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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/168

3:00 p.m., December 23, 1982

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	C. Taylor
J. de Groote	
B. de Maulde	A. Le Lorier
A. Donoso	
	C. Dallara
M. Finaish	T. Alhaimus
	Jaafar A.
T. Hirao	
R. K. Joyce	M. Casey
A. Kafka	
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
J. Sigurdsson	L. Vidvei
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. A. Kay, Assistant

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Also Present

African Department: J. M. Jimenez. Asian Department: S. Kimura, M. R. P. Salgado. Central Banking Department: L. M. Koenig, Deputy Director. European Department: B. Rose, Deputy Director; T. R. Boote. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitian, C. M. Loser. External Relations Department: G. P. Newman. Fiscal Affairs Department: V. Tanzi, Director; C. A. Aguirre, M. I. Blejer, P. R. Rado. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder. Research Department: W. C. Hood, Economic Counsellor and Director; G. H. Spencer. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Gupta. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Deputy Director; C. E. Sansón, Deputy Director; A. Baumgarten, M. E. Bonangelino, M. Caiola, C.-J. Linde, J. P. Pujol, F. Rubli-Kaiser, I. C. Tandeciarz, S. Umana, L. M. Valdivieso. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, S. R. Abiad, J. R. N. Almeida, S. E. Conrado, J. Delgadillo, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: L. E. J. Coene, T. A. Connors, R. J. J. Costa, M. K. Diallo, G. Ercel, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, P. Leeahtam, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, J. Reddy, C. A. Salinas.

1. MEXICO - PURCHASE TRANSACTION - FIRST CREDIT TRANCHE; EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors continued from the previous meeting (EBM/82/167, 12/23/82) their consideration of requests by Mexico for a drawing under the extended Fund facility 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). They also considered a decision on Mexico's exchange system (EBS/82/208, Sup. 1, Appendix V).

Mr. de Groote referred first to the situation regarding the amount of $76 million pledged by Belgian commercial banks. The responsible official in Citibank had the previous day reported receiving pledges to a total of slightly less than $76 million. He had however omitted to register a pledge by the Arab European Bank in Brussels. With that pledge, the total exceeded the $76 million agreed upon. In the circumstances, it might be useful to check whether all other pledges had in fact been recorded by the coordinating group.

Dealing with the substance of the request by Mexico, Mr. de Groote congratulated the Chairman for his initiative and creative imagination. The real question was whether the Executive Board was facing a special set of circumstances, or whether the Chairman had set a precedent for future cooperation. He himself was by no means certain that the Executive Board as a whole wished to enter into a system that would involve similar arrangements with the banking community. It was rather difficult to expect the banks to commit themselves without giving them some assurance that the authorities would guarantee their liquidity. Consequently, the generalization of the method used by the Chairman in the present instance would depend on the supervising authorities in the various countries setting up appropriate arrangements. There was also the problem of equal treatment. He understood of course that the creditworthiness of different countries that borrowed from the Fund was not always the same. Nevertheless, the commercial banks would have to accept rather similar obligations regardless of the borrower. The Chairman might well be expected to find analogous methods for ensuring that the banks would maintain liquidity in other countries that asked for the Fund's assistance. The point was important because, on the basis of Mexico's record, it was by no means obvious that Mexico had enjoyed particularly close relations with the Fund. Indeed, it might be said that it was a country that would have to demonstrate in the near future that it deserved the confidence that the Fund was placing in it.

His own feeling, after examining the document and listening to his colleagues, was that the Mexican authorities had not provided the Fund with a program, but only with something like a first approach to a program, Mr. de Groote commented. He did not see very well how the various elements of the program fitted together to provide the desired result. For instance, why was inflation expected to decline in 1983? Was it simply because wages were expected to rise more slowly, or how were wages in the private sector

to be moderated in the coming year? What Executive Directors had before them was not a program so much as a list of intentions, and of individual decisions taken in some areas of the economic field. In those circumstances, frequent reviews would be needed not only to ensure that the program was being implemented, but also to help the Mexican authorities to put forward a coherent program that would be in conformity with the obligations that they had contracted in accepting the extended arrangement.

His own view, Mr. de Groote went on, was that the outcome might differ from expectations, partly because the international environment would be less favorable than expected, and partly because the measures, although significant compared with those taken in the past, were not likely to yield the expected results unless additional steps were taken. For instance, in public finance, it was quite surprising that income tax, which was already low at 4 per cent of gross domestic product, was expected to fall to 3.3 per cent in 1983. Mr. Hirao had drawn attention to the procyclical effect of the budget deficit, and the authorities did not seem to have done anything to change the situation if the price of oil started increasing again. Indeed, none of the measures so far envisaged would increase the role of the private sector and diminish public demand on resources in Mexico. More broadly, therefore, the basic problems had perhaps not been touched upon, despite the apparent improvement in the relationship between the budget deficit and gross domestic product.

He had the same sort of feelings about the actions taken in connection with wages, Mr. de Groote stated. It was true that an incomes policy was envisaged for the public sector, but the authorities had not provided for limiting increases in wages in the private sector, where they had been large in recent months. If they were to have a coherent program, the authorities ought to see what they could do to influence the negotiations currently under way.

The expansion in the volume of money, Mr. de Groote observed, would be larger than was usually permitted under Fund programs, a phenomenon that would have adverse effects both on the inflation rate and on the exchange rate. As to the exchange system, it seemed unlikely that the dual exchange arrangement presently in force could last long. He had had experience with dual exchange rates in several other countries in his constituency, or where he had worked; where the difference between the two rates was large, the incentive for having all transactions, including commercial transactions, take place at the free market rate was large as well. The difference between the two rates gave rise to underinvoicing or overinvoicing, with the balance being paid to accounts in the United States or elsewhere. With the close contact between Mexican and American companies and banks, such a system did not seem controllable. Overinvoicing or underinvoicing was likely to take place on a large scale as soon as the public came to regard the free rate as being the real rate. Nor did he feel that the Executive Directors were being given much in the way of structural changes. Broadly, while he could approve the requested

drawing and the purchase transaction under the extended arrangement, the authorities' proposals should be regarded as only the beginning of a program that would be worked out in the months to come.

Mr. Polak commended the staff for a difficult task carried out against unusual odds. The staff paper was thorough and detailed, perhaps excessively so on certain points. Yet, it was clear that little was known about what would take place in 1983, let alone in 1985. In Mexico, perverse measures had been taken until the very last moment; surgery had been performed; and a large first aid program had been mounted. Like others, he complimented the Managing Director for the great responsibility he had been willing to assume at a critical moment. He wished also to compliment the U.S. financial authorities for their willingness to assume duties with respect to banks which they would certainly have been dismissed as totally inappropriate not long previously. A great majority of the banks had responded positively, even though they were committed to exposing themselves for even larger amounts, partly on the basis of the Fund's program and partly on the basis of faith in the President of Mexico and his team.

Although it had become fashionable to lump countries with certain financial difficulties into a single category, Mr. Polak observed, the case of Mexico differed from that of all the others; Mexico's payments problems had been created by an immense boom during a period when the rest of the world had been more or less stagnant. Historically, the growth rate in Mexico had been some 6 per cent a year, but Table 10 in EBS/82/208 showed that between 1978 and 1981 Mexico had been growing at an annual rate of between 8 per cent and 9 per cent. Even according to the staff projections, Mexico would be able to recover to a 6 per cent growth rate in 1985, with comparatively little growth in the intervening years. In other words, for the years 1982-84 Mexico would have to accept the necessity to offset the excessive growth rate that it had enjoyed in the three or four preceding years; but it was by no means clear that Mexico would be worse off by 1985 than if it had followed a persistent growth rate of 5 per cent or 6 per cent ever since 1977.

The point he had made, Mr. Polak explained, was relevant to the question whether the sacrifices that Mexico was currently making were bearable. The staff had stated that real wages had risen by 30 per cent in 1982, which meant that there was a clear case for a sharp reduction in real wages at the present time, particularly in the public sector where remuneration was relatively high. The authorities had been extremely vague regarding wages policy not only in paragraph 24 of the letter of intent but also on page 15 of EBS/82/208.

Similarly, the lack of strong adjustment appeared to be reflected in the low yield of the income tax, Mr. Polak stated. Moreover, some of the calculations seemed to suggest that the burden of adjustment being put on the Mexican economy was not seen as very grave by the Mexican authorities themselves. During the boom years 1977-81, investment as a percentage of gross domestic product had risen from 23 per cent to 28.6 per cent. For

the next two years, the investment figure was to be cut back to the level of 1977, but by 1985 it was to be restored to the 1981 figure, for both public and private investment alike.

The factor that had brought about the downfall of the Mexican economy was the lack of control of the fiscal situation, Mr. Polak commented. The situation had already been weakened before the spending spree that had started in 1977 and 1978. The authorities were certainly taking heroic measures to straighten out the situation. EBS/82/208, Supplement 3 gave a good description of the measures, and, expressed as a percentage of gross domestic product, the adjustment in the fiscal situation was large. However, the adjustment represented a reduction of roughly what had been added during the years of the spending spree; in other words, the cut in the fiscal deficit was to be from 16 per cent to about 7 per cent of GDP, the level that it had reached in 1977/78. The cut was to be brought about by concentrating heavily on reducing subsidies, which had grown out of all proportion, increasing the value-added tax, and a number of other measures. He found it particularly praiseworthy that in difficult circumstances the Mexican authorities not only had introduced the rather crude measures that he had mentioned, but were also taking a fundamentally different approach toward restructuring the public sector, on which they intended to report shortly.

The Mexican authorities had a long-standing reputation for using monetary measures to control both the domestic economy and the balance of payments, Mr. Polak recalled. Their use of that technique dated back at least to the 1940s and 1950s, and the Fund's understanding of the subject at that time owed much to what the Mexican authorities had been doing. The monetary side of the program seemed well designed, and there was every reason to believe that, with the competent control of the Bank of Mexico, monetary policy would play its traditional valuable role, presupposing that measures to control the rate of interest were not allowed to interfere with the market situation created by the monetary policy targets. Correct interest rates were absolutely essential for making sure that the targets would continue to be observed.

On the external side, Mr. Polak continued, a sharp cut in the current account deficit was inevitable given the financial commitments that Mexico would have to meet. The country would have to inspire the confidence of the banks by its balance of payments performance as well as by its other measures, if the funds put together by the banks and others were to continue to flow in. The cut in the current account deficit from 5.4 per cent of gross domestic product in 1981 to about 2 per cent in 1983/84 was large. While it was true that Mexico had already had a 2 per cent current account deficit in 1977, the interest rate burden had increased so much in the meantime that it was much harder to handle a deficit of the same size at present. He agreed with the staff that rationalization of the international side of the Mexican economy would have to have priority as soon as the Government was able to devote its attention to that aspect of its difficulties. Mexico's trade position had long been badly distorted by an excessively restrictive policy.

In the desperate situation of the past few months, there had been no way of avoiding adopting a floating rate for at least part of the balance of payments, Mr. Polak considered. Insofar as a pegged rate was relied upon, it was essential that it should remain realistic; much effort had been wasted during 1982 by moving the exchange rate either too little or too late. In the long run, however, it was only natural for a country in Mexico's situation to have a fixed rate on the U.S. dollar as much on account of capital transactions as on account of trade transactions. It would of course take a long period of financial reconstruction to create the preconditions for the Mexican peso to return to a fixed rate vis-à-vis the U.S. dollar. What would be needed would be the commitment to a financial policy that would ensure that the inflation rate in Mexico did not exceed that in the United States.

Making a historical reflection, Mr. Polak recalled that in the early years of the Fund the Mexican peso had been devalued at times that had been closely related to changes in the presidency every six years. Mexico had had rather large devaluations in 1948 and 1954, both years being at the end of the presidential term, when financial policy was being relaxed in preparation for an election. At the same time, the country had had small reserves, which made it difficult for the Bank of Mexico to withstand the pressure of capital movements. After the 1954 devaluation, the Mexican authorities had taken a firm decision that the cycle should be stopped, and they had asked the Fund for advice. In 1955, the Fund had delivered a report in which it had suggested that the cycle could be avoided by the adoption of stronger financial policies and the holding of larger reserves. The Mexican authorities had acted on the report and were thus able to avoid a number of cycles. Unfortunately, in 1976 and again in 1982 the presidential cycles seemed to have returned. He hoped that, following the changes brought on by the 1982 emergency, Mexican officials would resolve once again to embrace an approach to financial policy that would ensure stability on a lasting basis. He would support the two proposed decisions.

Mr. Joyce thanked the staff not only for the papers but for the many hours of work that had led to their production. He also thanked Mr. Senior for his introductory statement, and, finally, the Managing Director for the role that he had played at an important moment in the life of the international system and of the Fund. Not only the Fund but also the international monetary system as a whole was breaking new ground. He hoped that, in calmer circumstances in the future, the Executive Board could return to some of the questions that had been raised, notably the relations between the Fund and the commercial banks and, more generally, the best way of approaching such large-scale operations.

Although Mexico's current financial crisis had developed fairly quickly, the underlying factors had existed for many years. In particular, fiscal and monetary policies had been based on overoptimistic assumptions, leading to excessively expansionary actions over a prolonged period. During the past year, measures intended to correct the deterioration had on the contrary accelerated the process to the point where investors'

confidence had eventually disappeared. In those circumstances, the restoration of a viable balance of payments position would be a difficult and relatively lengthy process. Nevertheless, in view of the critical short-term problems facing Mexico, the authorities had little choice but to take aggressive action as quickly as possible if they wished to bring about a sustained turnaround in investment confidence.

The staff paper had outlined the specific combination of external factors that had led to the situation, Mr. Joyce noted. The program presented to the Executive Directors was both ambitious and wide ranging. While it would be reasonable to inquire whether the program was drastic enough, there were clearly limits to what the Mexican authorities could actually do. If the program was to work, like any program it would have to be acceptable not only to the international financial community but also to the people of Mexico. He was not as pessimistic about the future of the program as some other speakers, although he would agree with those who had mentioned that success would depend not only on what the authorities might do but also upon external developments. In that connection, he was rather concerned about the projection of a 38 per cent increase in nonpetroleum exports for 1983.

Commenting on certain aspects of the program, Mr. Joyce said that he did not have any clear idea of how the various elements would fit together. The Fund and the Mexican authorities together would have to work out the program during the life of the extended arrangement. Second, the staff had reached the conclusion that the natural rate of growth for Mexico was 6 per cent per year, and that the rate could be sustained while both internal and external balance were maintained. However, circumstances after the recovery could not be the same as they had been before the crash, and he doubted whether 6 per cent real growth could be achieved if the policies of restraint and consolidation that were called for under the program were effectively executed. Mexico should concentrate on the basic structural reforms needed to ensure a reasonable rate of sustainable real growth in the future; growth during the program should be treated as a residual.

It was clear, Mr. Joyce considered, that the past exchange rate policy, combined with the various protective measures, had had a distorting effect on the Mexican economy and the efficiency of Mexican industry, all problems that would need to be tackled if Mexico was to reduce its dependence on oil exports. Nevertheless, despite certain reservations, he did strongly support the program and the two proposed decisions. He commended the authorities for what they had done and welcomed the statements of what they intended to do. He hoped that the economy would turn around as quickly as projected and that confidence in Mexico could be rapidly restored.

Like others, Mr. Joyce observed, he wondered whether the interests not only of the Fund but also of Mexico would not have been better served if the Fund had been more successful in anticipating the crisis, which should never have taken place. It was less than six months since the

Board had discussed the economy of Mexico under an Article IV consultation. At that time, some Executive Directors had expressed deep-seated concern about the economic and financial situation in Mexico, and the staff had no doubt had the same feelings. Perhaps the Executive Board should have been more critical in its assessment. Moreover, there was no doubt that the failure of Mexico to come to the Fund, for whatever reason, had contributed to the depth of the present disorder and increased the amount of financing that Mexico was now forced to seek from the Fund and from commercial banks.

He was in broad agreement with the thrust of the adjustment effort, Mr. Joyce stated. Priority had been correctly placed on the need to improve fiscal performance, to control the rate of credit expansion, and to strengthen domestic savings. Those measures would permit, and the success of the program would require, the gradual liberalization of the exchange system, a further depreciation in the exchange rate, more realistic pricing policies, a reduction of subsidies, and the freeing of interest rates. If those steps were taken, it should be possible with perseverance over the next few years to create the conditions necessary for the resumption of sustained growth.

Commenting on proposed fiscal policy in Mexico, Mr. Joyce remarked that the targets set were impressive. The intention was to reduce the public sector deficit from 15.5 per cent of gross national product in 1982 to 3.5 per cent in 1984. Some of the key elements of the fiscal adjustment had been or were being initiated by the authorities. Important tax changes were being proposed; there had been significant revisions in public enterprise tariffs; on the expenditure side, significant reductions were envisaged in both current and capital account; major increases had been proposed in the value-added tax, which was to be extended to items not currently covered. Yet, changes in revenue were still heavily dependent on income from the petroleum sector. Indeed, petroleum taxes as a percentage of gross domestic product would rise from 8 per cent in 1981 to 13 per cent in 1983, while revenue from other taxes as a percentage of gross domestic product would either remain unchanged or decline. He commended the authorities for their commitment to carrying out major adjustments in public enterprise rates and tariffs. While major increases had been made in the prices of sugar, telephone calls, transportation, and above all petroleum, the staff had not clearly stated whether the increases were considered sufficient to bring prices more or less into line with economic costs. The data in EBS/82/208, Supplement 3, for instance, indicated that the deficits of many parastatals would increase in 1983. In particular, he noted that the staff had said that the prices of other important products were to reflect the economic cost of producing those goods and services. He would be interested to know how the staff saw the relationship between economic costs and market prices, particularly international market prices.

On the expenditure side, Mr. Joyce went on, wages would be a key element. The staff had said that the authorities did not intend to grant any adjustments to federal employees until September 1983. Nothing,

however, had been said about the size of the wage increases that would take place at that time. The staff had noted that future wage changes would be geared to the expected rate of inflation rather than to the past rate of inflation. It seemed evident that the authorities would need to be quite determined if they were to prevent public sector wages, and consequently private sector wages, from increasing too rapidly. He had been pleased to note the recognition by the Mexican authorities of the importance of wage policies; but the broader question of incomes policy had been inadequately addressed both in the letter of intent and in the staff paper. There did seem to have been substantial increases in real wages in some sectors, and he would be interested to hear the staff explain how it foresaw overall increases in real wage rates in the next few years.

In the monetary field, Mr. Joyce explained, he strongly supported the planned reduction in public sector credit, without which there would not be sufficient room for savings to move to the private sector. In view of the sharp increase in inflation, he welcomed the decision to pursue more restrictive credit policies, and he supported the quarterly reporting on domestic and foreign assets of the Bank of Mexico.

On the external side, the elimination of past arrears and the avoidance of new arrears were essential to the success of the program and should be accorded the highest priority, Mr. Joyce stated. Consequently, he supported the performance criterion calling for a minimum repayment of US$600 million of outstanding arrears in 1983. One aspect of Mexico's credit policy that he particularly welcomed was the decision to reverse the course set for interest rates earlier in 1982, a course that had had a serious effect on financial markets. Likewise, the decision to reduce credit subsidies on interest rates was desirable; the authorities should be urged to continue along that line as a way of protecting domestic financial markets in the years ahead, thereby avoiding the excessive use of foreign borrowing. The authorities would have to accord a high degree of flexibility to the determination of interest rates in the future. He welcomed Mr. Senior's remarks regarding the recent increases in the level of interest rates on 30-90 day paper. He would however appreciate more information about deposit rates in financial institutions.

Commenting on Mexico's intended external policies, Mr. Joyce stated that he had welcomed the announcement on December 10, 1982 that the exchange rate system in effect since September 1982 was being dismantled and that a more flexible two-tier system was being introduced. It was his hope that the authorities would move as quickly as possible to unify the exchange rate at an appropriate level. Clearly, a system involving a controlled exchange market and a generalized free market rate would require close supervision. At present, as he understood it, the rate in the controlled market was about Mex$95 = US$1, which was significantly different from the free market rate, said to be Mex$150 = US$1. In any event, the authorities should maintain the utmost flexibility in setting the controlled rate. If the market rate did not appreciate, the controlled market rate would have to be depreciated faster than the 50 per cent a

year currently envisaged. The maintenance of an unrealistic rate would require the continuation of exchange subsidies, something for which no provision was made in the Government's budget for 1983.

He supported the performance criteria, and indeed welcomed them, Mr. Joyce went on. However, on two points he would like some clarification. First, his impression was that the criterion regarding the maximum cumulative public sector deficit in nominal peso terms had not been commonly used in Fund programs. In the environment of high inflation in Mexico, the effectiveness of such a criterion clearly depended on the inflation targets. He did not necessarily disagree with the use of that criterion, but he would have appreciated more information on the sensitivity to inflation of the various components of both revenue and expenditure in the government program. Second, there were two domestic quantitative criteria relative to the assets of the Bank of Mexico. However, there was little explanation of the relationship between the Bank of Mexico and the recently nationalized banking sector. It was therefore difficult to ascertain the degree to which controls on the central bank would imply effective credit controls in the rest of the financial system. The restriction of net credit to the public sector was a fairly straightforward control of the monetization of the fiscal deficit through the central bank, while the criterion regarding net domestic assets required the control of the banking system by means of an accounting identity in the Bank of Mexico's accounts. He was not at all clear whether the two criteria would achieve the desired end.

Finally, Mr. Joyce remarked, he agreed with Mr. Erb and Mr. Taylor in their insistence on the desirability of more frequent reviews of the program with Mexico. Indeed, he imagined that the Mexican authorities would welcome such a course, since the credibility of Mexico in the financial markets was at stake, no less than that of the Fund.

Mr. Salehkhou expressed his gratitude to the Managing Director for his untiring efforts in the negotiations with Mexico. He also commended the staff for its efforts and thanked Mr. Senior for his valuable opening statement.

Because of the importance of the Mexican economy, Mr. Salehkhou considered, a great deal of time and attention was needed to probe the various aspects of the economy and to consider the program in all its details. The extremely short time available for reading the staff report, circulated moreover at a moment of heavy Executive Board work, had not given Executive Directors sufficient time to consider the current conditions in the country. While he had no doubt that the painstaking work by the staff would make up for a shortage of preparation on the part of Executive Directors, he hoped that the same flexibility and prompt attention to requests would be extended to smaller countries, particularly when their needs for resources were urgent, even though their role in the global financial crisis might not be so conspicuous as that of Mexico.

The main factors leading to the present serious imbalance in the economy of Mexico had been a gradual deterioration in external conditions--in particular a softening of the oil market--a rise in interest rates, the continued recession in the industrial countries, and the failure of the authorities to adapt domestic policies to the changing environment, Mr. Salehkhou considered. Indeed, domestic policies, far from reflecting the external downturn, had become ever more ambitious and expansionary.

In the circumstances, Mr. Salehkhou went on, it was reassuring to note that the new administration was fully congnizant of the severity of the problems facing it, and, judging by the bold measures taken so far, determined to tackle the problems at their roots. Within the structural imbalance was a serious lack of domestic savings, mainly in the public sector, the inefficiency of the productive system, and the inherent weaknesses in the balance of payments. In adopting the adjustment program and the austerity measures already introduced, the authorities had acknowledged the pervasiveness of the problems and the need to continue with adjustment for several years to come. In the 1983 budget, they had correctly emphasized the need to overhaul the value-added tax and to adopt a flexible taxation policy as a major source of revenue.

At the same time, Mr. Salehkhou went on, the authorities had adopted significant measures to contain expenditure. Outlays on expenditure were projected to decline by three percentage points in relation to gross domestic product in 1983, but it was clear that despite possible effects on investments, such medicine was absolutely essential if a sustainable payments position was to be achieved. The increases in the prices of such commodities as petroleum products, gas, sugar, electricity, and other public utilities would go far toward making the public enterprises more efficient, while other cost-cutting measures and a prudent wage policy were intended to ensure a gradual rise in public sector savings. There was however not much analysis of private savings. His understanding of the situation was that private savings were not currently of particular significance in the overall plan. Although they had fallen sharply in 1982, there were no explicit measures to correct the position. Similarly, there was little discussion of the monetary policy measures proposed for 1983 and 1984. Consequently, it was possible to conclude that the present negative rate of interest might not be regarded by the authorities as presenting an obstacle in the short run. Nevertheless, considering the relatively high level of income, it was possible that additional measures aimed at further strengthening private savings would be in order as a means of restoring confidence in the economy.

The performance criteria suggested by the staff correctly addressed the most urgent problems, Mr. Salehkhou considered. He hoped that the authorities understood that only adherence to such criteria would bring about the conditions needed for recovery, and that other supplementary measures would be required. In particular, heavy reliance on petroleum exports might not be prudent. It would be wise to boost other exports,

assisted by the depreciation of the peso. There was also a unique opportunity to expand the tourist trade, and he hoped that other measures aimed at tourism and non-oil exports would be adopted in the near future.

He was concerned by the assumption that inflationary pressures would continue in 1983, at a rate that might be even greater than that of 1982, Mr. Salehkhou observed. Continued inflation at such a rate would hardly restore confidence in the economy. Thus, much depended on future developments for an assurance of lasting success with the program. Adverse developments, both domestic and external, might completely undermine any initial gains; it was therefore crucial that a multipronged approach should be taken in tackling all the problems facing the authorities--economic, social, and demographic. Despite the dependence on exogenous developments in the months ahead, the staff had correctly pinpointed the immediate problem areas, and the programs agreed with the authorities were designed to tackle them. The performance criteria were well conceived to ensure continued viability of the economy during a most uncertain time. The austerity measures, notwithstanding their inevitable social costs, were necessary for the achievement of self-sustaining growth. He therefore supported both proposed decisions.

Mr. Jaafar said that his chair would support both the requests by the Mexican authorities, and welcomed the adjustment program to be carried out in the next three years. A number of lessons could clearly be drawn from the present case. It was evident that Mexico's debt problems had been mounting for several years without causing any great concern either to the authorities or to international institutions, including the Fund. Perhaps that situation had arisen because many lenders had been only too eager to provide resources for Mexico. In any event, either the Executive Directors had misread the available signs, or they had not been critical enough in drawing attention to the likely magnitude of the crisis and its consequences. Greater attention would have to be directed to debt statistics and debt management. He would be glad if some form of early warning system regarding debt burdens could be introduced by the Fund as a way of avoiding such crises in the future.

The Fund's role in the reconstruction of the Mexican economy would be important, Mr. Jaafar considered, not because of the volume of the funds that it was providing but because of the adjustment program that would accompany them. The SDR 3.4 billion provided by the Fund under the extended arrangement would be made available to Mexico evenly over a three-year period. The amounts involved were relatively insignificant in relation to the total needs of the country; the purpose of the program was to provide confidence to the banking community. If it did in fact do so, he would consider it to be highly effective. From the standpoint of the Mexican authorities, the adjustment program would be demanding. If, as seemed likely, slippages occurred in complying with the program, he would be concerned if the program were terminated in consequence. He therefore looked forward with great interest to the review scheduled to take place in May 1983.

Mr. Finaish remarked that the program worked out between the Mexican authorities and the Fund staff was a serious response to the present difficult domestic and external circumstances, which required an important change in economic strategy and major socioeconomic sacrifices. He supported both proposed requests.

Making general comments, Mr. Finaish observed that until recently the basic objective of economic policies in Mexico had been the maintenance of a high level of growth. Success of those policies had been widely acknowledged. As late as July 1982, the Chairman's summing up at the conclusion of the discussion for the Article IV consultation with Mexico had contained the sentence, "Directors paid tribute to the impressive accomplishments of Mexico over a period of years in output, economic diversification, employment, institutional development, and social sectors." The serious problems that had required a change in the course of economic policy in Mexico had arisen mainly from an overoptimistic assessment of the prospects for the world economy, and for the world oil market in particular. The result had been a rise in public sector expenditure with a doubling of the ratio of the fiscal deficit to gross domestic product in 1981, leading to heavy dependence on foreign creditors, accelerating inflationary pressures, a flight of capital, and a weakening of the current account. Attempts had been made to restore balance to the economy as early as mid-1981, but the gravity of the situation was not sufficiently appreciated. The economic adjustment program of 1982 had not been closely adhered to, thus significantly contributing to the aggravation of the problems facing the country and creating what the staff paper called "an atmosphere of crisis" later in the year.

In such circumstances, Mr. Finaish continued, the proposed three-year program, firmly endorsed by the new leadership in Mexico and assured of Fund support and cooperation in the capital markets, could contribute to the success of the policies that the authorities had adopted in their attempt to restore balance to the Mexican economy. The basic feature of the program was the attempt to bring about a sharp cut in the fiscal deficit, from 16.5 per cent of gross domestic product in 1982 to 8.5 per cent in 1983, with further reductions planned for the next two years. Great determination by the authorities would be needed to make such a program successful. The difficulty of the task might be gauged by considering that although the authorities had attempted to reduce the ratio of public sector deficit to gross domestic product by 3 per cent in 1982, in practice the ratio had increased from about 15 per cent to 16.5 per cent of gross domestic product.

The authorities had also paid considerable attention to the policies governing interest rates and exchange rates, Mr. Finaish noted, a procedure that seemed warranted because interest rates and exchange rates had a more pronounced role in the economy of Mexico than in that of many other developing countries. Unfortunately, there had been rather frequent shifts in interest rate and exchange rate policy in the past few months. Domestic interest rates had been raised in April 1982, to be lowered in September 1982 and raised again in November 1982. The exchange rate

system had also been subject to many changes, starting with the withdrawal of the Bank of Mexico from the market in February and its re-entry in June. A dual exchange market had been created in August and two official rates in September, together with a new exchange market in border areas in October, and the return to two exchange rates in December 1982. It was essential for the authorities to adopt more stable policies in the future, thereby minimizing the adverse impact of uncertainties.

In the external sector, Mr. Finaish said, it was encouraging that the current account deficit of the balance of payments had declined from $13 billion in 1981 to an estimated $6.5 billion in 1982. It seemed likely that further improvements would take place during the program period as demand management took hold at home and the prospects for Mexican exports improved abroad. The staff estimates indeed provided for an increase in exports, including petroleum, from $21 billion in 1982 to $23.7 billion in 1983, with further improvements in later years. Like others, he would be happy if the staff would comment on the realism of such a forecast.

Taking up what he called the "oil dimension of the Mexican case," Mr. Finaish remarked that one policy consideration that needed full assessment by the authorities was the increasing role of oil, especially in the external sector. As Executive Directors were aware, Mexico had become the world's fourth largest oil producer, after the United States, the Soviet Union, and Saudi Arabia. The staff had mentioned that in 1982 Mexico's proven oil reserves were the equivalent of 60 years' production at current levels, with potential reserves three times greater. The contribution of oil proceeds to total exports had risen steadily from less than 20 per cent in 1977 to nearly 73 per cent in 1982, and the staff had projected that the contribution would remain at over 66 per cent for the next three years. Such indicators pointed out the expanding role of oil in the Mexican economic and financial structure. One major concern for such a major oil producer should be the maintenance of a stable oil market, which called for greater cooperation and coordination at a global level. That was one of the tasks that would have to be addressed by policymakers as future prospects and programs would be increasingly affected by the complex developments and uncertainties of the world oil markets. At the time of the 1982 Article IV consultation with Mexico, he had raised a few questions about certain aspects, particularly the share of Mexican crude oil output taken by heavy and light oil; the extremely limited storage capacity in Mexico; and the potential for sales of natural gas, particularly that not associated with oil production.

The case of Mexico, Mr. Finaish considered, demonstrated that not only oil price increases but also weaknesses in the world oil market could cause shocks in the world economy. The case of Mexico might be called an example of the oil shock in reverse. If there were further dramatic changes in oil prices, there were likely to be serious implications not only for Mexico but also for such countries as Venezuela, Nigeria, and possibly others. While in the short run a dramatic decline in oil prices might enable some consuming countries to pay their debts more easily, in the medium and long term the effects on conservation and the development

of alternative sources of energy could only be deleterious. Moreover, before consumers received the benefit of a dramatic decline in oil prices, the damage to the larger producers might be sufficient to disturb the international financial system as a whole. There were of course also other short-run implications; for instance, some of those who lent to the banking system might be compelled to draw heavily on their deposits, and there could be a wholesale shift in the source of aid for the poorer countries.

The challenge to Mexico, Mr. Finaish observed, was to achieve realistic adjustment at the lowest possible human cost. The program would be difficult to carry out, but alternatives might well be worse. The challenge to international policymakers, including the Fund, was to draw the proper lessons in order to be able to strengthen the international financial system as a whole. Accurate assessments and appropriate action were particularly necessary at a time when the international economic situation was difficult and the room for maneuver limited. One lesson that might be drawn was that a country could be vulnerable to a lack of confidence by banks even if its economic position was not deteriorating sharply and it had great future potential. The rising weight of short-term debt seemed to make a lack of confidence even more likely. For Mexico, almost one quarter of total debt was short term, while in Argentina the proportion was probably one third, and for non-oil less developed countries as a whole about one fifth. The question of short-term debt therefore was one of general concern. A second lesson that might be learned was that the Fund, and the international community at large, would have to pay more attention than in the past to the "newly industrialized countries." Third, the present case might be the first occasion on which the Fund had intervened to avoid a crisis that might have had worldwide repercussions. It would therefore be interesting to consider how a crisis should be handled when it burst upon the world. A fourth lesson might be that the Executive Board would have to consider not only the role of the Managing Director, who certainly deserved great praise, but also the role of the Fund as a whole. Its involvement in the Mexican case had clearly raised certain expectations in the financial community. Fifth, there was the lesson about the bargaining strength of the larger countries, whose economic position was sufficient to cause disturbances throughout the international financial community. The bargaining position of the larger debtors was perhaps strong enough to limit the role of international institutions and to reduce the areas in which pressures could be applied. In those circumstances, what was needed was an active policy that could prevent a crisis from occurring. Perhaps even more important than a procedure for handling a crisis when it occurred would be to have in place a mechanism to smell out a crisis in the making. Clearly, the discussion of a drawing and a purchase by a single country was not the place to debate the place of the Fund in the whole economic scene. Nevertheless, at some time in the future it would be necessary to do so.

Mr. Prowse commented that the discussion should be an occasion for great satisfaction for the Managing Director and for the staff, and indeed for the Fund as a whole. Nevertheless, while the management and

staff had done everything that could be expected of them, and indeed more, the proof of the pudding would be in the eating. Like Mr. de Groote and Mr. Joyce, he felt that the outcome might be rather different from what was now expected.

The program proposed by the staff was quite appropriate and relatively orthodox, Mr. Prowse commented. In certain respects, the adjustment being sought was quite severe, but nothing short of severe adjustment was likely to deal with Mexico's problems. The program should perhaps have put even more stress than it did on the need to control, and if possible eliminate, inflation in the Mexican economy. Even at the end of the three-year period, there would still be a high rate of inflation, it was expected.

He was pleased to see that one aspect of the program was the requirement that arrears of private debt should be reduced by $600 million during 1983, Mr. Prowse stated.

One area of concern that slightly disturbed him, Mr. Prowse observed, was the expected performance of the budget. The fiscal deficit was expected to decline to 8.5 per cent of gross domestic product in 1983: there was to be a near-doubling of revenue, while expenditure was expected to decline in real terms. Unfortunately, most of the increase in revenue was expected to come from an increase in the domestic price of petroleum products and higher peso returns from exports. The second major source of an increase in revenue was the expansion of the value-added tax, which seemed quite appropriate. However, as for an increase in returns from sales of petroleum products, a reduction in the fiscal deficit as the result of an increase in the peso returns from exports of petroleum products was surely not particularly useful. What such an increase represented was an injection of revenue into the public sector that was unrelated to output. He would welcome a comment on the point in due course.

Second, the income tax yield appeared to decline from 5.8 per cent of gross domestic product in 1981 to 3.3 per cent in 1983, Mr. Prowse noted. The staff was no doubt correct in saying that the decline would reflect the sluggishness of the economy and the negative effects on corporate income tax of exchange losses. However, all that was said in EBS/82/208, Supplement 3 was that the authorities were contemplating a reform of the income tax. He would have hoped for a stronger formulation in the present circumstances, and he would welcome an indication of what sort of reform was being contemplated. He would also welcome an explanation of how much income tax would be levied on personal incomes and how much on business incomes, especially as he wondered whether there was not a good case for seeking to increase the amount of revenue from income tax, particularly in view of the sharp increase in real wages in 1981. If 1983 would be the first year in which public employees would pay income tax, the change would be a useful one.

He had also been disturbed by certain aspects of the wage arrangements, Mr. Prowse explained. The procedure for the determination of wages was not altogether clear. In the letter of intent, the Central Bank Governor

had written, "to protect the standards of living of the majority of the population and to enable workers to share equitably in the benefit of growth, economic policy will seek that wage movements be geared to the employment objective, protection of the standard of living of the working class, and the adequate participation by workers in the growth of income and productivity, within the framework of the Government's economic program." That statement did not make it very clear what the wages policy would be or how it would apply. On page 4 of EBS/82/208, Supplement 3, the staff had written "in regard to wages, the authorities do not intend to grant any adjustment for federal government employees until September 1983, when pay scales are scheduled to be reviewed, and then to increase wages at a rate in line with the expected rate of inflation at that time." If in fact "no adjustment" really meant "no discretionary adjustment" as well as no in-depth adjustment, the reduction in the real wages of government employees would be severe indeed. While he understood that the Government intended to reduce expenditure on wages and salaries from 8.1 per cent of gross domestic product in 1982 to 5.7 per cent in 1983, he wondered whether the authorities really expected to be able to do so without severe dislocation. He hoped that whatever the Government contemplated would not be so severe that it would be difficult to live with.

He was also worried by the action contemplated in connection with subsidies, Mr. Prowse remarked. The policy was apparently to reduce subsidies from 13.1 per cent of gross domestic product in 1981 to 9.8 per cent in 1983. The existing subsidies certainly represented a large drain on resources, mostly due to the state enterprises. If in fact the deficit of the electric utilities was expected to increase, as seemed to be the case from the figures, the situation would be most unfortunate.

It was evident, Mr. Prowse considered, that the financial system was dominated by nationalized banks, and that interest rates were determined by the Government. The authorities had tried to reduce interest rates, with the result that the capital outflow had accelerated. The authorities were now committed to adopting competitive rates; he would endorse such a program and urge the authorities to allow interest rates to move freely as soon as they considered it feasible to do so. It was important to note the interdependence between savings, interest rates, and capital movements.

Contemplating the point raised by Mr. Finaish and others, namely, whether more could have been done to avoid the emergence of the unsatisfactory situation in Mexico, Mr. Prowse wondered whether Article IV consultations were adequate. Would a more continuous form of surveillance have been helpful? What was essential was that the Fund and other institutions should be sufficiently flexible in their response to suddenly emerging crises. Apart from external debt, it seemed unlikely that the agencies would be able to foresee such events very far ahead. In any event, he hoped that at some time in the future the Executive Directors would be able to consider further the implications of the Mexican case for the Fund's surveillance process and Article IV consultations in particular.

What was important at the present moment, Mr. Prowse remarked, was the commitment of the Mexican authorities to the major objectives laid down in the program. Flexibility would be required not only of the Mexican authorities but also of the Fund in dealing with the finer points of policy. It was therefore important that the present cooperative relationship between the Mexican authorities and the management and staff of the Fund should be maintained. Clearly, quite frequent reviews of the program would be needed; it might indeed have been better to offer the Mexican authorities a stand-by arrangement rather than an extended arrangement.

The Deputy Director of the Western Hemisphere Department replied first to the queries regarding what could have been done to forestall the difficulties into which the Mexican authorities had fallen. While procedures could perhaps be improved, the consultation reports (SM/82/121 and SM/82/124) considered by the Executive Board at EBM/82/99 and EBM/82/100 (7/16/82) had dealt with many of the questions now being faced.

Replying to Mr. de Maulde's question regarding the sensitivity of interest payments to changes in interest rates, the Deputy Director indicated that a one percentage point change in interest rates appeared to mean a change of some $650 million in Mexico's payments. Mr. de Maulde and a number of other Executive Directors had inquired whether projected imports were not low relative to gross domestic product and therefore whether there might not be a constraint on the growth of GDP. Looked at in historical perspective, the ratio of private imports to gross domestic product did not seem particularly low. Moreover, recently there had been a great deal of external financing of imports, and exchange rate relationships might have raised imports to unsustainable levels. However, he himself did not see any very rigid linkage between imports and gross domestic product. Certainly, adjustment should mean that in due course output would develop satisfactorily; meanwhile, imports might follow a quite different course from that they had followed previously. Private foreign interest payments were being handled by the establishment of a deposit scheme, through which arrears could be paid off. There had been a suggestion that the staff had been too precise in predicting the adjustment path for the period ahead. Naturally, the figures would have to be examined at appropriate intervals, but the public sector deficit would need to be reduced, as would the use of foreign credit, regardless of the exact figures.

Replying to Mr. Teijeiro, who had asked a question about the relationship between the volume of money in circulation and gross domestic product, the Deputy Director explained that such ratios could be misleading at a period of accelerating inflation. Table 6 on page 19 of EBS/82/208 showed that there had been little growth in liabilities to the private sector in 1982. With a deceleration of inflation and an interest rate policy directed to promoting financial savings, it was expected that the ratio would improve in 1983. As to comments made by Executive Directors on the two-rate exchange market, it was recognized that when the difference between the two rates was large, problems could arise. For that reason,

the staff always urged authorities to seek unification at the earliest possible moment. Mr. Teijeiro had inquired whether capital inflows through the free market might not upset the control of money in circulation. As the central bank was not obliged to buy the proceeds of such capital inflows and would not customarily do so, the precise linkage foreseen by Mr. Teijeiro did not exist.

Questions had been asked by Mr. Nimatallah and others about when the World Bank would become involved in the Mexican situation, the Deputy Director recalled. The staff had reported that the authorities had indicated that they would be calling upon the World Bank as soon as the new administration had established itself. The authorities had indicated that they wished the World Bank to review the investment program and to provide some additional financing in due course.

As to the protective system, the Deputy Director considered that monitoring the system would be one of the more important features of the Fund reviews of the program, particularly in the later stages, when the authorities would have overcome some of the immediate problems faced. The staff considered the protective system to be an area in which major improvements would be needed.

Some speakers had raised questions about the behavior of nonpetroleum exports, the Deputy Director remarked. While the percentage increases for 1982 to 1983 seemed rather large, the actual figures were not large in U.S. dollar terms. The change would not seem to be large compared with earlier years. In 1983, there was likely to be less domestic pressure on resources than had been evident in the recent past, making more resources available for export. Furthermore, the 1982 figures might in fact be higher than had been shown by the staff.

Commenting on the considerations that had been in the minds of the authorities in dictating the setting of the controlled exchange rate--a question raised by Mr. Erb--the Deputy Director said that the authorities had wished to emphasize that it was not merely a matter of looking at the price relationships of the past; it was necessary to take into account that Mexico would not be obtaining capital flows of the order of magnitude that it had been obtaining earlier. Hence, adjustment was needed in connection with the exchange rate as well as in other fields. Regarding forward cover for certain capital transactions, a topic discussed in Appendix V to EBS/82/208, Supplement 1, the staff had been concerned lest the authorities should introduce subsidies in such transactions. The authorities had still not come to a final conclusion as to how they would proceed, but they had assured the staff that they wished to avoid introducing new subsidies. They had talked of using an adjustable premium as a way of spreading out the costs for the firms involved, without offering permanent subsidies.

Commenting on the actions of the authorities in connection with interest rates, the Deputy Director mentioned that the staff would have preferred the adoption of free interest rates for all instruments. As the

matter now stood, lending rates would be free but a number of deposit rates would be subject to control and were being adjusted upward. Several Directors had drawn attention to the sharp increases that had taken place in recent weeks. The authorities' view had been that interest rates should be related to the expected inflation rate, a result that would be similar to that obtained by opting for free interest rates. It was always difficult to know what the expected rate of inflation might be, but the authorities had felt that they might use the projections of prices under the program as a proxy. In fact, some of the rates in force on the deposit side were significantly above the expected rate of inflation, according to the program estimates, but considerably below the rates of price increases over the past 12 months. The authorities intended to adjust interest rates in the light of experience, more particularly in the light of the behavior of financial savings. They did clearly understand that the interest rate would have a considerable bearing on exchange rate policy.

A number of Directors, including Mr. Erb, had commented on the adjustment of prices in the public enterprise sector, the Deputy Director noted. The staff had in fact said in EBS/82/208, Supplement 3 that more price adjustments would have to be made in the public enterprise sector. Some price changes had already been scheduled, but others would have to be tackled by the authorities in the coming year. More generally, the authorities intended to try to control a much smaller set of price decisions in the private sector than in the past.

Taking up the structural aspects of the program, the Deputy Director recalled the earlier mention that the protective system would receive close attention. Although the investment program would be reviewed by the World Bank, the extended arrangement negotiated between Mexico and the Fund did involve many structural elements. The staff was looking for a substantial improvement in public savings and a reduction of the reliance on foreign financing. If carried as planned, the measures contemplated would bring about major changes in the economy.

The staff intended to complete the first review of the program with the Mexican authorities by May 15, 1983, the Deputy Director explained. There would also be an Article IV consultation, and subsequently a discussion with the authorities on the program for the second year.

Questions on credit policy had been raised by Mr. Laske and others, the Deputy Director noted. The credit program was largely dominated by fiscal policy. Mr. Polak had referred to the credit program of the Bank of Mexico as being well designed, and rightly stressed the importance of avoiding unrealistic interest rates. However, unless the fiscal policy was improved, it would be impossible for the Bank of Mexico to operate an appropriate credit program. The depreciation of the peso would have a positive effect on the public finances, as the staff had indicated in EBS/82/208. Mr. Laske had also inquired whether the elasticity of the response to the large increases in the prices of public sector commodities would not affect revenues, especially those from petroleum products. If

in fact domestic consumption of those products began to fall, more would become available for export. In the short run, elasticity was probably low, but he did agree that the price changes were substantial.

The point had been made by Mr. Malhotra, the Deputy Director recalled, that even in the later stages of the program the debt service ratio would remain high. That reflected the fact that the debt burden could be reduced only as the public finances improved, something that was likely to take place only over time. On the question of private savings, a point raised by Mr. Lovato, the staff had been referring to a period in which the economy would not be buoyant. In connection with wages, the authorities wished to see them based on prospective inflation rather than past inflation. If it should be possible to bring down the rate of inflation, it would then be possible to obtain wage settlements along prospective lines rather than historical lines. If wage adjustments were based on the past, the authorities would find themselves adjusting wages in line with price increases of between 90 per cent and 100 per cent a year.

Questions had been raised by Mr. Lovato and Mr. Sigurdsson about the level of wages in 1982, the Deputy Director observed. It had to be admitted that there had been large increases in real wages in that year, a development that had created problems. The gravity of the situation had been clearly understood by the authorities, who had mentioned the matter in the letter of intent. The emergency wage adjustment agreed to following the exchange rate changes of February 1982 had certainly added to the difficulties of the past year. There might however be some statistical defects in looking at wages on a year-over-year basis from 1981 to 1982, if only because price increases had accelerated throughout the year, while wages had been adjusted at the end of the first quarter and the second quarter respectively. If wages were examined by comparing the December 1981 level with the December 1982 level, part of the real increase would have disappeared.

Commenting on the labor market situation, the Deputy Director remarked that all the indications were that the demand for labor was weak, a situation that had been reflected in the wage adjustments in the private sector, as well as in those in many public enterprises. In many instances in the recent past, wage increases had been in the neighborhood of 25-30 per cent, notwithstanding the high rate of inflation. Moreover, when larger increases had been sought, the firms had been able to represent that they would be unable to afford them and that they would have to either dismiss employees or close down.

The staff had mentioned the growth rates that it expected in the coming years, the Deputy Director explained in reply to Mr. Zhang. The staff was expecting zero growth in 1983, followed by 3 per cent in 1984 and 6 per cent in 1985. Naturally, the staff was not putting those figures forward with any great confidence. More generally, the changes that the staff regarded as likely to be important as the result of the program were the increase in savings and investment, a more efficient use of resources,

and a decline in inflation. It was hard to say whether equity would suffer. The authorities intended to concentrate subsidies on the lower-income groups. There was some progressivity in income and other taxes. But in the end there seemed little doubt that consumption would have to be adjusted downward.

In the external sector, Mr. Zhang had inquired about the content of the staff's projections, the Deputy Director recalled. The projections took into account the refinancing of existing debt and a moderate increase in the total debt. As to whether the public sector adjustment could be absorbed, the answer was that it was in some sense already being absorbed. There would certainly not be foreign financing of the same size as in the recent past. On the other hand, in general terms, once an adjustment program began to be applied, more external financing became available, and more resources became usable by the country as a whole. The whole purpose of the adjustment program was not only to increase the volume of resources available but also to improve the efficiency with which they were used.

Replying to Mr. Hirao, the Deputy Director remarked that he did not believe that inflation in Mexico had been caused by the use of flexible exchange rates. The changes in the exchange rate basically registered the inflation that already existed. Mr. Hirao had also inquired whether adjusting the exchange rate downward to Mex$95 = US$1 would not make it difficult for private firms to make debt payments abroad. There was no doubt that a lower exchange rate did make it more difficult for firms to pay foreign debts, but the official rate that had been established was by no means unrealistic. Considering the period in which some of the debts had arisen, it was at least doubtful whether the cost to the Mexican private sector of making payments abroad would not have been higher if there had been a free exchange market at that time than would be involved in making the payments at the rate of Mex$95 = US$1. If a more favorable rate were assigned to the payment of debt, the question would arise of where resources would come from. They could not be taken from reserves, which were too limited to permit their use for the payment of private debt, and it seemed unlikely that the authorities could persuade the public to accept more adjustment to the public sector or a greater inflationary burden. It might indeed well be that some of the credit extended to private firms earlier might now look less satisfactory than it then had. Mr. Hirao had asked whether credits under trust funds from nationalized banks had remained inside the program limit. They were to be found either under the public sector borrowing limit or under the external debt limit. Naturally, if the nationalized banks were capturing private resources and lending them to the private sector, such funds would not be counted under limits.

That central bank financing of the deficit would continue to be rather high was an observation made by Mr. Taylor, the Deputy Director noted. In practice, it was proportionately smaller than the previous year, but would certainly have to be reduced still further to eliminate inflation, which was projected to be in excess of 50 per cent during 1983.

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The main engine for the reduction in the rate of inflation was the cutback in the public sector deficit. During 1982, when the public sector deficit had continued to be high and external financing had been reduced, the burden of financing the public sector deficit had fallen on the domestic financial system, and inflation had soared. The staff expected to see that process reversed under the program. It was certainly true that the way in which wage policy was handled would make a great deal of difference to the course of inflation.

While he would agree with Mr. de Groote that the Fund and Mexico were only at the beginning of the program, the Deputy Director went on, he would not agree with Mr. de Groote that there was no framework for the development of the economy or for the adjustment effort. The program agreed with the Fund certainly contained the framework; if Mr. de Groote meant that the authorities would have to make great efforts to fulfill the policies that had been laid down, he could but agree. Several speakers had asked whether the elements of the program would fit together. The program as a whole was self-consistent, although it would involve considerable effort to carry it to success. Naturally, it would require close monitoring, and it might well have to be adjusted in the course of the coming years.

As to whether the growth rate of 6 per cent forecast for 1985 might be excessive--a question raised by Mr. Joyce--the Deputy Director said that he saw the growth rate not as a target but as a residual. The sources of a 6 per cent growth rate would be investment and more efficient use of resources; he did not envisage it as a target that would be achieved by applying any particular demand policy. Mr. Joyce had been quite right in pointing to the continuing deficit of some of the public enterprises. The public sector deficit would certainly have to be reduced further after 1983. As to the way in which pricing policies were set, in some cases prices would be set by comparison with international prices. In other cases, there were no such standards, and at the least it was important to make sure that domestic costs were adequately covered. While it might be difficult to judge correctly in each instance, the aim was to reduce the burden that had fallen on the Federal Government of supporting activities that were uneconomic.

Taking up the question of exchange subsidies involved in the existence of the dual market, the Deputy Director remarked that in the strict sense of the term there had been subsidies through the exchange system throughout most of 1982 that would not recur under the new market arrangements as envisaged. The staff could however agree that if, for instance, petroleum products were traded at a price that was not the free market price, there well might be an element of subsidy involved; that feature was likely to cause a problem with any dual-rate system. He could not agree with Mr. Joyce that putting a ceiling on net domestic credit to the Government in peso terms was an unusual practice. There seemed to be no alternative method. It would not be possible to consider a limit in terms of a ratio to gross domestic product, if only because the necessary figures only became available with too much delay. Moreover, the aim

had been to try to frame a program that would lead to the desired targets--for instance, the reduction in the rate of inflation--and the ceiling expressed in pesos was a protection against any deviation that was not foreseen in the rest of the program. Such a procedure was by no means unusual in Fund practice. A point upon which he could agree with Mr. Joyce was that, when inflation was high, there were problems of estimation.

Commenting on the relationship between the Bank of Mexico and the recently nationalized banking system, the Deputy Director remarked that the aim of the authorities was to try to have the banks operate as they had previously. The banks would be expected to engage in competition and to submit to reserve requirements as before.

Discussing the point raised by Mr. Salehkhou whether the staff had given insufficient attention to private savings, the Deputy Director of the Western Hemisphere Department explained that the staff and the authorities had been concentrating on trying to create the conditions for an improved national savings rate by changing the public sector savings rate. In actual practice, both lowering the rate of inflation and providing realistic interest rates would be steps toward avoiding penalizing those who saved through the organized financial markets. Finally, in reply to Mr. Prowse's comment that financing the public sector deficit through an increase in the volume of pesos acquired by selling petroleum products abroad at a depreciated peso exchange rate was not very helpful, he would say that there was a difference between adjusting the exchange rate to a realistic level and merely accommodating the exchange rate to the rate of inflation.

A staff representative from the Western Hemisphere Department replied to questions on the relationship between Table 5 on page 18 in EBS/82/208, Supplement 1 and Table 16 on page 60 in the Statistical Appendix. Table 5, which dealt with the public sector projections for 1983, had been prepared on the basis of the earlier discussions that had taken place in Mexico before the new administration had taken office and the budget for 1983 finalized. At that time, the staff had been given some indication by the incoming administration of the measures that it intended to include in the budget, but final decisions on certain expenditure cuts and new revenue measures had not been taken. In those circumstances, the staff had decided to prepare an addendum that would incorporate the impact of the final budget proposal as submitted to the Mexican Congress. What was involved was largely a reclassification of the impact of the various measures.

Since some of the revenue measures--particularly some of the price adjustments on public sector goods--were not to be implemented until later in 1983, only those measures already in place were included in the budget document sent to Congress, the staff representative said. Consequently, the financial program as described in the addendum contained a line for scheduled additional revenue that was not part of the budget sent to Congress. Similarly, there were no provisions in that budget for expenditure out of the additional revenue, which might therefore be considered to constitute a contingency reserve for the Government. Plans for obtaining the additional revenue were quite firm. For instance, there had already

been a 100 per cent increase in gasoline prices at the beginning of December 1982, but the authorities had also announced that there would be quarterly adjustments throughout 1983. The expected yield of the additional amounts was included in the table in the Statistical Appendix, although the additional increases being contemplated in gasoline prices had not yet been made public. There were other prices that would also be adjusted in the course of the year and had not yet been made public; they too appeared under the heading of additional revenue.

In the budget document that was presented to Congress there were a number of outlays that had been specifically earmarked to cover certain chapters of the budget--such as wages, interest payments, investment expenditures, and the like--the staff representative went on. There was also a pool, amounting to some Mex$160 billion for the Central Government and Mex$204 billion for the public enterprises, set aside as unallocated expenditure to cover any unforeseen developments during the course of the year, and, in addition, an amount of Mex$204 billion as a global sum for the public enterprises. Resources drawn from those pools could be allocated to supplement either current or capital expenditure as needed. At the time that the budget was being worked out, neither the individual ministries nor the corporations had had a clear picture of the exchange rate that might prevail during 1983. Consequently, some of the figures provided by the government agencies and corporations were bound to be rather inaccurate, and the reserve pool of unallocated expenditure was intended to make good any deficiencies. However, because the public sector had a net surplus on foreign exchange operations, any depreciation of the currency in terms of pesos would, on the whole, have a net strengthening effect on public sector finances.

Some specific questions had been raised in connection with revenue measures in general and with the petroleum sector in particular, the staff representative noted. The figures for sales of the petroleum sector included the receipts from the domestic excise taxes on petroleum products, which would have a large increase in 1983. Although the price increase had been presented to the public as a single figure, part of it represented taxes that accrued to the Government rather than to the state-owned oil company.

Commenting on the fact that the revenue from income tax was expected to be lower as a percentage of gross domestic product in 1983 than in 1982, the staff representative explained that a number of changes had been included in the income tax in the budget sent to Congress. Among them were a 10 per cent surcharge on income levels above a certain basic figure, new minimum exemption rates, and a new 50 per cent withholding tax on distributed dividends. Certain adjustments made to the minimum exemption levels provided some relief for lower-income taxpayers, adjusting for the higher rate of inflation, but a number of exemptions previously available to public sector wage earners had been eliminated. The wage structure for public sector employees consisted of a basic wage together with a number of supplements, and in practice the supplements--which had been previously exempt from taxes--represented many times the basic wage.

The ratio of the basic wage to total emoluments was being increased by eliminating a number of the supplements and by compelling public sector employees to pay higher taxes on the income that they actually received. Moreover, for all taxpayers, income from all sources would be lumped together for the purpose of calculating the income tax; it would no longer be possible to divide income into separate sources as a way of evading the tax.

Some other special exemptions had also been eliminated, the staff representative explained. It was difficult to know how much difference some of the changes would make because no previous calculation had been made on what the elimination of the exemptions would yield; in some cases, therefore, there might be an understatement of the resulting revenue. However, a more important consideration for the weak performance of the income tax receipts was that corporate tax would be paid on the basis of 1982 income. For most corporations, 1982 income had been seriously affected by the losses that had occurred during the year because of the devaluation of the Mexican peso. In addition, for the past few months the economy had been experiencing negative growth, although on average for the year as a whole the economy still showed a growth of 1.5-2 per cent in gross domestic product. Consequently, the proportion of income tax to gross domestic product would be unusually low in 1983.

The value-added tax, the staff representative continued, was highly indexed to inflation because of the way in which it was calculated. There was bound to be some increase in the yield of value-added taxes because of the increase in prices; it was estimated that about 38 per cent of the increase in yield would result merely from the change in prices. In addition, the change in the rate from 10 per cent to 15 per cent was likely to yield an estimated Mex$235 billion, while the elimination of the earlier exemptions would yield another Mex$70 billion. The new rate on luxury goods was estimated to yield some Mex$35 billion. The increase in the value-added tax yield was thus made up of a combination of the increases in the existing rates and the introduction of new rates. Moreover, the authorities had widened the tax base by eliminating a large number of exemptions.

Some speakers had asked why the revenue of the controlled enterprises showed such relatively poor performance compared to the previous year, the staff representative went on. Some of the public sector enterprises were being closed, merged, or scaled down in their operations. It was perhaps worth recalling that the staff had explained in a footnote that the total revenue from the controlled enterprises included not only the receipts from their sales, but also the taxes. Consequently, when the volume of operations of the enterprises declined, so would the tax revenues; naturally, expenditure might also fall if operations were conducted on a smaller scale. The outcome would be lower figures both on the revenue and on the expenditure sides, but also a lower deficit.

The projections for wages and salaries took into account not only that there would be no provision for any wage increase for government employees until September 1983, and that adjustments at that time would

be based on an estimate of future inflation, the staff representative explained, but also that there would be some reduction in the number of employees because of the freeze on government employment. When positions became vacant, they would not be filled except for new teachers and military personnel graduating from the academies. Moreover, a number of employees would leave with the outgoing administration, and their posts would be left empty.

In the investment field, the second staff representative from the Western Hemisphere Department explained, there was no authorization for new projects. Most of the investment expenditure in 1983 would go toward the completion of existing projects. The only exception would be some infrastructure like new roads and sewage facilities, designed to provide employment but whose cost would not be at all large.

The staff representative from the Exchange and Trade Relations Department remarked that a number of Executive Directors had expressed support for the comprehensive nature of the criteria contained in the Mexican program. In that context, it should be noted that the number of criteria in the arrangement under discussion was no larger than in other Fund arrangements. Within the structure of the global program, the criteria represented an interconnected whole. The purpose of the foreign debt ceiling was to control borrowing; the balance of payments test was designed to ensure that international reserve management would be appropriate; the commitment to reduce and eventually eliminate arrears was an intregral part of such reserve management. From that standpoint, the difference between the amounts envisaged in the foreign borrowing ceiling and the balance of payments test could be viewed as a measure of the net official intervention in the foreign exchange market. Mexico's net official foreign borrowing in 1983 would amount to some US$5 billion, of which US$2 billion would be added to the net international reserve position, while arrears in external payments would be reduced by at least US$600 million. Those closely interrelated criteria could hardly be described as conflicting or inconsistent. The only possible element of conflict would be that if one of the ceilings was not observed, it would be difficult to hold to the others. But that was only the inevitable consequence of the consistency and interdependence among the three ceilings.

In reply to a question by Mr. Joyce, the staff representative went on, it could be said that, in most if not all programs, the government or public sector deficit was one of the most critical elements. What might vary from country to country was the way in which that deficit was defined, for its scope and the precision with which the corresponding ceiling was formulated depended not only on those factors, but also on the availability of statistical information. For example, in many cases the foreign financing component of the public sector deficit could only be known approximately, if only because the ceiling on foreign borrowing was related to the rate of loan contracts or authorizations rather than to net disbursements. It was, after all, net disbursements and net credit expansion to the public sector together that accurately traced the profile of the public sector deficit.

Commenting on the relations between Mexico and the World Bank, particularly in the context of the investment program, the staff representative explained that a key element in the planning and formulation of the Mexican program was the urgency for reaching agreement. If the whole public sector investment program had had to be reviewed in advance, it was virtually certain that agreement could not have been reached rapidly. The intention of the Mexican authorities to review the investment program with the World Bank to ensure its efficiency would surely be a sufficient guarantee.

A number of Executive Directors had commented on the effectiveness of the Fund's surveillance in identifying potential problems, the staff representative from the Exchange and Trade Relations Department recalled. There was general agreement with the goal of making surveillance effective, and mention had been made of the need for early warning systems. Early warning schemes, however, were not perceived as urgent or even necessary when crises were not in evidence. But, as crises became more imminent and the urgency for warning signals increased, the need for caution became greater to avoid precipitating the crises. Naturally, crises did arise, and ex post it was almost inevitable that all parties concerned should feel that something more specific could have been done to prevent the unfortunate episode. It might therefore be said that, to be effective, surveillance required a delicate balance in the provision of caution and alarm signals. He hoped that the experience of the Mexican economy would make it possible to find appropriate methods of foreseeing problems in advance, so that the need for alarm signals would be minimal.

Mr. Senior, replying to observations by Executive Directors, made the following statement:

> First of all, I want to thank the Directors for the keen interest that they have shown in the case of Mexico. Their support is greatly appreciated by the Mexican authorities, and so are their comments, questions, and counsel. You can be assured that I will transmit them to Mexico in great detail, as the Mexican authorities themselves have requested.
>
> The staff has answered practically all, if not all, questions. It is clear that this is a complex case, and that there was some urgency in bringing about a successful outcome at the earliest possible date. The authorities are particularly grateful to the Managing Director for his important and valuable efforts in bringing about a successful outcome for the numerous parties involved. His cooperation in the complex negotiations with banks regarding the rescheduling of debt and obtaining commitments for new money from banks and official creditors is indeed appreciated. As the Managing Director has indicated, some commitments from certain banks have not yet been received. In this regard, I should mention that I spoke to the Governor of the Bank of Spain, Mr. José Ramón Alvarez Rendueles, informing him that the response from the Spanish banks had not yet been

received. Mr. Alvarez Rendueles, has categorically confirmed that a favorable response from the Spanish banks has already been sent to the Bank of America from the Banco Exterior de España, the leader for 35 Spanish banks. The commitment from the Spanish banks amounts to US$93 million, representing the whole of their quota. Mr. Alvarez Rendueles is sending a transcript of the telex from the Banco Exterior de España.

The financial situation confronting Mexico is quite serious. The adjustment effort being undertaken by the authorities is substantial, some may even say ambitious. The authorities are well aware of the sacrifices involved, and they are committed to persevering in the adjustment effort. The measures already adopted are significant and are indicative of their firm commitment. There is clearly some way to go before Mexico's economy can be set once again on a sustainable growth path, but it has shown great resilience in the past. I am confident that recovery will be achieved in the not too distant future, and that Mexico will once again be able to sustain relatively high rates of economic growth while maintaining internal and external stability.

The approach that the authorities have taken to redress the present imbalances is pragmatic and forceful, but there is still a need to deal with more fundamental structural weaknesses in the future. Thus, the program being implemented by the authorities is to some extent a mixture, in which a shock approach is being taken to deal with certain weaknesses, while a more gradual approach has been adopted for certain other problem areas of the economy. For instance, adjustment in the fiscal field, one of the key areas causing the current disequilibria, is being dealt with in a forceful and courageous manner, while movement toward a unitary, freely floating exchange regime is being undertaken in a much more gradual fashion. In the present circumstances, this mixed approach would seem to be appropriate.

The authorities will follow a flexible interest rate policy with the objective of maintaining interest rates at levels that are competitive with international markets and positive in real terms as soon as feasible. Since November 8, interest rates for deposits have been significantly increased, while lending rates have been completely freed. This policy should promote financial savings and improve resource allocation among competing users according to their relative efficiency. The authorities have stated their intention to continue adjusting interest rates, if needed, on the basis of the expected rate of inflation as well as in line with exchange rate developments. Some interest rates, even now, are above the expected rate of inflation for 1983. This week, rates for fixed-term accounts of between one and six months rose by as much as eight percentage points from the previous week. Last night, the Board of Directors of the Central Bank of Mexico decided that, starting next week, interest

rates on three-month, six-month, and one-year fixed term deposits will further increase by half a percentage point. Thus, it can be expected that real interest rates will be positive during 1983. In addition, government financial institutions will be allowed to raise interest rates on their loan operations to reduce the need for subsidies. Currently, lending rates are on average fourteen percentage points above deposit rates.

Several Directors have referred to the importance of a prudent wage policy in the adjustment effort. The staff has already given an answer. I would like to add that wage negotiations for 1983 are being carried out in a very favorable atmosphere. Recent negotiations with the most important workers' unions in the public sector have resulted in moderate increases in wages for 1983, well below the expected inflation rate. As an illustration, the wages of employees in some public enterprises will increase as follows:

PEMEX	- no increase
Electricity company	- no increase
Telephone company	- 25 per cent
Railroad company	- 25 per cent

There have been other negotiations for more or less similar increases with smaller enterprises. Moreover, the authorities do not intend to grant any adjustments in salaries to central government employees until September 1983, and they are implementing a freeze in hiring throughout the public sector.

Regarding Mr. Laske's questions on the value-added tax, even though the increase in revenues from the VAT on luxury goods at first sight looks disproportionately high, it is the quotient resulting from the interaction of a number of factors. First, the rate itself has been doubled from 10 per cent to 20 per cent. Second, given the inflation rate of about 100 per cent in 1982 and the expected rate of inflation for 1983, the value of sales for a given volume would more than double just on this acccount. Third, for luxury goods the imported content is normally higher than that in other categories, so that the price increase for them would be even higher than the general inflation rate. Thus, it should not be surprising that the increase in revenue from this category is so high, even allowing for lower volume sales because of price increases.

I was very much interested in Mr. Joyce's comments on the performance criteria for the public sector deficit. The staff's comments in this respect are also helpful. Clearly, this quantitative limit on the public sector deficit is sensitive to exchange rate and inflation rate departures from the estimates or assumptions in the program. However, the public sector has a surplus in the balance of payments, so that an exchange rate depreciation larger than that assumed in the program can be expected to have

a favorable impact on public finances. Departures from expected inflation rates, could of course have a different impact. The same would be true for exchange rate depreciation in fields outside the public sector. Thus, as Mr. Prowse stated, we should retain a flexible attitude in the Board, just as the authorities should maintain flexibility and carry out further adjustments if necessary.

Many Directors have touched upon the subject of exchange rates and the exchange regime. The staff has dealt with this subject at length in the documents and in its answers. I should add that in present circumstances it is difficult to find any other pragmatic solution that would not run the risk of almost immediate failure. The previous generalized control system clearly did not work; the Bank of Mexico was receiving only relatively small amounts of foreign exchange. Almost the only export receipts coming into the Central Bank were the export earnings of PEMEX and foreign receipts arising from debts owed abroad. Capital outflows continued, although, instead of dollars being taken out of the country, pesos were carried abroad and later exchanged in border exchange houses. At the same time, the existence of a dual exchange system gave rise to large subsidies, which substantially increased the public sector deficit.

Thus, the authorities decided to abandon the generalized exchange control; they did not, however, consider it prudent to dismantle all controls at the present moment. Current international reserves in Mexico are still low even in relative terms, and these reserves have to be both safeguarded and strengthened. At the same time, the country's access to foreign financing is somewhat limited, so that only through an increase in exports and a reduction in imports can the needed foreign exchange situation be significantly improved. Moreover, confidence has still not yet completely returned.

The present system is intended to stimulate exports; protect against disorderly fluctuations in the exchange market; re-establish internal and external confidence in Mexico; provide an appropriate atmosphere for the rescheduling negotiations and create new inflows; promote tourism; be an incentive to capital repatriation; and smooth out trade in border cities.

In any case, it is the authorities' objective to introduce an exchange system without restrictions, as internal and external conditions allow. The current system is a significant improvement over the generalized control system.

Once again I would like to thank Directors, the staff, and management, as well as all the countries that have in different ways contributed to this successful outcome. I am sure that Mexico's situation will greatly improve in the not too distant future.

The Chairman, concluding the discussion, commented that in examining the requests, the Executive Directors noted that the size of the imbalances, both external and internal, that had been building up during recent years in Mexico--because of poor control of demand policies and overexpansionary wages policies at home, and overborrowing abroad--had left the authorities with little choice but to cut back severely on domestic demand. The purpose of the program put forward by the Mexican authorities was to restore both internal and external balance as a preliminary to regaining confidence, thus laying the foundation for further growth and employment. Commending the courage of the Mexican authorities, Executive Directors noted that they had already begun to take strong action, but warned that the external environment might be even less favorable than had been assumed, and that even more rigorous policies might be required.

Speakers had agreed with the staff that fiscal policy was the heart of the issue for the Mexican authorities, the Chairman remarked. The monitoring of government outlays and the effective reduction of the budget deficit were seen as opportunities for giving signals to the world financial community that the authorities were adhering to the program. In particular, speakers urged the authorities to bring about income tax reforms that had been discussed with the staff, as well as holding down current and operating expenditures, eliminating subsidies to both the public and private sectors, and placing a freeze on the hiring of civil servants.

A number of Executive Directors felt that the monetary policy to be followed by the Mexican authorities had been couched in rather general terms, and that it might not bring about a sufficiently rapid reduction in the rate of inflation or cause sufficiently swift adjustment, the Chairman continued. In particular, the Central Bank was felt to be continuing to finance the fiscal deficit to an unsatisfactorily great extent. Moreover, in view of the interdependence among savings, interest rates, and capital movements in Mexico, there were those who felt that a further freeing of interest rates would be essential. Speakers commended the abandonment of the interest rate policies introduced in September 1982. Similarly, many speakers found that the authorities were still rather vague on wage policy, even though the authorities had assured the Fund that they understood that a restrictive wages policy was central to eliminating inflation and successfully applying demand management policies.

On exchange rate policy, many Directors wondered how long a dual rate system, in which the official rate was currently about one half the free market rate, could last, the Chairman said. They urged the Mexican authorities to be flexible in setting the official rate, and to unify the two rates as rapidly as possible. The exchange rate would have to be broadly appropriate if either false invoicing or large capital outflows were to be avoided. On the external side, the authorities were urged to eliminate arrears as rapidly as possible as one of the actions most likely to help to restore confidence.

More generally, Executive Directors, noting that the first review under the program would take place in May 1983, expressed the view that the Fund should keep in very close contact with the Mexican authorities and inform them at an early stage if any slippages were seen as likely to occur, the Chairman remarked. A number of Directors would have liked to see a clearer view of the medium-term strategy, and some of them felt that a stand-by arrangement might have been more appropriate. However, in view of the major changes in public sector policy that would be introduced by the program, an extended arrangement was considered acceptable. Naturally, further measures would be required in due course to deal with structural aspects of the program, such as pricing policies, subsidies, the protective system, and the like.

Taking a broader view, the Chairman went on, the Mexican crisis had shown the importance of surveillance. A number of Directors had felt that the Article IV procedure should be more actively implemented. Article IV consultations, it was noted, should be frequent enough to bring to light emerging difficulties. A number of Executive Directors noted the interval in Article IV consultations with Mexico between November 1979 and June 1982. The staff would see to it that Article IV consultations took place at roughly annual intervals, regardless of the difficulties. The opportunity of an in-depth review of a member country's economy ought not to be missed, especially when the country was a major participant in the economic and financial system.

In that connection, the Chairman observed, Executive Directors ought to be aware that the Fund had not been inactive during the two-and-a-half years between Article IV consultations. In November 1981, the Deputy Director of the Western Hemisphere Department had sent to the authorities in Mexico a memorandum containing sentences like "the overall public sector deficit has risen from some 6 per cent of GDP in 1979 to perhaps more than 12 per cent in 1981. Over the same period, net external borrowing by the public sector has increased from 2.5 per cent of GDP to close to 6 per cent." The Deputy Director had also said, "in the light of the above, a major reorientation of public sector financial policies is needed. A continued growth of public spending at the rates of recent years would mean one or some combination of the following: acceleration of inflation, a further widening of the deficit on the current account of the balance of payments, or a possible reduction in the availability of credit to the private sector. The extent to which the rates of growth of public spending and of the public sector deficit need to be reduced cannot be judged precisely, but the changes would have to be large in relation to recent performance if domestic inflation is to be reduced to a rate more nearly in line with that abroad and if the balance of payments is to be made significantly less vulnerable to internal and external shocks. It is readily apparent that the magnitudes of social indicators--such as the growth of public spending and domestic prices, the public sector, the deficit of the current account of the balance of payments, and external borrowing by the public sector--are currently outside the ranges associated with satisfactory performance of the Mexican economy." What had been lacking was not the Fund's guidance, but any response by the authorities. With the benefit of experience, it was possible to feel that the memorandum ought to have been put before the Executive Board.

In future, he would take much more forceful action, the Chairman stated, and would conclude Article IV consultations within the normal time frame in spite of any other developments. At that time, however, it seemed likely that strong objections would have been raised to such a procedure. For the future, Article IV consultations should be not only more frequent but also detailed enough to cover external indebtedness, including short-term debt. The experience of Mexico clearly indicated the need for timely adjustment and early recourse to the use of the Fund's resources before a country overextended its foreign indebtedness.

Executive Directors had commended the staff and management on the way in which they had helped to handle the crisis in close collaboration with the Mexican authorities, central banks, the Bank for International Settlements, governments--particularly that of the United States--and commercial banks, the Chairman said. They wished to take stock of recent developments and draw lessons from them at some suitable time in the future.

Commenting on the financial package for 1983, the Chairman remarked that it had clearly been a cooperative exercise. He would ask the Executive Directors for those countries whose banks had not yet fully replied to the advisory group to take charge of that particular aspect of the operation. He hoped that they would be in a position to inform management or staff of the responses on Monday, December 27. The procedure adopted had been uniform for all banks and all the countries involved. Most of the countries concerned had fully covered the commitments that their banks had undertaken. It would be very helpful if the remainder would move rapidly. Even with the amounts to which banks had committed themselves, there would be very little leeway.

Mr. Lovato commented that he had tried to be in touch with those who were coordinating the work for the Italian banks. Although he had not been successful, he understood that a group of banks had committed themselves for the requested amount. The formalities would take some days.

The Executive Board then took the following decisions:

Purchase Transaction - First Credit Tranche

1. Mexico has requested a purchase equivalent to SDR 200.625 million, which is the amount equivalent to its first credit tranche.

2. The Fund approves the requested purchase.

Decision No. 7280-(82/168), adopted
December 23, 1982

Extended Arrangement

1. The Government of Mexico has requested an extended arrangement for a period of three years from January 1, 1983 for an amount equivalent to SDR 3,410.625 million.

2. The Fund approves the extended arrangement attached to EBS/82/208, Supplement 4.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7281-(82/168), adopted
December 23, 1982

Exchange System

Mexico maintains multiple currency practices and exchange restrictions as described in Appendix V of EBS/82/208, Supplement 1. In view of the circumstances of Mexico, the Fund grants approval of these multiple currency practices and restrictions until May 15, 1983, or the completion of the first review under the extended arrangement, whichever is the earlier.

Decision No. 7282-(82/168), adopted
December 23, 1982

APPROVED: June 1, 1983

LEO VAN HOUTVEN
Secretary