic revenues had continued to rise, owing to the adjustment in public sector prices. Public sector expenditure was being monitored closely; the authorities were aware that certain operating expenditures had risen faster than expected. He understood the concern expressed by the authorities and the staff about the deleterious impact of rising internal and external interest rates on the budget. Considering the extent of external borrowing and domestic credit in Mexico, the continued rise in interest rates was bound to have a significant impact on public finances. Could the staff comment on the extent to which the economy could withstand future rises in interest rates and on possible precautionary measures that should be adopted?

It was encouraging to note the increase in real balances, Mr. Kabbaj continued. Furthermore, financial savings during the first quarter of 1984 had allowed for an increase in net international reserves. In addition, demand for credit by the private sector had risen, a development that contrasted sharply with the decline in 1983 and indicated a reactivation of the economy.

Mexico's balance of payments position had improved considerably in the past few months, Mr. Kabbaj observed. The improvement in the current account, from a deficit of $5.5 billion in 1982 to a surplus of $5.5 billion in 1983, reflected the authorities' realistic demand management policy. The main factor responsible for the better balance of payments position, however, had been the sizable reduction in imports, resulting in an improvement in the trade account.

The restrictive demand management policy, the reduction in imports, and real capital investment had taken their toll on economic growth and employment prospects, Mr. Kabbaj continued. Gross domestic investment had declined by about 29 percent in 1982 and by a further 23 percent in 1983; real fixed capital formation by the public sector had borne the brunt of that decline. Consequently, real GDP had declined by 5 percent in 1983, compared with a 0.5 percent decline in 1982 and average real growth of 8 percent in each of the previous three years. The construction sector--accounting for 25 percent of GDP and more than 12 percent of employment--and the manufacturing sector had been hardest hit. Production in the manufacturing sector had declined by 7.3 percent in 1983. It was therefore encouraging that thus far in 1984 there were signs that manufacturing production had started to recover. The manufacture of capital goods had contracted by 9 percent in 1983, and was still in the doldrums. The construction sector had contracted by 14.4 percent in 1983, but showed signs of recovery.

It seemed that prospects for recovery in employment were apparent, Mr. Kabbaj said. The potential problem area was the containment of inflation, which had proved difficult to manage. The target of reducing inflation to 40 percent by the end of 1984 might prove elusive. On the other hand, considering the view shared by both the staff and the authorities that austerity measures should continue for some years, it was difficult to be oblivious to the need for some invigoration of the economy, so as to boost employment and growth. The aim should be to increase employment and growth while reducing inflation. The authorities had shown remarkable resiliency and foresight under difficult conditions, and there was every reason to be confident about their ability to achieve both aims.

Finally, recent encouraging reports had indicated the more realistic attitude being adopted by commercial banks with respect to multiyear rescheduling and better terms and conditions on Mexico's debt, Mr. Kabbaj commented. He welcomed that development, which was due, to a considerable extent, to personal efforts of the Managing Director aimed at convincing commercial creditors to reward good performance. Like other speakers, he hoped that similar sentiments would prevail in the future with respect to other borrowers that were also good performers. In conclusion, he could support the proposed decision.

Mr. Alhaimus remarked that Mexico had continued to make progress during the first part of 1984, following the considerable achievements of the first year of the program. Expenditure had been controlled, the external position had improved, and the confidence of the international financial community had been restored. Those successes were not only relevant in terms of the domestic economy but also of obvious international significance. However, difficult tasks still lay ahead, and the authorities would have to face various problems and uncertainties when conducting policy in major problem areas of the Mexican economy.

The large deficit of the public sector was perhaps the most critical area where strong and painful action had been necessary, Mr. Alhaimus continued. The authorities had made a remarkable achievement in reducing considerably the public sector deficit from 18 percent of GDP to 8.5 percent of GDP in 1983, and then to a figure considerably below the established program target during the first quarter of 1984. Furthermore, the staff expected that the fiscal position was likely to improve in the coming months, owing to the price adjustments recently introduced. It was not expected, however, that the authorities would have the same scope for adjustment following the strong measures taken in the past year. It was uncertain whether further burdens would have to be absorbed in case of additional increases in international interest rates. The adverse impact of recent interest rate increases had been judged by the authorities to be sufficient to justify activation of the contingency expenditure reserve in the 1984 budget. The staff, however, had urged the authorities not to use that reserve "in order to avoid excessive demand pressures and adverse signals to the market." As activation was intended, in part, in case there was evidence that economic activity was not recovering, could the staff provide an estimate of economic growth in 1984 and indicate whether it might exceed the target of 1 percent of GDP projected in the program? Promising growth was already reported in manufacturing, and agriculture was expected to grow by 4.5 percent in 1984, as indicated by Mr. Senior.

Impressive results had been achieved with respect to the balance of payments position, Mr. Alhaimus observed. A current account surplus of $5.5 billion had been recorded in 1983, following a deficit of the same magnitude in the previous year. An even sharper shift had been recorded in the overall balance. The continued improvement in the external position in the first quarter of 1984 had led to a revision of projections for the year as a whole. It was encouraging to note that one factor in the improvement had been the growth in nonpetroleum exports. The exchange rate adjustments had contributed to the restoration of Mexico's competitiveness, and progress had been made in narrowing the differential between the free and market rates. The strong adjustment effort had led to the restoration of confidence in Mexico and the consequent cessation of capital flight, which further contributed to the improvement in the external balance. Further evidence of the enhanced creditworthiness were the better debt rescheduling terms with respect to the maturity and interest rate spreads, secured in the April 1984 agreement with the commercial banks, as well as the adoption of a new multiyear approach by the commercial banks' Advisory Committee in June 1984.

However, adjustment had not been without painful costs, Mr. Alhaimus observed, and serious difficulties still lay ahead. Perhaps the most obvious setback had been the decline in GDP growth in 1983 by 4.7 percent, well below the program target. Inflation remained a source of concern, despite the progress made. The authorities expected that the rate of inflation in 1984 would be higher than the target of 40 percent. Furthermore, the uncertainties associated with the future evolution of international interest rates would remain a complicating factor for Mexico's adjustment policies, which did not always have sufficient room for maneuver. Nevertheless, Mexico's response to the severe difficulties had so far been remarkable, and it was reassuring to note that the authorities continued to demonstrate, in a practical way, their determination to adhere to the strong adjustment program.

Mr. Wang commented that Mexico had continued to make remarkable advances in adjustment since the Executive Board's discussion of Mexico at EBM/84/34 and EBM/84/35. For the first quarter of 1984, public finances had continued to improve, and inflation had continued to decline. The balance of payments and net international reserve position had strengthened further, while payments arrears had been eliminated. The progress made in restructuring Mexico's external debt reflected the country's improved creditworthiness in the international financial market.

The improvement in the balance of payments position had been achieved at the cost of a compression of imports and a decline in output, Mr. Wang observed. However, import and output performance had begun to improve during the first quarter of 1984. Imports had increased by a considerable margin, and there were clear signs that the economy was beginning to recover. That encouraging development was the result of the correct balance of austerity measures and efforts to stimulate economic growth; the authorities were fully aware that successful adjustment would be sustainable only if effectively supported by a healthy recovery. They were to be commended for their remarkable achievements.

In contrast to the favorable domestic developments, the international environment remained a cause for concern, Mr. Wang considered. The recent increase in international interest rates and the persistence of protectionism in Mexico's major export markets were additional hurdles in the path to successful adjustment, which must be undertaken by both debtor and creditor countries, not only countries with Fund programs. Indeed, adjustment by the program countries without concurrent improvements in the international environment would entail unnecessary hardship for their populations, and might appear unfeasible within existing social and political constraints. The Mexican authorities were fully aware of those constraints. In view of the persistence of adverse external developments, it was understandable that they might activate the contingency expenditure reserve included in the 1984 budget, while monitoring carefully its implications for inflation.

On the exchange system, the improved overall external position and the substantial increase in international reserves reflected the true competitiveness of the peso, Mr. Wang stated. The exchange rate gave little cause for concern at present. Finally, he could support the proposed decision.

The staff representative from the Western Hemisphere Department commented, with respect to questions on the behavior of the indices of output and employment, that the staff had expressed the indicators of economic activity in terms of percentage change over the same period of the previous year (Chart 1, SM/84/155) because of the problems of seasonality influencing the available information. However, owing to the deficiencies in those indices the staff had used a revised series of figures for industrial production, which was the closest indicator to GDP, to determine that the turning point in economic activity had occurred in August-September 1983. The latest data available showed that the unadjusted rate of growth of industrial production between September and March 1983 had been 7 percent, reflecting sharp growth in output; however, several seasonal elements would seem to indicate that the GDP growth rate implied by that rate had been overestimated. However, it now seemed fairly clear that the growth rate of GDP of 1 percent originally projected in the program had underestimated the real strength of the economic recovery.

There were strong indications of a recovery of confidence in the private sector, the staff representative remarked. Private sector credit from the banking system had increased during the first quarter of 1984, and there were indications that private sector investment was rising. The narrowing of the spreads between lending and borrowing rates in the banking system had helped to encourage private sector investment.

On the role of foreign direct investment in capital accumulation in the medium term, the staff representative continued, the Mexican authorities had formulated a program to promote foreign investment within existing legislation. In principle, foreign investors could not participate in new ventures with more than 49 percent foreign ownership, except in a number of sectors where the extent of foreign participation allowed was even smaller. However, in view of the current circumstances of Mexico, there had been a change in that policy on a case-by-case basis, and the authorities had presented a list of areas where foreign participation could exceed 49 percent depending on the merits of the particular investment. Priority was given to export-oriented industry, as opposed to more traditional import-substituting activities.

The rate of inflation of 30 percent for the first six months of 1984 indicated that inflation for the year would be higher than programmed, the staff representative stated. However, if the impact of the adjustment of controlled prices were eliminated, the underlying rate of inflation would be lower. Most of the controlled price adjustments had been made in the first half of the year. Preliminary estimates of inflation for July--a month when there had been no major corrective price increases and no wage increases--indicated that the underlying rate of inflation was in line with the target of 40 percent.

Many Directors had voiced concern about the authorities' wage policy, the staff representative noted. The wage increase of 56 percent might result in a higher rate of inflation than the authorities had envisaged. In fact, real wages would be determined by economic conditions, and any increase in wages in excess of the targeted inflation could result only in higher rates of inflation. The 56 percent accumulated wage increase was effectively a minimum wage increase. During the past 18 months, actual wages, particularly in industry and construction, had increased at a much slower rate than the minimum wage. Furthermore, wages in the public sector, which included public sector enterprises, had not increased by 56 percent.

The performance of the public sector had been a key factor in adjustment thus far, the staff representative went on. The reduction in the public sector deficit from about 18 percent of GDP in 1982 to 5.5 percent of GDP in 1984 had been the major contributor to the improvement in the balance of payments and the reduction in inflation. The targeted public sector deficit for 1984 included two thirds of the contingency expenditure. One third of the contingent expenditure would have to be covered through increased revenues or reduced expenditure in other areas. The staff was concerned that although the 1984 target for the public sector deficit of 5.5 percent of GDP was achievable under current conditions, the increase in expenditure could have an impact on aggregate demand and exacerbate current inflationary pressures. The balance of payments position indicated that there was some room for use of the contingency reserve. Mexico's net international reserves for the first six months of 1984 had been about $2 billion, which was in line with the target for the year as a whole, because borrowing by the public sector had been below the ceiling established for the first six months of the year. However, the staff was concerned that the activation of the contingency reserve might have a negative impact on prices and activate the economy in the short term, without generating any benefits over the medium term. Nevertheless, the program had been based on the possible use of part of the reserve, and the authorities had not indicated that they would modify the target for the public sector deficit.

The rapid increase in expenditure had been directed toward public sector enterprises, the staff representative indicated. The National Commission for the Support of Consumer Needs (CONASUPO), in charge of the import, purchase, and sale of agricultural commodities, accounted for the major increase in current expenditure. Owing to the good harvest in 1983/84, CONASUPO had had to shift from imports to domestic purchases of agricultural products, resulting in a sharp increase in financing needs for the first part of 1984. On the basis of available information, it appeared that that had been a one-time financing requirement, which could be absorbed over the remainder of 1984. However, other enterprises had shown an increase in operational expenditures, a development that concerned the staff. The authorities had expressed their intention to review expenditures carefully. The rate of growth of expenditure in the first quarter of 1984 was particularly high compared with the rate of growth a year earlier, a period during which there had been a virtual ban on expenditure. A comparison of those two periods therefore gave a somewhat distorted view.

The authorities had calculated that the rollback of price increases for telephone rates and the freezing of rates for certain public utilities, such as electricity, would have only a small impact on the budget, the staff representative indicated. Those price adjustments affected only private users, since industrial enterprises would continue to pay the higher rates for electricity and gas. A commission was currently assessing the required price adjustments in the remainder of the year, and it had indicated that, apart from the special concessions granted in June, adjustment policies would be maintained.

Subsidies granted by the public sector had increased as a proportion of GDP in 1983, the staff representative remarked. However, the total of current transfers, subsidies, and foreign exchange losses had declined from 6.5 percent of GDP in 1982 to 3.1 percent of GDP in 1983, and was expected to decline to 2.4 percent of GDP in 1984.

The Government's first priority was to sell those public enterprises that were part of the nationalized banking system, the staff representative indicated. About 80 percent of those enterprises had been sold since May 1984. The authorities were reviewing carefully which other enterprises should be sold. However, progress in that area would have to proceed at a slower pace, and would not entail a major reduction in the size of the public sector.

With respect to trade restrictions, there were no firm estimates of the impact on revenues of a shift from import restrictions to import tariffs, the staff representative said, but, on the basis of rough indicators, tariff reform could yield about 1 percent of GDP in new revenue. The size of the impact would depend upon import volume, the average rate of taxation of imports, and the special treatment granted to specific imports.

On monetary policy, real interest rates had become positive in May 1984, the staff representative commented. Although inflation had increased slightly in June, real interest rates remained positive.

Certainly, the increase in errors and omissions during the first months of 1984 could be related to the negative real rates of interest during that period, the staff representative recalled. But errors and omissions included a number of other items, particularly in a country where a dual exchange system existed. The authorities were also concerned about the increase in errors and omissions, and they had compared movements in that item with other movements in the balance of payments, including the current and capital accounts, to determine the adequacy of exchange rate policy. The changes in the errors and omissions item should be seen within a wider context of developments between 1982/83 and 1984.

On the exchange rate system, the peso had appreciated in real terms by 7 percent between January and April 1984, as measured by a particular basket of currencies and by prices in the countries included in the basket, the staff representative noted. The real exchange rate had been affected by both a higher rate of inflation in Mexico compared with that of its trading partners and the appreciation of the U.S. dollar, trade with the United States constituting about two thirds of total trade. The wording in the staff paper had been unclear with regard to the 1978-82 base period used to compare the real effective exchange rate; the staff had intended to indicate that the exchange rate prevailing in May 1984 had been more depreciated than the average rate during 1978-82, with a few exceptions.

A number of Directors had noted that the medium-term scenario in SM/84/155 was more optimistic than that presented in EBS/84/1, the staff representative from the Western Hemisphere Department observed. The new medium-term projections were based on recent information provided by the authorities, reflecting, in particular, revised projections for petroleum exports and some imports. Imports were expected to be lower than originally projected. In addition, interest payments had been revised. Although interest rate assumptions had become somewhat more pessimistic, the structure of debt had been more fully analyzed, and current projections took into account that a significant proportion of total debt was not linked to the London Inter-Bank Offered Rate (LIBOR) or to variable rates. Furthermore, the revised projections were based on the national program of development financing presented by the Mexican authorities, establishing a target for external borrowing in 1985-88.

The Deputy Director of the Exchange and Trade Relations Department stated that the staff had recommended approval of Mexico's multiple currency practices "in view of the circumstances of Mexico" because the authorities had undertaken a strong adjustment program, which was being implemented with success. The staff had been assured that the authorities would unify the multiple exchange system. On a related point, the staff report gave an impression that the exchange system was far more complex than, in fact, it was. There was a controlled marked rate for multitransactions and a free-market rate for all other transactions. The staff did not consider that the three other special rates gave rise to a multiple currency practice at present.

Mr. Senior remarked that the authorities had continued their adjustment efforts under the 1984 program with the same strength and determination as in 1983. That effort was reflected in the significant progress made toward the attainment of the program's objectives; the balance of payments position had improved, the fiscal position had strengthened, and inflation had decelerated. Prudent demand management policies and far-reaching structural measures in the fiscal, monetary, price, and external areas explained that progress. While the need to continue the adjustment effort was clear, the positive results achieved so far demonstrated that confidence had been restored.

Several Directors had referred to the slower than expected deceleration in inflation, Mr. Senior noted. However, overall inflation should not be compared to inflation during a period in which several one-time price adjustments had been made. Given the behavior of prices in the first six months of 1984 and the expected reduction in prices in the second half of the year, inflation would not exceed 50 percent at end-1984. His authorities regarded price increases in excess of those of Mexico's main trading partners as unacceptable.

With respect to the contingency expenditure reserve, Mr. Senior explained that his authorities wished to activate that reserve in order to counteract the negative impact that increases in international interest rates were having on economic activity. The expenditure reserve had been included in the 1984 budget as an instrument to be used in the event of unforeseen adverse developments. Mexico, whose external debt was equivalent to about 50 percent of GDP at a real interest rate of 2 percent, would have to absorb 1 percent of GDP to service its debt. However, the debt burden would be unsustainable if interest costs approached 9 percent, as at present, accounting for 4.5 percent of GDP. The total contingency expenditure reserve was equivalent to $1.6 billion. The increase in interest rates in 1984 would represent an additional interest payment of $1.1 billion only for servicing external debt. Including the interest payments on domestic debt, the contingency expenditure reserve would not be sufficient to offset the additional interest burden on the budget. Given the prevailing liquidity in the financial system, the contingency reserve could be financed with noninflationary resources.

His authorities were well aware that trade liberalization would help to reduce inflationary pressures and improve the allocation of resources, Mr. Senior indicated. Trade liberalization had proceeded gradually and in a pragmatic way, as reflected by the strong growth of imports by the private sector and the large number of unused import permits. A rapid liberalization could have had considerable effects on productivity, which now seemed to be recovering from the depressed levels of 1983. Given the sluggish rate of economic activity and depressed aggregate demand, inflationary pressures could result from trade liberalization because of the existence of oligopolistic and monopolistic structures in some sectors. The gradual liberalization of imports, to which his authorities were committed, would help to eliminate those undesirable structural rigidities and promote more efficient resource allocation.

With respect to exchange rate policies, Mexico's balance of payments position was the best indicator of the adequacy of the current rate of appreciation of the peso, Mr. Senior stated. The pursuit of a flexible exchange policy had allowed for a greater than envisaged increase in non-oil exports and in considerable import substitution, developments that explained the higher than expected surplus in the trade and current accounts. Nevertheless, his authorities would closely follow developments in the external position and in the behavior of prices and, if necessary, would review the current rate of depreciation so as to assure further consolidation of the gains achieved thus far.

The Chairman made the following summing up:

> Directors noted the remarkable progress made by Mexico in its recovery from the economic crisis that had affected the country in 1982, and they praised the authorities for their determination and perseverance in carrying through the adjustment program.
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> Successful implementation of the program had yielded a major improvement in the balance of payments in 1983 and the first half of 1984. In addition, price performance had improved, albeit at a slower pace than originally envisaged. Economic activity showed signs of recovering from the low levels experienced in late 1982 and early 1983.
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> Directors observed that the pursuit of a cautious fiscal policy had been the cornerstone of the adjustment process. Fiscal restraint, accompanied by suitable supporting policies, had been instrumental in lowering inflation, reducing reliance on foreign borrowing, and freeing financial resources for the private sector. Nevertheless, some Directors expressed concern about indications that certain categories of spending were increasing rather rapidly, especially in the public enterprise sector, and about decisions to limit the adjustment of some public sector prices; they urged the authorities to take the steps needed to avoid the emergence of new fiscal gaps and to reduce further the rate of subsidization of the economy. Directors emphasized the need to weigh carefully the possible use of the contingency expenditure reserve. While several Directors expressed some sympathy for the activation of the contingency reserve, the general view was that the growing strength of the economy this year and the continued high rates of inflation suggested that abstaining from using the reserve at this juncture would be advisable.

Directors remarked on the achievements attained by the monetary and credit policies that had been pursued. The steady improvement in financial savings and the sharp reduction in the financing requirements of the public sector had permitted an increase in the credit to the private sector, even as there had been a further accumulation of net international reserves. Directors were encouraged by the developments in respect of interest rates, particularly by the improvements in the structure of lending rates brought about by the reduction of the spread between free portfolio loan rates and deposit rates. They welcomed the recent agreement between the Mexican authorities and the World Bank on interest rates, but indicated that further progress in reducing financial subsidies was still needed.

Directors made reference to the crucial role of wage moderation in reducing inflation and assuring the country's competitiveness. They emphasized that gains in real wages could occur only by restoring sustained economic growth. It was noted that in the recent minimum wage negotiations the authorities had had to take into account considerations of social cohesiveness. Some Directors noted that the recent minimum wage award had made it difficult to achieve the inflation targets originally sought for 1984, and that it was therefore important in the period ahead to ensure that policies would give confidence that inflation would indeed be brought down.

Directors noted the gains in competitiveness that had been attained through a major currency depreciation in the early stages of the program, and they recognized its positive impact on the balance of payments. However, a number of Directors viewed with some concern the recent real appreciation of the currency, as the rate of depreciation lagged behind the inflation differential between Mexico and its main trading partners. Directors noted the margins still in favor of Mexico suggested by relative wage indicators, and the continuous strong performance of the balance of payments. However, they stressed the need to avoid a pattern of losses in competitiveness, given the possible repercussions on confidence. Therefore, they welcomed the indications given by the Mexican authorities that they were prepared to review their current policy of fixed, preannounced exchange rate moves if signs of a weakening of the balance of payments should emerge in the coming months. In this regard, a number of Directors expressed concern about recent suggestions of capital flight. They expressed reservations about the magnitude of the item "errors and omissions" that had developed in the first quarter of 1984, and they urged the authorities to follow very closely developments in the capital accounts of the balance of payments. Directors also encouraged the authorities to unify the dual exchange system as soon as possible. In the meantime, it was important to permit the free-market rate to act as a safety valve for any pressures that might emerge in the balance of payments.

A number of Directors were concerned that only limited progress was being made in improving commercial policies. The import licensing system had been liberalized, and the value of import licenses had increased, but import controls still remained in place for a wide range of goods and in some cases they had been intensified, particularly for items competing with local production. Several Directors pointed out the positive impact that import liberalization would have on prices in the short run and on efficiency and growth prospects in the medium term. Therefore, they emphasized the urgent need to accelerate the liberalization and rationalization of the import structure, particularly by shifting from import licenses to import duties. Several Directors also pointed to the potential contribution that private foreign direct investment could make to the balance of payments and growth prospects of the country, and they hoped that the authorities would encourage flexible policies in this field.

Directors welcomed the advances made in restructuring the public and private debt in 1983/84 and in eliminating external payments arrears. They viewed these developments as central to the restoration of Mexico's creditworthiness. Moreover, they attached considerable importance to the efforts under way to reach agreement with commercial banks on a plan to restructure Mexico's obligations on a multiyear basis.

In concluding, Directors expressed their support for the policies being pursued by the Mexican authorities and welcomed the impressive advances that had been made in establishing the conditions for a sustained recovery. They observed that Mexico would need to pursue its adjustment program for some time to come, particularly insofar as the structural aspects of policies were concerned. Structural reform was a key to sustained growth. Directors said that the improvements in policies made by Mexico since late 1982 attested to the authorities' capacity to make the further adaptations of policy necessary to restore Mexico's full economic health.

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

The Executive Board then took the following decision:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Mexico's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1984 Article IV consultation with Mexico conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Mexico maintains multiple currency practices as described in Part V of SM/84/155. In view of the circumstances of Mexico, the Fund grants approval of these multiple currency practices until March 31, 1985, or the completion of the next review under the extended arrangement, or the completion of the next Article IV consultation, whichever is earliest.

Decision No. 7771-(84/117), adopted
July 30, 1984

APPROVED: May 8, 1985

LEO VAN HOUTVEN
Secretary