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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/75

10:00 a.m., May 23, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	H. G. Schneider
	P. D. Péroz, Temporary
A. Donoso	J. Delgadillo, Temporary
R. D. Erb	
	T. Alhaimus
	Jaafar A.
T. Hirao	T. Yamashita
	D. I. S. Shaw, Temporary
A. Kafka	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
F. Sangare	
M. Senior	J. L. Feito
J. Tvedt	A. Lindø
N. Wicks	C. Taylor
	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

African Department: J. M. Jimenez. Exchange and Trade Relations Department: M. Guitian, C. M. Loser. External Relations Department: H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; P. R. Rado. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, J. M. Ogoola. Research Department: M. D. Knight, A. K. McGuirk. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, J. E. Gonzalez, A. S. Linde, J. P. Pujol, F. Rubli-Kaiser, L. M. Valdivieso, E. V. Zayas. Bureau of Statistics: E. Matayoshi, R. Pearson. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, C. J. Batliwalla, S. E. Conrado, S. H. Hassan, H.-S. Lee. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, R. Bernardo, J. Bulloch, T. A. Connors, G. Ercel, A. Halevi, W. Moerke, V. K. S. Nair, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Reddy, C. A. Salinas, Shao Z., H. Suzuki, M. Toro, A. Yasseri.

1. MEXICO - 1983 ARTICLE IV CONSULTATION, AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Mexico (SM/83/70, 5/9/83). They also had before them a report on recent economic developments in Mexico (SM/83/86, 5/17/83).

The staff representative from the Western Hemisphere Department made the following statement:

> On the basis of the latest data received, Mexico is meeting all the quantitative targets and limits of the program specified in the extended arrangement. The extended arrangement approved on December 23, 1982 established six quantitative performance criteria for purposes of the program. One of these--relating to external payments arrears--was an annual target.
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> Of the criteria subject to periodic performance limits or targets, the staff report already distributed to the Board has reported compliance with the target for net international reserves and the ceiling on net domestic assets of the Bank of Mexico. The staff has now received the data on the overall deficit of the public sector and its financing during the first quarter of 1983, and can report to the Board that all the remaining quantitative performance criteria have been met. The cumulative deficit of the public sector in the first quarter of 1983 was kept at Mex$183 billion, compared with a ceiling of Mex$360 billion authorized under the program. The cumulative use of foreign borrowing by the Mexican public sector, net of amortizations, reached US$901 million in the first quarter of 1983, compared with a ceiling of US$1,250 million authorized under the program. The public sector's net use of credit from the Bank of Mexico, which is measured by an amount outstanding, reached Mex$2,276 billion at the end of March 1983, compared with a ceiling of Mex$2,525 billion authorized under the program.
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> As a result of the compliance with these quantitative criteria, the only other requirement that has to be met under the program to entitle Mexico to make a further drawing is the completion of the present review. Should the Board approve the decision on the review that has been proposed in SM/83/70, Mexico will be entitled to purchase SDR 300.94 million.

Mr. Senior made the following statement:

> On behalf of my Mexican authorities, I would like to thank the staff for the excellent set of papers. My authorities are in general agreement with the staff appraisal.

In late 1982, the authorities formulated a medium-term adjustment program intended to lay the groundwork for a resumption of sustained growth of output and employment, which received the support of the Fund under an extended arrangement. Allow me to review briefly the main aims and philosophy of this program.

Given the magnitude and the nature of the current economic problems, the authorities have sought a careful balancing of priorities in their design of economic policy. The medium-term priority of the Government is to restore activity and employment levels. The authorities are aware that the attainment of that objective on a permanent rather than a temporary basis requires first abating inflationary pressures and strengthening the balance of payments. Short-run macroeconomic policies have thus been geared to adjusting the economy to a path of lower rates of nominal spending growth to bring it in line with aggregate supply and greater competitiveness of the domestic productive system.

The reduction of the public sector deficit was recognized as the key factor to controling domestic nominal demand, in order to reduce inflation and to strengthen the external position by reducing the need for foreign savings. The intended improvement of public finances involves a sizable reduction of the public sector deficit to the equivalent of 8.5 per cent of GDP in 1983, which implies more than halving the ratio recorded last year. This major budgetary adjustment, together with a cautious monetary policy, should allow rates of growth of total and private domestic credit compatible with the program's objectives for prices and the balance of payments. The strategy of economic adjustment also envisages a restoration of domestic savings, and, to that end, interest rate policy is being managed flexibly to increase significantly the opportunity cost of consumption activities. The exchange system is being adapted to promote the shift of expenditure and resources to the sectors producing traded goods. Thus, exchange rate policy has been conducted flexibly, courageous export promotion measures have been taken, and the protective system will be gradually liberalized with a view to rationalizing the structure of protection.

The set of policies mentioned above should bring about by the end of 1983 a reversal of the inflationary trend of the economy and a marked improvement in the external balance. In this latter respect, an amelioration of the current account is expected as a result of an increasing trade surplus; the external debt service will be significantly reduced, and the maturity profile of the external debt will be considerably lengthened. After undergoing this strong initial adjustment effort in 1983, the Mexican economy will continue gradually to adjust further over the remaining years of the program.

The policy actions taken so far have been in full compliance with the initial targets. Data on recent macroeconomic performance also indicate that the adjustment process so far is moving as expected, and that all the performance criteria have been met.

After a sharp real depreciation of the peso at the beginning of the program, exchange rate policy has been flexibly implemented so as to maintain the gains in competitiveness. Daily adjustments of the rate regulating the controlled market are effected on the basis of the expected inflation differential between Mexico and its major trading partners. In time, this policy will secure the reunification of the free and controlled market rates. As of May 8, important steps have also been taken to liberalize the trade system. Many existing restrictions on the import of raw materials and other productive inputs have been abolished, administrative procedures have been simplified, and tariffs, particularly those bearing on the production of export goods, have been significantly lowered. These courageous efforts show that the authorities are thoroughly committed to managing commercial policy in the direction of liberalization so as to foster efficiency and avoid distortions in the allocation of resources.

Despite the shortfall in revenues from income and value-added taxes due to the decline in the level of economic activity, the public finances recorded a significant improvement during the first quarter of 1983. The overall public sector deficit, in nominal terms, declined by 23 per cent below the level of the first quarter of 1982. Central government revenues rose by 113 per cent, while expenditures increased by 97 per cent. As a result of major upward adjustments in the prices and tariffs of public goods and services, revenues of public enterprises increased by 150 per cent, while their expenditures, including investment, increased by only 48 per cent. Their money supply has shown a declining trend, passing from an annual growth rate of 60.1 per cent in January to 49.7 per cent in late March. These rates of monetary expansion fall well below the rate of price increases, indicating a substantial contraction of liquidity in real terms. This stance of monetary policy, together with a flexible interest rate policy, has allowed the restoration of interest rates to realistic levels and has stimulated a marked recovery of deposits in the banking system during the first quarter of 1983.

Although most of the benefits of the adjustment process will not be felt until the second half of 1983 and thereafter, some encouraging results have already been recorded during the first quarter of the year. Thus, despite the decline in oil prices, the external sector has strengthened considerably in response to the real exchange rate adjustment and the lower rates of growth of real and nominal domestic spending. The balance of trade for the first quarter recorded a surplus of some $3.4 billion. This improved performance of the external sector has been due, to a large extent, to a $1.5 billion decline in imports, which have been reduced to less than one third their level of a year earlier.

Consumer prices have followed a clear downward inflationary trend, passing from 10.9 per cent in January to 4.8 per cent in March. In April the rate of increase over the previous month was of the order of 6.3 per cent, showing the impact of the sizable increases in gasoline and other administered prices which took place during that month.

In sum, I would concur with the staff that, although it will take some time for the full effects of the program to become evident, the policy actions carried out so far have been forceful and fully in line with the letter of intent of the extended arrangement. This certainly augurs well for the success of the program.

Before concluding, I would like to comment briefly on some specific points. In dealing with the exchange arrangements, the staff states that the current system may give rise to multiple currency practices arising from special rates applied to forward contracts for the payment of external obligations. In the view of my authorities, these operations actually mean a deepening of the forward exchange market. The difference between the exchange rates applied in these operations and the controlled exchange rate tends to be offset since, for any given time horizon, the interest rate forgone by those involved in such operations is expected to exceed the rate of depreciation of the peso in the controlled market. Thus, no subsidy may exist on a permanent basis, and no multiple currency practice arises.

The second point on which I would like to comment refers to some recent developments in the foreign exchange market. The staff indicates that there has been a revival of the parallel market, although the emerging spread has been very limited. In early February, due to uncertainty about developments in the international oil market and because the timing of the new loan agreement with foreign commercial banks differed somewhat from that originally expected, speculative pressures arose in the free market. However, when the adjustment in the price of Mexican oil and its impact on the balance of payments were announced and the fall in international rates was known, the rate in the border area tended once more to approach the free rate, and currently there is no longer a parallel market. Allow me to take this opportunity to state that my authorities are fully aware of the vital role played by the free market and will not allow developments that would endanger the flexible stance of exchange rate policy.

Mr. Kafka expressed agreement with the staff appraisal and the proposed decisions. The Mexican authorities deserved the Fund's confidence, support, and admiration for their decisive action in tackling the grave economic problems facing them in a world environment that was by no means favorable. In the five months since the program had begun, the Mexican economy had demonstrated far-reaching adjustment, both internally and externally.

Although Mexico benefited from the absence of formal wage indexing, the authorities did attempt to maintain the purchasing power of minimum wages in terms of 17 staples, Mr. Kafka continued. The staff had referred to the possible dangers resulting from greater frequency of minimum wage adjustments under the new wage law. With inflation running at high rates, more frequent adjustments might be unavoidable. They should be relatively harmless if suitably restrained.

There had also been significant increases in taxes and, above all, substantial upward adjustments in electricity tariffs and gasoline prices, Mr. Kafka noted. Apart from the resulting reduction in the public sector deficit, domestic savings had also been encouraged by a new interest rate policy, which was vital in view of Mexico's long, open frontier. The trend toward a strongly declining underlying rate of inflation was to be commended, despite the April increase in inflation attributable to corrective price adjustments, which Mexico had been right to undertake.

The existence of multiple currency practices was compatible with the country's present circumstances, Mr. Kafka said. He was not convinced that foreign exchange should be freely provided for unlicensed imports at the present stage, but he agreed that progress toward unifying the free and controlled rates for the peso was essential in the near future.

Adjustment in Mexico was occasioning heavy social costs because it had to be carried out within a restrictive international framework, Mr. Kafka concluded. In formulating their economic and trade policies, the international financial community and particularly those countries that had room for maneuver for stimulative policies or disposed of large reserves should take into account the international debt problem, not out of kindness or generosity but out of self-interest.

Mr. Erb said that he was in agreement with the staff appraisal and supported the proposed decisions. The Mexican authorities had made significant progress under the program with the Fund and were to be commended for implementing many difficult policy adjustments. However, several points emerged from the staff analysis.

First, interest rates and the controlled exchange rate were being adjusted on the basis of an assumed inflation rate at year-end of about 55 per cent, Mr. Erb continued. He had doubts about the adequacy of such a mechanical approach to setting interest rates. He agreed with the comment on page 24 of the staff report that "the question of the adequacy of the country's interest rate policy needs to be kept under close review, to ensure that it promotes the growth of savings and is consistent with the exchange rate policy being followed." On the related exchange rate issue, he strongly endorsed the staff's view that the authorities would be well advised to allow the free-market rate to serve as a true safety valve and to move as soon as possible to an appropriate unified rate. Again, adjustments were being made in the official rate on the basis of expectations of the rate of inflation. In effect, the underlying expectation seemed to be that the free-market rate would appreciate and move toward the official rate. In light of the staff's comment on the importance of the interest rate in relation to the growth of savings, at what point would the staff become concerned that the authorities' interest rate policy might not be adequate to generate the appropriate rate of savings over time? Moreover, what would the staff be looking for in determining whether the adjustments in the official exchange rates were adequate to unify the exchange rate over time? There might need to be some adjustment in the official rate.

Substantial fiscal adjustment was needed for the program to succeed, Mr. Erb went on, and it was important that the Government and public sector enterprises implement their expenditure plans in a manner consistent with the overall fiscal objectives. The discussion on pages 11-12 of SM/83/70 on procedures for settling arrears led him to believe that the Government was assuming a significant amount of the foreign exchange risk. As he understood it, the Government was accepting deposits for payment of external debts in pesos at present exchange rates; it would then pay the external creditor at some future time in foreign currency. If the exchange rate for the peso turned out to depreciate in the meantime, the Government could incur substantial losses that would have a large impact on the budget. Was the staff concerned about the potential exchange losses, and could the staff give Directors an idea of the size of those potential losses? He had also felt, in reading the staff report, that it was still unclear what the budgetary implications of such depository schemes had been to date in some of the guarantees provided. At what stage would there be a clear assessment of the costs of some of those developments in the current budget?

The Government of Mexico would be tested on the wage front in the near term, Mr. Erb remarked. He agreed with the staff that it was critical that any increase in wages agreed to by the authorities should be moderate.

More progress should be made in simplifying and rationalizing Mexico's restrictive trade system, despite present difficulties, Mr. Erb recommended. Achieving greater efficiency in the protective system was one of the important structural goals of the program. The present scheme of licensing imports appeared particularly inefficient. In that connection, he would like to be reassured by the staff and perhaps to be provided--if there were a complete enough inventory--with the components of the existing protective system. Thus, the Board would later be in a position to evaluate in some quantitative sense the degree to which trade liberalization was in fact taking place during the course of the program.

Mr. de Vries commented that he could support the proposed decisions; developments in Mexico appeared to be quite encouraging, and the program was on track. The course correction had been sharp, but there was still no clear picture of how the Mexican economy was evolving. He was however encouraged by the latest information that all the criteria set by the Mexican authorities had been met. They should thus continue on the new course and see how the economy reacted as the quarters progressed.

The budgetary position, a key element in the disequilibria that had built up in Mexico, had to play a key role in reachieving balance, Mr. de Vries continued. It was important that the various programs be implemented, both the reduction in spending by the authorities themselves and the cuts by public enterprises together with the adjustment of their charges and of the subsidies from which they benefited. Mr. Erb had just mentioned the exchange risk assumed by the Government in dealing with foreign trade. He himself had noted from the staff paper that the exchange risk had contributed to the large budget deficits in Mexico.

On monetary policy, Mr. de Vries went on, although it would be difficult for the authorities to move quickly from a planned and preferential system to one lacking those elements, he would urge that further progress be made. On the other hand, there had been a large change. In 1982, credit to the Government has been larger than the total increase in the money supply; in 1983, it had been less than 50 per cent of the increase in the money supply, indicating that there was room for credit to the private sector and also reflecting the improvement in Mexico's external accounts.

He agreed with Mr. Erb that wage developments would be crucial, Mr. de Vries remarked. Large reductions in real wages had already occurred, but, in preceding years, real wages had been rising extremely rapidly. He therefore hoped that the Government would be able to implement its wage policy.

He did have some doubts about the exchange regime, Mr. de Vries said. There were apparently three exchange rates: a controlled rate, a free rate, and a parallel rate. The trouble however seemed to be that the free rate was not free and that the parallel rate was not parallel, at least not all the time. If the authorities wished to restore confidence and achieve a more efficient allocation of resources, they might well have to make further progress on the exchange regime.

Mr. Grosche expressed his full support for the proposed decisions. His remarks would be confined to the key question of how the Mexican economy had been performing during the first months of 1983, after the Government had forcefully implemented a remarkable stabilization package that had received Fund support. There had been encouraging developments in certain areas, and he was especially pleased by the staff's statement that Mexico was meeting all the quantitative targets and limits specified in the arrangement with the Fund. Nevertheless, it was far too early to assess whether all the objectives for 1983 were likely to be achieved. Developments in certain areas gave cause for concern, and additional measures might be necessary.

One positive development, Mr. Grosche continued, had been the significant slowdown in increases in the consumer price index from over 10 per cent in January to under 5 per cent in March. He understood that the April figure was due to exceptional circumstances. Nonetheless, he would like to know the size of the monthly consumer price increases, for the remainder of 1983, that would be necessary to achieve the yearly inflation target of 55 per cent. It appeared unlikely, if not impossible, that the target would be met.

As to wage policy, he regarded the moderate adjustment granted the previous December as an important step toward halting the wage-price spiral, Mr. Grosche commented. However, like previous speakers, he saw a risk that the newly introduced possibility of revising minimum wages during 1983 might impair the stabilization effort. Therefore, he fully agreed with the staff that the Mexican authorities would need to continue to demonstrate caution and restraint in wage policy.

The authorities had implemented all the revenue and expenditure measures under consideration at the time the program had been announced, Mr. Grosche went on. Nevertheless, as the staff indicated on page 15 of SM/83/70, there remained some critical areas in which additional measures were needed to ensure that the fiscal target would be achieved. In particular, further action appeared necessary to strengthen the administration of the value-added tax and to offset exchange losses in the budget resulting from the special conversion rate for exchange rate transactions in U.S. dollars by Mexican residents. In general, strict fiscal discipline would remain essential to the efforts to reduce the fiscal deficit. On monetary policy, he had nothing to add to the staff view expressed on page 24.

With respect to trade policy, he was glad that in January the authorities had taken steps toward liberalization by lowering the existing import tariffs on some 1800 items, Mr. Grosche said. In the light of that encouraging development, he would like to urge the authorities to complete the restructuring of import tariffs as early as possible in order to move to a pattern of protection that enhanced allocative efficiency. He had noted with satisfaction from Mr. Senior's statement that the authorities had made a remarkable effort recently in reducing import restrictions. Could Mr. Senior say whether his authorities might consider implementing the staff proposal put forward on page 25 of SM/83/70, to give importers--still restricted in their access to licenses under the controlled market--access to the free market?

Progress toward an eventual unification of the exchange rates in the controlled and the free markets had been made only insofar as the controlled market rate had depreciated, Mr. Grosche commented. The free market rate had not appreciated, although such an appreciation had been considered desirable and would have been viewed as evidence of strengthening confidence in the Mexican peso. He therefore wondered whether a speedup in the gradual depreciation of the official rate might be justified, since the expected inflation rate of 55 per cent for the year was, in his view, unlikely to be achieved.

The economic crisis and the change in administration in 1982 had impaired a rapid recording of private external debt and the implementation of measures to deal with such debt appropriately, Mr. Grosche remarked. However, his authorities would like to express their concern about the way in which the matter had been, and was going to be, handled. In their view, more could have been done, especially in minimizing the danger that private Mexican debtors would encounter financial difficulties when trying to service their foreign debts directly.

He welcomed the intention of the Mexican Government to reach understandings on the refinancing and eventual settlement, in a multilateral setting, of the arrears on private credit that had received official guarantees, Mr. Grosche continued. His authorities would actively support negotiations of that kind. The way in which the Mexican authorities settled that issue should be geared to restoring international confidence in the private sector of the domestic economy.

It would take some time before the beneficial effects of the adjustment program in Mexico became fully evident, Mr. Grosche concluded. The policy measures implemented so far had been in line with the intentions of the program. The authorities should monitor the program carefully and in close cooperation with the staff. Additional adjustment measures that might become necessary to achieve the envisaged targets should be taken quickly and decisively. A full implementation of the Fund program was crucial not only for Mexico, but also for the Fund, whose credibility in helping to overcome the debt crisis was at stake.

Mr. Suraisry said that he was in general agreement with the staff analysis and could support the proposed decisions. Mexico's progress toward adjustment was being closely watched by the international financial community. While it was too early to reach any definite judgment, the program having been in operation for only five months, there were many encouraging signs, and the program appeared to be broadly on track. The authorities appeared to have made a good start in what would inevitably be a long process of stabilizing the economy and restoring international confidence. He found it particularly encouraging that the fiscal position had already improved significantly.

The revenue and expenditure measures agreed in December 1982 had all been implemented, and there was a good chance that the target of reducing the public sector deficit to the equivalent of 8.5 per cent of GDP would be met in 1983, Mr. Suraisry went on. He hoped that the authorities would continue to exercise firm control over the expenditure plans of public enterprises and government agencies, and he welcomed the authorities' intention to make periodic upward revisions in public sector tariffs. Encouraging progress had also been made in bringing down inflation. The moderate adjustment in minimum wages at the end of 1982, which had set the tone for subsequent private sector settlements, had been an important step toward breaking the link between past inflation and current wage adjustments. Nevertheless, since the authorities had left open the possibility that minimum wages might be revised more than once a year, there was a risk of renewed wage pressures. He would therefore urge the authorities to maintain a cautious policy stance, as there was no doubt that unrealistic wage increases could seriously undermine Mexico's stabilization efforts.

On the external side, he would encourage the authorities to press ahead with their efforts to deal with the large volume of outstanding arrears, Mr. Suraisry continued. It was essential to reduce those arrears as quickly as possible if Mexico was to establish its international creditworthiness. He also realized that the authorities had taken good measures to liberalize the trade system and, like other speakers, encouraged them to complete the liberalization of the country's trade system.

Finally, while recognizing that the initial emphasis in the Fund program had to be on implementing demand management measures and regularizing the debt position, he found it disappointing that the staff had said little about more fundamental structural reforms designed to improve resource allocation over the medium term, Mr. Suraisry remarked. When the Executive Board had discussed the extended arrangement with Mexico in December 1982, his chair had made the point that the papers did not include any assessment of Mexico's public sector investment program by the World Bank; a detailed assessment would have been useful. The current set of staff papers did not refer to any recent contacts between Mexico and the World Bank in that crucial area, a point on which he invited the staff to comment.

Mr. Schneider commended the staff for its concise descriptions of developments in Mexico since the discovery of large petroleum reserves in 1977, which provided almost a textbook case of how a country should not respond to an oil bonanza. The administration coming into office in December 1982 had taken a number of courageous measures in order to arrest the rapidly deteriorating economic and financial situation and also to bring about gradual recovery. In his view, the Fund's support of that underlying medium-term program had been well deserved. In domestic political terms, those measures had meant that the people of Mexico had accepted certain social costs and had forgone some economic development. Nevertheless, the authorities had no other choice but to correct the mistakes of the past by following a strict fiscal policy supported by a restricted monetary policy, in combination with a restrained wage policy. Moreover, there was still a need for further price adjustments in Mexico in order to enhance resource allocation.

The authorities would be well advised to accept the staff's view regarding greater exchange rate flexibility, especially in view of the prevailing uncertainties in international oil markets, Mr. Schneider continued. A further decline in the price of oil, even if only temporary, would be harmful to the endeavors of the Mexican authorities to stabilize their economy and would necessitate not only further domestic measures but also additional support by the international financial community, both from official sources and private sources. In that respect, he was disappointed that commercial banks had taken advantage of the rescheduling exercise to place a heavy additional financial burden on Mexico by raising fees and interest rates. While he understood that a number of commercial banks were trying in that way to cover their increased risks in lending to Mexico, the process might well be self-defeating.

In conclusion, the Mexican authorities were faced with a tremendous task of stabilization that could be accomplished only in the medium term, Mr. Schneider said. At the same time, the authorities were to be commended for the courageous measures taken so far, which deserved the continued support of the Fund. Thus, he could approve the two proposed decisions.

Mr. Péroz expressed support for the proposed decisions. Like Mr. de Vries and Mr. Suraisry, he agreed with the view, expressed in the staff report, that "given the short time elapsed since the adoption of the economic recovery program, it would be premature to make definitive judgments about the results of the policies being implemented." He also agreed with the tentative view expressed in the staff paper that the Mexican program appeared to be moving on track. It was reassuring to note that two of the major assumptions underlying the balance of payments targets--oil prices and interest rates--seemed to have remained valid and even appeared to leave some room for comfort.

One essential issue would continue to be a successful implementation of the fiscal policy adopted in the context of the financial program, Mr. Péroz said. The adoption in early 1983 of the present budget--which, as other Directors had noted, incorporated almost all of the cuts deemed necessary in spending and revenue--was a welcome development. The next area of uncertainty would be related to how successful the new fiscal policy turned out to be. One favorable indication would seem to derive from the currently low degree of central government financing through the Banco de México in the first months of 1983. Like other speakers, he would like to emphasize how limited the authorities' room for maneuver actually seemed to be. He looked forward to the answers to the questions raised by Mr. Erb and others about such issues as the impact of the assumption of exchange risk on the external debt.

On wage policy, a reasonable outcome in the mid-year adjustment would play a key role in the successful implementation of the authorities' strategy, Mr. Péroz continued. However, negotiations about the size of the adjustment had not yet provided an agreement consistent with the supportive role of wage policy to the authorities' anti-inflationary drive, so that a major area of uncertainty appeared to remain.

On the external side, it was probably unavoidable that, in present circumstances, a dual exchange market should be maintained for some time, Mr. Péroz remarked. While unification of the two markets would appear to be a desirable objective, it was doubtful whether such a unification could take place on a durable basis until the capital account of the balance of payments had been brought into better balance with the components of exchange rate determination. Furthermore, the strategy adopted by the authorities appeared to have been moderately successful in that some degree of convergence--although still quite insufficient--had been achieved so far and appeared to be continuing. He wondered, however, whether some greater flexibility in determining the transactions allowed to take place through the free market would not help to promote a faster pace of convergence.

He particularly welcomed the progress made toward settling Mexico's present arrears on private debt, Mr. Péroz concluded. In his authorities' view, the multilateral approach selected as a means of working out a solution to the problem was not only a guarantee of timely agreement but also a sign of success in the current negotiations and in the future attitudes of governments concerned with the extent of any additional support for Mexico's adjustment efforts. In addition, the staff report mentioned some difficulties that had arisen in connection with identifying credits guaranteed by official agencies, a large practical problem that had not yet been solved. His authorities were willing to assist in an effort to carry out the identification of credits and would provide the necessary information on French creditors as soon as feasible.

Mr. Doe said that he was in agreement with the staff's evaluation of the Mexican economy and supported the proposed decisions. The vigorous oil-based expansion of the Mexican economy that had occurred from 1979 through 1981 had virtually come to a halt in 1982, owing largely to the fall in oil prices and the worldwide recession. The interplay of those adverse developments, the short-term nature of many foreign loans, speculation against the peso, and some unfavorable policy initiatives had acted to move Mexico's balance of payments into a deficit position in 1982 for the first time in five years and had also led to the accumulation of external arrears. At the same time, the overall deficit of the public sector had risen to nearly 19 per cent, compared with an average of 10 per cent over the previous three years.

In cooperation with the Fund, the Mexican authorities had moved swiftly to take measures aimed at restoring sustainable internal and external balances, Mr. Doe continued. The authorities were to be commended for their determination in pursuing the adjustment program to date, particularly in their fiscal, pricing, and external sector policies. Since in the past Mexico had used the price mechanism as one of the vehicles for distributing the country's oil wealth, the liberalization of price controls and upward adjustment of prices in 1982 and early 1983 were indications of the authorities' flexibility in tackling difficult problems.

He welcomed the measures already taken or currently being considered in order to streamline the tax system, reduce distortions caused by inflation, and provide incentives to investors, Mr. Doe remarked. In particular, the elimination of onerous exemptions was a step in the right direction. He also welcomed the new policy on public sector hiring. He hoped that the Government would succeed in its efforts to halt the wage-price spiral and hence strengthen the base for a dynamic and competitive growth in the years ahead. The decision not to undertake new projects and to emphasize those with low import content would release some of the pressure on public sector spending. Finally, he would like to commend the collaborative efforts between Mexico and financial institutions that had led to the provision of bridge financing and successful rescheduling of debt service.

The significant depreciation of the peso in 1981 and 1982 would contribute to improving Mexico's competitiveness and its capability to earn foreign exchange, Mr. Doe noted. Along with the inflow of capital resulting from the restoration of confidence in the Mexican economy, improved competitiveness should pave the way for smooth servicing of the country's foreign debts. Finally, he agreed with Mr. Schneider that the imposition of additional fees on debts rescheduled by banks was an unfortunate practice that could be self-defeating.

Mr. Lovato said that he concurred with the staff's view that, although the limited time that had passed since the inception of the program did not allow more definitive judgments, the implementation of the measures under the program seemed to be on track, and the chances were good that the program's objectives would be achieved. He was glad to learn that the drop in international oil prices, which many had seen as a serious threat, had not led to any major reassessment of Mexico's current account prospects, and that it had been accompanied by a reduction in Mexico's interest cost, owing to the fall in international interest rates.

Fiscal performance seemed to be on track as well, Mr. Lovato went on, and only relatively minor changes had been made by Congress in approving the tax package. He agreed with previous speakers that there was room for improvement in administering the value-added tax. He was also happy to hear that the authorities expected no further exchange losses, for they could have been relatively large had the previous scheme been adopted.

Nevertheless, the original program appeared to have been optimistic with respect to the inflation rate, Mr. Lovato continued. The pace of price increases was still high, and he seriously doubted whether the original objective of a rate of inflation of 58 per cent year on year could be achieved. Some economists were predicting a 100 per cent inflation rate for 1983, and even the Mexican Finance Minister had said that he expected a rate of about 70 per cent.

High inflation might seriously affect two of the crucial components of the program, Mr. Lovato noted. First, it appeared that the pace of the devaluation of the peso, under the policies of daily adjustment, was likely to fall far short of the inflation differential between Mexico and partner countries. Even assuming that some competitive room for maneuver had been gained with the massive discrete devaluation in December, the danger of a quick real appreciation of the peso was still present. Furthermore, the hoped-for convergence of the controlled rate and the free-market rate was not occurring. Could the staff provide further comments on that point? In particular, he noted that the rate of depreciation--of 0.13 pesos per day--implied that the percentage rate of depreciation would decrease during the forthcoming period. What would be the authorities' view, if inflation continued at the present high rate? Second, the effects of high inflation might be felt in the authorities' incomes policies. It was clear that the current economic situation required wage moderation and restraint, but if inflation continued at the present rate, the implied reduction in real wages might be unacceptable and lead to resistance to a complete implementation of the program. As he had observed during the discussion in December, linking wage movements to expected inflation could be a dangerous experiment, if the forecasts turned out to be quite different from the actual outcome.

Turning to the pace of rescheduling of the external debt owed by private debtors, Mr. Lovato commented that the authorities were to be commended for establishing facilities that would guarantee forward exchange coverage for firms that agreed to rescheduling. However, he wished to urge the authorities to remain vigilant and to foster a return to normality. He did share the doubts and reservations already expressed about the hypothesis that the Government should take responsibility for private commercial debts, an event that might have undesirable consequences. In conclusion, he expressed support for the proposed decisions, noting that, in view of the medium-term outlook projected in Table 5 in SM/83/70, a continued effort would be required of the Mexican authorities and people for a long time to come. Therefore, the continued support of the Fund was warranted.

Mr. Kabbaj stated that when the Mexican Government had embarked on the Fund-assisted stabilization program in December 1982, the prospects of full recovery had seemed difficult indeed, as they still did. With the fall in petroleum prices, government finances and international reserves had come under considerable strain, and the overall deficit of the public sector had assumed unmanageable dimensions. Investment and savings had performed poorly, and, above all, confidence in recovery had been at a low ebb. The Government had taken a series of stiff measures aimed at restoring the economy to health in the medium term. Among the measures had been an initial major devaluation of the peso, subsequent gradual adjustments in the exchange rate, a series of price adjustments, drastic cuts in expenditure and imports, and steps to combat inflation and to restore private sector and foreign confidence in the economy.

During the previous five months, Mexico's international reserve position had improved, Mr. Kabbaj noted. Net domestic assets had shown a decline in the first quarter of 1983, and the monthly inflation rate in March 1983 had been significantly lower than the rate during 1982. Other improvements also attested to the authorities' successful pursuit of the program under the arrangement with the Fund, despite frequent obstacles. In fiscal policy--highly important because of the predominant role that the Government had come to play in recent years--the authorities had aimed at strengthening public sector finances. They had taken a number of significant steps to raise taxes, curtail expenditure, and limit the recourse of public enterprises to credit from banks and from other domestic and foreign sources. Nevertheless, there was a persistent need to monitor developments closely so as to avoid any unexpected slippages. In addition, monetary and credit policies had aimed at restoring confidence in the economy, raising savings, and providing the necessary resources for the private sector. In that connection, the interest rate policy had been managed flexibly.

In the external sector, Mr. Kabbaj commented, the exchange rate policy had also been managed flexibly: the periodic adjustments had been mostly corrective and had reflected the expected gap in the inflation rates between Mexico and its major trading partners. Those adjustments had followed a major initial devaluation of the peso in December 1982. The response of the export sector to such effective exchange rate adjustments remained uncertain. As a large part of Mexico's exports were priced in exogenous dollars, there had been declines in exports of manufactures, agricultural goods, and extractive products in 1982; exports were slated to rise only marginally in 1983. In fact, in both 1981 and 1982, declines in the nominal effective exchange rate of the peso had occurred. By contrast, non-oil exports had experienced a declining trend since 1979. Without a major overhaul and substantial diversification in the export sector, there were limits to what could be expected of a flexible exchange rate policy alone.

The significant decline in imports in 1982, which was projected to change little in 1983, had had a marked impact on the trade balance, Mr. Kabbaj remarked. The staff had expressed concern about the justification for continued tight control over essential imports; but Table 27 of SM/83/86 showed that the main cuts had been made in capital and intermediate goods. With gross domestic savings declining in 1982 and expected to stagnate or rise only marginally in 1983, investment had suffered in both years, and continued declines in industrial and capital imports would not help investment. With the overall balance of payments expected to show a surplus of nearly US$2 billion in 1983, there was obviously room for flexibility by the authorities in easing import restrictions.

The Government had achieved great success in the delicate task of maintaining control over incomes and domestic prices, while at the same time paying attention to the social environment, Mr. Kabbaj considered. There had been major overall increases in domestic prices, and a major liberalization of price controls had been carried out in January 1983. The wage law had been modified to permit more frequent revisions of minimum wages and the pursuit of a flexible wage policy, not an enviable task for the authorities in the present overall social situation.

Mr. Wicks said that he generally agreed with the staff appraisal: the success of the current extended arrangement was crucial not only for the future prosperity of Mexico, but also for the Fund's work in dealing with the international debt crisis. As he saw it, the immediate priority of the extended arrangement was to enable Mexico to restore its financial position, so as to place on a normal basis its relationships with the banks and other creditors. As Mr. Senior's statement implied, that condition was a prerequisite to the restoration of activity and employment.

In its papers, the staff had said little about the structural aspects of the program, Mr. Wicks went on. He agreed that the debt question should receive top priority. However, during the Board discussion the previous December, several Executive Directors had remarked upon the absence of direction on the structural elements in the arrangement. His authorities believed that it was important that the discussions between the Fund and the Mexican authorities about the second year of the program should focus on the structural aspects as well. His experience was that supply-side measures ought not to be deferred until so late in a program that they could have little effect upon its outcome. He would also like to see more evidence of the involvement of the World Bank in the program with Mexico.

He was in broad agreement with the staff appraisal of Mexico's fiscal policy, Mr. Wicks said. As the staff and Mr. Senior had indicated, the key to the success of the adjustment program was the strengthening of public sector finances; the authorities were to be commended for the strong measures introduced late in 1982. Nevertheless, two potential problems might jeopardize the objective of halving the public sector deficit by the end of the year and call for further adjustment. The first concerned the subsidy reduction policy, which already seemed to be coming under pressure. While fully understanding the Mexican authorities' reluctance to impose further price increases when the cost of living had already risen so high, he noted that it was generally agreed that strict pricing discipline was essential if a sharp reduction in public expenditure was to be achieved. The second problem was that the program relied too much on investment cutbacks. Certainly, investments had had to be cut back, but the ceilings on current expenditure also had to be reinforced. He found it encouraging that, according to Mr. Senior, the expenditure of public enterprises, including investment, had risen comparatively little during the first quarter of 1983.

Those problems on the expenditure side might be made worse by shortfalls in revenue from import taxes, the value-added tax, and the income tax, Mr. Wicks observed. To some extent, those shortfalls were the inevitable result of recession, but there were also references in the staff papers to greater tax evasion. Any losses on the revenue side would clearly have to be compensated in some way. The Mexican authorities might have to take further difficult decisions to recoup lost revenue by introducing further increases in the domestic prices of key products, such as gasoline. The Mexican authorities seemed well aware of all those difficulties, and he hoped that Executive Directors could be reassured that the authorities stood ready to reinforce actions already taken, if it appeared necessary.

The significant upward adjustment of interest rates in recent months was a step in the right direction, for which the Mexican authorities were to be commended, Mr. Wicks continued. Nevertheless, interest rates remained strongly negative in real terms, a worrying signal that might indicate the need for a more rapid adjustment of interest rate policy than originally planned. A positive adjustment would have a greater chance for success than reliance upon a prospective, but uncertain, reduction in inflation designed to bring real and nominal interest rates into line.

Wage policy was perhaps the most difficult and sensitive area of all, Mr. Wicks noted, and he accepted that the authorities' task was extremely difficult, if Mexico was to benefit from the increase in competitiveness obtained through depreciation of the exchange rate. He understood that the workers' confederation was threatening a strike in support of a claim for a 50 per cent increase in minimum wages, over and above the 12.5 per cent increase that was to take effect on July 1. The minimum wage might in fact move up by 18.5 per cent. Indeed, he had heard reports that that possibility made the planned reduction in inflation from 117 per cent to 55 per cent appear quite ambitious. Could Mr. Senior or the staff comment on the prospects for wages and the implications for the inflation targets?

On exchange rate policy, Mr. Wicks said he agreed with the staff that the authorities would be well advised to prepare to accelerate the unification of the controlled and free rates in order to help restore confidence and protect foreign exchange reserves. One point that he was unable to explain was the reported fall in non-oil exports by 16 per cent in the first two months of 1983 compared with the same period in 1982. The figure was surprising, given the increasing competitiveness expected to result from the depreciation of the peso. Did the fall have anything to do with the unofficial exchange rate arrangements? If so, there was all the more reason to move swiftly to unify the exchange rates. What was the timetable envisaged for the achievement of a single parity? His authorities would wish such a timetable to be a feature of the next review.

The forecast for Mexico's current account deficit in 1983 had become markedly more ambitious than the previous forecast, Mr. Wicks noted. The staff explained on page 8 of SM/83/70 that the forecast had been revised downward to US$2 billion from the original US$4.2 billion, a revision that seemed to reflect lower debt service payments, in particular by the public sector, owing to a fall in interest rates paid on dollar-denominated assets. Indeed, the new effective rate of interest on public sector debt was said on page 21 to be about 12.2 per cent. Did the debt figure fully take into account the spread, sometimes of more than 2 per cent, that Mexico was obliged to pay on rescheduled debt?

In conclusion, he supported the two proposed decisions and was in broad agreement with the staff appraisal, Mr. Wicks said. The Mexican authorities were to be commended for the robust beginning of a long adjustment effort, and it was a little too early to reach conclusions about the effectiveness of the actions taken. There were already signs that further action might become necessary. It would be a grave pity if the rewards of the good beginning were not secured by resolute follow-through action, if it were required.

Mr. Tvedt commented that the Mexican recovery program, supported by an extended arrangement, was designed to reverse the deterioration in Mexico's economy. Even though, given the short time elapsed since the adoption of the extended arrangement, it would be premature to make definitive judgments about Mexico's performance under the program, the staff papers made it clear that the forceful economic and policy measures taken so far had been implemented as planned. As a result, the Fund program with Mexico appeared to be on track, and there was ground for some optimism about the country's future performance. He was especially pleased to learn about the positive developments in international reserves and consumer prices.

An improvement in the budget was at the heart of the program, Mr. Tvedt noted. The authorities seemed to have attacked the huge fiscal problem vigorously and with a certain amount of success. Fiscal developments would have to be monitored closely in the period ahead; improved tax administration could play an important role in strengthening the budgetary situation. Administered prices had been raised partly to reduce the fiscal deficit, but also to encourage more efficient resource allocation, which could also come about as a result of changes in the level and structure of interest rates. He therefore welcomed the adjustments made in interest rates since November 1982. If demand for private credit, which had been weak in the beginning of 1983, should start to pick up, there should be an adequate availability of funds. He was encouraged to read in the staff paper that the Mexican authorities had reaffirmed a commitment to keep a limit on the use of domestic financing by the public sector.

The staff was correct in maintaining that the exchange rate should be managed with flexibility, Mr. Tvedt continued. Over time, an important objective should be to unify the exchange rate system. Another important objective should be to remove existing protectionist devices, and he welcomed the steps taken to liberalize the trade system.

The moderate wage increase granted in December 1982 and the new strategy on wage policy had allowed the authorities to break the link between past inflation and current wage adjustments, Mr. Tvedt said. However, he was concerned about the danger that, as pointed out in the staff appraisal, pressures might develop for more frequent wage adjustments, given the possibility that minimum wages might be revised more than once a year. He agreed with the staff that slippages in wage policy might severely undermine the authorities' domestic stabilization effort.

To sum up, Mexican decision makers had implemented a number of measures covering all the main fields of economic policy in an effort to overcome the serious problems facing the country, Mr. Tvedt remarked. The authorities had moved as fast and as far as could reasonably be expected in prevailing international conditions. Therefore, he supported the two proposed decisions.

Mr. Malhotra expressed agreement with the staff appraisal and noted that the Mexican program, one of the most important supported by the Fund, was off to a good start owing to courageous decisions taken by the authorities in several related areas. In the most crucial area of public finance, a number of steps had been taken that appeared to have yielded good results. The budget was in broad conformity with the target set for the overall deficit as well as the budget deficit. The authorities had tried to make the exchange rate and interest rate policies flexible; the balance of payments outlook, at least in the short term, appeared to have improved considerably. The five quantitative performance criteria that were to be monitored by the end of the quarter under review had been met. He recognized that the authorities would need to display vigilance and perseverance if they were to attain the objectives of the program.

The projection for the rate of inflation in 1983 was important, Mr. Malhotra noted, because it was the basis for assumptions regarding both exchange rates; if the actual rate of inflation turned out to be different, some problems could arise with respect to the pricing of foreign exchange as well as interest rates on deposits and credit. Therefore, he would appreciate hearing the staff's view on the prospects for inflation during the rest of the year. During the first three months of 1983, there had been a large decline in the rate of price increase, and the slight increase during April had already been explained. However, some uncertainty about the future course of inflation still remained.

The first wage settlement under the program had been moderate, a development that he welcomed, Mr. Malhotra went on. While the authorities should continue to err somewhat on the side of moderation during future wage settlements, a measure of realism might be necessary if the other measures in the program were to enjoy broad support.

Export growth in 1983 was projected at 1.8 per cent, Mr. Malhotra remarked, a figure that looked disappointing in view of the comprehensive steps taken by the authorities to promote exports. He shared Mr. Suraisry's disappointment that the staff had not yet provided a medium-term scenario, especially for investment, an omission that should be rectified in future staff assessments and reports. Moreover, in light of the modest export growth projected, he wondered whether Mexico was experiencing problems owing to protectionism in industrial countries. The section of SM/83/86 dealing with Mexico's exchange and trade system did not contain the usual analysis of restraints imposed by other countries on Mexican exports, and he would like to know why.

The authorities had reduced import duties on a large number of items and had liberalized the trading regime considerably, Mr. Malhotra observed. With regard to the future, they would have to take into consideration the prospects for Mexican exports. The Fund had to be careful in recommending a one-sided correction by a country experiencing a sharp squeeze on export earnings, and he would like further information on that point.

During the discussion of the Fund's program with Mexico, his chair had expressed the hope that interest rates in important economies would so evolve as not to place large additional burdens on Mexico and other countries facing debt problems, Mr. Malhotra went on. Although interest rates had come down recently, the spreads charged by banks on rescheduled debts had gone up. If the gains on the interest rate were to be substantially neutralized by increased charges, he could not see how countries' debt problems were going to be resolved. He appreciated the keenness of bankers in trying to protect themselves against what they might consider to be increased risks, but they would do well to realize that the Government and the people of Mexico, and many other institutions and governments as well, were trying to help the country in its efforts to adjust. It was important that the banks, apart from maintaining, or even increasing, the flow of funds to Mexico, should also play a part in easing the burden of charges.

Mr. Alhaimus said that, although it would be premature to make definitive judgments on the results of policies being implemented in Mexico, the program seemed to be on track according to the staff reports and encouraging results had been recorded during the first quarter of 1983, as stated by Mr. Senior. The magnitude of the difficulties faced by the country had been highlighted by the final data for 1982, which showed that the public sector deficit had reached 18.5 per cent of GDP, that GDP itself had declined for the first time in 50 years, that annual inflation had reached the unprecedented rate of 100 per cent, and that the overall balance of payments had been in deficit by US$6 billion despite improvements in the current account. The authorities seemed determined to maintain the public sector deficit for 1983 at the limit specified by the program with the Fund despite some unforeseen developments in the exchange rate, interest rates, and agricultural production. It was encouraging that the authorities had strengthened revenue further by introducing measures not originally included in the 1983 budget. A positive sign had appeared in the external sector as the Bank of Mexico had gained US$1.3 billion in net international reserves in the first quarter of 1983, compared with the program target of merely no loss in reserves. The inflation rate, as reflected in the monthly consumer price index, had fallen significantly during February and March compared with December and January. Despite the adverse impact of uncertainties in the oil market in February, exchange rate developments had been more moderate.

The success of the program depended on Mexico's continued adherence to strong measures, especially those designed to contain inflation, Mr. Alhaimus continued. Much still depended on developments in the oil market. The authorities had already said that, should petroleum prices drop considerably below current levels, they would need to review their economic strategy and adjustment program.

Mr. Wang commented that, although only a few months had elapsed since the adoption of the medium-term economic recovery program in Mexico, encouraging results had already been recorded in many important fields during the first quarter of 1983. He was especially pleased to note from the staff's statement that all the quantitative targets and limits in the program specified for the first part of 1983 had been met, an achievement for which the authorities were to be commended. In giving his support to the two proposed decisions, he hoped that the Mexican authorities would continue to carry out effective policies in light of specific conditions and would achieve greater success in implementing the adjustment program.

Mr. Hirao noted that he was in broad agreement with the staff views. It was encouraging that the program under the extended arrangement had been on track for the first few months. The authorities should be commended for taking bold adjustment measures, strengthening public finance, and introducing flexibility into incomes and price policies. A decline in international interest rates had offset the adverse effects of a decline in oil prices on Mexico's fiscal and balance of payments position. However, the interest rate decline had been decelerating recently, and the prospects for oil prices were still uncertain. It was thus all the more important for the authorities to maintain the momentum of their adjustment efforts. He agreed with Mr. Wicks that little had been said in the papers about supply-side developments, which were important in a longer-term perspective.

The 1983 budget had been formulated in order to achieve the key objective of substantially reducing the public sector deficit in relation to GNP, Mr. Hirao recalled. The final outcome of the fiscal balance in 1983 would greatly depend on oil prices, international interest rates, and exchange rates, but, given the uncertainties relating to those three external factors, it was all the more important to obtain control over public expenditure. The authorities had been cautious in making no allocation of global spending authorizations; they had correctly been strict in identifying priority areas and in tightening fiscal discipline for the rest of 1983.

On monetary policy, the authorities had to ensure an attractive rate of return on domestic instruments in order to promote savings and increase financial resources in the banking system, Mr. Hirao noted. Adjustments had been made in interest rates, but they should be kept under close review, particularly with a view to ensuring an adequate flow of funds in the private sector.

The authorities should be commended for their efforts in wage moderation, Mr. Hirao said. The size of the minimum wage increase given early in 1983 had been much smaller than the average rate of inflation during 1982, so that the authorities had broken the long-standing link between past inflation and wage adjustments. It would be desirable for wage moderation to continue at the time of the mid-year wage review. In order to prevent the rekindling of domestic inflation, the authorities should be cautious when considering compensatory wage adjustments that might be demanded on the grounds of eroding purchasing power owing to the depreciation of the peso or administered price adjustments. The number of items under price controls had already been halved. Reforms such as those should be continued in years to come.

The authorities had done well in terminating the generalized system of exchange controls in December 1982, as it had led to various problems, including the development of a parallel currency market, hidden subsidies, and the disruption of import flows, Mr. Hirao observed. The introduction of a dual exchange system had been one step forward toward a single flexible exchange rate system. Since that time, the controlled market rate had been depreciating rapidly, while the free market rate had been stabilizing. It was encouraging that the gap between the two rates had narrowed. As the staff recommended, it was important to allow the free market to serve as a safety valve for the system. The authorities should be encouraged to allow currently restricted external transactions to be conducted through the free market so that more goods could be imported without prior import licensing. In conclusion, he supported the proposed decisions.

Mr. Prowse also expressed support for the draft decisions and agreement with the staff appraisal. In particular, he was glad to note from the staff's opening statement that Mexico's performance had been completely in line with the targets: the authorities were firmly implementing what the Executive Board had regarded the previous December as a stern adjustment of policy. He shared the concern expressed by Mr. Wicks about the large subsidy element in the budget, and wondered whether the staff could provide any reassurances on that topic. He also agreed with Mr. Wicks's concern whether the decline in inflation could be maintained.

The gain in net reserves was welcome, Mr Prowse went on. As Mr. Senior had said, Mexico had had a trade surplus in the first quarter of US$3.4 billion, a notable achievement in the light of the drop of oil prices during that period. Could the staff clarify its expectations for the overall balance of payments for the rest of 1983 and perhaps for 1984? In particular, did the staff foresee any possibility that the Fund would revise program targets owing to recent developments in oil prices and interest rates?

Like other Executive Directors, Mr. Prowse continued, he had been pleased at the progress made by the authorities toward completing the formal requirements for debt restructuring and in particular the agreement reached with the banks to maintain interbank deposits at current levels, an agreement that contrasted with the difficulties being experienced by some other major debtor countries. Like Mr. Lovato, however, he had been concerned to read in the staff report that pressure was being put on the Government to assume the external obligations of the private sector. While believing that the staff would oppose such pressures, he invited the staff to clarify its position.

Even if the program worked, Mexico by 1987 would have a debt service ratio of 65.5 per cent, and it was open to question whether that variable represented an appropriate medium-term objective, Mr. Prowse remarked. Perhaps it was the best objective that could be hoped for, but it would not make restructuring of the economy or achieving dynamic growth any easier. He also wished to support the remark made by Mr. Schneider and supported by Mr. Malhotra concerning the charges imposed by banks for rescheduling. On a previous occasion when his chair had raised the same point, the Managing Director had expressed some concern at the cost not merely of the spreads but also of the fees for rescheduling, and the issue should be kept under continuing scrutiny. On the exchange rate, he supported the proposed decision approving Mexico's multiple currency practices and restrictions, but at the same time he endorsed the staff view--which Mr. Senior had said was shared by his authorities--that flexibility in the free rate for the peso was the best defense against the buildup of speculative positions and the subsidization of capital flows. The unification of the exchange rate structure should be an early objective.

On income and price policies, Mr. Prowse said, at the time of Board approval of the arrangement the previous December, his chair had been concerned at the lack of precision and clarity in the letter of intent with regard to wages. The January outcome that had held the increase in minimum wages to 25 per cent had been satisfactory, but he wished to record his concern at the current situation. For instance, he had read that there was a likelihood of a widespread strike on June 1 unless agreement was reached on a 50 per cent wage increase. While some compromise would probably be possible, he hoped that the staff could reassure Directors that the actual increase granted would be lower than 50 per cent.

Turning to Mexico's trade policy, Mr. Prowse agreed with the staff that progress toward liberalization had been modest. Could the staff or Mr. Senior say whether the Mexican authorities were considering accession to the GATT, a matter that they had been actively considering during the Multilateral Trade Negotiations in November 1979?

As to the substance of economic performance in Mexico, Mr. Prowse said that, after reading the staff papers, he was still unclear about how output and employment would evolve in the Mexican economy. A former Executive Director of the Fund for Mexico, Ariel Buira, had been reported as saying that manufacturing output had declined by 11 per cent and that employment had declined by 4 per cent. Did those figures indicate any need for concern about the authorities' ability to maintain the stern adjustment measures currently in place? He also wondered whether those figures should induce Directors to be cautious about the estimates for the external sector. How closely was the apparent decline in the real economy linked to the good outturn in the balance of payments?

Despite the queries that he had posed, the Mexican program was a suitable one that had been implemented as well as could have been hoped, Mr. Prowse concluded. The success of the program did not depend entirely on the efforts of the Mexican people; it was important that the recession in Mexico's partner countries should not continue beyond 1983 and that trade protection affecting Mexican exports should diminish rather than increase.

Mr. Shaw indicated that, like other Directors, he agreed with the staff appraisal and supported the proposed decisions. While it was too early to assess the performance under the program, his chair was encouraged that the authorities had remained in compliance with the program so far. The focus of the program should be on fiscal adjustment, especially if the revenue measures did not yield as much as the authorities expected, so that he would encourage them to make additional adjustments in current expenditure. He also noted that the movement on trade and pricing policies had been in the right direction, and he had been encouraged by the moderate increase in nominal incomes. However, he was concerned about the possible adjustment of wages occurring more than once a year and believed that the authorities should emphasize wage restraint.

On the external side, Mr. Shaw continued, he echoed the concerns expressed by Mr. Grosche, Mr. Péroz, and Mr. Suraisry. His authorities believed that any difficulties with the private sector guaranteed debt ought to be resolved within a multilateral framework, and they would advise the Mexican authorities to continue to pursue the current approach. The authorities should also move toward a unified exchange rate for the peso and adopt a more flexible exchange rate policy. Finally, the authorities were to be commended for their courageous and determined implementation of the program.

Mr. Jaafar said that he was in general agreement with the staff appraisal, fully supported the proposed decisions, and was pleased to note that the program had remained on track. He concurred with the staff that financial policy was the key. Strong adjustments had been made, but he would like to see the Mexican authorities making greater efforts to improve public finances, particularly on the revenue side, and achieve adjustments in expenditure. He would like to see them implement an incomes policy, which ought to reduce inflation and inflationary expectations. They should also obtain greater control over public expenditure to reduce the fiscal deficit further. The need for wage moderation was obvious: he welcomed the authorities' intention to break the link between wage adjustments and inflation. It was important for the success of the program to keep wage adjustments moderate. The staff was correct in saying that greater caution in wage policy was vital to the success of the adjustment effort. The authorities might also wish to take additional measures to raise interest rates in order to reduce inflation and improve the country's balance of payments.

The actual outcome in several areas in 1982 had turned out to be quite different from the estimates made in the December 1982 staff paper, Mr. Jaafar observed. At that time, Mexico's real rate of GDP had been expected to rise by 2 per cent; it was now expected to fall by 2.2 per cent. Estimates for the GDP deflator had changed from 63 per cent to 58 per cent, for the current account ratio from -3.6 to -1.7, for the ratio of overall public sector operations to GDP from -16.5 to -18.6, and for domestic credit from 146.6 to 186.2. In the light of the great changes in some variables, would the staff's projections for 1983 have to be revised accordingly? Any revision of the 1983 projections would affect the performance criteria agreed to with the Fund and would require approval from the Board. The staff should be encouraged to revise its projections whenever economic environments in member countries changed noticeably.

Mr. Delgadillo noted that the implementation of the first stage of Mexico's tight economic recovery program had already brought about a considerable improvement in the fiscal situation. Moreover, Mexico had fully complied with all performance criteria agreed to with the Fund. The authorities were to be commended for their determination to correct the imbalances in the economy.

Regrettably, the Fund staff did not expect Mexico's inflationary objective to be achieved, at least in 1983, Mr. Delgadillo went on. Higher inflation would be understandable, given the large one-time adjustment in many controlled prices and subsector tariffs as well as the large depreciation of the peso in 1982. Owing to those developments, the Fund program might well have become much more restrictive, especially in the fiscal area, the performance criteria for the deficit having been expressed in peso terms. As the inflation rate had turned out to be higher than expected, had not the nominal deficit figures become much smaller in real terms? In other words, might the Fund thus be asking the Mexican authorities to undertake a much larger adjustment effort than that to which they had previously agreed? In conclusion, he supported the proposed decisions.

The staff representative from the Western Hemisphere Department, addressing questions on output and employment in Mexico, explained that, especially in the last quarter of 1982, there had been a sharp drop in economic activity, partly related to the uncertainties prevailing just before approval of the extended arrangement and partly related to the establishment of exchange controls by the Government. There had been bottlenecks in production; from the first quarter of 1982 to the first quarter of 1983, the index of manufacturing had fallen by about 11 per cent. Moreover, the rate of open unemployment might have gone as high as 8 per cent, compared with about 4 per cent a few months earlier. Such figures as those were on employment related mainly to people who paid social security taxes, and in October 1982 there had occurred a sharp drop for the first time in many years in the number of people covered by social security. While there had been some pickup in the level of employment after October, it had been relatively minor, and output had increased hardly at all from the last quarter of 1982 to the first few months of 1983. Although the level of economic activity and employment in the economy was depressed, there had at least been no further deterioration during the first three months of 1983 compared with the three months immediately preceding.

The rate of price increases in Mexico had been sharp in December and January, the staff representative recalled. Part of the increases reflected adjustments made in a large number of public sector prices together with the liberalization of controls on private sector prices in January 1983. To some extent, the staff had expected a sharp increase in prices during the early months of the program with the Fund. He hoped that those price rises would have only a one-time effect, particularly if further increases in wages or in credit led to additional pressures on prices. At the time that the program had been framed, the staff had believed that wage policy was going to be prudent and that credit and fiscal policies were going to be tight, so that, once the impact of the peso devaluation and the changes in corrective prices had taken effect, inflation should slow sharply in the second half of 1983. Thus, in setting an inflation target for the year as a whole, the authorities had discussed a figure of 55 per cent, about half the inflation rate for 1982. In any program, changes in the level of economic activity might bring about changes in performance as time developed, and such changes might require some adaptations of policy to try to maintain the economy on the growth path that had been selected. In Mexico, it was important to determine precisely which policies were inflationary and whether the fiscal, monetary, and wage policies currently in effect would tend to reinforce the trend toward decreasing inflation or whether they would tend to perpetuate a high rate of inflation.

On wages, the authorities had been extremely prudent in the adjustment of minimum wages granted in December, the staff representative observed. While there had been strong demands for further increases, the authorities had indicated that they would try to stick as closely as possible to the figure for wage increases announced at the beginning of the year. As the issue was politically sensitive, the authorities had not wished, at the time when the program had been approved by the Board, to be extremely explicit about it; since wage agreements were being negotiated, they did not wish to give the impression that the final figure was being imposed on them from outside. Nevertheless, their intention had been to try to keep wage policy quite moderate, and the staff had received further assurances from them on that point. The authorities had said that, given the inflation target for 1983, the interest rate policy and the exchange rate policy should be adjusted to be consistent with achieving that target. They had also said that the exchange rate policy should be adjusted in order to maintain the real exchange rate of the peso unchanged from the end of 1982. To the extent that the authorities saw that inflation might be accelerating more than expected, they might wish to review the rate at which some of those policy instruments were adjusted. Moreover, the authorities had agreed that the exchange rate policy should take into account the size of international reserves, and also that the interest rate policy should take into account credit and savings developments.

Some Directors had questioned the investment policy of the Mexican Government and the role of the IBRD in Mexico, the staff representative recalled. At the beginning of the program, the authorities had not been completely clear on their investment plans. In any event, it was clear that the urgency of the situation and the size of the prospective adjustment implied that there would have to be sharp cuts in all kinds of spending; a large share of the cuts occurred in investment outlays, particularly since it took longer to delay the construction of a project than to make cuts in some types of current expenditure. At about the time when the Fund mission had been in Mexico in March, an IBRD team had arrived. As he understood it, the IBRD staff was preparing a report on the investment program and was discussing with the Mexican authorities the priorities that would be established for investments in the medium term. In some areas, the strategy that the IBRD would propose might be slightly different from that of the authorities, but in general the IBRD was pleased with the way in which the authorities had proceeded to review investment. The IBRD report would be available later in 1983, so that, by the time the Executive Board discussed the second year of the arrangement with Mexico, the Fund staff would be able to present a more complete picture to Executive Directors.

Another area of preoccupation with respect to the budget had been that of exchange losses and other subsidies, the staff representative continued. The authorities had moved forward in trying to eliminate exchange losses and to reduce other subsidies substantially. As part of the program, the prices charged by public sector enterprises had been greatly increased in December 1982; the authorities had also announced that they would conduct quarterly reviews of certain prices, such as gasoline, which had a direct effect on the cost of living index. Every time such an adjustment was made, it raised the figure of the price index for that particular month. However, the adjustments made in April 1983 had not resulted in such a sharp jump in the rate of price increase. Thus, to the extent that the authorities made further cutbacks in existing subsidies and approached the goal of full cost coverage, the percentage of adjustment would tend to be smaller.

Some Directors had asked whether the staff saw a need for revising some of the targets in the balance of payments, the staff representative recalled. At the time of the staff's discussion with the authorities, the feeling had been that the targets for the overall balance of payments could stay as they had been framed. The authorities had felt that, if some adjustment were made in the accounts, it would mostly affect the level of imports. They had made a small downward revision in the amount of imports available for 1983. However, they had not felt the need to go back to the markets to ask for more financing. One favorable development had been the sharp decline in international interest rates. The figures in the staff paper fully took them into account, and they had assisted countries like Mexico by diminishing the external payments that they had to meet.

A question had been raised about the performance of Mexico's nonpetroleum exports and the possible effect on them of the exchange rate policy, the staff representative remarked. Certainly, having a dual exchange rate with a large spread produced an incentive for many people to try to channel transactions--particularly export transactions--into the free market rather than the official market. The authorities were aware of the problem and had indicated that they would like to proceed toward unifying the exchange rates; like many Executive Directors, the Fund staff believed that the more quickly they could do so the better. During the first few months of the year, there had been some diversion of transactions, and the official statistics, particularly those dealing with exports, might not have reflected the total level of nonpetroleum exports that had in fact taken place.

Questions had also been raised about export restraints and incentives, the staff representative observed. The authorities had removed most of the special incentives to exports that had previously existed. For example, the tax certificates once granted to encourage exports had been dropped after the December devaluation of the peso. As far as he knew, the paper mentioned all other incentives that were given to exports. Furthermore, Mexico had never imposed many restraints on exports in the past. However, with the introduction of exchange controls, Mexican exporters now had to make official declarations in order to be able to export. The authorities had undertaken some initiatives to try to simplify the paperwork involved in those declarations.

One Director had asked whether Fund programs should be revised in the light of changes in inflation and GDP, as they became known, the staff representative recalled. In framing all country programs, of course, the staff established targets and ceilings in nominal terms. The staff referred to the targets as ratios in relation to GDP because it was a convenient way of trying to indicate the order of importance of some of the variables; many people found it easier to understand a deficit expressed as a certain percentage of a country's GDP rather than a certain figure in a currency that might well be unfamiliar. Moreover, GDP estimates tended to change, as a long time normally passed before accurate information became available. When the staff had come to the Board in December, it had been working with figures dating from August or September or even earlier, and developments during the last few months of 1982 had affected some of the staff's estimates. As one Executive Director pointed out, in some cases unforeseen occurrences between September and December had substantially affected the figures for the year as a whole. In deciding whether a change should be made in the program, Executive Directors might wish to focus on whether the targets set were feasible and whether the policies currently in place place were likely to achieve those targets. The Fund staff had raised the question with the Mexican authorities, who had explained that, on the basis of current conditions and the policies in place, the fiscal and balance of payments targets were achievable.

In light of the constraints on the fiscal and balance of payments targets, the changes that might occur in inflation, GDP, or economic activity might in fact require the Mexican authorities to make a stronger adjustment, the staff representative from the Western Hemisphere Department concluded. However, if available financing did not expand, the authorities would have to live with the old targets. In that way, the program might in fact become a bit more restrictive.

The staff representative from the Exchange and Trade Relations Department reassured Mr. Prowse, who had asked whether the public sector would assume private debt obligations, by explaining that as a general proposition such an assumption was not advisable, because it would reduce the discipline that the market was supposed to impose on private operations. As to the cost of some of the rescheduling, the staff was concerned about countries like Mexico and Brazil. At a certain point, the most relevant issue to be addressed had seemed to be the amount of financing and the degree of rescheduling that could be obtained from commercial banks, but that did not mean that the terms had been considered irrelevant. It was simply much more difficult to come to a practical conclusion about reasonable terms. Nevertheless, it would indeed be unfortunate if the terms of refinancing merely served the purpose of passing today's problems on to tomorrow, and in that sense the staff was concerned with those terms.

The possible losses in the exchange rate scheme put in place by the Mexican Government had been mentioned by Mr. Erb, the staff representative continued. As he understood it, the scheme to allow the private sector to pay its foreign liabilities did not in principle involve any subsidies for the first three or four years. During that period, the Government entity would be receiving deposits, so that the Government would not be experiencing any loss. After that time, subsidies and losses could arise from the repayment of foreign exchange, because the authorities had made their calculations on the basis of what they expected the path of the exchange rate and the interest rate to be and had therefore implicitly judged the likely inflation differential used to determine the exchange rate between the U.S. dollar and the Mexican peso, in which those deposits were going to be made.

He had been concerned that some Executive Directors had felt that there were not enough structural elements in the program, the staff representative from the Exchange and Trade Relations Department went on. Although there were doubts about how long the moderate wage policy could be sustained, it clearly had an important structural impact; a strong fiscal adjustment was also a critical ingredient. He would argue that the type of reduction in the public sector deficit sought in Mexico was one structural aspect of the program, others being the rapid exchange rate adjustments and the pricing policy measures. The only structural aspect that could give rise to misgivings was the speed at which trade was liberalized, the exchange system regularized, and existing subsidies eliminated.

Mr. Malhotra said that, in raising the question about restraints on Mexico's exports, he had been hoping a statement would be incorporated in future staff reports about protectionist measures affecting Mexican products in export markets. As regards inflation, the staff assessment appeared to be that, after the impact of the 1982 devaluation and a large number of price adjustments had been absorbed, the rate of inflation would abate. As he understood it, the staff maintained that, if the program developed as expected, major changes in policies for adjusting exchange rates and interest rates might not be needed.

The staff representative from the Western Hemisphere Department explained that inflationary pressures in Mexico would taper off once the initial impact of corrective measures had passed. Thus, it was important for the authorities to maintain their incomes policies and credit policies throughout that period so as to ensure that whatever corrective price changes occurred would not be fed back into the system. To the extent that the inflation rate might turn out to be higher than expected, the authorities should maintain flexibility on interest rates and exchange rates so as to maintain the exchange rate of the peso unchanged in real terms.

While the Mexican authorities had made a number of complaints about protectionist measures imposed in their export markets, the staff representative continued, they had not addressed that problem during the course of the consultations. The Fund staff had asked them whether they wished to make a statement, but had been told that the authorities were involved in bilateral negotiations and would prefer to handle it in that way.

Mr. Malhotra noted that the country's restrictiveness of a country's import policy was a subject of a great deal of comment and description by the Fund staff. Could the staff make it a regular feature of reports for consultations and reviews of programs to see how a country's exports were being affected by protectionist measures in other countries? Such information would show how far a country could adjust on its own and to what extent adjustment would depend on action taken by its trading partners.

The Acting Chairman explained that the Fund management had indeed asked the staff to take up more vigorously questions of protectionism in foreign markets and trade policy in Article IV consultations.

Mr. Erb suggested that it would also be important to look at any export restrictions that might affect a member, including restrictions maintained by countries that might not be the member's principal markets simply because these restrictions were so prohibitive that they blocked any entry into their markets by another country. Many countries had such highly restrictive practices that they offered no market at all to some other countries.

A number of Executive Directors had raised questions about the spreads and fees charged by commercial banks, Mr. Erb recalled. Even taking into account the higher spread, the total cost of borrowing was not far out of line with other costs of capital, whether for countries, corporations, or consumers in countries with major capital markets. The problem was perhaps that, in the past, fees and charges had been too small. In light of the recognition of some of the risks inherent in international lending, the spreads had quite appropriately widened over the U.S. prime rate and LIBOR, which, after all, were short-term rates offered to high-quality depositors.

The Acting Chairman observed that the topic of spreads and fees in bank arrangements with countries could be usefully examined by the staff to compare the resulting total interest charges with those on borrowing instruments of comparable maturity. Mr. Prowse had of course been correct in recalling that Mexico's balance of payments, particularly in the future, would be in a better position if the rates were lower. However, more realistic quantitative work was needed in order to reach a judgment about the extent, if any, to which the fees and spreads charged by the banks were inappropriate, quite apart from the question of what, if anything, the International Monetary Fund could do about such charges.

A question had also been raised by Mr. Prowse about possible Mexican membership in the GATT, the Acting Chairman continued. Apparently, the possibility of membership in the GATT had become a controversial domestic political issue in Mexico, and it seemed unlikely that Mexico would join the GATT any time soon.

Mr. Senior commented that one of the points to have emerged from the discussion was the magnitude of the adjustment undergone by the Mexican economy. The 1982 economic crisis had called for a determined reversal in the stance of policy, which placed great demands on economic management and social consensus. The Mexican authorities fully understood the nature and magnitude of the problem and had formulated an economic program embodying the adjustment effort required. Developments so far showed that the program was being carried out in full compliance with the initial targets: all performance criteria had been met, and basic macroeconomic trends were moving along the desired pathways. His authorities would continue to monitor closely the application of policy instruments so as to ensure that the program's objectives would be attained.

Many Directors had touched upon the relationship among the assumptions, instruments, and objectives of the program, Mr. Senior continued. Real GDP growth in Mexico was expected to be significantly negative in

1983, compared with the assumption of zero growth contemplated in the program. While developments in the real economy were undoubtedly subject to a wider margin of error than nominal variables, the degree of economic stringency to which the Mexican people were being subjected would depend upon the behavior of real variables, particularly real GDP growth. In Mexico, where the labor force grew by 4 per cent a year, a zero growth rate of GDP would entail a sharp cutback in the people's standard of living; negative rates of growth would imply even larger deteriorations in the standard of living and much greater hardship for the people. While adjustment was needed to attain a viable and sustainable external position, care should be exercised not to subject the economy to a degree of adjustment greater than that warranted by the attainment of external balance. If some variables should deviate markedly from the course originally forecast, some instrumental variables ought to be modified accordingly so that the economy could attain the intended objectives.

He shared the concerns expressed by some Directors that if, for a variety of exogenous or unforeseen reasons, inflation in Mexico turned out to be higher than foreseen and if policy instruments expressed in nominal terms were not modified, the Mexican people might well have to face real income losses much greater than currently intended, thus resulting in overadjustment on the external front, Mr. Senior said. The social costs associated with markedly negative rates of growth in real GDP could be extremely high and an attempt should be made to minimize them. In his view, financial programmers, and the Fund in particular, had to keep under review the compatibility among assumptions, instruments, and objectives so as not to impose on the country an adjustment effort more severe than intended in real terms.

Some Executive Directors had commented that Mexico was assuming a potentially high exchange risk relative to private commercial debt, Mr. Senior observed. However, the same exchange risk would be assumed if the Banco de México or the Mexican Government contracted external loans to finance the reduction of private arrears, selling foreign exchange to the private sector in the local currency. Thus, the mechanism as it had been designed would not lead to any additional exchange risk other than the risk that would result from a simple decrease in arrears financed by additional foreign debt.

However, there was still commercial risk, a matter that concerned the authorities, Mr. Senior continued. In present circumstances, many private enterprises would not have local currency with which to buy the foreign exchange that they needed for paying arrears or making deposits under the FICORCA scheme. If the Mexican Government extended special loans to those enterprises for such a purpose, it would indeed be assuming the commercial risk, in addition to the exchange risk. The FICORCA scheme contemplated allowing such loans in special cases, but the authorities would keep the scheme under constant supervision and review. In any event, they were committed to reducing arrears. Furthermore, governments and banks had indicated their clear preference that Mexico should deal with those arrears, even if it meant that the Government of Mexico assumed not only the exchange risk but the commercial risk as well. The authorities considered that they should not assume the commercial risk, although they were maintaining a flexibly pragmatic attitude.

Some Executive Directors had asked questions about the Government's policy stance on imports, Mr. Senior recalled. The previous Friday, the Government had announced a reduction in tariffs, mainly for agricultural and raw material imports. The reduction was designed to increase the efficiency of resource allocation.

When considering interest rates in Mexico, Directors should take into account that interest was paid every month, so that the relevant indicator was the level of effective yield, Mr. Senior noted. As the staff had said in SM/83/86, the effective interest rate for three-month deposits had been positive in real terms and was currently 0.56 percentage points higher than the inflation rate. The effective yield on treasury bills was currently 2.3 percentage points above the inflation rate. In sum, his authorities were committed to fostering the adjustment currently taking place and intended to carry out additional measures if they were needed to attain the program's objectives.

The Acting Chairman said that the Managing Director had held an extended discussion the previous Thursday with Mr. Silva Herzog, the Secretary of Finance and Public Credit of Mexico. The Secretary had made it clear that the current Mexican estimates for 1983 were for negative growth of about 2-4 per cent. The authorities also hoped that the rate of inflation through 1983 could be held to no more than 70 per cent. The Secretary had been explicit that the principal undertaking for the deficit of the nonfinancial public sector would be regarded not as a percentage of GDP but rather as an absolute figure of Mex$1.5 trillion. He had reaffirmed that the Mexican authorities were not asking for a change in that figure. Moreover, on a number of policy elements--including the exchange rate, interest rate, and wages--the Secretary had given indications that the Managing Director had found reassuring. For example, he had said that the Government was fully aware of the need for keeping the increase in the minimum wage at mid-year at a modest level. While it would no longer be possible to stick to the Government's original offer of 12.5 per cent, the intended wage increase would be less than 18 per cent.

The Acting Chairman then made the following summing up:

> Directors praised the determination and forcefulness with which the Mexican authorities have moved to implement the economic adjustment program supported by the extended arrangement with the Fund. The size of the imbalances--both external and internal--that had been building up during recent years made necessary a severe cutback in domestic demand, and the authorities had responded with the needed resolve. The adjustment program was geing carried out without hesitation, thus showing the political devotion of the authorities. The results of the first few months of the year were encouraging and indicated that the program was on track, though perhaps with a higher rate of inflation and lower growth than had been forecast.

Directors viewed with favor the authorities' decision in late 1982 to allow the Mexican peso to depreciate and to liberalize the restrictions in the exchange system, and they welcomed the steps taken to support the exchange rate policy with monetary, fiscal, and other measures to restore internal and external balance.

Directors emphasized that fiscal policy was a key component of the economic program, and that perseverance in maintaining strict discipline in this area was crucial for achieving the aims of the program. Although the actions already taken were bringing about a significant improvement in the fiscal situation, the reduction of public expenditures to a rate consistent with a large deceleration of inflation would require substantial and sustained effort in the period ahead. Measures could also be taken to strengthen tax administration.

A number of Directors noted that recent exchange rate movements and other corrective price measures were likely to result temporarily in a high rate of price increase, perhaps even beyond the levels originally projected under the program. But the changes in cost/price relationships were a necessary part of the process of adjustment. It was stressed that it was particularly important that the public enterprises maintain flexible pricing policies while trying to increase productivity and reduce costs, and that subsidy payments be curtailed not only to improve the public finances but also to prevent further distortions in the efficiency of resource use.

Directors referred to the central importance of avoiding large wage increases that would work at cross-purposes with these adjustment initiatives and would delay the return of conditions favorable to job creation. The need for caution in this field was strongly emphasized in relation to the mid-year increase in the minimum wage. This was considered by a number of Directors to be the most difficult and important element of policy at the present time.

Directors were encouraged by the flexibility that the authorities were showing in their handling of interest rate policy, but they observed with some concern that some interest rates continued to be negative in real terms. They also noted that the new forward exchange coverage schemes for private sector debtors underscored the continued need for a coordinated approach in the handling of interest rate and exchange rate policies based on a realistic course for the exchange rate so as to avoid the generation of new subsidies. Some Directors also pointed out the need to continue to work toward eliminating existing subsidies associated with preferential credits.

On exchange rate policy, Directors recognized the efforts to restore international competitiveness since late 1982, but some Directors stressed the troublesome distortions that over time would result from a dual-rate system. They welcomed the trend toward reducing the differential between the two rates but urged the Mexican authorities to unify their two rates as rapidly as possible. Many Directors urged the Mexican authorities to eliminate arrears as rapidly as possible.

A normalization of external payments would undoubtedly help to restore confidence and Mexico's creditworthiness abroad, although it was recognized that the resources available for the reduction of arrears were still quite limited at this time. Some Directors observed that it was important that any negotiation with foreign creditors for refinancing of arrears be conducted in a multilateral framework.

Directors noted that the refinancing negotiations on the external public debt had been successful in diminishing the pressures on the balance of payments in the immediate future. They emphasized, however, that the easing of the debt management problem on a lasting basis would only come about through the reduction in the public sector's reliance on foreign borrowing. Some Directors cautioned the authorities against assuming private debt obligations, given the already heavy burden borne by the public sector and the need to avoid action that would impede the use of external financing by the private sector in the future. Concern was also expressed regarding the consequences for the budget of the Government's assuming exchange risks in the servicing of foreign debt.

With respect to commercial policy, a number of Directors pointed out that the use of import restrictions was inefficient and costly in terms of growth and output and employment. The ability to import, particularly through the free market, was considered an important safety valve for the system that should be allowed to operate without undue hindrance. Directors noted the preparatory work that had been done by the Mexican authorities for a liberalization of trade, and they urged that actions in this direction start to be taken without delay. It was hoped that in due course a quantitative evaluation of trade liberalization effects could be made.

To conclude, Directors generally agreed that the thrust of the policies being implemented by the authorities was appropriate to the current circumstances of Mexico. They encouraged the authorities to continue with their adjustment effort and to stand ready to take additional measures as might be necessary to keep the adjustment effort on track. The point was also stressed by several Directors that structural measures of adjustment should be fully addressed in the second year of the program in a medium-term framework and in conjunction with the World Bank. It was noted in this respect that it would be important that Mexico not face unduly protectionist moves in other countries.

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

The Executive Board then took the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Mexico's exchange measures subject to Article VIII, Sections 2 and 3, in light of the 1983 Article IV consultation with Mexico conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Mexico maintains multiple currency practices and exchange restrictions as described in Section V of SM/83/70. In view of the circumstances of Mexico, the Fund grants approval of these multiple currency practices and restrictions until May 22, 1984, the completion of the next review under the extended arrangement, or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 7406-(83/75), adopted
May 23, 1983

Review Under Extended Arrangement

The Fund and Mexico have conducted the review pursuant to paragraph 4(c) of the extended arrangement for Mexico (EBS/82/208, Sup. 4) and as contemplated in paragraph 29 of the letter dated November 10, 1982, from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico attached thereto. The Fund finds that no new understandings are necessary regarding circumstances in which purchases may be made for the period after May 15, 1983 and until the next review under the arrangement.

Decision No. 7407-(83/75), adopted
May 23, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/74 (5/20/83) and EBM/83/75 (5/23/83).

2. COMMISSION OF THE EUROPEAN COMMUNITIES (CEC) - TECHNICAL ASSISTANCE

In response to a request from the Commission of the European Communities for technical assistance, the Executive Board approves the proposal set forth in EBD/83/142 (5/17/83).

Adopted May 20, 1983

3. APPROVAL OF MINUTES

The minutes of Meetings 82/160 and 82/161 are approved. (EBD/83/138, 5/16/83)

Adopted May 20, 1983

APPROVED: October 19, 1983

LEO VAN HOUTVEN
Secretary