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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/34

10:00 a.m., March 2, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. Kone, Temporary
J. de Groote	
	X. Blandin
	J. Delgadillo, Temporary
	M. K. Bush
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
M. A. Senior	
	A. Lindå
N. Wicks	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Asian Department: S. P. O. Itam. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitian, P. Neuhaus. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. Katz, P. R. Rado. Legal Department: G. P. Nicoletopoulos, Director; J. M. Ogoola. Research Department: A. Lanyi, C. L. Ramirez-Rojas. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Gil Diaz, Z. Hodjera, C. M. Loser, J. P. Pujol, L. M. Valdivieso. Bureau of Statistics: E. S. Heredia. Advisor to the Managing Director: E. W. Robichek. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, S. E. Conrado, L. Ionescu, H.-S. Lee, W. Moerke, G. E. L. Nguyen, Y. Okubo, I. R. Panday, P. Péterfalvy, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, R. Bernardo, M. B. Chatah, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, N. U. Haque, H. Kobayashi, J. A. K. Munthali, G. W. K. Pickering, E. Portas, M. Rasyid, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, Wang C. Y.

1. MEXICO - REVIEW UNDER EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the review of the performance during the first year, and the program for the second year, of a three-year extended arrangement for Mexico (EBS/84/1, 1/3/84; Cor. 1, 2/29/84; Sup. 1, 1/30/84; Sup. 1, Cor. 1, 2/29/84; and Sup. 2, 2/29/84).

The Chairman informed Executive Directors that the Mexican authorities had asked the Fund to consider increasing Mexico's access to Fund resources to 125 percent of the new quota. The Interim Committee and the Executive Board had stressed that access to the upper limits of the enlarged access policy would depend both on the seriousness of the member's balance of payments needs and on the strength of its adjustment effort. Those two criteria should guide the Executive Board when considering the request by Mexico. Executive Directors would have to determine whether Mexico had made sufficient progress under its 1983 adjustment program and whether the policies to be followed in 1984 would meet the criterion of a strong adjustment effort. Personally, he had no doubt that the performance under the 1983 program and the measures to be introduced in 1984 were outstanding in terms of the strength of the adjustment effort.

Management had considered the Mexican authorities' request carefully, the Chairman went on. In responding to that request, the Executive Board should examine all its aspects in a manner consistent with present policies. As the 1984 program had been formulated on the basis of access of 103 percent of the old quota, it had not been seen as appropriate to propose a late and automatic shift to the higher access limit. Although there was no question about the strength of the adjustment effort, the question of the seriousness of the balance of payments need had to be assessed. Thus, during 1984--perhaps at the time of the Article IV consultation in July--the Executive Board should reconsider the authorities' request. At that time, Executive Directors would be in a position to determine whether the 1984 program was being implemented successfully, and whether the adjustment program was still on track.

As for the criterion of a balance of payments need, the Chairman continued, Executive Directors would have to consider whether the balance of payments situation justified an increase in the use of Fund resources. It was difficult to determine at the present time the circumstances that might justify access to the higher limits. Any need triggered by a relaxation of the adjustment effort would be inappropriate as it would not meet the first criterion of a strong adjustment effort. However, an increase of need could be consistent with the maintenance of a good track record, for example, if Mexico increased trade liberalization, or if exogenous factors caused a temporary deterioration in the economic situation.

The staff representative from the Western Hemisphere Department remarked that the comments in the staff papers had been based on information gathered during the staff's visit to Mexico City in early December 1983. In the past few days, the staff had received additional information

on end-1983 figures from the Mexican authorities. Net international reserves had reached US$5,480 million during 1983, compared with the target of accumulating a minimum of US$2 billion under the program. As for the cumulative reduction in external payments arrears, the authorities had committed themselves to repaying a minimum of US$600 million during 1983; actual payments had exceeded that amount, totaling US$1,088 million. In addition, negotiations had been undertaken with various creditors to refinance other outstanding arrears. At the end of 1983, there remained a total of US$280 million of identified arrears pending payment that the authorities had indicated they would pay at end-March 1984.

The cumulative net foreign borrowing by the public sector had reached US$4,686 million, compared with a limit established under the program of US$5 billion, the staff representative went on. Net domestic assets of the monetary authorities had contracted by Mex$502 billion; the program had provided for an expansion of up to Mex$104 billion. The stock of net credit to the public sector by the monetary authorities had reached Mex$2,839 billion at the end of 1983, against a permissible ceiling of Mex$3,097 billion contemplated in the program. On the basis of the information provided by the authorities on the various sources of financing of the public sector, and according to the methodology for calculating the overall public sector deficit employed throughout the year, the staff estimated a public sector deficit in 1983 of Mex$1,621 billion, which was higher than the Mex$1,500 billion projected under the program.

The Mexican authorities had calculated an overall deficit of Mex$1,520 billion in 1983, based on the above-the-line operations of the public sector agencies and public enterprises, the staff representative from the Western Hemisphere Department stated. The difference between the two figures--Mex$1,621 billion and Mex$1,520 billion--could be explained by the existence of public sector deposits that had been misclassified in the banking statistics as private sector deposits. Those deposits had increased significantly by Mex$101 billion during 1983, apparently owing to the delays in implementing some investment projects. If account was taken of those deposits, the public sector deficit would be Mex$1,520 billion. Subtracting the foreign deposits acquired by PEMEX (the state petroleum corporation) of about US$400 million, the overall public sector deficit would be approximately Mex$1,450 billion.

The Chairman, responding to a question by Mr. Zhang, stated that the Mexican authorities considered that they had a serious balance of payments problem and that they should have the benefit of the larger maximum access limits under the new quotas.

Mr. Senior made the following statement:

> The new Administration, which took office on December 1, 1982, faced a very serious economic situation. During the preceding months of that year, a growing disequilibrium between nominal demand and output--as a result of the low real interest rates and real appreciation of the exchange rate--was affecting

the external sector of the economy. By the end of 1982 the economy was suffering from stagnating output, growing inflationary pressures, and an acute external imbalance that gave rise to large capital flight and a virtual suspension of most international payments. The new Administration moved quickly to implement a strong adjustment program that was supported by the Fund under an extended arrangement now ending its first year. The implementation of the program has been highly satisfactory, placing the economy in a better position for recovery and sustained growth in the coming years. Not only has the intended degree of adjustment been accomplished, but it has been achieved on a timely basis.

The firm implementation of the policy actions has led to macroeconomic results that are better than expected in some key areas. The most outstanding outturn has been the major turnaround in the external position of the economy. According to the latest figures provided by my Mexican authorities updating those provided in the staff document, the trade balance has shown a remarkable improvement from a surplus of US$6.8 billion in 1982 to an estimated surplus of US$13.6 billion in 1983. As a result, the current account of the balance of payments has shifted markedly to a surplus of US$5.6 billion in 1983 from a deficit of US$4.9 billion in 1982, and gross reserve holdings have risen to US$4.9 billion. Inflation has been considerably reduced from an annual rate of 98.8 percent at the end of 1982 to 80.9 percent at the end of 1983. Progress in this field has in effect been more significant than indicated by these figures, if account is taken of the fact that by the end of 1982 prices were increasing at more than 200 percent on an annual basis, whereas by the end of 1983 the annual inflation rate, as extrapolated from December data, was about 60 percent. On the other hand, the estimated 4.5-4.7 percent fall in output in the first year of the program has been more severe than expected.

The program, therefore, has been extremely successful in arresting the dangerous trends characterizing the economy at the end of 1982, namely, the cessation of external liquidity inflows, hyperinflation, and rapidly falling output.

While output has fallen more than envisaged in the program, both the inflation rate and the balance of payments have improved to a greater extent than expected. It was very difficult to anticipate the response of economic agents to any policy package in an environment as uncertain as the one surrounding the Mexican economy at the end of 1982. Given this uncertainty and the associated depressed state of entrepreneurial expectations, it should come as no surprise that private investment has not reacted quickly to the halving of the public sector deficit. However, if a single factor could be held responsible for that set of

macroeconomic outcomes--biased toward the achievement of external balance--it should be the greater than expected devaluation that has taken place. The macroeconomic position is the result of a larger than expected initial imbalance and a policy mix that resulted in more expenditure-switching than anticipated, but that, in conjunction with the strong import substitution process observed during the year, prevented a more pronounced fall in real GDP. Following a sizable depreciation of the peso, prior to implementation of the program--a measure that was necessary to restore the rate's credibility--exchange rate policy has been flexibly implemented to maintain competitiveness and to strengthen the balance of payments. Therefore, demand and resources have been shifted from foreign to domestic markets and from sheltered sectors to import-competing activities and non-oil exporting sectors. Although there have already been important beneficial effects of this policy on the non-oil tradable goods sectors, the full response of the productive structure to the real depreciation of the currency will not be felt for some time, especially given the depressed state of the world trade and intense protectionist pressures. In addition, by the end of 1982, the Mexican productive structure had become highly dependent on some basic imported inputs; the devaluation had therefore depressed output in the short term, particularly in those sectors producing non-traded goods. Moreover, the increased local currency burden of servicing the private external debt as a result of the devaluation was of considerable importance.

Even if, as happened in this case, increases in labor and other incomes do not fully offset the nominal devaluation and if ceilings on domestic credit are observed, inflation may be more elastic than output to exchange rate changes in the short run. It is not only that the money multiplier of nominal domestic credit grows as a result of larger than expected external assets gained essentially through cuts in net imports and real income, but also that the nominal income velocity of money tends to increase because of both higher inflationary expectations associated with the devaluation and the lagged impact of the substantial 1982 devaluation.

The different time profiles of the effects of devaluation on prices on the one hand, and on the level and pattern of production on the other, may account to some extent for both the greater than expected fall in output and the higher than anticipated inflation rate for most of the year. Of course, it can always be argued that a more restrictive demand management policy could have partially offset the inflationary impact of exchange rate changes. However, tighter financial policies could have dramatically affected the standard of living of a population that, growing at an annual rate of 2.8 percent, has already faced a decline in per capita output of the order of 7.5 percent and a significantly larger fall in per capita income when account is taken of the large current account surplus.

According to the revised estimates provided by the Mexican authorities, the nominal value of the public sector deficit at the end of 1983 amounted to Mex$1,520 billion, slightly above the ceiling contemplated in the program, but equivalent to 8.4 percent of GDP, which still is less than the 8.5 percent of GDP initially programmed. The marginally higher nominal deficit is the result of greater than anticipated exchange losses and interest payments. In a developing economy, with a heavy external debt, the public sector deficit is positively correlated to the pace of inflation and devaluation even if, as in this case, the public sector has sizable foreign exchange receipts. Therefore, the need to service the public external debt at a more devalued exchange rate and the internal debt at much higher nominal interest rates called for a more restrictive stance on non-financial public expenditures as well as higher increases in taxes and the prices of public goods and services. Thus, the public sector deficit in 1983 implied greater cuts in real expenditure and real disposable income, based on the assumption of a lower than actually experienced rate of inflation. Indeed, since the inception of the program, it was noted that a greater exchange rate depreciation and inflation rate than originally foreseen would result in a much more severe fiscal adjustment in real terms. Moreover, the fiscal adjustment in 1983 started from a higher than estimated public sector deficit in the previous year when the program was framed. The fiscal deficit for 1982 was about 18.5 percent of GDP, rather than the 16.5 percent originally estimated. Therefore, instead of a reduction equivalent to 8 percentage points of GDP, the fiscal deficit was reduced by 10 percentage points of GDP--a real reduction that was 20 percent greater than originally planned. The more pronounced fall in economic activity also had an unfavorable impact on public finances. Tax collection, particularly value-added proceeds and other revenues of the public sector, was severely affected. Federal tax collection and other nontax revenues were equivalent to only 9.9 percent of GDP in 1983, in contrast to 11.4 percent as originally envisaged. Public expenditure, excluding interest payments, was reduced from 31.4 percent of GDP in 1982 to 20.5 percent of GDP in 1983. In sum, the greater than envisaged fiscal imbalance experienced in 1982, together with the combined effect of a greater than anticipated exchange rate depreciation and inflation rate, and the unfavorable impact of a more pronounced fall in economic activity led to a substantially larger fiscal adjustment than originally contemplated for 1983. This bears witness to the determination of my Mexican authorities to effect the required adjustment.

The prudent course envisaged for financial policies in the period ahead will ensure that the rate of inflation will be reduced, while the measures to shift resources and spending power to the sectors producing traded goods will continue to favor the steady growth of those sectors. This process will be

greatly assisted if the international economy recovers and protectionist pressures diminish. The strategy of economic policy for the period ahead depends on these considerations.

The main aim of the economic program for 1984 is to continue the adjustment of the economy to a noninflationary growth path while preserving the gains made on the external front. Prospects for the economy are now better than they were in the last year, and the lagged beneficial effects of increased competitiveness will continue to work so that a reduction in the rate of inflation from 80.9 percent in 1983 to 40 percent in 1984 on a December to December basis should be compatible with a recovery of real GDP growth of about 1 percent.

The projected recovery in economic activity is based on a significant increase in private investment and on the continued growth of exports and import substitution. The 1984 economic recovery program includes a series of important policies oriented toward further progress in the restoration of confidence in order to foster private investment flows. To that end, the program calls for increased credit flows from the financial system to the private sector. It is expected that the liabilities of the banking system will continue to increase during 1984, as a result of the expected reduction in inflation and the flexible implementation of interest rate policy which will promote domestic savings. The liabilities of the banking system to the private sector are expected to increase significantly as a proportion of GDP. Interest rates are expected to continue to decline at a rapid rate during the year in step with the decline in the inflation rate. Similarly, the public investment program contemplated for 1984 gives priority to investment in sectors such as housing, infrastructure, transportation, communication, and agricultural development, which have a beneficial effect on the level of employment, have a low import content, and, at the same time, are expected to contribute to the recovery of economic activity.

After the severe fall in real wages that took place during 1983--25 percent according to some estimates--it is the intention of the Mexican Government to avoid further declines in 1984. This policy should contribute to the recovery of economic activity by supporting domestic demand and social stability. In this regard I would like to underscore the significant contribution of the Mexican labor movement during 1983 to the successful adjustment effort in general, and to the fight against inflation in particular. The sense of responsibility shown by labor unions in accepting great restraint in their wage demands during 1983 imposed a substantial share of the adjustment burden on their members.

Fiscal stringency will continue to be the major tool to bring about the intended disinflation of the economy. To this end, the overall public sector deficit will be reduced from 8.4 percent of GDP to 5.5 percent of GDP by the end of this year. The 1984 budget includes a contingent expenditure of about Mex$277 billion; if it is not used, the fiscal deficit will be lowered by this amount. The Mexican authorities intend to release the additional expenditure only if, after the first half of the current year, there is evidence that, despite the measures taken by the Government, the economic recovery is not under way. Furthermore, the contingent expenditure will be released only if noninflationary resources, namely, real savings, are available to finance it.

Exchange rate and interest rate policies will continue to be managed flexibly so as to preserve the competitiveness of domestic production and financial assets vis-à-vis the rest of the world. In this regard my Mexican authorities continue to be committed to unifying the exchange system, although the dual market will be maintained temporarily to sustain orderly conditions in the capital account. A continued liberalization of trade, in conjunction with the programs to promote the growth of exports, will further assist economic recovery. The impressive turnaround of the external balance last year was needed to regain the confidence of the international financial community in the Mexican economy; it has helped to obtain better terms and conditions for the commercial bank financing required to support the adjustment effort this year. Substantial progress has been made in securing the US$3.8 billion loan requested this year of the financial community. According to the information we have received from the Mexican authorities, it is expected that negotiations will be completely finalized soon, and that the loan agreement will be signed by the end of March. The authorities have reaffirmed their intention to eliminate all remaining arrears in the coming months.

In sum, the Mexican authorities have been courageously implementing the adjustment program, and outstanding results have already been obtained. This, together with the policies embodied in the 1984 program, augur well for the continued success of the adjustment effort and the capacity of the economy to return to adequate growth rates within a framework of relative price stability and external equilibrium.

Extending his remarks, Mr. Senior said, with respect to Mexico's request for augmentation, that his authorities were in agreement with the approach suggested by the Chairman, namely, to consider the issue at the time of the Article IV consultation, although his authorities would have preferred the additional resources to be made available at the outset of

the 1984 program. They would treat such additional resources on a stand-by basis, and under no circumstances would they be used for the purpose of relaxing the adjustment effort.

His authorities considered that the public sector deficit in 1983 had been Mex$1,520 billion, Mr. Senior indicated. That figure had been calculated on the basis of net financing--gross financing minus deposits by the public sector--and income expenditure accounts. In its figure, the staff had not included the public sector deposits. However, his authorities stood ready to take any additional measures that might be appropriate to implement fully the adjustment program for 1984 as set forth in the letter of intent. They were fully committed to adjustment.

Mr. Kafka indicated his agreement with the staff appraisal. The Mexican authorities had clearly demonstrated courage, decisiveness, and their ability to implement difficult policy adjustments. Moreover, they had rendered a valuable and vital service to the entire financial community by demonstrating that a debtor country could quickly, although by no means painlessly, re-establish its creditworthiness.

As for fiscal policy, Mr. Kafka went on, a significant set of measures had been implemented during 1983 resulting in a dramatic reduction in the public sector deficit. The reduction of subsidies, improvement in pricing policies, and strengthening of tax administration had led to a marked improvement in public sector savings of about 5 percent of GDP between 1982 and 1983; for the first time in a number of years, public sector savings would reach a positive level in 1984. He was sure that the Mexican authorities would maintain the necessary fiscal discipline in the future.

On monetary and credit policy, interest rates had been increased in order to stimulate domestic savings, Mr. Kafka observed. The spread between loan and deposit rates had also been reduced. Those moves should help to bring down the rate of inflation further. He congratulated the authorities for pursuing an appropriate policy and encouraged them to continue that policy in the future. The contingent ceiling placed on loans of development banks and official trust funds to the private sector, in order to avoid any proliferation of subsidized loans, was welcome.

A dramatic turnaround, initiated in 1982, had taken place on the external side, particularly in the trade and current accounts and in reserves, Mr. Kafka remarked. Equally impressive was the progress made in narrowing the spread between the exchange rates. The Mexican authorities were wise, however, to maintain a free market rate as a safety valve.

Furthermore, he congratulated the Mexican authorities for the sharp reduction in private sector arrears and their decision to eliminate the remaining private sector arrears, Mr. Kafka commented. He welcomed their intention to rely increasingly on capital resources from multilateral and

bilateral agencies, thereby improving the debt structure. It was encouraging that the Mexican authorities would, during the first semester of 1984, implement reforms aimed at completing the liberalization of the country's trade system.

Mexico had laid the basis for future sustainable growth if world conditions would permit it, Mr. Kafka observed. However, in terms of output and employment, the country had paid a heavy price for its success. Per capita output had declined by about 8 percent in 1983, and by about 13 percent between 1981 and 1983. Furthermore, there had been a loss in domestic absorption of about 20 percent, owing to the negative resource gap resulting from the excess of interest payments over loan receipts. Real wage losses had been even greater. Those developments were dangerous for any poor country, and Mexico was to be congratulated on its solid political structure. Nevertheless, the situation would give cause for concern unless an unexpectedly rapid and sustained recovery of the industrial countries enabled Mexico to resume economic growth. It was essential for the leading countries of the international community to promote their own growth and to devise ways to make it possible for the debtor countries and other less developed countries to benefit from the industrial countries' recovery. The developed countries should place emphasis on open trade policies. Financial policies should be improved so as to reduce interest rates, which were most damaging to foreign borrowers, as domestic borrowers often shared the burden with the income tax authorities. There was also a need to adapt bank regulations in some industrial countries to intensify and facilitate the role that banks had played in the past two years in debt renegotiations.

Finally, on Mexico's request for augmentation, there was no doubt that the authorities' efforts merited an increase in access, Mr. Kafka stated. It was in the interest of the international financial community to provide Mexico with as many resources as possible, as quickly as possible, even if Mexico did not intensify the adjustment efforts already proposed for 1984 and 1985.

Mr. Delgadillo indicated his broad agreement with the staff appraisal. The Mexican authorities deserved the Fund's confidence, support, and admiration for their decisive action in tackling their economic problems in a world environment that continued to be unfavorable. In the first year of the extended arrangement, far-reaching economic adjustment had been achieved on both the internal and external sides. The impressive reduction in the current account deficit of the balance of payments was a clear indicator of the progress under the program and was a basic precondition for noninflationary recovery in the Mexican economy.

In the medium term, however, a recovery in economic activity would require the introduction of structural measures aimed at improving conditions in the private sector, Mr. Delgadillo observed. If the revival of private investment failed to materialize, the stabilization program might be seriously handicapped as political pressure for increased wages and expenditure would develop. The authorities could create better conditions

for private investment by increasing the deregulation of external trade. A further reduction in imports could take place simultaneously with a relaxation of exchange rate policy. Given the current narrow spread between free and controlled exchange rates, it might be appropriate to move to a unified exchange rate and to allow the free market rate to serve truly as a safety valve. A slightly faster pace of peso depreciation, coupled with a more decisive dismantling of trade restrictions, could improve the relative prices of tradable goods and foster export-oriented activities. After a significant devaluation of the peso at the beginning of the program period, the rate of monthly devaluations seemed to be lagging behind the rate of inflation, which could lead to an undesired appreciation of the exchange rate. Could the staff comment further on that matter?

On monetary policy, he agreed with other speakers that the country's interest rate structure needed to be kept under close review to ensure that it continued to permit the growth of savings and that it was consistent with the exchange rate policy, Mr. Delgadillo said. Nominal interest rates must be flexible enough to ensure that negative real interest rates did not result from any unpredicted jump in inflation.

As for fiscal policy, he endorsed the Government's commitment to reducing fiscal imbalances and its intention to emphasize capital expenditure, Mr. Delgadillo remarked. Such a reallocation would reduce pressures on the budget and would lead to a more efficient allocation of resources in the economy.

In view of the weak performance of industry in terms of output and employment during 1983, some public support might be required to avoid a further reduction of aggregate demand, Mr. Delgadillo indicated. That support could be oriented to labor-intensive projects with low import components, as suggested by the staff; but in the medium term, economic activity should rely less on government support and more on private sector investment, which could be enhanced by a reduction of government controls and by ensuring clear and stable price signals to the private sector.

Developments with respect to output and employment had been less encouraging than with respect to public finances and the balance of payments, Mr. Delgadillo observed. The contraction in output observed in the second half of 1982 and the first quarter of 1983 had been larger than expected. It was unfortunate that adjustment had had such a heavy toll in those areas, particularly in the manufacturing sector. He wondered whether the projections for growth of GDP in 1984 might be too optimistic, given the continuation of the world recession and the weak performance of the private sector in 1983. Could the staff elaborate on that matter and indicate the assumptions underlying the projected 1 percent growth of real GDP for 1984?

He welcomed the progress made by the Mexican authorities in debt restructuring, which would permit a more orderly adjustment in the balance of payments and would strengthen Mexico's image with foreign lenders and

potential investors, Mr. Delgadillo commented. Although Mexico would continue to face large debt servicing requirements in future years, the continuation of prudent demand management policies and a restoration of adequate output growth would moderate the country's reliance on foreign savings. Nevertheless, Mexico--as well as most developing countries--would need to count on the continued cooperation of the international financial community in coping with its financing needs. In conclusion, he supported the temporary approval of Mexico's exchange practices.

Mr. Polak said that he shared the staff's and the Chairman's commendations for the prompt and appropriate measures taken by the Mexican authorities before the program had been implemented. Those measures had been continued under the adjustment program. Mexico had met the performance criteria with substantial margins, and had surpassed most of the program's objectives. Mexico's performance confirmed that decisive action could have significant results over a short period.

The most impressive results had been with respect to the balance of payments, although exports had begun to recover only in the last few months of 1983, Mr. Polak considered. Two factors had been responsible for the success in that field. First, private sector imports had unexpectedly dropped from US$9.2 billion in 1982 to US$3.5 billion in 1983, whereas the program had foreseen some increase above the 1982 level. Could the staff indicate how much of that decline had been made up by a larger use of domestic substitutes? Second, capital flight, which had been US$11 billion in 1982, had virtually ceased. With the restoration of confidence, a potentially large inflow could come about in future years. As a result of those two favorable developments, Mexico had been able to rebuild its reserves to about US$5 billion from a negligible level in August 1982.

Production had not yet responded to the stimulus of a more appropriate exchange rate, Mr. Polak observed. Indeed, as Mr. Senior had explained, the sharp exchange rate movement had inevitably had a negative output effect, in part because it had necessitated a more severe fiscal adjustment than originally planned. He was grateful for Mr. Senior's explanation, because it increased the plausibility of a resumption of growth as the temporary consequences of the initial exchange rate adjustment were overcome. He agreed with Mr. Senior that the ability of the authorities to overperform on the fiscal targets in spite of the negative impact of the exchange rate movement deserved particular commendation.

He was in general agreement with the staff's views with respect to the adjustment program for 1984, Mr. Polak continued. The authorities' medium-term objective of bringing inflation down to a level that was in line with inflation in the United States was ambitious, but appropriate. Mexico's experience with an unchanged exchange rate vis-à-vis the dollar for more than 20 years--between 1954 and 1975--had been positive, and he encouraged the authorities to reduce inflation to a level where a fixed exchange rate policy would again become possible. An early abolition of the dual exchange rate would be appropriate; the purported advantages of the present exchange system in managing the capital account were questionable.

Clearly, further improvement in the public finances was a key element in the anti-inflationary program, Mr. Polak remarked. He noted the inclusion in the budget of an authorization for contingent expenditure to be released if the economy did not pick up and if "sufficient noninflationary resources are available." How would the authorities determine if "real" savings were available for that purpose? The release of contingent expenditure should be considered with caution, as should the medium-term approach to the balance of payments position. In that respect, he was surprised at the forecast increase in imports in 1984, from US$8.5 billion to US$14 billion, which was well above the 1979 level. Although imports had been higher in 1980 and 1981, extreme boom conditions of investment had occurred in those years. He could see the need for a substantial increase of imports in 1984 over 1983, but he hoped that a 65 percent increase would not prove necessary, even after allowance had been made for maximum liberalization of imports.

The current account of the balance of payments was projected to register a small deficit in 1984, Mr. Polak observed. Scenario A of the medium-term balance of payments projections indicated a rise in the current account deficit in the following years, reaching a deficit of US$3 billion, or 1.3 percent of GDP, by 1988. The public sector debt would increase by about one third between 1983 and 1988, from US$65 billion to US$88 billion. The debt service ratio would therefore be high, peaking at 59 percent in 1987 when up to US$14.5 billion of public debt would be falling due, owing to the bunching of rescheduling. The staff's calculations implicitly assumed that new foreign credit to meet those repayment obligations would be available; the alternatives of a new rescheduling of debt already scheduled or a large recourse to involuntary bank lending were unattractive. More cautious balance of payments objectives would therefore be advisable. In particular, given the high level of capital imports in 1979-81, the authorities should aim at reducing their debt in absolute terms or at least containing it at the present level. A credible balance of payments position in the medium term was an essential precondition to reverse previous capital flight.

Finally, Mexico's request for augmentation raised questions on the way in which the Fund could adjust its financial assistance based on the performance of the member and the member's balance of payments need, Mr. Polak said. In conclusion, he could support the adjustment program and he agreed with the proposed decisions.

Mr. Suraisry remarked that the improvement in the Mexican economy in 1983 had been remarkable; inflation had declined, the fiscal deficit had been sharply reduced, the balance of payments had been strengthened, and the debt position had been regularized. Those impressive achievements owed much to the authorities' serious adjustment efforts and to the support of the Fund. He commended both parties.

Unfortunately, the improvement in Mexico's financial position had been accompanied by declining economic activity and imports, Mr. Suraisry observed. But the economy was currently well placed for a resumption of

growth. He fully supported the objectives of the 1984 program, aimed at further stabilization in the context of a gradual recovery in economic activity.

In the area of public finances, Mr. Suraisry went on, the program target of reducing the public sector deficit by about 3 percent of GDP in 1984 would depend to a great extent on the authorities' ability to control current expenditure, as revenue projections might be optimistic and as development expenditures were expected to increase. The programmed rise in public sector investment in 1984 was welcome. Public investment had borne the brunt of expenditure cuts in the past two years, but there was scope for a gradual increase in investment to enhance growth prospects. The World Bank's support for the general thrust of Mexico's development plan and the investment priorities of the authorities was encouraging. The Fund and World Bank staff should collaborate closely to ensure that stabilization and development would take place simultaneously.

The moderate wage adjustments granted in 1983 had contributed to the reduction of inflationary pressures and had facilitated the authorities' adjustment effort, Mr. Suraisry considered. The January 1984 increase in the minimum wage by about 30 percent was consistent with the objective of reducing inflation to 40 percent by the end of the year. But the scope for further wage adjustment during 1984 was extremely limited, and he urged the authorities to maintain a cautious stance in that area.

On the external side, considerable progress had been made during the past year in simplifying the exchange system and narrowing the spread between the controlled and free market rates, Mr. Suraisry commented. He welcomed the authorities' intention to continue with a flexible exchange rate policy so as to maintain competitiveness. He encouraged them to unify the exchange system as soon as possible, but, in the meantime, he could go along with the existing dual system, especially as a balance of payments test was included in the program. The improved terms of new loans by commercial banks to Mexico were welcome; they provided evidence of the country's successful adjustment effort. The chances for continued success would increase as a result of an easing of Mexico's debt service burden.

The staff had indicated that Mexico would face a difficult external payments situation for the remainder of the decade, even under favorable assumptions regarding the growth in its foreign exchange earnings, Mr. Suraisry observed. The debt rescheduling of the past two years would result in a large increase in future debt service obligations. Mexico's ability to repay its debts would depend not only on a vigorous recovery in the world economy, but also on the pursuit of a sustained domestic adjustment effort. Finally, he wished the authorities continued success and he supported the proposed decisions.

Mr. de Groote indicated his support for the proposed decisions. He was concerned, however, about the assumptions underlying Mexico's balance of payments need. The medium-term projections in the staff paper gave

the impression that, assuming continued adjustment efforts and a favorable external environment, Mexico's external situation might gradually improve, as evidenced by declining ratios of interest payments to exports and to GDP, and of external debt to GDP. At first sight, that improvement seemed to be achievable with only modest net inflows of capital of about US$3-5 billion a year. A closer look--particularly at Table 8 of EBS/84/1, Supplement 1--revealed, however, that those small net flows concealed large gross financing flows, which needed to be spelled out more clearly. The staff had based their projections on a yearly flow of financing equivalent to two or three times the amount of new money to be obtained in 1984. The banks would thus have to refinance the maturing debt or reschedule nearly the entirety of the debt falling due each year until the end of the decade. The banks would thus have to increase their exposure in Mexico at least until the end of the 1980s. The staff's assumption regarding new financing was not unrealistic, but would need continuous collaboration between the Fund and the commercial banks. Therefore, some indication of the duration of Mexico's financing needs should be given to the banking community.

Despite the authorities' commendable adjustment efforts, a significant improvement in the external debt situation could not be achieved in the next few years, Mr. de Groote considered. Any disruption in the delicate balance between continuous adjustment, adequate financing, and a protracted recovery in the industrial world could have negative consequences for Mexico and for international financial relationships. Continuous Fund involvement to provide guidance in adjustment and financing was therefore necessary. The staff had illustrated in Scenario B how the adjustment process could be shortened by introducing more active measures for transferring resources to the external sector. Adjustment efforts thus far had already resulted in a 20 percent decline in real income in 1983, demonstrating that a delicate balance between adjustment and financing already existed. Further progress with respect to the balance of payments--perhaps through a greater liberalization of imports--was not conceivable unless Mexico had the benefit of additional financing. The Chairman's remarks were most useful in that respect, and the Fund should continue to monitor the Mexican situation closely.

When considering Mexico's request for augmentation at the time of the Article IV consultation, the Fund should take into account the additional resources that Mexico could hope to obtain from the markets and the better than projected export receipts, Mr. de Groote stated. Developments in the coming months would indicate whether the industrial world was experiencing a sustained recovery, which might improve Mexico's export performance. A careful examination of Mexican developments within the framework of the world economic situation would be required. He was in favor of allowing full access to the Fund's resources in cases where a country could demonstrate successful adjustment and where there was further financing need. In order to strengthen the role of the Fund, it was essential that the limit of 125 percent of quota be regarded as a real possibility for countries meeting those criteria. Finally, he welcomed the inclusion in the staff paper of the World Bank evaluation of Mexico's public sector investment strategy, a practice that should be followed in other cases.

Mr. Lindå commented that in the first year of the Fund-supported adjustment program, the Mexican authorities had made commendable progress in correcting the severe imbalances in the economy. Particularly noteworthy were the improvements in the fiscal and balance of payments areas. His chair had been slightly apprehensive about the capacity of the Mexican authorities to achieve the targets and objectives of the first year of the adjustment program. He was encouraged to find that those concerns had been unwarranted. Nevertheless, further progress was still necessary, a fact that was underscored by the high debt service burden that would prevail at least through 1989. Continuous and firm adjustment policies, requiring political strength and courage on the part of the authorities, were essential for the country to meet its external obligations for the rest of the decade. He agreed with the staff appraisal and could support the proposed decisions.

Inflation was expected to be reduced from 80 percent in 1983 to 40 percent in 1984, Mr. Lindå observed. Furthermore, the staff had indicated that the authorities had made the reduction in inflation one of their central policy objectives and that they were "seeking the virtual elimination of inflation." The staff had also stated later in the paper that inflation was expected to decline through 1985-88. When did the authorities expect to bring inflation under control? There were advantages to moving more quickly on the inflation front; the momentum of the adjustment effort might be lost by a too gradual approach.

With respect to wage increases, Mr. Lindå went on, wage developments in 1983 had contributed to the reduction in inflation; however, the wage outlook for 1984 seemed quite uncertain, particularly in view of the sizable increases in minimum wages granted at the beginning of 1984. Table 23 of EBS/84/1, Supplement 1 showed that real urban minimum wages had fallen by about 30 percent between January and December 1983, and a further adjustment would undoubtedly be called for at the beginning of 1984. Would it not be better to secure a real minimum wage through more ambitious inflation objectives? The outlook for wages had been a major area of uncertainty when the Executive Board had considered the adjustment program for the first year; it was again an area of uncertainty at the beginning of the second year. Perhaps the authorities should give increased priority to designing a more clearly defined incomes policy.

With respect to the authorities' exchange rate policy, Mr. Lindå noted that the Mexican peso had been adjusted daily by Mex$0.13 against the U.S. dollar since December 20, 1982, in order to reduce the inflation differential between Mexico and its trading partners. The daily adjustment in both markets was still at Mex$0.13 a day. How closely did the authorities monitor the pace of adjustment, and when would they change it?

Finally, the Mexican authorities had made considerable progress in a short period and were already reaping the benefits in the form of improved creditworthiness, Mr. Lindå commented. However, the growth performance and the employment situation in the past two years had both been disappointing; he hoped that strong economic growth might be revived in the near future and that the authorities would be rewarded further for their efforts.

Ms. Bush remarked that the Mexican authorities had shown perseverance in implementing their adjustment program. Over the past year, there had been a remarkable turnaround in the balance of payments position and a striking reduction in the public sector deficit. The authorities' determination to get the Mexican economy back on track was apparent from the fact that all the performance criteria had been met, with a substantial margin in most cases. However, there was still work to be done to restore economic stability and growth. The targets for 1984--real growth of 1 percent, inflation of 40 percent, a ratio of public sector deficit to GDP of 5.5 percent, monetary expansion of more than 40 percent, and foreign debt equivalent to about 40 percent of GDP--were still unsatisfactory in terms of the authorities' ultimate objectives. Their medium-term goals were much more ambitious than the results projected for 1984.

Commenting on Mexico's performance in 1983, Ms. Bush said that the reduction of the budget deficit in relation to GDP by 10 percentage points and the turnaround in the external current account from a US$3 billion deficit to a US$4 billion surplus were worthy of attention, particularly considering the difficulty many countries had experienced in those areas. First, the budget deficit had been reduced almost entirely from the expenditure side, as capital investment, wages, and capital transfers had declined in relation to GDP, and as exchange losses had been virtually eliminated. Furthermore, as the forecast tax revenues had not materialized, downward adjustments in excess of program targets had been made in the capital account, thereby permitting the authorities to meet the targeted deficit.

Second, Ms. Bush went on, the turnaround in the current account of the balance of payments had been brought about largely by drastic compression of private sector imports. In both the near and medium terms, it was questionable whether a sustained improvement in the current account should be achieved by holding down imports. Although real GDP had declined in 1983, the authorities were expecting a real growth of GDP of 5 percent a year beginning in 1985. Given that assumption, she wondered how long imports could be held to levels significantly lower than they had been in previous years without jeopardizing economic growth. According to the staff projections, imports would not reach the peak level of 1981 by the end of the decade. Could the staff comment on that issue? Could it provide any information about the composition of imports? How essential were imports for growth and development, and was the import growth assumption consistent with the projected growth of real GDP of 5 percent?

On a related point, the balance of payments position had improved as a result of the dramatic turnaround in the errors and omissions item of more than US$10 billion between 1982 and 1983, reflecting, in part, improved confidence, Ms. Bush went on. Continued adjustment should boost confidence further and should have a positive effect on capital movements, as well as on the willingness of foreign lenders and investors to provide financial resources. Recent news articles had reported that the Mexican authorities had relaxed some restrictions against foreign investment, and some had also implied that the 50 percent Mexican ownership requirement

might be relaxed in certain areas. Could Mr. Senior clarify the changes that had been made? The authorities should take positive steps in that respect; incremental equity investment could become an important complement to export earnings over the medium term in sustaining a viable external position.

As for other developments regarding the balance of payments in 1983, exports of manufactures, receipts from tourism, and border trade receipts seemed to have been responsive to the exchange rate depreciation, notwithstanding the adverse J-curve effect from the initial worsening in the terms of trade, Ms. Bush continued. Developments in 1984 should be more favorable and would provide a better test of the benefit of Mexico's improved competitive position.

Commenting on the program for 1984, Ms. Bush said that further progress needed to be made on the inflation front. There had been little deceleration in the approximately 4 percent monthly rate of price increase since spring 1983. Could the staff comment on that issue? To what extent had movements in the consumer price index in 1983 been affected by price deregulation and what would be the effect of further deregulation in 1984? Did the staff agree that most of the pent-up inflation had been spent?

The concentration of public sector investment on infrastructure seemed appropriate, Ms. Bush stated. Given the lack of progress thus far in increasing employment, emphasis should be placed on labor-intensive projects. Nevertheless, the authorities should keep in mind the need to structure projects in a way that would not create an unnecessary budget drain. She welcomed the relative shift in the burden of adjustment from capital outlays to current outlays in the public sector budget and the favorable opinion expressed by the World Bank concerning Mexico's public sector investment priorities.

The savings and investment targets for 1984 did not seem ambitious, compared with an investment ratio of almost 21 percent in 1982 and the much higher rates of the early 1980s, Ms. Bush observed. Additionally, the target of a gross savings rate of slightly more than 18 percent of GDP seemed low when compared with the rate of 19 percent of GDP in 1983. How appropriate were savings incentives? Real interest rates at the end of 1983 had been barely positive for 3-month deposits, and had been quite negative on 12-month deposits and on treasury bills. She could understand the authorities' wish to bring down high nominal rates by decelerating inflation, but it would be risky to bring interest rates down far in advance of actual inflation rates and inflationary expectations, especially in the early stages of the recovery when the personal savings rate might decline. Furthermore, she encouraged the authorities in their efforts to foster growth of the securities markets, which might ultimately prove to be a good avenue for encouraging more domestic and foreign investment.

With respect to pricing policy, she wondered if prices were sending appropriate signals to the economy, Ms. Bush said. The price of foreign exchange seemed to be realistic, judging from movements of the real

effective rate, which, despite some appreciation during 1983, was much depreciated from the levels reached between the 1976 devaluation and the end of 1982. Following traumatic exchange rate crises in 1976 and 1982, the authorities should continue to pursue a flexible policy. However, the goal of exchange rate unification still seemed highly uncertain, as it depended to some extent on the vague criterion of restoring orderly conditions in the capital account. What did that mean and when did Mr. Senior or the staff consider that such conditions would exist? As the differential between the controlled and free market rates had been narrowed substantially, would not the current period be an opportune time for unification?

Notable progress had been made in adjusting prices on publicly produced goods and services, especially energy, Ms. Bush observed. But it might be politically less sensitive and more efficient if more prices could be determined by market forces, rather than by discrete policy decisions.

While commending the Mexican authorities' adjustment efforts to date, she was disturbed by the comprehensive restrictions--such as exchange licensing, import licensing, price controls, and preferential interest rates--that still existed, Ms. Bush stated. She recognized that the authorities had taken some steps in relaxing those restrictions, and the proposed new tariff schedule to be substituted in some cases for import licensing was greatly welcome. However, she encouraged the authorities to move faster in that direction. In the same vein, suspension of the main export subsidy program in mid-1982 went in the right direction, but she urged the authorities to formally abolish that program.

Could the staff address the issue of local content and export performance requirements for foreign investors in Mexico, Ms. Bush inquired. Those requirements had expanded over time, most recently to the computer and pharmaceutical sectors. It was appropriate for the Fund to address such distortions, including export subsidies, as part of its emphasis on encouraging market-determined economic adjustment and in view of structural adjustment expected under an extended arrangement. Protectionist pressures were strong in all countries, not least in her own, which was Mexico's major market. If those forces were to be contained, it was essential that all countries take steps to roll back protectionist measures, while benefiting from the ensuing competitive market.

Finally, Mexico had received more favorable terms for some loan arrangements with commercial banks, Ms. Bush noted. Mexico provided evidence that an improvement in a country's economic and financial condition was likely to be reflected in improved risk premiums. In conclusion, she supported the decisions as proposed by the staff.

Mr. Wicks stated that Mexico's progress in 1983 had been remarkable. Confidence in the Mexican economy was being restored, as demonstrated by the virtual disappearance of disguised capital outflows and by Mexico's

ability to raise new money on the markets at a much improved rate. The initial stabilization period in Mexico had been completed successfully. He commended the Mexican Government and the Mexican population.

In the second year of the extended arrangement, the authorities should build on their previous success and should sustain the momentum of the adjustment effort, Mr. Wicks continued. The medium-term projections included in the staff paper demonstrated that much more remained to be done. He shared Mr. Polak's concern about the medium-term debt position, and Ms. Bush's concern that the authorities should improve the climate for foreign investment, which would obviously help the medium-term financing position.

He hoped that the authorities would continue with the structural reforms, in particular, the phasing out of price controls, the replacement of import restrictions by a more effective tariff system, and the unification of the exchange rate, Mr. Wicks remarked. Progress had been made in 1983 in all of those areas, and he welcomed the further progress envisaged in the letter of intent. Indeed, the improvement in Mexico's economic position in 1983 gave the Executive Board ground for expecting further structural action sooner than had been anticipated.

On more specific aspects of the program, Mr. Wicks went on, pricing policy was a difficult area, as the two priorities of reducing inflation and adjusting prices appeared to conflict. Little could be achieved in the medium term by bottling up inflation. The authorities had made progress in 1983 in adjusting public sector prices, reducing subsidies, and relaxing price controls; much of the repressed inflation of earlier years had already been passed through to prices. He welcomed the measures planned for 1984, but he urged the authorities to consider the complete elimination of price controls. In the long term, the abolition of price controls would lead to the efficient allocation of resources and the improvement of incentives, which was an important part of economic adjustment. Had the staff made any estimates of the consequences of such action on inflation in the short term? Progress in inflation would depend greatly on the level of wage increases. Although the Mexican people had made great sacrifices in that area already, he agreed with the staff that, given the inflation rate of about 40 percent and the increase in minimum wages of about 30 percent in January 1984, there was little room for further wage increases in mid-1984.

With respect to fiscal policy, the key objective must continue to be a reduction in the fiscal deficit, Mr. Wicks stated. The emphasis on capital expenditure, especially on infrastructure, was appropriate. While he appreciated the authorities' reasons for encouraging labor-intensive projects, he hoped that job creation would not become the main criterion for determining which investment projects should proceed. He welcomed the paper prepared by the World Bank staff reviewing public sector investment in Mexico (EBS/84/1, Supplement 2). He hoped that the preparation of such papers could become standard for the Executive Board's discussion of extended arrangements or of a series of stand-by arrangements. However,

the World Bank report was an interim one, and the Bank should follow up with more detailed studies. It was worrying that the World Bank believed that some aspects of the investment program gave cause for concern.

More generally, public expenditure would need to be kept strictly under control, Mr. Wicks indicated. The staff could have usefully included in its papers more discussion about transfers to states and municipalities; it was evident from Table 25 of EBS/84/1, Supplement 1 that current transfers to states and municipalities were on a rising trend and would reach 2.3 percent of GDP in 1984. Did that figure represent the full burden of the states on the Federal Government? Did the staff consider that the controls on state expenditure were adequate, and were any measures being contemplated to improve control over public sector agencies not subject to control at present? He shared the staff view that the authorities should proceed with great care before mobilizing the contingency reserve provided in the budget. Any action that could increase inflationary pressures would be unwelcome, and he hoped that that issue would be discussed more fully in the next Article IV consultation.

The improvement on the external side had been dramatic, Mr. Wicks observed. The situation with respect to the trade, current, and capital accounts was much improved. In particular, the gains in reserves in 1983 had exceeded by a wide margin the US$2 billion increase targeted for 1983. A further increase was projected for 1984. It was appropriate to reconsider the dismantling of import restrictions and the unification of the exchange rate. Recent developments had been encouraging regarding import restrictions, and the authorities' intention to implement a new tax schedule in the first half of 1984 and to liberalize import permits at a faster pace than in 1983 was welcome. Nevertheless, import licenses were still required for about 87 percent of imports. A major objective of the extended arrangement had been to end such restrictions. Indeed, in its letter of intent, the authorities made a cogent case for replacing the present system--which led to a lack of import competition, thus reducing the incentives for domestic enterprises to become more efficient, and produced distortions and inefficient resource allocations--with one that was more efficient.

A prompt return to a unified exchange rate was highly desirable, although the level of that exchange rate was debatable, Mr. Wicks continued. The staff had noted that one consequence of the dual rate was the leakage of export receipts; the medium-term balance of payments projections argued clearly for avoiding such leakages and for promoting exports wherever possible. Could the staff comment on those sectors with the potential for increased exports, to which it had referred in Scenario B? What encouragement might be given to those sectors in order to stimulate export growth?

Finally, he welcomed the authorities' intention to eliminate outstanding arrears by the end of 1984 and, in particular, their intention to repay those arrears for which peso deposits had been constituted at

the Bank of Mexico by the end of March, Mr. Wicks concluded. Had the authorities dealt with all countries' arrears? If some remained, what was the timetable for dealing with them?

Mr. Ismael stated that the turnaround in the Mexican economy in 1983 had been remarkable. The success reflected the determination and commitment of the authorities to implement the program, and he commended them for their perseverance. Continued perseverance would be difficult; in pursuing adjustment to the extent required in Mexico, economic growth would suffer owing to the severe compression of imports and public expenditure. The immediate objectives of the adjustment program should be to prevent further losses of foreign exchange and excess liquidity, but adjustment measures would be difficult to justify if growth was not revived in the medium term.

In view of his concerns for economic growth, he urged the authorities to bring inflation under control as soon as possible, Mr. Ismael went on. Indeed, substantial progress had been made in containing inflation, but more progress was required to bring it down to more acceptable levels. He supported the authorities' objective of reducing inflation to 40 percent in 1984; however, in view of the rise in the monthly inflation index for January 1984, he wondered whether that level was within range. It was essential for the authorities to pursue a flexible exchange rate policy if inflation was to reach the targeted level for 1984.

He supported a flexible exchange rate policy because there was little room for maneuver in the medium term, Mr. Ismael continued. First, the authorities should continue pursuing an export-oriented growth policy, which would be possible only by maintaining inflation at least at the level of Mexico's major trading partners. Furthermore, a reduction in the debt service burden from about 50 percent over the next five years to a sustainable level of about 20-25 percent would not be feasible unless the energy picture changed substantially. Second, Mexico needed to maintain essential imports for medium-term growth objectives. The severe compression of imports on the scale that had taken place recently was not a desirable adjustment measure. However, it was not unexpected, given the acute foreign exchange shortage during Mexico's financial crisis. In the long term, improvement in the current account would have to come from better export performance and from domestic adjustment that would make the economy less dependent on imports. Competitiveness therefore would have to be maintained.

Besides taking action to reduce inflation, the Mexican authorities should avoid large wage increases that could exacerbate the inflation and unemployment situation, Mr. Ismael considered. Wages policy would be more appropriately based on productivity increases. The staff had included little discussion in its papers on wage developments subsequent to the Executive Board's most recent discussion on Mexico (EBM/83/75, 5/23/83). The staff had mentioned that the minimum wage would be adjusted in 1984. Were there any further developments in that area? He would support a minimum wage increase for social reasons, but urged the authorities to be cautious.

He was encouraged by the fact that both the authorities and the unions had shown restraint and responsibility with respect to wage measures for 1983. He would be extremely concerned, however, if wage settlements in 1984 were greater than the cost of living increase. Could Mr. Senior elaborate on his statement that the Mexican authorities intended "to avoid further declines" in real wages in 1984?

In sum, the authorities' aim should be to consolidate and sustain the progress made thus far, Mr. Ismael remarked. The challenge of containing inflationary pressures through continued austerity was difficult, and supportive policies would also be required. Severe cutbacks in expenditure--particularly in public investment expenditure--might prove counterproductive in the long term. Economic recovery was essential to promote private investment activity. He urged the authorities to be more flexible on interest rate policy. Negative real interest rates did not encourage private savings and could lead to a misallocation of resources. Finally, he could support the proposed decisions.

Mr. Salehkhou stated that although the Mexican economy was not yet out of the woods, it was clear that in the first year of the adjustment program, the authorities, in cooperation with the Fund, had been successful in dealing with the difficulties that had faced the economy in the past three years and that had threatened the stability of the international monetary system. While the economic and financial policies had been unable to prevent a further contraction of GDP in 1983, progress had been made in containing inflationary pressures and improving the current account and overall balance of payments. Those two objectives were appropriately considered to be the cornerstone of the extended arrangement for Mexico. The performance in those areas, to a large extent, had restored confidence in the economy and improved the conditions for resuming a sustainable and healthy economic growth.

As for the policies pursued in 1983, it was noteworthy that despite considerable uncertainties about the various elements of the program and the response of the population to the far-reaching policies, the authorities had achieved the program's original goals, Mr. Salehkhou said. Additionally, all the performance criteria had been observed--some with considerable margin--and many doubts clouding the stabilization efforts had been removed. Mexico's performance in the past year had also been made possible by the cooperation and assistance of most of its partners, although the burden of adjustment had not been equitably shared between Mexico and its foreign creditors, particularly the commercial banks. Indeed, lending terms had been severe during the first year of Mexico's adjustment program, putting a heavy burden on the country at a time of extreme difficulty. The recent relative improvement in such terms was a welcome step; he hoped that commercial banks would make more efforts to tailor their conditions to the situation in debtor countries and to the seriousness of those countries' adjustment programs. Such an improvement in terms was as much in the banks' as in the debtors' long-term interests.

With respect to the program for 1984, he agreed with the thrust of the staff analysis and could support the proposed decisions, Mr. Salehkhou indicated. On fiscal policy, the continued containment of the public sector deficit should strengthen the adjustment effort. That policy, which aimed at reducing the inflationary pressures on the economy and emphasized the distribution of credit to the private sector, should clearly pave the way for a resumption of private investment and economic growth. He welcomed the fact that the projected reduction in the deficit should be accompanied by an increase in public sector investment. The provision for contingent expenditure to bolster the recovery if necessary in the second half of 1984 and the cautious conditions attached to spending seemed appropriate.

As for pricing policy, considerable liberalization had already taken place despite the maintenance of control over about 300 goods and services, Mr. Salehkhou observed. Moreover, the existing price controls were designed mainly to prevent excessive and unjustified price increases, while paying due regard to the impact of price increases on low-income citizens, thereby broadening the base of support for the stabilization efforts. The authorities' wage policy reflected their cautious and serious approach, which emphasized the importance of growth and competitiveness in any sustainable improvement in real wages.

Commenting on monetary and credit policies, Mr. Salehkhou stated that an improvement in the official allocation of credit should be encouraged. Nevertheless, the reduction of financial subsidies, particularly with respect to loans by development banks, should be conducted with great care as their role continued to be crucial in some sectors of the economy. Continued efforts to control inflation, while channeling additional credit to the private sector, were also welcome.

The continued reduction in the differential between the two exchange rates would facilitate the eventual unification of the dual rate, Mr. Salehkhou considered. Given the progress already achieved in that regard and the useful role of the dual system in the management of Mexico's capital accounts, the authorities' reluctance to consider unification at present through an accelerated reduction in the spread was understandable, particularly as their stabilization efforts had a long way to go.

With respect to Mexico's request for augmentation, Mr. Salehkhou remarked that he had no doubt about Mexico's eligibility for an additional use of resources. The request should, however, be considered thoroughly--taking into account not only Mexico's balance of payments need but also the prospects for a better implementation of the adjustment program--before a decision was taken by the Executive Board. He could go along with the course of action suggested by the Chairman at the present meeting.

While the program with the Fund and the related financial arrangements had improved Mexico's prospects for recovery since the 1982 debt crisis, the settlement of Mexico's financial obligations had been delayed, Mr. Salehkhou observed. Moreover, Mexico's outstanding external debt was

currently even larger, and its stabilization efforts had had high costs in terms of growth. Therefore, while he encouraged the authorities to continue their commendable adjustment efforts, a sustainable and healthy economic growth was the only real solution to the crisis. In that regard, the 1984 adjustment program was aimed in the right direction as it provided for an improvement in growth by strengthening confidence in the economy, reducing the public sector deficit, channeling more credit to the private sector, and accelerating the pace of import authorizations.

Mr. Lovato stated that as the Chairman had mentioned in a recent speech in Brussels, Mexico "provides a good illustration of how adjustment policies, when implemented with determination, do work." He agreed with the staff appraisal and could support the proposed decisions. The soundness of the Fund-supported adjustment program for Mexico had already received the implicit approval of private capital markets in the form of more favorable capital flows and improved credit terms; the Fund should not withdraw its support. There were two elements of the general economic situation that could be considered as highly satisfactory--the trends in public finance and the balance of payments situation--and two areas in which full success remained to be reached, although favorable prospects were in view--inflation and real growth.

Developments in the public finances had, in part, initiated the recent crisis, Mr. Lovato recalled, and fiscal policy had been appropriately assigned a central role in the adjustment program. The targets for the public deficit were being reached. Public investment, which had carried a substantial part of the adjustment burden in 1983, was expected to increase in 1984 as a percentage of GDP. Those positive developments reflected the implementation of a sound and well-balanced fiscal policy, carried out despite the considerable constraints imposed by the abnormal flow of interest payments.

The balance of payments was also expected to improve in the following years, Mr. Lovato observed. Mexico's external payments structure before the 1982 crisis had been characterized by a current account deficit compensated by substantial private capital inflows, making the overall balance slightly positive. The staff's projections indicated that the balance of payments would return to a similar situation, although with a slightly smaller current account deficit and a correspondingly stronger inflow of foreign reserves. Those projections implied that the reabsorption of Mexico's sizable public debt would have to be matched by a corresponding increase in the holdings of real and financial Mexican assets by the international private community; the current policy direction and the associated restoration of confidence were therefore crucial for the future of the country.

He commended the Mexican authorities for their realistic and courageous policy of exchange rate depreciation, Mr. Lovato went on. The negative repercussions of such a policy on domestic price inflation had been unavoidable and had been largely compensated by the equalizing effects of foreign current and capital payments. However, after a substantial period of time,

a constant absolute depreciation of the exchange rate implied a decreasing rate of depreciation, and was compatible with the maintenance of foreign competitiveness only if the inflation differential also followed a decreasing pattern. A flexible exchange rate policy must be followed in the fullest sense, and not merely by the willingness to permit a depreciation of the home currency.

He commended the authorities for their realistic evaluation of the microeconomic and macroeconomic implications of financial intermediation by the private sector and their intention to limit the extent of that intermediation, Mr. Lovato continued. The network of subsidies that was implicit in a system of public preferential credit was potentially a powerful instrument of sectoral as well as regional policy, whose medium-term implications should be investigated fully to avoid unwarranted consequences. Could the staff provide more information on the sectoral distribution of subsidies and of the current system of public lending?

The progress achieved by the authorities was laudable, Mr. Lovato said, but they should be encouraged to continue pursuing the adjustment policies and to give particular attention to those areas in which performance had been less satisfactory. With respect to growth and employment, he was pleased to hear from Mr. Senior that appropriate policies were planned for 1984 to foster investment in sectors that were especially important in creating employment. He urged the authorities to act promptly to review the tariff structure and to replace the import-licensing system by a comprehensive tariff-oriented system. Furthermore, the dual exchange rate system, which would result in distortions and might reduce the credibility of the authorities' policies, should be dismantled. The implementation of appropriate measures was important to the success of any adjustment program, but he shared the view expressed by Mr. Kafka that a recovery of the economies of major industrial countries, and therefore a recovery in international demand, could provide helpful support for the authorities.

Mr. Grosche congratulated the authorities for successfully adjusting the economy along the lines of the Fund program. The Mexican example made a strong case against those who favored a more gradual approach to adjustment. That was, of course, not to say that the Mexican example had proved without doubt that only a shock approach was appropriate.

The program had achieved a degree of adjustment that had been more pronounced than the Executive Board, the staff, or even the authorities might have intended, Mr. Grosche considered. The turnaround in the external position and the significant drop in output had been particularly dramatic. Developments in those two areas had been even stronger than estimated in the staff paper. He questioned whether the pace of adjustment might not have been too rapid, as it had imposed a substantial burden on the Mexican population, and there was the risk that the economy would once again follow a more expansionary path. Nevertheless, he recognized that given the serious circumstances facing Mexico in 1982, a shock approach to adjustment had been unavoidable and had proved successful thus far.

As for the second year of the program, it was crucial that the gains made on the external side be preserved--while allowing for some pickup in economic growth--and that inflation be further reduced, Mr. Grosche continued. The 1984 adjustment program supported those objectives, and he fully shared the staff's analysis and policy recommendations.

On the external side, the maintenance of competitiveness was essential for adjustment to be successful, Mr. Grosche noted. Continuous efforts to promote exports were necessary so that imports could be increased without widening the current account deficit. The authorities' exchange rate policy, pursued since late 1982, demonstrated their awareness of the importance of appropriate exchange rate adjustment. The current rate of depreciation would maintain competitiveness broadly at the level prevailing at end-1983, provided the price objectives for 1984 could be reached. If inflation were not reduced as planned, an acceleration of the rate of depreciation would be appropriate.

With respect to the medium-term projections of Mexico's external debt, Mr. Grosche said, Table 8 of EBS/84/1, Supplement 1 showed that after 1985 the debt service ratio would be approximately double that in 1984. Three conclusions could be drawn from those projections. First, no slippages in the program should be allowed. Second, any scope for additional external adjustment during the program period should be used. Third, it could not be overemphasized that Mexico would need to count on the continued cooperation of the international financial community in coping with its financing needs and handling its debt repayment schedule. The authorities had considerable reason to count on that support. Their firm adjustment policies and the results obtained to date had undoubtedly helped to regain the confidence of the international financial community. The continuation of strong adjustment efforts should further improve terms and conditions of financing from private banks, which would help Mexico to overcome its difficulties after 1985. Finally, he could fully support the Chairman's position with respect to Mexico's request for augmentation, and, he supported the proposed decisions.

Mr. Alhaimus remarked that the Mexican authorities had achieved considerable success in dealing with the serious economic difficulties that had culminated in the crisis of 1982. The most significant achievement had been the sharp decline in the fiscal deficit from more than 18 percent of GDP to about 8 percent of GDP, which had contributed to a greater than projected improvement in the trade balance and to a notable deceleration in the rate of inflation. It was not surprising that the major adjustment effort had adversely affected economic activity, resulting in a large fall in growth of real GDP in 1983. Program projections had not envisaged such a decline, and further discussion of that issue could have usefully been included in the staff paper.

One of the most important features of the 1984 program was the introduction of measures to arrest the decline in output, Mr. Alhaimus considered. A further improvement in the public finances was also essential for the success of the program. In an effort to reduce the fiscal deficit

to 5.5 percent of GDP in 1984, the authorities intended to strengthen public sector savings by stressing an improvement in tax administration and enhancing the viability of public enterprises. Furthermore, public finances were expected to benefit from the recovery of economic activity in 1984; real GDP was expected to grow by 1 percent in 1984, as opposed to a decline of 4.5 percent in 1983.

Various factors should contribute to the recovery of output, Mr. Alhaimus went on. The strengthening of public sector savings would permit an increase in capital expenditure. Imports would be allowed to increase substantially, thus easing the severe input shortages that had impeded productive activity, especially in the private sector. Furthermore, the 1984 budget contained authorization for a contingent expenditure to be released should economic activity not recover. The release of the entire amount might breach the fiscal deficit criterion under the program, but the staff and Mr. Senior had indicated certain safeguards to which the authorities were committed.

The fact that most of the projected 9 percent increase in exports was expected to come from the nonpetroleum sector was interesting, Mr. Alhaimus stated. Only a small increase in the value of oil exports was expected, and that owing mainly to the increase in the price of heavy crude oil. The 1984 program was based on the assumption that the volume of oil exports would not change in that year, an assumption that was reasonable given the market prospects and the need to ensure a stable world oil market. On a related point, could the staff elaborate on domestic pricing of oil products? In its paper, the staff indicated that the authorities would base their domestic pricing decisions on the international price of oil. That policy was in line with the staff's suggestion to other major oil exporting countries that the international price could be used to determine any implicit subsidy on domestic petroleum products. Should the international price invariably be used as a target for domestic prices, irrespective of the wide diversity of economic circumstances of countries, whether oil importers or large oil exporters? Aside from theoretical issues, there were many practical implications of a universal price for oil products, and they could lead to undue difficulties if applied in an inflexible manner.

In conclusion, Mexico's adjustment efforts in 1983 had been largely successful, Mr. Alhaimus considered. The 1984 program was realistic, emphasizing the need for continued fiscal discipline and for a reduction in inflation, while introducing measures that might contribute to economic recovery. Continued adherence to the strong adjustment program and the improved global outlook should enhance Mexico's ability to tackle its severe debt problem and resume a normal level of growth, sustained more by domestic savings than by external capital flows.

Mr. Joyce stated that the authorities should be congratulated for taking decisive steps to correct the domestic and external imbalances in the Mexican economy. Mexico's successes in the first year of the Fund-supported program demonstrated that a properly defined and effectively

implemented adjustment program could yield significant improvements in a short period; it was also a tribute to the Fund staff and the Mexican Administration who formulated the program. He hoped that the Mexican experience would serve as an example to other countries faced with similar economic difficulties. He was also heartened by the fact that confidence in Mexico--and more generally, in the international financial system--had been restored somewhat, owing not only to the efforts of the Mexican authorities, but also to the willingness of the population to make the necessary sacrifices. The improved confidence also demonstrated the readiness of members of the international financial community to reassess their position in Mexico after the authorities had demonstrated their determination and ability to take the necessary adjustment measures.

Nevertheless, much remained to be done, Mr. Joyce remarked. The Mexican economy was still in the process of recovering from a deep recession. While the steep decline in output had been arrested, economic activity remained low. Moreover, inflation was projected to be 40 percent in 1984, about 11 percent higher than in 1981. The external debt service burden remained large, and the sharp increase in the debt service ratio forecast for the next ten years was cause for concern. It was essential for the authorities to sustain the momentum of adjustment, if the economic gains achieved over the past year were to be consolidated.

The adjustment program for 1984 was broadly appropriate and he could support the proposed decisions, Mr. Joyce indicated. He welcomed the authorities' dedication to reducing inflation, although progress in that area had not been satisfactory thus far. Their plan to tighten the fiscal system was appropriate, and he welcomed the additional information provided by Mr. Senior indicating that Mexico had been more successful in that area in 1983 than originally indicated. The pool of savings available to the private sector should be increased in order to sustain recovery.

The current account of the balance of payments, which had improved in 1983, was expected to deteriorate in 1984 and to remain in deficit, Mr. Joyce observed. That pattern was not unexpected in a developing country that was likely to remain a capital importer for some time. Furthermore, economic recovery could not be maintained if imports were to remain at the 1983 level. Those factors underlined the importance of pursuing a flexible exchange rate policy.

With respect to external debt, the improvements in the terms of new borrowing by the authorities, the virtual elimination of speculative capital outflows in 1983, and the success to date of debt restructuring reflected the international community's growing confidence in the Mexican economy, Mr. Joyce considered. He welcomed the authorities' intention to eliminate outstanding arrears in 1984, as well as the steps already taken to facilitate the restructuring of private sector debt. However, the sharp increase in the debt service over the next few years was cause for concern. That situation would worsen as the grace periods negotiated in the restructuring of debt in 1982-84 came to an end. The projected easing of the debt burden expressed as a percentage of GDP depended on

the successful achievement of the growth objective. There would probably be a need for additional credit and additional rescheduling of debt in the future. The external debt situation further underlined the urgency of increasing exports and bringing about economic recovery. The level of exports depended not only on the authorities' efforts, but also on the willingness of other countries--developing and industrial--to accept Mexico's exports. Mexico's recovery would be costly not only to the Mexicans, but also to other countries.

Some progress had been made in easing the rigidities in the Mexican economy, by relaxing some of the restrictions and modifying the subsidy system, Mr. Joyce noted. Furthermore, the authorities appeared to be more receptive to opening the economy to foreign investment. Could Mr. Senior or the staff provide any further information on that development? Significant progress had already been made with respect to trade, but the list of prohibited items remained long. The sooner Mexico could shift to a tariff-oriented system the better, and he urged the authorities to take further action in that area.

His authorities would be willing to consider the authorities' request for augmentation of Fund resources, Mr. Joyce indicated. He agreed with the Chairman's proposal to consider that request at the time of the next Article IV consultation with Mexico. However, there were broader issues--the role of the Fund in reinforcing successful adjustment and the treatment of augmentation requests by countries with programs negotiated prior to the most recent quota increases--that should be considered by the Executive Board at some future date. In conclusion, Mexico seemed to be on the road to recovery, and its accomplishments to date were commendable.

Mr. Morrell praised the authorities for the substantial progress achieved in 1983 and for meeting all performance criteria under the program. Unfortunately, that success had been achieved at considerable cost in terms of lower output and reduced living standards for the Mexican population. Although the authorities' determination had been an important element in the success of the program, the support of the Mexican people should not be overlooked. He commended the labor unions in Mexico for the responsible attitude that they had shown. Wage determination was critical, and the authorities must be careful to avoid a system of full indexation to cost increases. He supported the proposed decisions and endorsed the program for 1984.

The Fund staff should be commended for specifying a program for 12 months, Mr. Morrell went on. Recently, there seemed to be a tendency for the staff to specify programs for a shorter period. The use of charts in the staff paper to demonstrate the authorities' performance under the program was helpful, and the staff should consider using such an approach in future papers.

He welcomed the decision to establish quarterly ceilings on the financial intermediation by the development banks and the official trust funds, in light of the substantial increase in credit extended through

such intermediation during 1983, Mr. Morrell stated. He also welcomed the authorities' intention to encourage those institutions to maintain positive interest rates on domestic savings instruments, although nominal interest rates could be expected to decline with the rate of inflation. He urged the authorities to expedite the modification of interest rate subsidies so as to improve the efficient allocation of resources and to reduce the disparities among lending rates.

On the external side, the authorities' intention to continue pursuing a flexible exchange rate policy and to unify the exchange rates was welcome, Mr. Morrell commented. In view of the virtual cessation of capital flight and the significant narrowing of differences between the controlled and free market rates during 1983, he wondered what the authorities meant by their intention to maintain the current dual exchange system until orderly conditions were restored in the capital markets. The authorities should be encouraged to unify the exchange rates as soon as possible. There were circumstances, however, where a dual rate of exchange was appropriate as a transitional measure; nevertheless, the transitional period in the case of Mexico would be about two years. In conclusion, he agreed with the Chairman that the next Article IV consultation with Mexico would be an appropriate time to consider Mexico's request for augmentation.

Mr. Blandin indicated his support for the staff appraisal and the proposed decisions. Mexico's example provided evidence that an adjustment policy, when pursued with determination by the authorities in cooperation with the Fund, could bring rapid improvement in the economy. The impressive results achieved by the authorities during 1983--despite a difficult international environment--had enhanced the potential for growth, not only in 1984 but also in the medium term. The successful containment of inflationary pressures had been crucial in that respect; the monthly rate of price increases had been reduced by more than one half. All performance criteria under the extended arrangement had been observed, in some cases with substantial margins. The authorities should be commended for those results.

On the external side, Mr. Blandin went on, the trade surplus had almost doubled in 1983 compared with 1982, and the current account balance had improved by US$10.5 billion. In spite of that commendable improvement, it might be wondered whether the decrease in imports had been too sharp, adversely affecting Mexico's trading partners as well. Furthermore, he wondered whether the link between the reduction of imports and real output had been underestimated in the analysis. He would appreciate some comments by the staff on that matter.

He agreed with Mr. Senior that a flexible exchange rate policy should be pursued to preserve the competitiveness of Mexican goods, Mr. Blandin remarked. He could understand the authorities' caution with respect to a unification of the dual exchange rates, given the risk of capital flight. The authorities had been successful in narrowing the spread between the rates of the Mexican peso in the free and controlled markets in 1983.

Furthermore, the authorities' wish to maintain a free market as a safety valve was understandable, but the elimination of a dual market should be sought in the medium term to avoid distortions.

He welcomed, in particular, the substantial effort made to regularize and restructure the external debt of the private sector, Mr. Blandin commented. The authorities' intention to eliminate the remaining arrears by the end of 1984 was appropriate. The improved international confidence had allowed Mexico to borrow US$3.8 billion under better financial terms, reflecting the success of the authorities' efforts.

On the domestic side, the authorities had implemented with determination a restrictive fiscal policy, Mr. Blandin noted. Consequently, the public sector deficit had been slightly lower than the program ceiling of 8.5 percent of GDP. That success had been achieved despite greater than anticipated exchange losses and interest payments, a pronounced fall in economic activity, and a fiscal deficit in 1982 of 18.5 percent of GDP, rather than the 16.5 percent of GDP originally estimated. In the past, the Executive Board had had many opportunities to explain slippages in adjustment programs brought about by adverse external or internal developments. In the Mexican case, it was encouraging that, despite adverse macroeconomic developments, the Mexican program had remained on track owing to the authorities' determination. The Mexican approach should be an example for other countries experiencing economic difficulties.

The authorities were entering the second year of their medium-term adjustment program, having already achieved impressive results, Mr. Blandin observed. They had demonstrated exemplary commitment toward the achievement of necessary, but sometimes costly, adjustment. Those courageous efforts would have to be maintained; the 1984 program seemed particularly appropriate and conformed to the aims of the extended arrangement. As other Executive Directors had stressed, the investment policy would be of crucial importance in enhancing the economic recovery.

Mr. Hirao commended the authorities for the substantial progress achieved in 1983; in particular, the reduction in the public sector deficit and in inflation and the strengthening of the external position. He especially welcomed the authorities' determination to bolster public finances. The comprehensive fiscal measures and more realistic pricing policy for goods and services to the public sector had been instrumental in the adjustment process. Notwithstanding the remarkable progress achieved, the budget deficit remained large, inflation was still high, the balance of payments position was weak, and the debt service requirements were heavy. There was a need to continue the thrust of the policies; the authorities should seek a further reduction in the rate of inflation and a gradual resumption of economic growth, without undermining the gains achieved in the balance of payments position.

He could fully support the 1984 program, which envisaged the continuation of the adjustment efforts, Mr. Hirao stated. In view of the progress made in Mexico's trading partners in reducing inflation, the

authorities had appropriately identified the reduction of inflation as one of their central policy objectives. To bring about recovery while reducing inflation, an increase in economic activity would have to be based on the revival of private sector activity. It was therefore appropriate that the 1984 program was oriented toward fostering private investment flows.

A reduction in the public sector deficit should remain the key element of adjustment efforts, Mr. Hirao commented. The envisaged improvement in the current account of public sector operations was welcome. The strengthening of public sector savings would allow an increase in capital expenditure within the framework of reducing the overall deficit. In that respect, the comprehensive plan to strengthen tax collections would play an important role in securing additional federal revenue. On the expenditure side, the review of public sector investment programs seemed appropriate. The authorization for contingent expenditure contained in the 1984 budget should be utilized cautiously and only if economic activity did not recover and if noninflationary resources were available to finance that expenditure.

Commenting on monetary policy, Mr. Hirao remarked that interest rates on domestic savings instruments should be adjusted to make the holding of such instruments attractive. He welcomed the modification of interest rates charged on preferential credit, which should allow a more efficient allocation of resources.

As for pricing policy, continued relaxation and increased flexibility in the management of the remaining price controls would be necessary to maintain adequate incentives for producers, Mr. Hirao went on. The wage policy should be forward looking and should be consistent with the overall objectives of the program.

The maintenance of a flexible exchange rate policy would be important to ensure competitiveness, Mr. Hirao stated. He was encouraged to note the authorities' intention to relax existing exchange restrictions further. The system of protection had permitted wide disparities in incentives among sectors. He hoped that the authorities would proceed with the tariff reform, which should enhance resource allocation. The task of adjustment facing the authorities would not be easy, but with continued perseverance and steadfast implementation of their adjustment policies, the resumption of sustained noninflationary economic growth was well within reach. Finally, he could support the proposed decisions.

Mr. Zhang indicated his support for the proposed decisions. He agreed with Mr. Senior that the Mexican authorities had demonstrated courage and determination in implementing the Fund-supported adjustment program. The outstanding results obtained with respect to the financial variables in 1983 and the additional structural measures being introduced were impressive. The authorities would be able to continue their adjustment efforts on a firmer basis. However, those adjustments had been associated with a 4.5-4.7 percent decline in output, a fall in real wages

of 25 percent, and a decline in manufacturing employment of more than 10 percent. A large-scale redistribution of incomes had taken place during 1983, and the impact of adjustment had not been proportionally shared by all economic and social groups. Could the staff indicate whether the burden of adjustment would continue to be borne by only some economic and social groups in 1984 and 1985 under the present Fund-supported program? What would be the implication of such an approach, and would there be any attempt to try to reverse the trend in that regard? The urgent need to recover from the current economic and financial crisis should not undermine the fundamental purposes of economic development.

He would be interested to know how the structure of the Mexican economy after the completion of the present extended arrangement would compare with the objectives of the National Development Plan 1983-88, Mr. Zhang went on. In its report, the staff had confined its comments on the Plan to qualitative statements; could the staff describe the details of the Plan in quantitative terms?

The large improvement in the trade balance in 1983 had been due entirely to the large decline in imports, indicating that the depreciation had had no effect on Mexican exports, in contradiction to what the staff had advocated, Mr. Zhang observed. With the recovery of domestic output and the consequent increase in imports forecast for 1984, would the equilibrium in the balance of payments be maintained? In the medium term, Mexico would still have to depend upon inflows of new capital to finance its balance of payments needs. Did the staff expect a return of capital on a large scale in the near term? In spite of its internal adjustment efforts, the maintenance of a viable balance of payments position in Mexico, as well as a lessening of its debt problem, would remain, to a large extent, dependent upon the volume of world demand for its exports, the degree of protectionism in other countries, and the level of interest rates in the international financial centers. Finally, the 1984 program would help to increase Mexican economic growth while maintaining relative price stability and external equilibrium. He wished the authorities continued success, and would consider their request for augmentation in the manner suggested by the Chairman.

Mr. Jayawardena commented that Mexico's adjustment during the first year of the extended arrangement was remarkable and deserved commendation. He recalled the evolution of the Mexican debt crisis and the serious concerns about the strength of the authorities' commitment to overcome the problems. Belying those fears, the new Administration had moved decisively in reversing long-standing imbalances in the economy, as well as overcoming a crisis of confidence. The Fund's role had been crucial at that time; the success of the program was important not only to Mexico but also to the Fund.

The turnaround in the external current account from a deficit of US$3 billion in 1982 to a surplus of US$4 billion in 1983 and the reduction in the fiscal deficit by 10 percentage points in 1983 were remarkable, Mr. Jayawardena stated. The substantial depreciation of the peso

had been necessary for successful adjustment and had been crucial for the re-establishment of confidence, as evidenced by the halting of capital outflows that had threatened the economy.

Nevertheless, those achievements had been made at tremendous cost, Mr. Jayawardena observed. Growth had been negative, imports had been compressed, and real income had fallen substantially. Those negative effects could have destabilized the sociopolitical structure of any country, but in Mexico's case, two factors had helped to maintain stability. First, the new Administration, determined to correct past imbalances, had moved with great courage and pragmatism. Second, there had been a remarkable sociopolitical consensus on the need for adjustment, as evidenced by wage restraint exercised by the trade unions. Those factors should not be taken for granted when formulating future policies; political realities should be considered when deciding on economic priorities.

The proposed program for 1984 was appropriate, Mr. Jayawardena considered. A further reduction in the fiscal deficit, the continued pursuit of a flexible exchange rate policy, and a cautious monetary policy would go a long way toward curtailing inflation. A reduction in inflation to levels prevailing in neighboring countries, such as the United States, was fundamental, first, for a substantial turnaround in the balance of payments position; second, to restore the confidence of the domestic and external markets--the Mexican problem had been blown out of proportion by a loss of confidence; and third, for an equitable distribution of income.

The authorities' courage in facing the economic realities emphasized the responsibilities of other countries desiring an orderly evolution of the world economy, Mr. Jayawardena noted. He was in full agreement with the Managing Director, who had referred to the obligations of other countries to help Mexico. The World Bank and the commercial banks should also help to ease the burden of adjustment in Mexico. Countries should not increase protectionism, thereby obstructing the efforts of Mexico on the export side.

He was concerned about the Chairman's reference to the fact that the staff had devised Mexico's adjustment program on the basis of access of 102 percent of quota, although the Chairman's summing up at EBM/83/167 (12/2/83) had clearly indicated that access in each case would be determined on a continuum of zero to 102 or 125 percent of quota, Mr. Jayawardena stated. The Mexican program, when originally devised, had been considered strong enough to deserve maximum access. The Executive Board, therefore, should be sympathetic to the request for augmentation, given Mexico's clear need for balance of payments assistance. His authorities hoped that the twostep approach of determining access of 102/125 percent of quota would be avoided.

The staff representative from the Western Hemisphere Department said that during 1982, prior to the Fund-supported adjustment program, there had been a sharp contraction of economic activity as a result of the financial crisis that had been developing. During 1979-81, economic growth

had been rapid; by 1981, the economy had been growing at a rate of about 8-8.5 percent of GDP on an annual basis. While no quarterly data were available for GDP, other indicators of economic activity suggested that in the first quarter of 1982, economic growth had slowed to about 6-6.5 percent of GDP, and by the second half of that year it had been as low as 2-3 percent of GDP. In the last quarter of 1982, GDP had contracted at an annual rate of 10 percent. The financial crisis had been felt throughout the economy, and with the imposition of import and exchange controls, economic activity had declined because of a lack of foreign exchange to buy imports.

In early 1983, a slight improvement had been evident in some sectors, although the economy had still been depressed, the staff representative commented. By the end of 1983, the economy had begun to stabilize. Economic activity in some sectors--such as tourism and import-substituting sectors--had begun to pick up as a result of the exchange rate change. But other sectors--particularly those related to the construction industry or to the procurement of inputs for the public sector investment program--had been heavily affected. Economic activity had been the lowest in late and early 1983, while the overall contraction in activity in 1983 had been about 3-5 percent of GDP. For 1984, even a 1 percent increase in GDP would be a relatively modest goal because of the low base. In fact, the staff had considered the possibility that economic growth might be even higher than 1 percent of GDP, given the good agricultural crop expected in 1984. In the petroleum sector, a continued leveling off was projected. There had been a boom in the tourist sector. The authorities did not expect any further deterioration in the industrial and construction sectors. Furthermore, public sector investment would increase somewhat in 1984, and if private sector investments also began to increase, there would certainly be room for growth. However, the authorities had asked the staff to be conservative in estimating economic growth in 1984 to avoid creating unrealistic expectations.

Imports, particularly private sector imports, had been low in 1983, in part because of the restrictions on imports, especially in late 1982 and early 1983, the staff representative from the Western Hemisphere Department noted. In early 1983, private sector imports had been extremely low, given the time lag between the issuance of permits and the actual import arrival in Mexico. However, imports had picked up by the end of the year. While some Directors had been concerned that the staff's projections of imports might be too high, others believed they were too low. The staff expected imports to be about 6-6.5 percent of GDP, a ratio that was consistent with the achievement of a rate of economic growth of 5 percent. During the mid-1950s and 1960s--a period of rapid growth of about 6 percent a year, with low inflation, and without balance of payments difficulties--a ratio of imports to GDP of 6.5 percent had been impressive. That ratio during 1981 had been completely distorted in view of the financial crisis and the inappropriate exchange rate prevailing at the time. However, the volume of imports had declined sharply between 1979 and 1983;

taking 1979 as the base year with import volume of 100 percent, imports in 1983 were estimated at about 55 percent, and the volume projected for 1984 would be about 85 percent.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/33 (2/29/84) and EBM/84/34 (3/2/84).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/125 through 83/127 are approved. (EBD/84/57, 2/23/84)

Adopted February 29, 1984

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/40 (2/28/84) is approved.

APPROVED: August 20, 1984

LEO VAN HOUTVEN
Secretary