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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/167

10:00 a.m., December 23, 1982

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

Executive Directors	Alternate Executive Directors
	P.-C. Maganga-Moussavou, Temporary
	C. Taylor
J. de Groote	
B. de Maulde	A. Le Lorier
A. Donoso	M. Teijeiro
R. D. Erb	C. Dallara
M. Finaish	T. Alhaimus
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
J. Sigurdsson	L. Vidvei
Zhang Z.	Wang E.

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

Also Present

African Department: J. B. Zulu, Director; J. M. Jimenez. Asian Department: S. Kimura, M. R. P. Salgado. Central Banking Department: L. M. Koenig, Deputy Director; D. R. Khatkhate. European Department: B. Rose, Deputy Director; W. L. Hemphill, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; D. K. Palmer, Deputy Director; M. Guitian, S. Kanesa-Thasan, C. M. Loser. External Relations Department: C. S. Gardner, Deputy Director; D. M. Armour, H. O. Hartmann. Fiscal Affairs Department: V. Tanzi, Director; C. A. Aguirre, M. I. Blejer, P. R. Rado. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, J. M. Ogoola. Research Department: W. C. Hood, Economic Counsellor and Director; M. Goldstein, G. H. Spencer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Deputy Director; C. E. Sansón, Deputy Director; A. Baumgarten, M. E. Bonangelino, M. Caiola, J. E. Gonzalez, Z. Hodjera, A. S. Linde, J. P. Pujol, H. O. Struckmeyer, I. C. Tandeciarz, S. Umana, L. M. Valdivieso. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: L. Barbone, R. Bernardo, T. A. Connors, R. J. J. Costa, M. K. Diallo, G. Ercel, C. Flamant, I. Fridriksson, G. Gomel, A. Halevi, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, Zhang X.

1. MEXICO - USE OF FUND RESOURCES - FIRST CREDIT TRANCHE; REQUEST FOR EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered requests by Mexico for an extended arrangement equivalent to SDR 3,410.625 million and a purchase in the first credit tranche equivalent to SDR 200.625 million (EBS/82/208, 11/12/82; Sup. 1, 12/13/82; Sup. 2, 12/21/82; and Sup. 3, 12/21/82).

The Chairman observed that Mexico's financial requirements not covered by the International Monetary Fund and other direct investment sources would amount to $7 billion for 1983. On November 16, when speaking ing to the international banking community in New York, he had proposed $2 billion of that amount be provided by official sources and $5 billion by banks. He had of course been referring to new exposure. In addition, a vast effort was under way to reschedule the amortization due in 1983 on the medium-term and long-term stock of debt. There was also the important innovation of including short-term debt in the stock of debt to be rescheduled or restructured over a number of years; the Fund would have been happy to act in the same way a few years previously in a case like that of Turkey.

As to Mexico, the banks had agreed to reschedule over an eight-year period not only the amortizations due in 1983 on Mexico's medium-term and long-term debt, but also the bulk of the short-term debt, an element that should help to stabilize Mexico's external position, the Chairman remarked. Furthermore, the international banks had agreed to keep at the present level their deposits with Mexican agencies making transactions on the interbank market.

Some time previously he had explained to the banks that he would feel able to approach the Board and ask for its support of the proposed use of Fund resources only if he had sufficient assurances that the banks would meet Mexico's requirements stemming from the design of the program with the Fund, the Chairman continued. He would also like to ask for the support of Executive Directors in carrying through the vast international support operations that the Fund had coordinated. Executive Directors should not miss an opportunity to ensure the success of the operation.

He had suggested that $2 billion be contributed by official sources, the Chairman recalled, and he had received written assurances from governments that a supplementary credit of $2 billion would be paid to Mexico in 1983. He would especially like to thank the U.S. Treasury staff, and in particular Mr. McNamar, for the extraordinary stamina that it had shown during the previous weeks in gathering together all the strands that made up the support package.

The banks had had a quota of $5 billion, the Chairman said. In view of the need to syndicate $5 billion among 1,400 or 1,500 banks, he had been convinced that it was technically impossible for responses from all the banks to arrive by the date of the present meeting. The Fund had thus held discussions with the advisory group on what figure would constitute a critical mass, i.e., an amount large enough to satisfy him that sufficient momentum had been created in the banking community. The advisory group had suggested a figure of $3.5 billion; he had replied that the amount was too low. After a long discussion in the range of $4 billion, he had said that he would be satisfied if, at 10:00 a.m. on December 23, positive responses had been received for $4.5 billion, a figure eventually accepted by the banks.

At 5:00 p.m. on December 22, the Chairman continued, the cable room of Citibank had reported commitments of $4.32 billion; the banks had thus fallen short of the total amount by $680 million and of the critical mass by $180 million. As the objectives that he had set had not been achieved, he invited Executive Directors from countries whose commercial banks had not yet contributed their full share to consult with the authorities concerned on the best means of securing the additional funds.

Of the $5 billion to be contributed by the commercial banks, quotas for individual countries had been established on the basis of the exposure of their commercial banks in Mexico, the Chairman commented. Some in the advisory group had suggested that the banks commit themselves for more than their share to make up the $5 billion. There had, however, been strong resistance in the advisory group to the suggestion, because it might have served as an escape valve for many banks, particularly small ones, which would rely on commitments by the major banks to take care of their own shares. Eventually, the overcommitment mechanism had been discarded, and each bank had been asked to increase its exposure in Mexico by 7 per cent. It was a purely mathematical exercise; there was no safety margin. In other words, each country and each bank had to provide its full quota if the full $5 billion were to be available.

Japan had a quota of $918 million and had already pledged $826 million, leaving a shortfall of $92 million, the Chairman went on (see Annex I). While no answers had officially been received from Spain, with a quota of $121 million, the Governor of the Bank of Spain, Mr. Alvarez Rendueles, had said the previous day that $93 million had been committed. However, the telexes to that effect had not been received by the cable room of Citibank.

Italy's quota was $130 million, the Chairman noted. As $8 million had already been pledged, there was a shortfall of $122 million. Belgium had a quota of $76 million; answers had been received for $46 million, leaving a shortfall of $30 million. Switzerland had a quota of $222 million; answers having been received for $128 million, the shortfall was $94 million, but he was in constant contact with Mr. Leutwiler on the subject.

A number of countries, including Canada, the United Kingdom, and the Netherlands, had contributed amounts in excess of their quotas, the Chairman remarked. There was a problem with regard to Germany, whose quota was $265 million, although answers had been received for only $218 million.

Apparently, three banks had not yet answered. From Arab countries, whose quota was $107 million, $50 million had been promised so far. Citibank was in close touch with each of the banks concerned, and hoped to obtain the remaining $57 million in a short time.

The United States had a quota of $1,911 million, the Chairman said. U.S. banks had so far committed $1,676 million, leaving a shortfall of $235 million. The problem in the United States stemmed from the large number of small banks that had granted credits to Mexico, sometimes for relatively minor amounts. Those working on the matter were hopeful of being able to obtain replies from the smaller banks soon.

Mr. Senior made the following statement:

> On behalf of my Mexican authorities, I would like to express their sincere appreciation for the valuable and timely cooperation of the Fund management and staff. The authorities are especially grateful to the Managing Director for his efforts and valuable help in bringing about delicate negotiations with banks and other official creditors. Changes and adjustments in policy to cope with rapidly evolving circumstances and developments have also placed a heavy burden on the staff and on the Mexican officials in the timely preparation of documents for our discussion today. The desirability of having an approved stabilization program before the end of the year has made necessary the issuance of supplementary documents even as recently as last Tuesday, and a short time has been given to the Board in a complex and important case. My Mexican authorities are very much aware of the Executive Directors' cooperation, and have instructed me to express to the Board their appreciation.
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> In broad terms, the Mexican authorities are in agreement with the staff assessment concerning developments in the Mexican economy during past years, and with its perspectives for the near future in the context of a stabilization program with the Fund. Since the Article IV consultation with Mexico last July, underlying economic conditions have drastically changed in Mexico. The country's financial situation, in particular, has markedly deteriorated owing to an accumulation of both external as well as domestic factors. As is well known, during 1977-81 the Mexican economy experienced remarkable progress, output grew at an average annual rate of 8.5 per cent, while real per capita income rose by over 6 per cent a year. This expansion, made possible by a rapid rise in oil production and exports, was broadly based in different sectors and was accompanied by important progress in employment, health, and education. In particular, employment, chronically one of Mexico's main economic and social problems, increased at an average annual rate of 5.4 per cent, well above the 3.5 per cent annual rate of growth of the labor force.
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> This rapid economic growth gave rise to intensified demand pressures, and major financial imbalances emerged in 1981 as

world economic activity and trade stagnated, interest rates reached record levels in international financial markets, and oil export prices softened. On the domestic front, the situation was aggravated by an attempt to sustain growth rates in the face of unfavorable external developments, which led to a marked increase in the public sector deficit and in its financing requirements. External public debt sharply increased, and some crowding out in the internal financial markets arose. To redress this situation, the Mexican authorities adopted a series of important measures in the second half of 1981, which turned out to be insufficient to cope with the uncertainties that prompted capital flight and caused that substantial deterioration in the external position. This led the Central Bank to withdraw from the exchange market in February of this year; from that date on, the crisis has been deepening. The staff documents explain in sufficient detail the developments that have taken place in the last few months, the measures that were adopted by the authorities in their effort to redress the imbalance, and their decision to negotiate a three-year extended arrangement with the Fund, so there is no need to repeat them in this statement.

The new Administration that took office at the beginning of this month, has ratified the agreements reached with the Fund as set out in the letter of intent of November 10. The new authorities are well aware of the current economic situation and are determined to carry out the required adjustment, with special initial emphasis on short-term, demand-oriented policies in order to set the basis for sustained growth in the medium term. This is a realistic, though somewhat painful approach, but the authorities are resolved to forcefully confront immediately the key problems of the economy in order to restore confidence and to lay the bases for more fundamental structural reform in the later phases of the medium-term program. Nevertheless, even now, some important measures that have been adopted are geared to deal with structural problems. The gradual liberalization of the exchange system, the depreciation of the exchange rate, new pricing policies, and institutional changes in the public sector are some of the measures that should stimulate fundamental changes in the economy. The overall program adopted by Mexico, and more specifically the undertakings during its first year, represent a serious and ambitious effort. The authorities should be commended for their courage in tackling an admittedly difficult situation in such a forceful fashion.

In general terms, the program's objectives are to slow down inflation, reduce reliance on external financing, reduce the economy's vulnerability to external developments, and restore external equilibrium. The centerpiece of the program, and its most ambitious undertaking, is the marked reduction of the public sector deficit, from about 16.5 per cent of GDP in 1982, to 8.5 per cent of GDP in 1983, to 5.5 per cent of GDP in 1984, and to 3.5 per cent in 1985. Such reductions would allow for decreased external and internal financing requirements of the public sector, a substantial increase in current savings, more available financing resources for the private sector, and overall easing of demand pressures in the Mexican economy. In broad terms, the first-year adjustment in the public sector deficit, of about 8 percentage points of GDP, is to be based on an increase in revenue of about 2.5 percentage points of GDP, and a reduction of about 6 percentage points of GDP in expenditure, including a reduction of little more than 3 percentage points in capital expenditure.

It is necessary to underline the extraordinary effort required from the Mexican Government and population to bring about such a sharp fiscal adjustment. With respect to the revenue measures, these include higher taxes, tariffs, and prices. The most important tax measure is an increase in the value-added tax, from an average yield of 8 per cent to 15 per cent. For luxury goods, the rate has been increased from 10 per cent to 20 per cent, and some items that were not subject to this tax will now be included. Another important tax measure is the 10 per cent income tax surcharge for persons earning over five times the minimum wage. On prices and tariffs, the most significant measures are the doubling of gasoline prices and the overall increases in all petroleum by-products, including a tripling in the price of diesel and a monthly increase in gas and fuel oil prices. Additionally, sugar prices have been raised by 116 per cent and domestic telephone rates by 22.5 per cent; tolls for urban and intercity roads, as well as rail and air fares are also being increased. In Mexico City, real estate taxes and water tariffs will be substantially adjusted to fully reflect the price increases of past years.

On the expenditure side, an austere budget strictly related to the availability of financial resources has been proposed to the Congress for 1983. This budget preserves basic public services, gives priority to investment in construction and other labor-intensive programs, and devotes special attention to debt service payment. Public expenditure will be reoriented to give special priority to social programs and to support regional development projects. The growth of current expenditure is being contained in order to increase public savings. This effort is expected to yield a positive rate of public sector savings of 2.4 per cent of GDP in 1983, compared with a negative savings rate of 1.2 per cent of GDP in 1982.

Rules and regulations to assure fiscal discipline, adequate programming, and efficiency in the execution of authorized public expenditure are being reinforced. Salaries, fringe benefits, and expense accounts will be limited, and extraordinary compensations eliminated.

Overall public expenditure is projected to increase by 43.5 per cent in 1983, a rate well below the expected rate of inflation. Investment in priority sectors is projected to increase by 94 per cent, while investment in nonpriority sectors will grow by only 17 per cent. The share in total programmed expenditure of priority sectors will increase to 60 per cent, while that on nonpriority sectors will be reduced to 39 per cent. Expenditure for social welfare will grow by 43 per cent; for rural development by 44 per cent; for transportation and communication by 57 per cent; and for the supply of basic foodstuffs by 71 per cent, all well below the current inflation rate. In summary, as mentioned before, total public sector expenditure in 1983 is estimated at 38.9 per cent of GDP, substantially less than the figure of 44.3 per cent of GDP estimated for 1982.

Wage policy will obviously have an important bearing on the success of the fiscal adjustment and on the performance of the economy more generally. The authorities are well aware of this and are quite determined to bring about a policy of wage restraint. In this regard, they intend to avoid indexation to past inflation and, rather, to seek adjustments on the basis of expected lower inflation rates. The minimum wages for 1983 are being negotiated at present. This is an important exercise since the increase in the minimum wages will be taken as a guideline for salary negotiations during 1983. President de la Madrid in his first statement to the nation on December 1 requested both workers and entrepreneurs to moderate their demands for wages and profits. The latest available information indicates that minimum wage negotiations for 1983 are being carried out in a favorable atmosphere and that demands for minimum wages by the labor unions are being tempered by their desire to preserve employment. Recent negotiations have resulted in increases of 25-30 per cent; such an increase will contribute to the fight against inflation.

As I have already indicated, the tightening of fiscal policy will permit in the period ahead a more normal resumption of credit flows to the private sector. This should help to sustain economic activity within the program's targets on inflation, external borrowing, and reserves. Within the context of the program the main goals of monetary and credit policy are to combat inflation, to promote savings, and to ensure an adequate flow of credit to the private sector. To that end, interest rate policy will remain flexible and competitive. The rate on 30-day to 89-day deposits is now 57 per cent, 16 percentage points higher than the levels of three weeks ago. The interest rate on cetes, a three-month treasury certificate whose yield is payable at maturity, is also at the highest level of the year, standing at nearly 59 per cent. If capital and interest are reinvested, the annual interest rate is much higher than the nominal interest rate. This effective annual interest rate is estimated at about 73 per cent for cetes and over 77 per cent for 90-day deposits. At present, interest rates are considered to be close to their desired levels, as inflation for 1983 is projected at 50-55 per cent on a December to December basis.

From September 1 to December 20, a generalized exchange control system was in effect. The experience obtained during this period confirmed the impossibility of controlling foreign exchange receipts of a number of balance of payments items, in particular tourism, workers' remittances, and border transactions. This system stimulated the creation of a peso exchange market abroad. My authorities believe that it is not desirable to maintain exchange transactions outside the banking system and outside the country since this policy favors capital flight and undermines their capacity to regulate the domestic exchange market.

Last Monday, December 20, the Mexican authorities introduced a new exchange system more in line with Mexico's present economic and financial situation. This is a combination of a free and a controlled market. The main objectives of this dual exchange rate system are to stimulate exports and the repatriation of export proceeds. The system should simplify and facilitate international transactions, promote tourism, and bolster capital inflows as well as discourage outflows, thus contributing to the recovery of confidence. In the present circumstances of Mexico, and especially when account is taken of the still precarious reserve levels and confidence climate, a drastic change toward a single, completely liberalized exchange regime is at present precluded. Nevertheless, the authorities have such a system as their objective, and will gradually move toward complete liberalization as experience and internal and external conditions permit it. I should say, however, that under the present system, care will be taken to maintain an adequate level of competitiveness for exports, reduce incentives to nonessential imports, and discourage speculative capital movements. Under the new system, the current exchange rate in the controlled market is of the order of Mex$95 per US$1, which represents a significant depreciation of 35 per cent in relation to the previous controlled rate, and will be further depreciated by about 50 per cent throughout the year. The free market rate is currently running at Mex$148 per US$1, and in the first two days of operation the free market has had a greater supply of dollars than the demand for the same currency.

Mexico's external sector has had to adjust quite rapidly during the present year. The current account deficit, which was projected at the beginning of the year at about US$11 billion, is now estimated at slightly over US$6 billion. The trade balance has recorded a substantial improvement, passing from a deficit of US$2.3 billion in 1981 to a projected surplus of US$6 billion in 1982. The main adjustment has been in imports, which have declined by more than US$8 billion from 1981 to 1982. Exports are estimated to maintain their 1981 level. The sharp reduction in imports has been due to the decline in activity, the exchange rate adjustments, and the generalized exchange rate control introduced on September 1. The impact on production of such a reduction has been significant, as some shortages of imported inputs arose. The new exchange system is expected to help to alleviate this situation and to stimulate supply.

External indebtedness is an area of major concern. Interest payments on public debt are current, and principal payments were suspended in late August. A process of debt restructuring is being carried out in realistic terms, taking into account the debt repayment obligations and balance of payments prospects for the years ahead. The Mexican public sector debt is to be restructured in the coming months and no later than March 23, 1983. At the same time, commitments for US$5 billion in new money are being negotiated with the private banks for 1983, and a favorable response has been received. In addition, US$2 billion is being negotiated with official creditors, and a substantial proportion of this amount has already been committed.

Owing to the scarcity of foreign exchange, certain arrears have occurred with regard to private sector debt payments. Recognizing the need to provide for the settlement of these obligations, the authorities have adopted an ad hoc procedure that was described at length in a telex sent by the Secretary of Finance and Public Credit of Mexico to the international banking community on December 8, 1982. To be eligible, interest payments obligations must result from loans entered into before the imposition of exchange controls on September 1, 1982, and must be registered with the Ministry of Finance and Public Credit. The Banco de Mexico will then assume the obligations and, on January 31, 1983, 10 per cent of the outstanding balance of such obligations will be remitted to the foreign banks. The remaining balances will be paid off in monthly installments, subject to foreign exchange availability. A similar mechanism is envisaged for suppliers' credits. Given the latest estimates for exchange inflows in the controlled market and priority uses for such resources, it is now expected that the programmed reduction of at least US$600 million in arrears will be achieved by June 1983.

The private banking system was nationalized on September 1, 1982. Bank management by the public sector is not new in Mexico; national banks have competed with private banks for many years. Ways will be explored to ensure an adequate participation of savers and other sectors of society in the management and the patrimony of these institutions. Over time, the banking system will be rationalized and restructured to achieve efficiency and economies of scale, and a number of separate banks will be retained to stimulate competition.

The measures being adopted for 1983 and for the program period as a whole will surely require a major effort by the Mexican population, especially after a sustained period of high rates of growth. The authorities have frankly indicated that a significant degree of sacrifice will be required from everyone, but that it is necessary to redress the imbalances. In the past, the Mexican economy has shown great resiliency in recovering from temporary serious setbacks. Also, as the staff recognizes, Mexico has shown repeatedly in the past a capability for sustaining high rates of growth while maintaining internal and external stability. We are confident that Mexico will be able to resume such balanced growth in the near future.

Mr. Kafka thanked the staff for the special efforts that it had made to keep Executive Directors up to date about measures taken recently by the Mexican authorities. His chair warmly supported Mexico's request for an extended arrangement and a drawing in the first credit tranche, despite the shortfall in contributions from commercial banks, which he was sure would be overcome in a short time. The Mexican crisis had resulted from disappointed expectations and from the delay between realizing that a forecast was erroneous and making the necessary change in policy.

The program was strict, but, under present circumstances, it was the only feasible one, Mr. Kafka considered. There was not enough finance available for a more gradual approach. Of the resources required under the program, a large part would have to be provided from outside the Fund. The Managing Director had done an exceptional job in prevailing upon official entities, as well as on the private financial community, to agree in record time to supply new resources as well as to a vast amount of rescheduling. Perhaps if the Fund had larger resources, a more gradual program could have been financed; in the circumstances of Mexico, the marginal utility of even such a relatively small sum as an extra $1 billion or so in the first year would have been great indeed. Nevertheless, he was not arguing for a different phasing for Mexico's drawing from the Fund. Rather, he was expressing regret that the Fund's resources did not permit it to help to finance modestly larger drawings under the program.

The financial measures in the program appeared to be well designed, Mr. Kafka went on. The several changes foreseen in the economy were as necessary as they might be hard to bring about. No more than the indispensable was being demanded of Mexico, and no more should be demanded. The incentives to stimulate domestic savings and exports went in the right direction. It was regrettable, but only realistic, that a large part of the adjustment had to derive from a reduction in real public sector investment. Indeed, a major concern had to be that the rate and extent of income redistribution inherent in the program should remain within tolerable limits.

It was noteworthy that the international financial community, under the leadership of the United States and through the Bank for International Settlements (BIS), had been able to provide bridging finance for Mexico rapidly, thereby avoiding what could otherwise have become an even more serious international crisis, Mr. Kafka concluded. He knew from his own experience that, when circumstances in a member country permitted, the

Fund was capable of negotiating a program with extreme rapidity, but it had no means of providing bridging finance. Something more institutionalized than the bridging finance provided through the BIS could be helpful in future. He had suggested several times that the Executive Board should study that proposal. He had been greatly encouraged by U.S. Treasury Secretary Regan's suggestion for a new bridging finance facility, which might conceivably be situated within the Fund itself.

Mr. de Maulde considered that the international financial community, under the leadership of the Fund, had demonstrated considerable skill in sorting out a situation that should never have arisen. Mexico was a clear case of adjustment unduly delayed with the support of misguided borrowing, on an ever-shorter-term basis, from unwise commercial banks. The so-called surveillance process had obviously failed to produce early warnings, a point to be kept in mind when Executive Directors discussed the issue of Fund surveillance. The size of Mexico's external problem was such that the consequences of letting it escalate could well have been severe for the entire international monetary system. His authorities greatly appreciated the sense of responsibility and the high professionalism displayed by the Managing Director in tackling the matter in an innovative way. Through his unrelenting efforts, the cooperation of central banks, the BIS, commercial banks, and the Fund had yielded results, and his authorities were glad to contribute their share to the operation. It should also be noted that the Fund's policy of enlarged access had fully demonstrated its usefulness in the case of Mexico. Regrettably, the staff report had been distributed on December 13, so that Executive Directors had had only seven working days to communicate the report to their capitals and to digest it themselves. Equality of access to information, as well as the credibility of the Executive Board, would be compromised, unless the case of Mexico were considered an exception.

He could fully support the objectives of the program, Mr. de Maulde continued. As stated in the staff appraisal and acknowledged by Mr. Senior, the most important factor behind the worsening of Mexico's price performance and the widening of its current account deficit had been the expansionary stance of the public sector. A major adjustment in that stance had, fittingly, been made the core of the 1983 program. The more general objectives of slowing down inflation and restoring the balance of payments position were also unobjectionable. The question was therefore not how to assess the validity of those objectives but rather how to achieve them, given a number of assumptions.

Against the background of the international environment, one key element for the program had been the availability of external financing, Mr. de Maulde observed. The Mexican advisory group had now secured the consent of the principal banks to a $5 billion increase in their net exposure in Mexico. He had been glad to note from EBS/82/208, Supplement 3, that agreement had been reached on eliminating interest payments arrears and on inaugurating a deposit scheme. He hoped that the deposit scheme, together with the example of the larger banks, would induce the smaller banks to participate actively in providing financing for Mexico.

Another important element was the level of interest payments, which was dependent on interest rate levels in international markets and on the spreads and fees associated with new loans and rescheduling. He assumed that certain hypotheses had been made on those various elements, and he would appreciate further elaboration by the staff on how sensitive the interest payments were to a departure from initial expectations. Finally, he had noted that the declining trend in the ratio of non-oil exports to GDP was supposed to be reversed quite abruptly. While the relatively modest amount of non-oil exports might justify such a forecast, he was still somewhat uncertain about the impact of higher costs of the import content on those exports, and about the increased competition from two other major Latin American countries that might try to expand sales of similar products in the same markets.

On the domestic side, the time lag between the contractionary impact of reducing the public sector deficit and the projected recovery of the economy through a revival of private sector activity seemed to be short, only half a year, Mr. de Maulde noted. It was difficult to assess the relationship between overall growth, the public sector deficit, and the current account deficit, as the last variable had been greatly constrained in 1982 by the availability of foreign financing. He would appreciate further information on the relationship between economic activity in the non-oil sector and the current account deficit in periods during which crowding out by the public sector had been less perceptible than in more recent years.

The stance of monetary policy was to some extent a residual of the results achieved in the public sector and the exchange rate field, Mr. de Maulde remarked. He agreed with the staff that interest rate management should be greatly facilitated by the disappearance of dollar-denominated deposits. The proposed drastic adjustment in the public sector was fully appropriate. He had noted the subtle difference between the "draft budget" and the "fiscal plan" for 1983. The additional receipts provided for by the latter would stem from price increases authorizing commensurate additional expenditure, both amounting to 1.4 per cent of GDP. He would not be surprised if the additional expenditure had to be scaled down; without mentioning the possibility of overruns on expenditure included in the budget, the revenue forecasts were heavily dependent on a projected level of economic activity. The budget also provided for a large reserve for spending, amounting to 2.4 per cent of GDP. Although such a reserve was not unusual, its large size might raise some concern about the authorities' ability to control various categories of expenditure. Mr. Senior or the staff might wish to elaborate on the procedures governing the use of the reserve.

Wage policy in the public sector appeared to play a leading role in wage settlements, Mr. de Maulde continued. He fully supported the view that restraint would be needed over the medium term, and that incomes policy might have to play a more important role than fiscal policy once the public sector deficit in Mexico had returned to a reasonable level.

On the exchange rate system, he agreed with the staff that the extraordinary circumstances prevailing made the temporary establishment of two exchange markets appropriate, Mr. de Maulde said. Given the large size of both the controlled market and the free market, the two rates for the peso might well converge in the not-too-distant future. Incidentally, he had noticed a loophole in the scope of transactions covered by the controlled market: a provision was made for other transactions specifically authorized by the monetary authorities. He was sure that the authorities would exercise restraint in making use of that loophole. On the more fundamental question of the level of the exchange rate, it appeared to be predominantly constrained by the rate of equilibrium in the capital accounts. He hoped that when Mexico's steps toward adjustment had been acknowledged by the outside world, automatic forces would bring about a return to more traditional determinants of the exchange rate, such as indicators of competitiveness. He did find it unacceptable that the Mexican authorities had so far disregarded the issue of the settlement of private external debt, a decision that might lead to a grave deterioration in the position of various firms and also in Mexico's international image. Could Mr. Senior and the staff say what measures were being considered to solve the problem?

When devising the battery of performance criteria and review clauses, the Fund appeared to have aimed at some sort of perfectionism, Mr. de Maulde stated. Although such a view might be justified under the circumstances, he would not be surprised if some conflict were to arise among the criteria on foreign borrowing, the level of reserves, and, to a lesser extent, the reduction in arrears. Therefore, analysis would be required to ascertain how the conflicts had originated, whether they were permanent or temporary, and what corrective actions might need to be taken.

Structural adjustment was indeed present in a program relying primarily on demand restraint, and he hoped that it could be enhanced in the coming years, Mr. de Maulde commented. He regarded as tentative the staff's forecasts for the growth of GDP, the public sector deficits, and the current account deficits, as it appeared extremely difficult to assess what would be a viable balance of payments position for Mexico in 1985 or even 1984; it was impossible to predict the availability of foreign financing in those years. He would appreciate further elaboration on the point. In conclusion, the present situation was the result of decisions taken by both the Mexican authorities and the banks; it was their responsibility, as well as the Fund's, to allow the much needed adjustment to take place.

Mr. Teijeiro welcomed the program, which was of the utmost importance for an orderly adjustment of the Mexican economy and for a solution to the present world financial situation. The measures already in place made the adjustment program an impressive one. Nevertheless, he had some comments.

On page 38 of EBS/82/208, Supplement 1, the staff indicated that the ratio of the demand for money to GDP had risen from 33.6 in December 1981 to 35.0 in December 1982, Mr. Teijeiro noted. The rise implied that the money supply must have grown at a faster rate than domestic prices. As the growth in the money supply had been greater than the growth in nominal GDP, the question was whether the staff's assumptions about the behavior of the demand for money might be too optimistic. At the end of 1982, the stock of money would be 35 per cent of GDP, against less than 31 per cent in 1980, a year in which the inflation rate had been much lower and interest rates much less negative in real terms. It therefore seemed likely that adjustment would occur at the beginning of the program in the form of higher inflation and faster exchange rate depreciation. He asked the staff to comment on the expected behavior of the demand for money, and he wondered whether a more aggressive interest rate policy would not be a necessary condition for maintaining the demand for money at the assumed levels.

If the demand for money did not behave as expected, the program targets for inflation and the balance of payments might be jeopardized, Mr. Teijeiro went on. How much of the effect would show up in the balance of payments would depend on the flexibility of exchange rate policy. He believed that the two-tier exchange system described on pages 1 and 2 of EBS/82/208, Supplement 3, could only be a transitory one. Its only usefulness might be that the free exchange market could give indications about where the equilibrium exchange rate of the peso could lie. There was no way that such a system could survive permanently. For example, since it was possible to service Mexico's external debt through the controlled market, there would always be an incentive to pay as much as possible of that debt through that channel. Therefore, either the assumptions of private capital movements would not hold, or, if foreign currency were brought back, it would be at the free market exchange rate, in which event an exchange loss and a consequent monetary expansion would occur. He wondered whether the two-tier system was actually an implicit system of exchange rate guarantees and whether, if his description was correct, it had been taken into account in the program.

There was some question whether a more aggressive interest rate policy and a rapid movement toward unification of the exchange rate system would be helpful developments in the near future, Mr. Teijeiro remarked. There was no precise answer to many of the questions that he had raised, because it was impossible to make correct assumptions about crucial parameters. Thus, the Fund should keep close watch on developments under the program, take a flexible view of any future developments, and be ready to make quick adjustments if they became necessary. His personal feeling was that the adjustment in the Mexican economy would be more painful than it had been previously, unless there were a quick and major improvement in the world economic situation. Despite the remarkable job accomplished in connection with the banks, he was afraid that there would be leakages in the program, mainly through uncontrollable channels like import financing. It should not be surprising, therefore, if the slowdown in economic activity would worsen.

Even with a successful program, some aspects of the Mexican economy would remain damaged in the medium term, Mr. Teijeiro said. The main damage had been to incentives for private investment; given the large price fluctuation, a sense of normal relative prices had disappeared, and the risk of making any investments had increased dramatically. If a value of 100 were assigned to domestic wages measured in dollar terms for 1977, the figure for 1981 would have been about 250; in 1983 it might well be back to 100. With that kind of experience, private investment could be expected to behave sluggishly in principle for the next few years. Such experience was not unique to Mexico; it had been the consequence of a highly unstable world environment that had promoted large fluctuations in the terms of trade combined with procyclical behavior by the financial community and the public sector.

In 1978-80, the Mexican economy had benefited from expanding oil production and also from a cyclical boom in the terms of trade, Mr. Teijeiro recalled. The authorities would have done well to promote an anticyclical policy, incurring a budget surplus and repaying foreign debt. What had happened, not only in Mexico, but also in most of the countries currently experiencing difficulty, had been just the opposite. The financial system had been ready to lend large amounts of money, and the public sector had taken the opportunity to increase spending. At that time, Mexico had enjoyed an improvement in its terms of trade, greater foreign credits, and higher public sector spending. At present, the country was at the opposite phase of the cycle, where all economic variables were acting in a contractionary manner. How could private investment and private initiative be expected to behave in a recessionary economy that in the recent past had provided such unstable market signals for the direction of investments? In fact, there was still a risk that Mexico's cyclical experience might be repeated. As soon as interest payments on the external public debt came down to more normal levels, the price of oil improved, and fiscal revenue rose with the recovery of the economy, the public sector would be able to increase its spending in a dramatic way. Thus, it was of the utmost importance for the health of the Mexican economy that clear medium-term policies on revenue and the exchange rate were developed so that the private sector could regain confidence and help with the recovery of the economy. The agreement reached on an extended arrangement would support the Mexican authorities in that task.

Mr. Nimatallah warmly supported the request of the Mexican authorities for an extended arrangement and a purchase in the first credit tranche. Furthermore, the Managing Director was to be commended for the way in which he had handled the Mexican case. Approval of the decision on Mexico should signal the helpful role that the Fund could play in alleviating international balance of payments imbalances.

The resources provided by the Fund to Mexico in the medium term were quite small in relation to Mexico's total financial needs, Mr. Nimatallah noted. In addition, the Mexican authorities would be able to draw, upon Board approval of their request, only a small fraction of the total amount at any one time. The emphasis was clearly on promoting adjustment, generating international confidence, and monitoring the economy.

About one year previously, the Board had discussed a request by India for an extended arrangement, Mr. Nimatallah recalled. The circumstances under which India had made its request were quite different from those of Mexico. India had approached the Fund at an early stage of its balance of payments difficulties, while Mexico's request had come after a crisis had erupted. He therefore encouraged countries to come to the Fund early in a search for solutions to their balance of payments problems and for a response to their needs.

Turning to the specifics of the Mexican problem, Mr. Nimatallah pointed out, first, that the fiscal adjustment effort envisaged during the program period was substantial. For instance, the public sector deficit as a proportion of GDP was expected to decline from 16.5 per cent in 1982 to 8.5 per cent in 1983 and to 3.5 per cent in 1985. For those targets to be achieved, a considerable adjustment effort had to take place on both the revenue and the expenditure sides. The measures taken recently in connection with the 1983 budget appeared to be adequate to achieve the program targets for 1983. Nevertheless, the situation required continuous monitoring, and the authorities should be prepared to take additional measures if the program targets seemed to be endangered.

Second, the quantitative performance criteria specified in the program were quite comprehensive and provided adequate safeguards for the conduct of suitable adjustment policies, Mr. Nimatallah continued. There were three quantitative performance criteria covering domestic policies and three covering international policies. The coverage was extensive and appropriate in Mexico's circumstances. He supported all the quantitative performance criteria for 1983, as listed in Table 9 of EBS/82/208, Supplement 1.

Third, the approach toward conducting a flexible exchange rate policy and reducing the restrictiveness of the exchange system was realistic, Mr. Nimatallah considered. Obviously, a complete and immediate reversal of all the policies in place could not be expected. However, the authorities were to be commended for their courage in adopting the measures announced on December 10, 1982. Further reforms in the exchange system would have to be made in light of evolving circumstances.

Fourth, he had expected to see in EBS/82/208 an assessment by the World Bank staff of Mexico's public sector investment program, Mr. Nimatallah remarked. The omission of that assessment might leave something to be desired in the program under the extended arrangement. Could the staff comment on that point?

Fifth, he agreed with the staff's emphasis on the review of Mexico's protective system in the context of the extended arrangement, Mr. Nimatallah said. The review was compatible with the goal of achieving a better allocation of resources. Was the World Bank staff to monitor progress in that area?

As to promoting a better allocation of resources, the program could probably have been strengthened by containing more explicit policies to promote nonpetroleum exports, Mr. Nimatallah considered. An export-oriented growth strategy would make it easier to reduce protection and therefore the distortions in the economy. He was unsure whether Mexico's other exports would be encouraged by large importing countries, given the present state of the world economy.

In conclusion, the Mexican authorities had already shown a determination to adjust by adopting courageous measures, for which they were to be commended, Mr. Nimatallah said. The road ahead would be rough, and perhaps would require more sacrifices. He therefore encouraged the Mexican authorities to stick firmly to their commitment to adjust.

Mr. Erb commended the Managing Director for his handling of the Mexican situation from the very beginning and commended the staff for its responsiveness in working with the Mexican Government. It was also clear that the international monetary system as a whole had been quite flexible in its response, given the reactions of governments as well as commercial banks. It was difficult to overstate the significance of the program's successful implementation, not only for Mexico but also for the Fund and for the system.

Making some general comments, Mr. Erb noted, first, that Mexico had had an extended arrangement with the Fund from 1977 to 1979. Even during that extended arrangement, particularly toward the end, the authorities' policies had appeared to be getting out of line. Only three years had elapsed until another extended arrangement was needed. Second, he was concerned by Mexico's failure to maintain up-to-date Article IV consultations with the Fund. For almost two and one half years, from March 1980 to July 1982, the Executive Board had been unable to consider a consultation with Mexico. The Mexican case also emphasized the importance of discussions on foreign asset and liability management between the Fund and members. Bankers might have been surprised when Mexico became unable to service its external debts in a timely manner; economists had not been surprised. External debt management should be an important area for Fund surveillance.

Third, Mexico showed what could happen when a country's decision makers failed to make prompt adjustments in economic policies as conditions changed, Mr. Erb remarked. Mexico's policies in 1980 and 1981 had been unsustainable, even if the optimistic world economic outlook and oil outlook on which the policies had been based had actually materialized. Once it had become clear that the world economic condition was not as good as originally expected by the Mexican authorities, they had had to make the adjustments in their economic policies.

Fourth, the Fund's program was designed to begin a reversal in the deterioration of Mexico's economic situation, Mr. Erb went on. In that sense, it was a growth-oriented program, not a program of externally imposed austerity for the sake of austerity. The situation in Mexico had deteriorated so badly that it was relatively easy to see what actions had to be taken in the first year of the adjustment program. As a practical matter, there was little room for discretion, since the authorities intended to reverse the economic deterioration. They had had an incentive to undertake adjustment, because the alternative would have been much worse. Indeed, during 1982, the rapidly declining current account balance had had a negative impact on domestic economic growth, as well as on imports. During 1982, economic growth in Mexico had sharply declined. He suspected that, even though growth might have been positive on a year-over-year basis, by the second half of 1982 economic growth had probably become sharply negative. Futhermore, Mexico's imports had sharply declined during 1982; improvements were projected throughout the program, at least in nominal terms. The economic policies recommended by the Fund were consistent with restoring economic growth throughout the world, and not only in Mexico.

Apparently the exchange rate, with supporting policies, was being relied upon to hit a number of targets, Mr. Erb observed. According to the staff paper, the exchange rate in a controlled market was to be adjusted daily, initially at an annual rate of about 50 per cent. He was unsure how the authorities would decide on the correct exchange rate, since, as described on page 1 of EBS/82/208, Supplement 3, many elements would be taken into consideration in its determination. For example, the staff said that in establishing the new rate, the authorities had indicated that they were taking into account not only the past behavior of prices in Mexico and in other countries, but also the reduced availability of external credits to Mexico, the effects of the contraction in world trade and of the changes in the terms of trade, the need to avoid reliance on subsidies to exports, the quotations currently prevailing for the Mexican peso in the parallel market at the border with the United States, and considerations of domestic employment. It thus seemed that the authorities' exchange rate policies suffered from some overdetermination. He gathered, though, in reading the staff recommendations, that the setting of quarterly targets for net foreign assets by the Bank of Mexico would be the determining factor, taking into account the restrictions on foreign borrowing. While those targets might place some undesirable constraints on the ideal role of reserves, he did hope that they would be effective in helping the authorities to resist the temptation to support the exchange rate of the peso. Such support in 1981 had proved costly and ultimately ineffective. He understood that the authorities believed that present circumstances made unification of the exchange rate impossible. Like other Executive Directors, he hoped that the exchange rate system could be unified as soon as possible.

He wondered whether the staff could provide more details about the forward coverage on foreign exchange that the Bank of Mexico was ready to provide for the repayment of the existing debt, Mr. Erb continued. He was concerned about the potential budgetary consequences of that policy, which suggested that there might be a potentially open-ended drain on the budget, especially if the domestic economic situation did not improve as dramatically as the authorities hoped. While there would be a risk premium attached to the forward coverage, he wondered whether it would be sufficient. Indeed, if the risk premium were set too high, it would suggest that the Government lacked confidence in the future course of its domestic policies.

In spite of the staff's assurance that the authorities intended to follow an active interest rates policy, deposit rates seemed to be below likely inflation rates, Mr. Erb commented. Thus, he questioned whether interest rates provided an adequate incentive to save in peso-denominated deposits. Was there still not an incentive to save abroad, considering domestic and foreign interest rates, likely inflation rates, and the exchange rate risk? Even if the authorities could prevent capital flight--which they could not--would there not still be incentives to move financial assets into real assets in a search for inflation hedges? He would like to hear the staff view on the level of interest rates, on what further adjustments were going to be needed, and on how the Mexican Government would determine the size of those adjustments over time.

As other Executive Directors had noted, an incomes policy was an important element in Mexico's economic policy determination, Mr. Erb noted. He was pleased that the authorities intended to make wage policy forward-looking in the sense of being consistent with the declining rate of inflation and with the protection of employment. He would stress that wage policy must be supportive of the exchange rate changes already made and those contemplated, if the devaluation of the peso was not to be inflated away.

He was pleased that some prices of important products had been adjusted toward their scarcity values, Mr. Erb commented. He would like more details about how close the administered prices of goods and services were to world prices. When exactly were prices "to be adjusted so as to cover the economic costs of producing these goods and services"? Since the program was for the medium term, he would like assurances that price changes were not to be regarded as once and for all. In fact, since there would be a continued exchange rate adjustment, there should be provisions for the devaluation of the peso to be reflected in the domestic prices of those goods whose prices were administered. In reading the staff report, he had thought that the initial steps in raising prices had been designed to reduce the fiscal deficit, a goal that was of course desirable. At some point, however, the question of resource allocation came into play. Whether the pricing structure was suitable for encouraging the efficient allocation of resources within Mexico would ultimately be as important a consideration as the impact of price changes in reducing the budget deficit. Of course, the fiscal deficit and improvement in the budgetary situation were at the heart of the program. The authorities were correct in attacking that huge problem from both the expenditure side and the revenue side. In that respect, he could not too strongly urge the authorities to implement the planned budgetary policies firmly, since failure to do so would result in the failure of their stabilization effort.

Although the broad direction of corrective policy was evident for the first year, the policies to be implemented in the second and third years were less clear, Mr. Erb remarked. There was no doubt that adjustment would take a long time and that debt service payments were going to be large for many years beyond the program period. He would await further details about the structural changes that were to take place in the next few years under the extended arrangement with the Fund.

In addition to the structural changes in interest rates, the exchange rate, and prices, he was concerned about Mexico's system of protection, as briefly described on page 22 of EBS/82/208, Supplement 1, Mr. Erb continued. He thus joined other Directors in stressing the importance during the program period of significantly reducing the protective devices that had been set in place by the authorities. He would be somewhat more confident if reviews were conducted between the authorities and the Fund more often than once a year. Presumably it was expected that there would be ongoing consultations between Fund staff and the Mexican authorities during 1983. If the reviews took place more frequently, the authorities might be better able to make necessary adjustments in problem areas as they arose.

In closing, he had been encouraged by the policy initiatives taken by the new Administration in Mexico, Mr. Erb said. The authorities seemed ready to undertake the difficult task of adjustment that lay ahead. Yet, as other Directors had noted, the required adjustments were enormous, and would take many years to carry them out.

Mr. Laske commended the Managing Director for his intense efforts, and those of the staff, to establish the adjustment program with the Mexican authorities. The Managing Director deserved particular commendation for bringing about the cooperation of the banks in securing the necessary financing for the next year of Mexico's continuing external deficits. He could support both the request for a first credit tranche drawing and the request for an extended arrangement.

From 1977 to 1981, Mexico had been undergoing an impressive structural transformation of its economy, Mr. Laske recalled. High rates of growth of GDP had led to substantial improvement in the quality of life and the welfare of the Mexican people. In the wake of the discovery of new oil deposits and of rapidly rising oil prices, the authorities had achieved remarkable success in reducing unemployment and improving education and health. However, those impressive achievements had been accompanied by a rapid acceleration of inflation, a widening of the deficit on current account, and an unsustainable increase in external debt, particularly in loans with short maturities. While a weakening in the international market for petroleum and other Mexican export commodities in 1981 had contributed to those unfavorable developments, an overambitious and, consequently, expansionary fiscal policy had also played a large role. To a great extent, the difficulties of the Mexican authorities stemmed from the failure to match plans with available resources.

As pointed out in the staff paper, the Mexican authorities had taken some adjustment measures quite early in 1981, and subsequently in 1982, with the objective of countering the effects of slipping foreign exchange earnings and of improving the deteriorating budgetary situation, Mr. Laske remarked. The measures proved to be too timid to prevent a further aggravation of the internal and external imbalances, and they had failed to prevent a grave economic crisis. Regrettably, some of the measures taken had even added to the difficulties and had had detrimental effects on confidence, both at home and abroad. For example, the establishment of a dual exchange market with two fixed rates for the peso had caused a substantial increase in the public sector deficit for 1982. The imposition of exchange controls had further reduced the availability of foreign exchange. The policy of reducing interest rates had led to negative growth in financial assets.

The chance of adopting a gradualist approach for coping with the economic crisis had been exhausted some time previously, Mr. Laske went on. In present circumstances, successful adjustment required decisive and vigorous action. The objectives and strategy of the medium-term program formulated by the Government represented a bold step toward tackling Mexico's key problems. He had been greatly impressed by the speed and determination with which the authorities were trying to revamp the economy. The staff was certainly correct in pointing out that the program envisaged drastic adjustment in crucial policy areas. It might have been difficult for the authorities to accept a markedly lower rate of growth of GDP and a reduction in the economy's capacity to create new jobs, because Mexico had already faced high rates of employment and of population growth. There was, however, no workable alternative to such strong austerity measures, which were being imposed not for austerity's sake but rather to restore national and international confidence, a crucial development if there was to be a successful turnaround in Mexico's economic position.

Over the previous two years, the public sector deficit has reached a size that was obviously unsustainable, Mr. Laske pointed out. The authorities had therefore rightly given top priority to making a substantial reduction in the budget deficit over the program period. The main adjustment in the public sector deficit was to take place in 1983, during which a decrease from 16.5 per cent of GDP to 8.5 per cent was foreseen. If that ambitious target were achieved, a considerable slowing of inflation and a reduction in reliance on foreign borrowing could be expected. The targets for the current account deficit and for the rate of inflation were also ambitious, but, on the whole, he could wholeheartedly support the program's objectives. The quantitative performance criteria seemed to be in line with the quantitative objectives of the program. He had been particularly impressed by the combination of the various performance criteria, which went beyond what was usually incorporated into Fund programs with member countries. Considering the extremely difficult economic situation confronting Mexico, the somewhat more elaborate network of criteria was certainly justified.

One of the basic assumptions underlying the program was that the resources provided by the Fund would be supplemented by adequate capital inflows from other sources--prominent among them, the commercial banks--and by a restructuring of Mexico's foreign debt profile in the years immediately ahead, Mr. Laske noted. As the Chairman had pointed out at the beginning of the meeting, those assumptions could be regarded as having been met. Personally, he was not worried about the shortfall of some $680 million in new exposures; in fact, bankers in Germany had informed him the previous week that a somewhat smaller figure than $7 billion might be sufficient because of the complex nature of Mexico's external debt and the composition of various elements therein. He also believed that the Fund could have reasonable confidence that many of the banks that had not yet responded would fall into line once it became known that the Executive Board of the Fund had agreed to an extended arrangement for Mexico.

While he warmly supported the objectives and strategy of the adjustment program, he found it somewhat difficult to assess whether the measures already implemented or to be implemented would eventually prove adequate to achieve the objectives that had been established, Mr. Laske said. The main reason for his uncertainty was that the Mexican Government had completely changed the stance of economic policy. It had implemented or would implement a great number of new measures whose effectiveness could not be known with great precision. He had therefore to rely on the staff's expertise in judging the adequacy of the measures. He was glad that the staff considered the measures to be suitably designed to achieve the objectives of the program.

The key provisions of the program were fiscal, Mr. Laske considered. The 1983 budget rightly called for significant adjustments in major expenditure and revenue categories. On the revenue side, the most important measure was the reform of the value-added tax, which was expected to provide additional revenue equivalent to nearly 2 per cent of GDP, mainly by raising the general rate from 10 per cent to 15 per cent and by introducing a 20 per cent tax on luxury goods. Could the staff shed more light on the underlying assumptions concerning the projected developments in value-added revenue?

In addition to the revenue and expenditure authorized in the budget, the fiscal program for 1983 provided for a considerable contingency reserve, amounting to 1.4 per cent of GDP, Mr. Laske commented. The reserve was to be built up from the proceeds of additional revenue measures and was meant to finance additional expenditure not currently approved in the budget. While the staff had mentioned some projected revenue measures on pages 5 and 6 of EBS/82/208, Supplement 3, he had failed to find detailed information about the nature of the potential additional expenditures under the contingency reserve. He personally wondered whether the reserve might be set aside as a precautionary fund, so to speak, in case the objectives of the budget, because of unforeseen developments, could not be achieved with the measures already in place or soon to be put in place. He would appreciate any enlightenment that the staff could provide on that topic.

As for wage policy, Mr. Laske remarked, he agreed with the authorities and the staff that incomes policy was of considerable importance if the public sector deficit was to be reduced, the rate of inflation lowered, the balance of payments position improved, and the exchange rate unified and stabilized. Unfortunately, the staff papers gave only vague information about the wages and incomes policy to be pursued. He was somewhat confused about the projected increase in wages and salaries; Table 5 on page 18 of Supplement 1 indicated that the increase in wages and salaries would exceed 50 per cent in 1983, while Table 1 on page 7 of Supplement 3 showed an increase of only 25 per cent. The latter figure might well be in accordance with the objectives of the program. Could the staff supply an explanation for the divergence?

He had noticed in Table 1 of Supplement 3 that a considerable part of the adjustment in 1983 would stem from a reduction in investment spending in real terms, Mr. Laske went on. The reduction might be unavoidable and even desirable under present circumstances, when some development projects appeared to require more financial resources than were currently available and would overstrain the implementation capacity of the Mexican economy. Nevertheless, he had found the reduction in investment outlays to be large, and he wondered whether there might be merit in financing additional outlays by the contingency reserve, which amounted to as much as 18 per cent of total investment outlays. He welcomed the authorities' intention to seek assistance from the World Bank in carrying out a comprehensive review of their investment program, and he hoped that the Bank and the authorities could make rapid progress in that undertaking.

He had been impressed by the extent to which the authorities had adjusted crucial prices charged by public enterprises in the recent past, Mr. Laske stated. Prices for petroleum products had been increased by up to 200 per cent, for electricity by 50 per cent, and for sugar by 117 per cent. He hoped that those bold price adjustments would not lead to an excessive reduction in the volume of sales, which could endanger the revenue target of the budget. What was the price elasticity of petroleum, electricity, and sugar? What negative effects, if any, might the price increases have on the growth of revenue from sales of those goods?

The staff's comments on money and credit were somewhat too general, Mr. Laske considered. If he understood correctly, credit policy did not play a fully independent role, but was more a reflection of the authorities' development plans. As the staff had said, policy would be conducted flexibly to ensure that interest rates played their customary role in allocating credit among competing uses and in promoting savings. He wondered what the staff had had in mind by using the word "customary." He was not sure whether interest rates in Mexico had been managed in a way that would be customary in other market economies. For instance, in the recent past, interest rates on deposits had remained far below the rate of inflation and had not supported the adjustment efforts to the extent that would be desirable. As Mexico appeared to be one of the developing countries in which interest rate policy could play an active role, he had been pleased to learn from Mr. Senior that the new Government intended to break with the old customs and had committed itself to a more realistic interest rate policy; but the authorities had some way to go to achieve that end. As to the lending rate on loans, he welcomed the decision to drop controls and to allow the market to determine those rates. Unfortunately, the staff had not mentioned the present level of interest rates for lending.

On December 10, the Mexican authorities had abandoned the generalized system of exchange controls, introduced only a short time previously, and had established new exchange arrangements, Mr. Laske observed. Those arrangements included a controlled exchange market and a generalized free market, a gratifying decision on the part of the authorities. It had become clear that the exchange system in effect between September and December had not been working effectively. The new arrangements represented a major liberalization, and he agreed with other speakers that a speedy unification would be desirable, but it might not be achievable because of the low level of international reserves currently at the authorities' disposal. An immediate restoration of a unified free market rate for the peso might still be affected by speculative transactions, so that it was difficult to define a realistic exchange rate. As Mr. Erb had pointed out, the authorities' new exchange rate policies seemed to suffer from some overdetermination.

The restored system of a controlled rate and a free rate eliminated the substantial subsidies that had rapidly become a serious strain on government finances, Mr. Laske remarked. It was therefore important for the exchange rate in the controlled market to be managed flexibly. He was glad that a review of the exchange rate would be held before May 1983 with the Mexican authorties, as the complex system that was, out of necessity, going to be maintained would require close monitoring by the Mexican authorities and the Fund staff. What effect would the drop in the value of the peso and the resulting rise in debt service payments in peso terms have on the budget, especially since the staff had said on pages 5 and 6 of EBS/82/208, Supplement 3, that the exchange rate in 1983 would involve a more depreciated peso than had been assumed in the government budget?

Recently, the rate of growth of economic activity in Mexico had dropped sharply, Mr. Laske noted. One important reason had been the development of production bottlenecks in some sectors following a sharp decline in imports. Would the volume of imports projected for 1984 and 1985 allow the rates of economic growth that had been forecast? After all, the volume of imports foreseen for 1984 and 1985 appeared to differ little from the low volume of imports in 1983, a year for which no real growth of GDP could be expected.

The projected decline in Mexico's current account deficit from 3.6 per cent of GDP in 1982 to 1.2 per cent in 1985 was an appropriate target, but it might be ambitious, Mr. Laske went on. The improvement principally reflected large surpluses in the balance of goods and nonfactor services. Should the staff's estimates concerning oil prices, interest rates, and world economic recovery turn out to be less favorable than currently expected, the outcome for Mexico's balance of payments would be quite different. Under such circumstances, a central objective of the adjustment effort--to reduce the present unsustainable level of foreign debt--might become quite difficult to attain.

To overcome the present crisis, the authorities would have to implement consistently all the measures set forth in the Fund program, Mr. Laske said. Recovery in Mexico would also depend on the hoped-for recovery of the world economy, especially a recovery in the U.S. economy, because of the close relationship between the United States and Mexico. Recovery would also depend on suitable amounts of foreign savings being provided for the financing of Mexico's remaining deficits, and interest rates would play a large role in determining that availability.

In conclusion, the Mexican authorities had made an immense effort to cope with the key problems of the economy, Mr. Laske remarked. A number of uncertainties remained on both the international and the national level. Therefore, developments, particularly in the public sector, should be monitored closely. In general, the Fund should make an extra effort to monitor more closely the evolution of countries' external indebtedness, in particular the short-term part of that external indebtedness, which had become such a source of concern in Mexico.

Mr. Malhotra joined his colleagues in complimenting the management and the staff of the Fund for having assembled the program in consultation with the Mexican authorities. He was particularly impressed by the efforts undertaken by the Managing Director to ensure that commercial banks and some central banks assembled the requisite financing for Mexico for 1983. Those efforts represented an extension of the Fund's involvement in a new policy area. He also noted that some governments--notably that of the United States--had responded positively in supporting the complex exercise.

The program under the extended arrangement was a comprehensive one, and he was glad that the Mexican authorities were determined to undertake a major adjustment effort, Mr. Malhotra remarked. As other Executive Directors had commented, a drastic reduction in the deficit of the public sector was the central area in which the authorities' efforts should be concentrated. The firm commitment of the new Administration to the program was demonstrated not only by the letter of intent, but also by what had been called the "draft budget" for 1983. Like Mr. Nimatallah, however, he had not seen the details of the authorities' intentions with respect to the investment budget. He had observed that reduction in the public sector deficit would entail cuts not only in current expenditure but also in investment expenditure. The staff papers had included some general observations about the direction the authorities could take with regard to public investments, but greater detail would have enabled Executive Directors to appreciate the situation better.

He agreed with Mr. de Maulde that the Mexican case, as well as the other cases likely to come before the Board, fully justified the enlarged access policy, Mr. Malhotra continued. In fact, as noted by Mr. Kafka, the resources that the Fund could provide to support those programs that entailed a determined adjustment effort appeared to be inadequate. The Executive Directors should note that the importance of the enlarged access policy had been underscored by developments in many member countries.

As Mr. Laske had pointed out, the chances for the success of the Mexican program would be greatly enhanced if international interest rates remained under control, Mr. Malhotra stated. It was important that the staff's assumptions about the effective rate of interest on external debts over the next few years should prove to be approximately correct, since large fluctuations in international interest rates would tend to disrupt the program. There was an increasing awareness in many countries, including the United States, that interest rates were an important area of policy that should continue to engage the attention of the international community.

The Mexican authorities were already discussing a restructuring of their debt with commercial banks, Mr. Malhotra said. There was an expectation that the short-term debt would be restructured into medium-term debt, a move that should help the Mexican balance of payments during the next several years. Apparently, the effort made by Fund management for 1983 would have to be repeated for 1984 and 1985. Mexico's difficulties showed how important it was for countries to pursue the correct policies and to keep foreign debt under restraint.

The program for Mexico provided that the authorities' reliance on commercial bank financing from abroad would be limited, Mr. Malhotra noted. Under the circumstances, such limitation was unavoidable. In the past, certain authorities had tended to emphasize that some developing countries should considerably increase their recourse to commercial financing. The case of Mexico and of several other countries should make it clear that countries needed to exercise great caution in that area. Banks flush with liquidity had enough powers of persuasion to encourage prospective clients to borrow. If, in addition, the voices of governments were raised to push developing countries to contract more external commercial debts, problems could arise. They should not allow debt accumulation to go beyond what might be called prudent limits. He was glad that many Executive Directors had stressed the need for the Fund to try to monitor the debt position of member countries. In particular, it should be noted that, whenever a country began to incur short-term debt in order to pay off its obligations on medium-term debt, it had reached the danger point, and some advice and action would be necessary. He also agreed with Mr. Nimatallah that the Mexican case underscored the need for countries to approach the Fund at an early stage of their difficulties, a move that should be encouraged in the interest of both members and the international monetary system.

The adjustment program on which the Mexican authorities were so resolutely embarking was a difficult one, and in the future a number of obstacles and uncertainties might well arise, Mr. Malhotra remarked. For instance, even after the period of the extended arrangement, debt service as a proportion of exports of goods and services would remain extremely high, although the staff had stated it might have declined by that time. He believed that the more relevant ratio was that of debt service to exports, an area in which Mexico would probably continue to encounter difficulties. Moreover, the sharp reversal of the expenditure volume and pattern and the need for action on wages could entail considerable economic and social strain. While there was no escape from strong adjustment measures, the need for such drastic steps might have been avoided if an adjustment program could have begun earlier.

He warmly supported the request of the Mexican authorities and the recommended decisions, Mr. Malhotra concluded. The past economic record of Mexico had been good; the country had been growing at a high rate and had done much to improve the quality of life of its people. Mexico had great potential, and he was sure that, if the right policies were followed, it would again resume its march on a growth path.

Mr. Lovato thanked the staff for its excellent work and the Managing Director for his role in persuading the banking community to avoid self-defeating withdrawals of credit. The problems that the Mexican program was going to tackle were of a magnitude and structural nature such as to justify a commitment of resources by the Fund for the three years of the extended arrangement. At the time of the most recent Article IV consultation with Mexico on July 16, 1982, Executive Directors had expressed some concern about the growing size of the external debt, but they had not expected anything like the crisis that had arisen in the following two months. He would therefore like to stress the need for a speedy implementation of monitoring procedures that would enable the Fund to follow the debt position of countries and to intervene more effectively in time. Furthermore, a great deal of the Fund's credibility had been put behind the Mexican program. Failure of the program would have wide-ranging consequences: Mexico's financial crisis would be rekindled, and the Fund would find it much more difficult to fulfill its role. There were two conflicting requirements. On the one hand, the necessary adjustment was very large, and the Fund could not avoid requesting it. On the other hand, it was important for the Fund that the program succeed; it was therefore rather alarming that Mexico was trying to undertake what was probably the largest adjustment effort in a Fund program. He hoped that, should minor slippages occur, the program could be adjusted without causing it to collapse.

The reasons for the dramatic worsening in the internal and external situation of Mexico were clearly outlined in the staff papers, Mr. Lovato continued. He therefore wished to comment on some of the assumptions behind the program. Unfortunately, the projection that petroleum exports would grow by almost $1 billion seemed rather optimistic given the recent trends in petroleum prices, while the 38 per cent value increase in "other commodities" was also open to question, particularly in view of the continued state of the world economy. Could the staff provide more details on the actual composition of non-oil exports?

The program itself clearly identified the root of the problem as the budget deficit and set out to reduce that deficit dramatically, Mr. Lovato remarked. The budget deficit of Mexico had doubled from 1980 to 1981, growing by 7 percentage points of GDP, and it was much more difficult to adjust downward than upward. The main stress of the fiscal program would be on the revenue side: revenue was expected to double, contributing about 4.5 percentage points of GDP. Given the relatively inelastic tax base, that effort would have to rely heavily on large increases in indirect taxation and in controlled prices. The Mexican authorities were to be commended for their courageous resolve in effecting those measures, which were clearly quite difficult politically, especially in view of the wage moderation that was to accompany the program. Nevertheless, a feasible solution would have to involve an increase in the relative share of direct taxation, which currently accounted for only 40 per cent of federal government revenue, or a mere 4 per cent of GDP. Could the staff elaborate on the likelihood of such an increase, which was of paramount importance? On the expenditure side, it was regrettable that public investment would have to incur a substantial reduction. He hoped that, as soon as the financial situation had been stabilized, the authorities would find it possible to restart a viable investment program. He appreciated the authorities' decision to maintain closer cooperation with the World Bank. He also shared the concern expressed by other Executive Directors on the size of the contingency fund amounting to about 1.4 per cent of GDP.

As in every Fund program, a crucial component for Mexico would be the behavior of public and private savings, Mr. Lovato noted. While public savings, which were supposed to increase by 2.5 per cent of GDP, had been covered at length by the staff, surprisingly little attention had been given to the expected behavior of private savings. Indeed, from Table 10 on page 52 of EBS/82/208, Supplement 1, he had seen that private consumption--and thus presumably private savings--was treated as a residual component. He was therefore somewhat worried that the staff had forecast that the savings ratio would fall by about 4 percentage points in one year. Granted, disposable income would be severely curtailed because of the reduction in real wages and the rise in taxation. Nevertheless, he wondered whether the staff felt able to rely on those figures.

The treatment of incomes policy in the paper had been sketchy, Mr. Lovato considered. He agreed with the staff on the crucial importance of that element in Mexico's adjustment. How were wages going to be set in both the private and the public sectors before disinflation had worked itself through and while prices were still soaring at a rapid rate? Having read the argument put forward in the paper that indexation schemes should be forward-looking not backward-looking, he would appreciate some further thoughts by the staff on how the expected inflation rate should be measured and how the weight-setting process would be linked to that index.

The choice of a suitable exchange regime and the conduct of exchange rate policy were essential ingredients in the program, Mr. Lovato went on. He shared the staff's view that Mexico should further liberalize its exchange system, previously fragmented in an extensive multiple rate mechanism, and should set as its goal a fully unified and free floating exchange rate for the peso. He recognized, however, that transitionally Mexico should be allowed to maintain the multiple currency practices and exchange restrictions that were currently in place. The present dual market arrangement had represented a considerable improvement in terms of lower resource costs and a smaller effect on public finances. It was incumbent upon the authorities to ensure that the regular exchange rate was managed in a flexible manner that would restore competitiveness to the economy, with the aim of reaching a viable external payments position. Most pressures exerted by strains in the balance of payments would have to be absorbed by the floating exchange market in which most external transactions were to be conducted. Any large deviation of the controlled rate from the floating rate would have to be offset by quick policy corrections if resources were to be used without unduly impinging upon public finances.

In conclusion, he wished to underscore the importance that his authorities attached to a successful completion of the program, Mr. Lovato said. Mexico's problems, by their nature, went well beyond the national frontiers. At a moment when the Mexican leadership was showing a high degree of political courage, by accepting the prospect of much lower growth rates than those to which Mexico had become accustomed, the Fund had to demonstrate its support so that, by the end of the program period, the Mexican economy would again be robust.

Mr. Zhang supported Mexico's requests for an extended arrangement and a drawing in the first credit tranche. The proposed program involved severe adjustments in the economic mechanism of Mexico and would have long-term implications. He had four questions for the staff. First, the staff expected that, after the present program ended in 1985, Mexico would be able to grow at a rapid rate, perhaps 6 per cent a year, with internal and external stability. He would be interested in learning what pattern of growth the staff had foreseen after the country emerged from three years of sharp deflation. Moreover, what would be the fundamental changes in Mexico's economic and social relationships and in its institutional structure as a result of the Fund program? Second, would the cost of adjustment be equitably shared by all sectors of the economy?

Third, was the forecast for the external sector during the next three years too optimistic, Mr. Zhang asked, in view of the continued world recession and rising protectionism? Was the estimate for the increase of factor income payments between 1982 and 1985 too low, as a result of the new recent borrowing and rescheduling as well as the uncertainty surrounding future international movements of interest rates? Fourth, could the Mexican fiscal structure, which was not yet as flexible and elastic as in developed countries, carry out and sustain the impact of such a drastic reversal in the budgetary balance and in fiscal policies?

What fundamental changes in Mexico's basic economic structure would result from the proposed changes, since in the past the public sector had been the predominant dynamic force in economic development in Mexico?

Mr. Hirao recalled that during the Article IV consultation with Mexico the previous July, he had expressed the view that a strengthening of public finances would be the key element in the adjustment effort that aimed at improving Mexico's balance of payments position. It was reassuring to note the authorities' firm commitment in the letter of intent to address that fundamental problem in the medium term. It was also reassuring to see the letter from the new Administration confirming the continuity of policy. The current public sector deficit, estimated at 16.5 per cent of GDP, was indeed large by any standard; it would require drastic adjustment efforts and perseverance by the authorities to reduce the deficit as planned. According to the staff paper, the authorities were determined to take a broad range of measures, including holding down current and operating expenditure, eliminating or reducing subsidies, freezing the hiring of public employees, and reviewing public investment projects with a view to reducing expenditure. Furthermore, major adjustments were being carried out in the pricing policies of public enterprises, in general taxation, and in administrative fees. Those were the integral elements of the adjustment program, and he urged the Mexican authorities to implement those policy measures to the fullest extent possible.

He joined the staff in welcoming the authorities' intention to pursue a flexible interest rate policy attuned to the need to promote financial savings and allocate them efficiently, Mr. Hirao remarked. He agreed with the authorities that interest rates should reflect inflationary expectations and the requirements of exchange rate policy. He also welcomed the lifting of controls on interest rates charged for loans and the placement of greater quantities of treasury bills through the auction system.

On December 10, the Mexican authorities had announced the lifting of the generalized control system for foreign exchange, Mr. Hirao noted. He welcomed the new exchange arrangement, for it sought to restore normal economic and financial relations between Mexico and the rest of the world, and it would also eliminate costly subsidies. Nonetheless, while he could appreciate that the Mexican authorities had had to stop short of a full liberalization of the system and had instead decided to introduce a new dual market as a temporary measure, he concurred with the staff view that it would be important for the controlled market rate to be adjusted over time with a view to maintaining Mexico's international competitiveness and facilitating the eventual unification of the exchange markets. He was interested in knowing what effect the flexible exchange rate policy might have on inflation. In addition, there were concerns among commercial banks that foreign debt repayment by the Mexican private sector might become more difficult because of the sharp depreciation of the peso; they were also concerned that profits of private firms might be seriously squeezed. He would be grateful to learn the authorities' views on that score.

Mexico's current account deficit had fallen from $13 billion in 1981 to about $6.5 billion in 1982, and was expected to drop further in 1983 to about $4.25 billion, Mr. Hirao commented. A contributing factor in that favorable development was the projected increase in petroleum exports by almost $1 billion, to be achieved mainly through an expected rise in volume. The assumption behind that projection was that international petroleum prices and the export mix between light and heavy crude oil were projected not to change significantly from the prices and the mix prevailing during the second half of 1982. He would be interested in hearing the staff's assessment of those projections and assumptions, especially in the light of recent supply and demand developments in the world market.

He welcomed the authorities' intention to seek a wage policy that was in harmony with price and employment goals and to avoid indexation to past inflation, Mr. Hirao said. He had noted from Table 15 (EBS/82/208, Sup. 1) that net credit flows to the public sector through official banks other than the Bank of Mexico had increased significantly in 1981. Had the performance criteria set forth in paragraphs 1 and 2 of the Technical Memorandum of Understanding taken account of that development?

His authorities fully recognized the special circumstances under which the Fund had to play its role in dealing with Mexico, Mr. Hirao stated. There had been an urgent need to formulate an emergency rescue package unprecedented in its size and depth, without which there might well have been a serious threat to the stability of the international financial markets. His authorities were grateful for the skillful and dedicated work performed by the management of the Fund, through which the program had been arranged. In their view, some lessons had been learned for the future.

First, the Fund should keep in mind that it was the debtor country that had been borrowing from the banks, Mr. Hirao went on. Hence, it would be the debtor country that ought to assume the primary responsibility and take the initiative in negotiating with banks or possible creditor countries.

Second, it would be most efficient if a small group, like the advisory group on Mexico, representing a great number of banks, conducted negotiations with the debtor country, Mr. Hirao recommended. His authorities believed that that method of cooperation was conducive to an earlier agreement, and they would like to emphasize the importance of equitable treatment of banks in such negotiations, so that no group of banks would gain any special advantage or suffer any disadvantage.

Third, it might be useful to organize at an early stage an informal group that would explore ways in which supervisory authorities could best assist the debtor country on the basis of information supplied by that country and the Fund, Mr. Hirao said. His authorities felt that closer consultation between the Mexican policymakers and supervisory authorities might have been helpful, especially given the various assumptions that had been made on Mexico's external financing requirements.

Fourth, the Fund's primary role should be to restore public confidence in the economy of a debtor country by formulating a suitable adjustment program, thereby facilitating the country's access to private credit markets, Mr. Hirao commented. There might be additional cases like that of Mexico, in which parallel negotiations with private banks would be needed in order to consolidate the basis for implementing the Fund program. Private banks, for their part, should form their own judgments about their priorities in extending credit because of commercial considerations, while at the same time paying due attention to the maintenance of stability in the international financial system. Therefore, private banks could find it useful to obtain the relevant information concerning stabilization programs to be supported by the Fund. Close contact between the Fund and private banks would be useful and should be accompanied by close consultation between the Fund and the supervisory authorities.

Finally, in a period of uncertainties and strains in the international financial system, cooperation among member countries, the Fund, and commercial banks was indispensable, Mr. Hirao observed. His authorities were fully prepared to take their share of that responsibility in the collective endeavor. The Fund's role would become increasingly important. His authorities were particularly interested in how the Fund would build up its own resources under the Eighth General Review of Quotas. They strongly hoped that the quota structure would be rearranged so as to enable them to contribute resources to help the Fund to perform its task. In conclusion, he supported the proposed decisions.

Mr. Sigurdsson expressed admiration for the personal initiative undertaken by the Managing Director and his colleagues in helping to solve the financing problems of Mexico. He supported the proposed decisions.

As noted by the staff, a successful adjustment by Mexico required a rapid reduction in the large imbalances in public sector finances, Mr. Sigurdsson continued. The staff had also stated that the key element in controlling domestic demand was fiscal policy; while the statement was no doubt correct, another element with a strong bearing on domestic demand was incomes policy. Unfortunately, the staff appraisal mentioned incomes policy only briefly and in general terms. He had missed a focused discussion of the development and the determinants of income during the program period. Like Mr. Laske, he wondered about wage developments in the public sector. In addition, he had noted from Table 11 on page 53 of EBS/82/208, Supplement 1 that real minimum wages had increased by about 35 per cent in 1982 and real wages in construction had increased by 32 per cent, although there was no entry for manufacturing wages in 1982. Could the staff say whether that development reflected all wage and salary developments in that year? He would appreciate it if the staff could elaborate on the background for those high increases in real wages in 1982 and say what the prospects might be for the outcome of the coming wage negotiations. After increasing substantially during 1981-82, the ratio of wage expenditure by the public sector in relation to GDP was expected to fall significantly in 1983. The reduction was seen to be much more substantial in Supplement 3 than in Supplement 1, but it was not entirely clear to him what the basic differences were between the two public sector projections, and he would be happy if the staff could elaborate on those differences.

He had missed in the staff paper a comment on the situation of the labor market in Mexico, Mr. Sigurdsson recalled. It was difficult to obtain reliable statistical information on the subject, but more explicit comments on the problem of unemployment and prospects for its evolution during the program would have been warranted. He would like to endorse the staff appraisal with regard to exchange rate policy and, in particular, the importance of the unification of the exchange system and the avoidance of exchange restrictions. Finally, the Mexican authorities were to be commended for having embarked on such an ambitious and courageous program of adjustment.

Mr. Taylor joined other speakers who had paid tribute to the staff for the amount of work that it had put into the Mexican request, under considerable pressure, and to commend the Managing Director for the constructive role he had played in bringing the negotiations to a successful conclusion. In addition, he welcomed the Managing Director's efforts with commercial banks to arrive at a coordinated solution to Mexico's immediate financial difficulties. As previous speakers had pointed out, the case of Mexico was a good example of the crucial role that the Fund could play as a catalyst; it would also have to be agreed that under no circumstances could the Fund meet all of Mexico's financial needs, although it could provide a significant sum. What a well-designed program could do was to give confidence to donors and creditors, particularly commercial banks, and encourage them to continue lending to a country that was having extreme difficulty. In those circumstances, it was essential that the Fund program should be seen to be adequate and effective, as the continued confidence of creditors would depend greatly on that perception.

He warmly endorsed the staff appraisal and the proposed decisions, Mr. Taylor continued. On the basis of the Chairman's observations at the beginning of the present meeting, it appeared that the response by the banks had been sufficient to justify going ahead with the program. The Fund staff had put together a strong stabilization program with comprehensive performance criteria. If there was a doubt in his mind, it would be whether the authorities would be able to implement smoothly such a sharp and large adjustment in their fiscal and external position. However, in the circumstances, there had been little choice, and the alternatives would probably have been worse.

The new Administration in Mexico was to be commended for moving quickly to give substance to the policies that had been only broadly outlined in the letter of intent signed by the previous Administration, Mr. Taylor said. He was impressed by the immediate ratification of the adjustment program and by the speed with which measures had been announced and implemented. Such actions encouraged confidence in the determination of the new Government to tackle the country's problems. The targets of the program, particularly on the fiscal side, were ambitious, but the current difficulties were largely the result of the authorities' failure in the past to adjust domestic demand adequately to external developments, especially the world recession and high international interest rates. The authorities had started well, but they would have to strive hard to keep up the momentum of adjustment in the months ahead.

It was natural to wonder, when a strong program was presented to the Board, what degree of sacrifice was being asked of the requesting country and whether it could be reasonably expected to bear the burden, Mr. Taylor commented. He would have appreciated a little more information on that point from the staff. Among the many projections provided in the staff paper, he had been unable to discover any figures that encapsulated the likely consequences of the program for Mexican living standards over the next year or two. No doubt a significant fall could be expected in real wages and in personal consumption. But the standard of living would probably recover in due course when output revived. However, given the large increases in real wages in 1982 and the fairly good medium-term prospects, it might be correct to conclude that the burden of adjustment on Mexico was not impossibly onerous.

Turning to the details of the program, Mr. Taylor remarked that he fully supported the emphasis placed on correcting public finances. As the staff had indicated, it would be quite difficult to achieve a sustained reduction in Mexico's foreign borrowing unless the public sector deficit was brought firmly under control. He also wished to endorse the comments made by other Executive Directors that successful implementation of the fiscal measures would be essential if the overall deficit was to be halved as a proportion of GDP.

He had noted with some concern that central bank financing of the public sector deficit was likely to continue at a high level in 1983, Mr. Taylor continued. There were obvious risks that such financing would jeopardize the inflation target, and he had listened with interest to the remarks of Mr. Teijeiro on that point. He agreed with the various comments made by other speakers that the upward adjustment of interest rates on deposits in the banking system should serve to encourage domestic savings. He welcomed the intention of the new Administration to pursue a flexible policy in that field. In passing, he wondered what the main factor was behind the appreciable slowdown projected in the rate of inflation for 1983. Perhaps a rapid deceleration of wage increases would be the principal element; he wondered about the implication for profit margins in the face of sharp price deceleration. There might well be a sharp squeeze in profit margins.

As to the exchange system, Mr. Taylor went on, he welcomed the decision to abolish the system of generalized exchange controls and the move being made toward major liberalization. The new system of multiple exchange rates proposed recently seemed complex: it would make it difficult for the authorities to move toward their stated objectives of avoiding detailed controls, encouraging exports, and reducing the attraction of the peso market within the United States. Clearly, the gap between the controlled rate and the free market rate would be critical and should not be allowed to widen. In the circumstances, it seemed fitting that Fund approval of Mexico's exchange system was limited to the period until the May review of the program.

Perhaps the staff could shed some light on the arrangement described on pages 50 and 51 of EBS/82/208, Supplement 1, under which the Bank of Mexico was to provide foreign exchange for the repayment of foreign debt obligations outstanding on December 1, 1982 at a guaranteed exchange rate, Mr. Taylor asked. It was unclear to his authorities how that arrangement tied in with recent press reports that, under the new exchange control system, the Bank of Mexico would accept payment in pesos at the controlled rate for interest payments and foreign loans contracted before December. He was unsure how the proposal tied in with the corresponding local currency deposit scheme to be established for the settlement of arrears. At any rate, it might be useful if the staff or Mr. Senior could inform the Board of where things stood under the new exchange control system.

Other speakers had been concerned about what they had felt to be the general optimism underlying export projections, a concern that he shared, Mr. Taylor said. In particular, the assumption of a somewhat increased volume of oil exports at unchanged prices and with an unchanged product mix appeared extremely vulnerable. Of course, many of the variables affecting exports remained outside Mexico's control, but the substantial growth expected in non-oil exports did reinforce the need to maintain a competitive exchange rate for the peso.

As to the choice of an extended arrangement for Mexico, his authorities regarded the May review as being of critical importance, and they hoped that it would be comprehensive enough to cover domestic as well as external policies, Mr. Taylor commented. He would be glad if the staff could confirm that point. At the same time, the review would need to focus on wider issues reflecting the major structural weaknesses in the Mexican economy. After all, the rationale for selecting an extended arrangement was that Mexico would have to mobilize domestic resources in order to continue servicing its large debt burden. His authorities agreed that Mexico's immediate difficulties could be traced to problems of demand management that could have been addressed under a series of stand-by arrangements. Nevertheless, the decision had been taken to move on a broader front, and it seemed important to make sure that the program was a thorough one conforming fully to the guidelines for extended arrangements. Consequently, he hoped that the staff and the Mexican authorities would use the period until the May review to define more clearly the three-year program, bearing in mind the criteria for extended arrangements. In general terms, the staff and the authorities would have to give careful thought to supply-side measures designed to achieve a better balance in the economy, including not only a reform of the tax structure and a re-examination of the role of public enterprises, but also a clearer view on the development of the investment program.

Like other speakers, he hoped that the World Bank would be able to make a substantial contribution to the discussions of Mexico's investment program, as indeed had been normal practice in previous extended arrangements, Mr. Taylor stated. Attention would also have to be paid to the removal of trade barriers and the implementation of measures to improve resource allocation. The object of such a review would be to create a convincing program for the longer term as well as a timetable for achieving sustainable external balance, with due consideration to Mexico's position as a capital importer and a rapidly developing and resource-rich economy. His authorities were keen that Mexico should be equipped with a program that set forth the objectives and policies for the whole of the extended arrangement and that was adequate for the solution of the country's problems.

In conclusion, the Fund had provided Mexico with a springboard with which it could launch a comprehensive campaign to overcome its difficulties. The task ahead for the Mexican authorities was not an enviable one. It was most encouraging that they had made a good start. It would be essential to keep a close watch on developments, so that the first review in May should be regarded as a major stepping stone. The efforts of the authorities fully deserved the support of the Fund, and he wished them every success.

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

APPROVED: June 1, 1983

LEO VAN HOUTVEN
Secretary

MEXICO

Mexico - Commercial Bank Contributions: Indication of Shortfall

(Status: 12/23/82 - 10:00 a.m.; In millions of U.S. dollars)

	Quota	Answer	Shortfall
Japan	918	826	92
Spain	121	0	121
		(93)*	(28 probable)
Italy	130	8	122
Belgium	76	46	30
Switzerland	222	128	94
Germany, Federal Rep. of	265	218	47
Arab Countries	107	50	57
United States	1,911	1,676	235
Canada) United Kingdom) Netherlands)	these are all over their quotas		
France	quota met in full		

Source: Citibank (Mr. William Rhodes; Ms. Andrea Bauer).

*Per Governor of Bank of Spain.