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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/148

10:00 a.m., September 8, 1986

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

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	Jiang H.
J. E. Ismael	
A. Kafka	H. A. Arias
	M. Foot
	H. Fugmann
M. Massé	L. Leonard
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
S. Zecchini	

L. Van Houtven, Secretary
A. Akanda, Assistant

Also Present

IBRD: R. B. Steckhan, Latin America and the Caribbean Regional Office. African Department: A. Tahari. Asian Department: H. Neiss, Deputy Director; A. Singh. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; M. I. Blejer, J. T. Boorman, C. Brachet, L. H. Duran-Downing, P. Neuhaus. External Relations Department: M. Goldstein, H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; E. S. Kreis, C. Schiller. Legal Department: F. P. Gianviti, Director; S. A. Silard. J. V. Surr. Research Department: W. C. Hood, Economic Counsellor and Director; D. Folkerts-Landau, N. M. Kaibni, M. D. Knight, A. Muttardy. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. O. Bonvicini, M. Caiola, J. Ferrán, J. Gil-Diaz, E. R. J. Kalter, L. L. Perez, J. P. Pujol, C. L. Ramirez-Rojas, A. C. Santos, L. M. Valdivieso. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, L. P. Ebrill, G. D. Hodgson, J. Hospedales, K. Murakami, A. Ouanes, P. Péterfalvy, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, O. S.-M. Bethel, J. de la Herrán, F. Di Mauro, G. Ercel, R. Fox, G. K. Hodges, A. R. Ismael, Z. b. Ismail, S. King, W. K. Parmena, J. E. Rodríguez, S. Simonsen, B. Tamami, L. Tornetta, H. van der Burg, E. L. Walker, B. D. White.

1. MEXICO - 1986 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Mexico together with a request for an 18-month stand-by arrangement in an amount equivalent to SDR 1.4 billion, with the possibility of augmentation to SDR 2.2 billion (EBS/86/161, 7/23/86; Cor. 1, 9/5/86; Sup. 1, 8/15/86; Sup. 1, Cor. 1, 9/5/86; Sup. 2, 9/4/86; and Sup. 3, 9/8/86). They also had before them a background paper on recent economic developments in Mexico (SM/86/220, 8/26/86; and Sup. 1, 8/27/86).

Mr. Ortiz made the following statement:

My authorities wish to express their appreciation to the staff for the competent and professional task performed--often under severe time pressure--in connection with the 1986 Article IV consultation and the request for a stand-by arrangement. They are also very appreciative of the management's imaginative and active involvement in the several stages of the setting of the financial arrangements contemplated under the program. In what follows, I will first comment briefly on the economic performance of Mexico during 1985. The second part deals with the significance of the oil shock, the response of the authorities, and some recent developments. My concluding comments will focus on the program for 1986-87 and the economic strategy for the medium term.

The problems of 1985

The year 1985 began on a note of moderate optimism owing to the favorable results obtained with the application of the adjustment program of 1983-84, although the signs of weakening of world economic activity, particularly of the oil market, were worrisome. An additional cause for concern was that the external surplus resulting from the implementation of adjustment policies during the previous two years was achieved at a much higher cost than expected--in terms of foregone output and declining living standards. Inflationary pressures, although substantially lower than the peak of 1983, remained stubbornly high.

Partly due to the severity of the recession, the economy reacted with surprising vigor to the non-oil export and investment demands prompted by expanding world trade in an improved business climate since mid-1984. The reactivation of public expenditures which took place in the last quarter of 1984 and the first quarter of 1985, albeit from a very low base, coincided with this period of robust private demand. Initially, the domestic banking system was able to finance the associated demand for credit from both the public and private sectors, since it had been accumulating excess reserves. However, renewed pessimism on the balance of payments outlook motivated by a negative flow of external financial credit during the first months of 1985 and the bleak prospects of the oil market resulted in private capital outflows and a reduction of savings channeled through the domestic financial system. In turn, this resulted in a higher expansion of primary credit from the central bank and a loss of international reserves.

The authorities reacted forcibly if not swiftly to the deteriorating trend of the international reserve position. In mid-1985 a comprehensive policy package was implemented, including expenditure cuts--in addition to those made earlier in the year in response to the first decline in oil prices--such as the cancellation of all public sector vacancies, a reduction in the number of employees, and the elimination of 15 Under-Secretary posts, and exchange and trade liberalization. A severe tightening of credit policies was introduced at a later stage. The September earthquakes aggravated an already difficult situation. In addition to the human dimension, the negative impact on public finances, inflation, and output was quite significant. The measures that were implemented resulted in a reversal of the losses of international reserves, although the deviations in fiscal and monetary figures from the original targets could not be entirely corrected. The balance for the year was mixed: the economy grew at a slower rate than in 1984 at 2.7 percent in 1985 compared with 3.7 percent in 1984; inflation was slightly higher, where the consumer price index increased 63.7 percent in 1985 compared with 59.2 percent in 1984. Employment was maintained and private investment grew at a vigorous pace--23 percent in real terms, including changes in inventories. The public sector borrowing requirement as a proportion of GDP increased from 8.6 percent in 1984 to 10.0 percent in 1985, reflecting much higher interest payments on domestic debt than those contemplated under the original budget and its subsequent revision--those payments had resulted from the impact of an inflation rate that had turned out to be much higher than forecast under the program. Indeed, this effect explains about one third of the deviations of the fiscal target.

In sum, the deviations of the program's objectives observed in 1985 can be attributed to an unexpectedly strong reactivation of economic activity which became difficult to control in the midst of a deteriorating external environment. Delays in obtaining relevant economic information hindered the implementation of more timely actions. But as evidenced by the strong corrective measures taken to prevent a significant setback, the deviations were not the result of a change in economic strategy motivated by political reasons as it sometimes has been claimed.

The oil shock and recent developments

Consistent with the aim of reinforcing the economic strategy drafted at the outset of the current administration, the 1986 budget presented to Congress had three main objectives: (a) to strengthen the fiscal position of the public sector with a view to reducing inflation and promoting economic efficiency; (b) to secure a wide social participation in the orderly implementation of the various tasks of reconstruction associated with the natural disasters; and (c) to accelerate the ongoing process of structural change and industrial reconversion, thereby increasing the productivity of state enterprises.

In addition to the structural policies, the backbone of the adjustment process was to be a sharp reduction of the public sector deficit. Expenditures were scheduled according to a much tighter calendar from that implied by the historical seasonal pattern, and sizable inflows of foreign capital were planned for the beginning of the year. These measures, together with consistent monetary and exchange policies, were to be reflected in a substantial slowdown of monetary aggregates and an abatement of inflationary pressures. A slowdown of economic activity--but not an outright recession--was an inevitable by-product of the anti-inflationary efforts.

The oil price shock at the beginning of 1986 forced a reconsideration of the economic program. The first step was to evaluate the impact of the oil shock on both public finances and the balance of payments, and to assess--to the extent that this was possible--whether the shock could be considered transitory or of a more permanent nature. This was no easy task given the rapidly changing conditions of the oil market and the uncertainty surrounding the evolution of petroleum prices even in the immediate future. Compared with 1985, the loss of petroleum export earnings for 1986 is estimated at approximately US$9 billion, or about 6 1/2 percent of GDP. This is equivalent to more than 20 percent of all public sector receipts and to 39 percent of total exports. To put these figures in perspective, in the context of domestic production, the oil shock is equivalent to the total agricultural production of the country; in terms of the budget, it exceeds the total wage bill of the Central Government plus the parastatal sector.

Although the initial estimates of the revenue loss were not as large, after a few weeks it became evident that the magnitude of the shock was much greater than anticipated and that the country could not possibly absorb it in the short term. Since it was not foreseen that market developments would lead to a recovery of previous revenue levels, it was considered essential to formulate a strategy for the medium term. Meanwhile, given the fact that Mexico had received practically no external finance since late 1984, and that prospective negotiations with foreign creditors would take a long time, the protection of international reserves was considered essential. To this end, the strict credit policy implemented at the end of 1985 consisting of a freeze of credit granted by the banking system--which was to be only of a temporary nature--has been continued during 1986. In addition, a flexible interest rate policy has resulted in positive domestic real rates of interest in spite of rising inflation. At the same time, exchange rate policy has been very active, resulting in an estimated real effective depreciation of 34 percent during the first six months of the year. On the budget side, expenditure cuts and reschedulings have resulted in a drop of 22 percent in real terms of the outlays of the Federal Government during the first semester of 1986, while non-oil fiscal revenue has increased 1.2 percent in real terms.

What are the results of these policies? On the external front, policy implementation has succeeded in limiting reserve losses while maintaining punctual debt service payments to date with negative net financial inflows from abroad--during 1986, net payments on the principal of public and private debt in the order of US$1.7 billion have been registered. This has been possible due to a rapid non-oil export growth, a reduction of imports and significant inflows of private capital. Non-oil merchandise exports increased 30 percent during the first semester of 1986, partially compensating for the drop of 57.2 percent of oil exports. Total imports fell 9.6 percent during the same period, while those corresponding to the public sector dropped 29 percent. Banco de México has purchased about US$1.3 billion in the "free market," which has been almost continuously "offered" at the quoted exchange rate. This explains the narrow margins existing between the controlled and free market rates during most of the year. Of course, the domestic absorption of the oil shock has not been costless. Industrial production during the first four months of the year has fallen 2 percent, while inventories have risen, indicating the possibility of a further, more pronounced drop. Employment in the manufacturing sector has also shown signs of weakness in spite of the continued reduction of real wages. Inflation has risen as a natural consequence of the depreciation of the exchange rate and other cost-related factors aggravated by the credit stringency. During the first eight months of the year, the consumer price index increased 47.6 percent, compared with 30.1 percent for the corresponding period of 1985. In a sense, inflation is a mechanism that allows for the transfer of real resources abroad. In view of these developments the statement in the last paragraph of page 43 of the staff report that "The actions taken (referring to the credit/exchange rate policy mix) have not been sufficient, however, to avert a sizable loss of international reserves and an acceleration of inflation,..." is somewhat perplexing. If this is taken to be a normative statement in the sense that the authorities should have done more, a pertinent question would be to ask, in the context of a counterfactual exercise, what would have been the required output/real wage drop consistent with the maintenance of, for instance, end-1985 reserve and inflation levels?

The program for 1986/87 and the medium-term strategy

The fundamental objective of the economic program designed by the authorities--Programa de Aliento y Crecimiento, which was announced jointly by the Secretaries of Finance and Public Credit and of Programming and Budgeting in July--is the restoration of growth rates of the Mexican economy between 3 percent and 4 percent for 1987-88 under conditions of financial stability. This objective should be achieved through a combination of structural policies and demand management measures on the domestic front, as well as adequate external financing. The authorities envisage a substantial reduction of resource transfers abroad in the context of coresponsibility and burden sharing on the part of Mexico's creditors. Growth should be investment and export led. Investment resources should become available both from an increased domestic saving effort of the public sector and a reduction of transfers abroad. The greater resource availability should permit an easing of credit conditions to the private sector and a lowering of interest rates that, in turn, are expected to stimulate private investment. The maintenance of an adequate exchange rate policy, together with fundamental changes in commercial policy aimed at liberalizing foreign trade, ought to establish a favorable and more permanent environment for export growth. The planned reduction of the public sector deficit, the alleviation of the tight financial situation of the economy, and an improved climate of expectations resulting from a more realistic perspective of the servicing of the external debt should contribute to abate inflationary pressures and propitiate an environment of financial stability. In carrying through with this program, my authorities consider that it is essential to isolate the economy--at least on a temporary basis--from further shocks of the oil market. Given the adjustment efforts already undertaken, it was important to ensure that the program would not be frustrated by additional negative developments on Mexico's most important export product. In addition, given the priorities of the program, a mechanism was incorporated to facilitate economic reactivation if it had failed to materialize early in 1987, which was the rationale for the oil and growth contingencies.

The core of the demand management measures envisaged in the program is a reduction of 3 percentage points of GDP at the level of the primary balance. As stated by this chair on several occasions in the past, inflation creates several distortions in the measurement of the public sector deficit, which hinders an appropriate evaluation of the progress made in the fiscal area and may result in the setting of unrealistic targets based on excessively optimistic assumptions about the future course of inflation. This is the motivation for proposing the monitoring of the fiscal effort at the level of the primary balance. The fiscal objectives are projected to be met mostly through revenue measures that include both, yields from a tax reform estimated to reach 1.3 percent of GDP, and adjustment in the prices and tariffs of public enterprises which should produce about 1.2 percentage points of GDP over a period of 18 months. In addition, total expenditures will be cut in relation to GDP by 0.5 percent, although current expenditures will be reduced by a full percentage point to allow for an increase in investment of 0.5 percent. Given the magnitude of past expenditure cuts and the urgent need to increase investment expenditures, it is the view of my authorities that the major thrust of the fiscal effort must come from the revenue side. These measures will be accompanied by the continuation of monetary and credit policies designed to maximize the contribution of the fiscal impact on the attainment of the macroeconomic objectives. Some recent adjustments in public sector prices taken in July and August are gasoline, 47.1 percent; diesel, 38.6 percent; liquid gas, 46.2 percent; railroads, 55 percent freights and 60 percent passengers; airlines, 50 percent; Mexico City metro, 2,000 percent; telephones, 15 percent. In addition, the prices of petroleum products will be periodically adjusted with a view to keeping them in line with international prices and, in general, the authorities intend to avoid the emergence of significant slippages of the real prices of goods and services provided by state enterprises.

Structural policies constitute an essential element of the program. Trade policy and the public sector are the two main areas encompassed by the authorities' medium term-oriented structural reform plans. Regarding trade policy, it is important to point out Mexico's decision to enter GATT and to participate in the new round of trade negotiations which are scheduled to begin shortly. In addition, the World Bank Executive Board approved a trade policy loan of US$500 million that will support Mexico's effort to continue reducing quantitative restrictions, tariffs, and to eventually eliminate reference prices. These actions underscore the authorities' decision to transmit a firm signal to investors and exporters that the opening of the Mexican economy to foreign trade will not be reversed. As shown in the Annex, this is not a riskless strategy, especially in view of the current state of the world protectionist environment and the extremely adverse evolution of the terms of trade. Nevertheless, the steps already taken have no precedent in Mexico's modern history. Approximately 89 percent of the import tariff, accounting for about 65 percent of the value of imports, is now free from quantitative restrictions, compared with less than 20 percent in 1982. The range of import tariffs has been cut by over one half, and it is expected that by the end of 1988 the maximum tariff level will be in the order of 30 percent. The combination of exchange rate and trade policies has already yielded tangible results, as evidenced by the dynamic performance of non-oil exports mentioned earlier. Although total imports have fallen during the first five months of 1986, the value of "temporary imports"--import components to be incorporated in export goods--increased 42 percent.

The structural reforms of the public sector are aimed at trimming the size of the Government and improving the efficiency of state enterprises. As mentioned in the staff report, public expenditures other than interest payments have declined by more than 10 percentage points of GDP since 1982, and they are expected to reach less than 25 percent of GDP in 1986. This has implied drastic cutbacks in both investment and current expenditures. The share of public investment in GDP has fallen about 4 percentage points of GDP, a reduction of about 70 percent in real terms. During the previous year, per capita public investment expenditures were below those levels registered in the 1975-79 period. The wage bill of the public sector has dropped 2 percentage points of GDP, resulting in a steeper fall of real earnings of government employees in relation to the rest of the economy. The share of value added by the Government has dropped from 9.3 percent of GDP in 1982 to 6 percent in 1985. If all public enterprises are considered, the public sector contributed only 22 cents of every peso of value added produced in the Mexican economy in 1985, while the private sector produced the remaining 78 cents. These figures are in sharp contrast to others that have occasionally appeared in the press indicating almost opposite weights.

The authorities have proceeded to improve the efficiency of public enterprises along three major lines: desincorporación, the reduction of subsidies, and industrial reconversion. The policy of desincorporación includes the selling, merging, closing and/or transferring of public enterprises. The number of public enterprises and agencies has been reduced from 1,155 at the beginning of the present Administration to less than 700 at present. A major modification in the strategy followed thus far, designed to further this process, is the expected publication of a list of strategic and/or priority entities to remain under state control. Thus, in contrast to previous practice, the Government will define which entities will be kept, while the rest will be sold, merged, closed, or transferred. To date, the Government has divested from its interests on the automobile industry and from its holdings in hotels and restaurants. Many other companies in the areas that include textiles, porcelain tableware, electrical appliances, and conductors have been sold to the private sector. The Government is also in the process of divesting its controlling interest on Mexico's largest airline. The system of subsidies has been completely revised with a view to eliminating those benefiting high- and medium-income groups.

Government transfers to state enterprises, other than those related to debt service, have declined by 3 percentage points of GDP between 1982 and 1985--a reduction of 40 percent in real terms. Subsidies granted through the national marketing board, CONASUPO, have been totally overhauled--subsidies on most foodstuffs have been eliminated while those granted on the consumption of basic staples have been drastically cut. CONASUPO's operating subsidy has been cut by 70 percent in real terms over the last four years. The areas covered by the initiatives on industrial reconversion aimed at modernizing and improving the efficiency of the parastatal sector are steel, sugar, energy, fertilizers, shipbuilding, and railroads and included the following measures: in steel, the Fundidora de Monterrey plant was closed and more than 6,000 workers lost their jobs--in addition, measures to increase profitability in other enterprises have resulted in a decrease of 38.4 percent in real terms of transfers to this sector over the past 3 1/2 years; in sugar, two mills have been shut down and the rest are being totally overhauled, eliminating 2,500 administrative jobs in the holding company; in fertilizers, three low-yield plants have been closed and a fourth one is in the process of liquidation; in railroads, unprofitable passenger routes have been canceled and transfers have declined 82 percent; in oil, nonpriority projects have been canceled, resulting in a cut of 40 percent in real terms of PEMEX's budget since 1981; in electricity, more efficient use of installed capacity and higher energy prices to consumers have permitted a transfer reduction of 72 percent in real terms.

An agreement on the restructuring of the Mexican public debt with commercial banks was reached in 1984, and the multiyear rescheduling arrangement was formally concluded in 1985. The main objectives of debt management policy were spreading over time the maturities of the public debt with a view to creating sufficient space for the normalization of Mexico's relations with its creditors and reducing the cost of debt servicing. At the time, based on a favorable balance of payments outlook, the various indicators that measure the country's debt service capacity were foreseen to improve substantially over time. For instance, the public debt/export ratio was envisaged to decline about 70 percentage points from 1985 to 1990. These projections were formulated on the basis of what were then considered conservative assumptions on the evolution of export growth, oil prices, and the expansion of world trade and the domestic economy. For example, the Mexican authorities' projections of the evolution of petroleum prices in the medium term were lower than those corresponding to the baseline scenario of the 1984 world economic outlook. In the circumstances, the balance of payments picture worsened considerably, and so did Mexico's prospects of obtaining "spontaneous" financing from the capital markets. Even before the recent oil shock, the evolution of the terms of trade had been most unfavorable. As seen in the Annex, in 1985 alone the net terms of trade effect was in the order of US$6.9 billion, after discounting the favorable impact of lower interest rates. In view of these developments, the authorities have again approached official and commercial creditors seeking both financial support for the present program and more realistic terms and conditions for the servicing of the public debt in the medium term. In the ongoing negotiations with commercial banks regarding their contribution to the financial package foreseen under the program, the authorities are seeking to arrange debt service payments in accordance with Mexico's capacity to pay in the context of continued adjustment efforts and sustained economic growth. In the same spirit of the provisions incorporated in the Fund arrangement, my authorities are of the view that Mexico's debt service capacity is essentially related to the evolution of oil prices and interest rates. They regard the clearing of the medium-term horizon of the debt situation as a necessary condition for the re-establishment of a favorable climate for investment, both by residents and foreigners, in physical as well as financial assets. Mexico has officially requested a restructuring of certain obligations to the Paris Club creditors, and the authorities are expected to meet with them on September 16. The monetary authorities of 16 countries and the commercial bank creditors of Mexico have agreed on a stand-by facility for US$1.6 billion in support of the countries' international reserves of which US$1.1 billion is to be provided by official sources. On August 31, US$850 million of the official portion was made available and drawn by the Mexican monetary authorities. My authorities attach special significance to export-oriented foreign investment, and consider that the beneficial effects of the transfer of technology may even be more important than the balance of payments contribution. As stated in the letter of intent, a significant number of projects with 100 percent foreign-owned capital have been approved over the last four years. My authorities vigorously intend to streamline the administrative procedures for the approval of investment projects, particularly those leading to non-oil export promotion. In the context of the foreign investment and debt management policies, the authorities have recently issued precise guidelines and procedures for the implementation of debt/equity swap operations.

In his fourth State of the Nation Report, delivered on September 1, President Miguel de la Madrid stated:

> In the next two years, we shall continue to be temperate in our habits, but we shall not be pessimistic in our attitudes. Our austerity effort is continuing, but now it affords promising prospects of vitality and growth. The consolidation of our reordering measures will guarantee continuity in the development process. The new impetus given to the strategy of structural change will enable us

> to raise the overall productivity of our economy, lay the groundwork for a gradual improvement in social welfare levels, and open up the prospect of a more promising future.

Mr. Nimatallah asked whether there had been any recent developments in the financing arrangements for Mexico.

The Chairman replied that the negotiations on the financing arrangements relating to the main package had begun rather late. The authorities had presented suggestions that had launched the negotiations on September 3. It might still be possible to finalize the financial arrangements before the Annual Meetings.

Mr. Nimatallah remarked that it appeared that the Chairman might have taken action on the negotiations without informing the Board of his intentions. Since it was the first time that the compensatory financing had been built into a request for a stand-by arrangement, he would have preferred prior discussion by the Board on the issue. He added that the growth contingency mechanism should also have been discussed earlier.

The Chairman observed that, at the time of his return from Europe on September 2, there had been no decision on how the Mexican case would be tackled. After inquiring about the status of negotiations between the authorities and the commercial banks, he had informed the Board on September 5 that it would be best to approve the stand-by arrangement in principle and that the request should be taken up at the Board meeting on September 8 (EBM/86/148); the Board had agreed to that proposal. He added that he had informed Mr. Nimatallah on September 4 of management's opinion that the stand-by agreement should be approved in principle.

In order to avoid the breakdown of negotations between the Fund and the authorities on July 11, it had been necessary for management to use its discretion in developing and presenting to the authorities the oil and growth contingency mechanisms, the Chairman pointed out. However, he had briefed the Board on July 21 (EBM/86/120) about the status of the negotiations prior to the completion of the letter of intent and his presentation to the commercial banks in New York on the financial aspects of the program on July 23 and 24.

As the contingencies were ideas that had been developed during the course of the discussions on July 11 and 12, the Chairman said, it had not been possible to interrupt the negotiations to make a formal report to the Board on ongoing developments. Nonetheless, he felt very strongly that his conduct of the negotiations had been transparent.

Mr. Nimatallah remarked that the Executive Board had not been informed of the negotiations early enough. He had been surprised to find information on the discussions published in the press without his prior knowledge. He strongly believed that there should be more cooperation between management and the Executive Board on negotiations with individual countries.

The Chairman reiterated that the contingencies had been formulated in response to the potential breakdown in negotiations on July 11, following a full day of discussions on the calibration of the fiscal deficit. He believed that the contingencies had reassured the authorities about the risks involved in the fiscal adjustment proposed by the Fund.

Mr. Ortiz said that he wished to reassure Mr. Nimatallah that his authorities had made no announcement to the press either on the details of the negotiations or the types of mechanisms being formulated. Owing to the number of people involved, it was possible that information had indeed leaked to the press. The only official statement that had been issued had been provided at the press conference held at the time the agreement had been signed.

The staff representative from the Western Hemisphere Department pointed out that the authorities' intention to request a stand-by arrangement had been indicated to the Board at the time of the approval of Mexico's request for an emergency purchase (EBM/86/5, 1/10/86). Although the negotiations had already begun at that time, there had subsequently been dramatic developments in the economic conditions of the country that had necessitated substantial reformulation of the program.

The Chairman noted that he had had his first meeting with the new Minister of Finance of Mexico on June 27, when they had agreed to resume negotiations on July 11. As he had stated earlier, he had persuaded the delegation to continue discussions after it appeared that negotiations were breaking down on July 11. Throughout the night of July 11, he had developed the oil and growth contingency mechanisms, which he had presented to the delegation on July 12. The presentation had been made at his discretion without prior Board briefing because of time constraints and the tentative nature of the proposals. On July 13, a tentative agreement on the aide memoire had been reached, which required the approval of the President of Mexico. On July 14 he had informed the Board (EBM/86/114) of the status of negotiations. On July 18 he had received a call from the Minister of Finance that the President had approved the agreement and that work on the completion of the program could proceed. As the call had arrived very late that day, he had not been able to call a Board meeting; however, he had called available Executive Directors to apprise them of the situation. He had reported to the Board on the latest developments on July 21 (EBM/86/120), which had been followed by an informal presentation to the Executive Directors on the gist of the program.

Mr. Nimatallah said he was not yet convinced that he had been adequately informed. He requested that further discussions be held in a closed meeting.

The Chairman reiterated that leaks to the press had not emanated from the staff and that he had been very vigilant in informing the Board of the progress on the negotiations. He expressed some concern at the silence of other members of the Board, which might be interpreted as lack of confidence in him.

Mr. Kafka responded that the Directors had been listening to the exchange of views between Mr. Nimatallah and the Chairman, and on their behalf, since he felt sure that they would support his position, he expressed the full confidence of the Board in the Chairman.

Mr. Kafka made the following statement:

We warmly support Mexico's request for a stand-by arrangement and strongly endorse decisions by the Managing Director and the Mexican authorities to bring the request to the Executive Board today for a decision "in principle." Such a practice, although not customary, seems to us to be justified by Mexico's circumstances.

A major readjustment effort by Mexico had begun in 1985. Recently, Mexico has been hard hit by events which have been entirely outside its control. Even the changes in petroleum prices which have taken place since the most recent meeting of OPEC are not bringing sufficient relief to the country.

A triad of fiscal readjustment in the context of wide social participation in the task of reconstruction after natural disasters and the acceleration of structural change underlies the program before us. The program is well conceived, courageous, difficult, and necessary. Fiscal retrenchment with expansion of investment and reduction of current discretionary expenditures is unusual, but commendable. Fiscal retrenchment need not be the only quick-acting part of an anti-inflationary strategy. Should there be other potentially quick-acting mechanisms in the case of Mexico?

The program before us contains two contingency mechanisms. We have had contingent values for performance criteria previously, but not, as far as we are aware, contingent lending commitments. Also, we do not believe that we have had explicit promises by Fund management of submission to the Executive Board of requests for waivers for reversible delays or shortfalls in lending commitments. Progress in the direction of flexibility is to be welcomed and, indeed, is essential if the Fund is to perform the functions which pertain to it. We commend the Managing Director for his flexibility.

The basic philosophy of the program follows the same design we have used since the inception of the debt crisis: a combination of adjustment and financial assistance. The proportions in which these two ingredients are combined appear to be about 1:1 for the 18-month period of the program. According to Table 11 on page 27 of the staff report, the fall in petroleum prices assumed for 1986 and 1987 deprives Mexico of about US$9 billion in export revenue, over 6 percent of GDP. About half this loss will be financed in each year and the other half will be adjusted;

hence, adjustment amounts to a very large burden. It would have been desirable for the international community to have offered more substantial assistance to Mexico without creating an excessive debt service burden. One must hope that steps in the direction of alleviating Mexico's burden will be forthcoming.

There are other ways of expositing the burden borne under the program by the Mexican economy. The fall in real per capita absorption in 1986 and 1987 that is implicit in the program--real per capita GDP income plus or minus the per capita current account balance--will be no less than 2.3 percent and 1.1 percent, respectively, after having already declined substantially from the beginning of the debt crisis in 1982 to 1985. In the same way, manufacturing real wages in 1985--Table 10 of the background paper--were about 30 percent below their level in the year of the inception of the debt crisis, and real minimum wages declined even more. One must assume a further deterioration in 1986. Also noteworthy is the decline in the labor force as a percentage of the total population since the debt crisis, as noted in Table 9 of the background paper.

The nature of financial assistance under the Mexican program also follows tradition. Essentially, relief is given in the form of additional borrowing from public and private sources, basically multilateral organizations and commercial banks. This borrowing is expected to raise total external indebtedness by almost 12 percent from end-1985 to end-1987; the increase since end-1982 would be over 20 percent, as noted in Tables 14 and 16 on pages 36 and 40, respectively, of the staff report. Deducting prospective official reserve net increases of US$6.5 billion over the five years to end-1987, the net debt increase is only 13 percent, not in itself an impressive proportion. But it is associated with no increase, rather a decrease in real GDP--Table 15 on page 38, and staff data--since 1982. Insofar as it is the objective of the debt strategy to enable countries to resume a sound growth process with the help of voluntary borrowing, one must ask oneself whether the prevailing method is preferable to a method or methods that could grant relief in other ways. Is it certain that other methods would not be able to achieve the return to voluntary borrowing more quickly than the method of additional lending which has been chosen as the essential avenue of relief?

One important aspect of the program refers to the participation of the Fund in the additional borrowing that is to take place. Under the extended arrangement in 1982, the Fund's participation, in terms of total disbursements, would have amounted to 24 percent had the program not been interrupted; under the proposed arrangement, the Fund's participation in terms of expected disbursements would be about 9 percent, excluding the emergency drawing and borrowing under the contingency mechanisms.

Insofar as relief is to be granted basically by additional borrowing, it is clear that the international financial system would be better off if the Fund participation were larger and, therefore, able to contribute more to relief even for a country that was already indebted to it.

In its appraisal, the staff calls our attention to the fact that the program is subject to considerable risk. I think it is our duty to run risks--even considerable risks--and I think the management has acted correctly in being prepared to take those risks. In this connection, we fully endorse the authorities' belief--page 10 of the staff report--to the effect that "with the economy already in recession, an attempt to compensate immediately and in full for the loss of export earnings through adjustment alone could not be sustained...such a course of action could bring...disruption in production and employment...so acute as to jeopardize orderly relations between Mexico and its foreign creditors." We also endorse the last sentence of the first paragraph on page 44 of the staff report that recognizes that since full and immediate adjustment to the drop in oil earnings would be both politically very difficult and detrimental to capital formation, the program calls for substantial financial support. It calls not only for financial support, but also support in the opening of access to world markets for Mexico's potential exports. In this context, it would be helpful had there been some extrapolation of debt and debt service even beyond 1991, when amortization payments on rescheduled debt would presumably become payable at higher rates than in preceding years.

Finally, one must recognize that negotiations of Fund programs are not only difficult but time consuming. Yet, one may regret that negotiations of the present agreement did not take place more rapidly. We hope that the banking community will rapidly give the help that is being asked of it in its own interest.

Mr. Nebbia made the following statement:

We welcome the fact that Mexico and the Fund have reached agreement on a program of growth-oriented adjustment and structural reform supported by a stand-by arrangement. The key features of the program are a contingency clause that will avoid an interruption of the program in the event that negative developments take place in Mexico's external environment; a trigger-point mechanism for public investment to secure the target of recovery in economic activity in 1987; and the use of the nonfinancial public sector operational balance as a more precise measure to monitor the fiscal effort that is being undertaken by the authorities. The manner in which these key innovations operate should be very carefully assessed in order to adapt them appropriately should their adoption be useful in other Fund-supported programs. It is worth noting that this program contains a set of supply-oriented structural policies aimed at fostering economic efficiency and reinforcing the country's growth prospects in the long run.

We are also very satisfied to see that the staff and the authorities agree that the design of the program and its external financing proposal constitute a reasonable balance between financing and adjustment and, therefore, the country deserves the support of private banks, multilateral institutions, and governments.

We consider that the access under the proposed stand-by arrangement is appropriate, given the seriousness of the member's balance of payments position and the adjustment efforts required, as well as the need to signal to the creditors that the Fund will continue to have an important role in Mexico's adjustment process. If the oil contingency mechanism were fully utilized, the total credit outstanding with Mexico would be equivalent to about 404 percent of the country's quota by the end of this stand-by arrangement. This is a matter that should be appropriately considered at the time we discuss our policy on access limits for 1987. There are several indebted developing countries in which the Fund will play an important role in the future and any lowering of access limits would not be helpful for this difficult task.

Major adjustments in fiscal policy have already taken place, as evidenced by the reduction of the operational deficit by more than 10 percentage points of GDP between 1981 and 1985. As the staff report explains, the increase in the public sector borrowing requirement (PSBR) has been caused mainly by a rise in the rate of inflation that has pushed up nominal interest payments on internal public debt. The total interest payments by the public sector increased from 5 percent of GDP in 1981 to an estimated 18.5 percent of GDP in 1986. Therefore, we agree with the authorities that the PSBR, which contains a large element of debt amortization in real terms in its interest payments, is not the most appropriate measure for monitoring the fiscal effort.

The program envisages a strong fiscal package that consists of a structural reform of the tax system, adjustments in the prices and tariffs of the public enterprises, and reductions in public expenditures in relation to GDP.

In 1986, public investment will represent less than half its 1981 value. We agree with the authorities that it is not desirable to reduce it to the point of jeopardizing the efficient operation of strategic productive and social sectors. Thus, we support the slight increase in public investment under the program that will allow an increase in the efficiency and productivity of the operations of public enterprises.

The supplementary capital expenditure contingency mechanism to ensure the economic recovery envisaged for 1987 is fully justified.

As to monetary policy, I would like to stress that while monetary growth should evolve at a pace consistent with a gradual deceleration of inflation, an adequate supply of credit should be provided to the private sector if Mexico would like to resume a steady path of growth in the long run.

Regarding the anti-inflationary strategy, it should be noted that there was a major devaluation of the currency in mid-1985. Since that time, inflation has accelerated, although the Government has tightened credit policy and cut public outlays. I cannot find a clear explanation for the recent acceleration of inflation in the staff report. I would also like the staff's assessment of the effects of the measures included in this program on the rate of inflation in Mexico.

The significant trade policy reforms that authorities are implementing will foster a more open economy with more efficient resource allocation. The incorporation of Mexico into the GATT is an important indication of the authorities' commitment in this area.

The expansion of non-oil exports constitutes a necessary condition for restoring growth without creating new disequilibria in the balance of payments. Thus, we welcome the flexible exchange rate policy, the liberalization of the import regime, and the simplification of export procedures; these policies will reduce the antiexport bias of the economy. In this respect, we also share the concern of the Government that it is necessary to promptly remove all trade barriers raised in the key markets abroad in order to facilitate the access of exports from the developing countries.

Adjustment and finance are strongly interrelated in this program. A significant amount of external revenues provided by multilateral institutions and banks are required to implement the policies aimed at a resumption of economic growth and external payments viability. We believe that this program is strong enough to deserve the creditors' confidence.

The oil contingency mechanism constitutes an important security device of the program. This mechanism ensures that even if Mexico was to face negative external developments in key export prices, it would be able to fulfill its commitments under the stand-by arrangement. An attempt to compensate immediately and in full for the loss of export earnings through adjustment alone could disrupt production and employment at a social cost that could jeopardize orderly relations between Mexico and its foreign creditors.

I would like to express this chair's appreciation to the management and the staff, and the Managing Director in particular, for having reached an agreement with such pragmatism. My authorities and I, in my capacity as Executive Director, would like to support all the efforts and the way in which the whole negotiation process has been conducted by you. I support the proposed decision.

Mr. Polak made the following statement:

When the Executive Board met in January (EBM/86/5, 1/10/86) to approve the emergency drawing related to the earthquake in Mexico, the country was implementing strong measures to correct the slippages that had occurred during 1985. As the staff report shows, those slippages were considerable; indeed, at 10 percent of GDP, the PSBR was almost double the original target; monetary policy was rather loose and the rate of inflation, therefore, was stubbornly high; the exchange rate had appreciated again, at least until mid-1985; and the pace of structural reforms was rather low. Soon afterward, oil prices collapsed, and almost exactly four years after the debt crisis had struck, Mexico appeared to be back in the same situation. Indeed, the economic figures in 1986 look almost as bad as in 1982: the PSBR now is estimated at some 17 percent of GNP, compared with 18 percent in 1982; the current account is back in deficit again, at US$3.5 billion, compared with US$6.2 billion four years ago; and the rise in the GNP deflator at 85 percent is higher than in 1982, when it was 60 percent. The most worrisome fact is that Mexico now faces this situation with a debt/GNP ratio that is almost 1-1.5 times as high as in 1982, and also with a much increased debt service ratio.

Against this background--which was broadly known to us before the staff report became available--I have studied with great care the authorities' letter of intent. My interest in this letter had been raised by the extensive previews of certain aspects of it that had appeared in the press.

I may be wrong in my interpretation of the letter of intent, but I must say that, while I have great understanding for some of the policy positions taken and admiration for others, the document as a whole does not strike me as being fully responsive to the emergency situation--and that is not too strong a word--that faces Mexico at the present time. Too many of the paragraphs still exude an atmosphere of partial response--the very attitude that lay behind the deteriorating situation of 1984 and part of 1985. Where one would have hoped for a statement that the authorities would do what was necessary, one reads--repeatedly--that the response will be "flexible," which in practice may well mean that some steps would be taken in the right direction, but probably not enough of them at an early date.

Among the positions for which I have full understanding, I might mention the view of the authorities that the abruptness of the decline in exports makes it inevitable that the adjustment process be spread over a number of years. Thus, I endorse the stand that the decline in current account be kept to US$4 billion against a fall of oil exports of US$9 billion. I am more skeptical, however, about the very gradual reduction in the deficit foreseen for the years after 1986. I say this in the light of the very high debt ratios for Mexico, which are expected to rise further over the medium term. The proposals for 1986 and 1987 foresee an increase of about 16 percent in Mexico's external debt. One should expect that after such a large increase--from the banks, the Fund, and others--there should be a period during which bank credit on a net basis stabilizes before one could count on a resumption of spontaneous credit. There is also a real question whether official credits can reach the expectations implied for the years after 1987 or that non-oil exports will perform along the optimistic lines of the scenario presented by the authorities. I was struck by the fact that the staff does not accept responsibility for the medium-term projections in its report--an unusual situation that would deserve some explanation. It would be useful to know which staff members were involved in the preparation of the report; the standard listing on page 1 of the staff report is absent.

In view of this precarious medium-term outlook, I am not happy with one of the novelties of this program--the public works program with its external financing mechanism that would be introduced should economic growth remain sluggish. This mechanism would imply that an extra debt burden would be created without adequate safeguards to ensure that it could be serviced. The indicator needed to activate this program has yet to be negotiated. It seems to me not part of the implementation of a medium-term growth program, but rather in conflict with such a program, to insert this fine-tuning device for additional borrowing based on some monthly figure for the index of industrial production. It is also too easy to assume that all necessary steps to resume growth would have been taken if all performance criteria had been met. Even if one accepts some flexibility for government public works expenditure in the light of an appraisal--rather than a crude indicator--of performance of the economy, it is not clear to me why public works that are said to involve mostly domestic expenditure should be fully debt financed.

The second novelty of the program is the additional finance and changes in the program that would be triggered by a decline of the oil price below US$9 a barrel. It now seems unlikely that this provision will become a reality, but its inclusion in this request has already led to demands by other countries for comparable treatment. My difficulty with this proposed part of the Mexican program is not with the fundamental substance that a further severe decline in oil exports might lead to additional international assistance and a matching adjustment of the program, but with the form of the request. The Fund has a facility for this very purpose--the compensatory financing facility. If Mexico qualified, it would have access to compensatory financing within the rather generous limits of that facility. Mexico could have specified in the letter of intent that it intended to request compensatory financing in certain circumstances. I am not in favor of the Fund agreeing--without adequate consideration of the implications for its general policies--to an ad hoc mixture of compensatory financing and a stand-by arrangement. In passing, I note that the staff report does not even discuss how the activation of this hybrid would or would not conform to the access limits under either the policy of enlarged access or that of the compensatory financing facility.

I can see some merit in the introduction of the operational government budget deficit. As was mentioned during the Executive Board seminar on inflation and the measurements of fiscal deficits (Seminar 86/7, 6/4/86), correcting a deficit for the impact of inflation might be useful in bringing about more clearly the underlying developments of the Government's finances. However, to focus solely on the operational deficit could imply that the problems relating to the financing of the PSBR are underestimated, and those problems might have a bearing on the future developments of the PSBR. It is clear that those problems are occurring in Mexico. On page 13 the staff report mentions that the Government would have to pay increasingly higher real interest rates--that do show up in the operational deficit--to have its deficit financed. Also, the introduction of the primary balance would offset the impact of rising real interest payments on the increase in government debt; those payments eventually would have to be made. It would be essential to analyze at the time of the reviews, on the basis of a judgment that includes the rate of inflation and the actual nominal deficit, whether adjustment had been sufficient.

Looking at the fiscal effort envisaged under the program, the figure of 6.5 percentage points mentioned in Table 6 of the staff report looks impressive. However, one has to compare this figure with the total slippage that occurred in 1985 of almost 5 percentage points of GNP, the loss in revenue on account of lower oil prices--4.1 percentage points of GNP--and the increase in real interest payments--1.1 percentage point. Thus, out of the total deterioration over the last two years, only two thirds is compensated. While the measures the Government has impl - mented, and those that have yet to be implemented under the program, are certainly impressive, it is clear that further improvement of the fiscal balance is urgently called for. In this context, it should be noted that the authorities will rely to a considerable extent on financing their deficit by money creation--thereby fueling inflation--and on administrative measures, such as the requirement that banks invest 35 percent of their deposits in government securities, thus crowding out the private sector from bank credit and hampering the development of domestic financial markets.

With respect to monetary policy, the staff and the authorities do not seem to have set their sights high enough. More is at stake in a situation of hyperinflation than that monetary policy should be "consistent with" the balance of payments targets. Monetary policy has a task of its own: to put inflation under pressure and thus to create the conditions--including inevitably high real interest rates--for stopping capital flight. The staff's analysis in this area is not as helpful as it could have been. The staff focuses on the decline in the demand for real balances as a result of inflation, but it underplays the impact of increases in the money supply on inflation.

Furthermore, the financial system in Mexico is operating under heavy administrative regulations, as evidenced by the large reserve requirements. Such regulations tend to introduce various rigidities and inefficiencies in the system that are not conducive to an efficient allocation of resources and may well be one of the contributing factors to capital flight. A reform of the financial system--by introducing more competition among banks and by having market forces play their part--should, therefore, be a primary goal for the authorities.

The devaluation of the peso during 1982 played a crucial role in the initial success of the authorities' adjustment policies. However, the real rate was soon allowed to appreciate once more. The change in policy in mid-1985 has thus far only been sufficient to bring the real effective exchange rate back to the level of end-1982. Additional devaluation to facilitate the process of liberalizing foreign trade might therefore be warranted. I fully support the staff's views regarding the dual exchange market. There is evidence that the continued existence of an official rate has been a persistent temptation to depreciate that rate too slowly. Consequently, I believe that the economic costs of a dual exchange market have exceeded those of occasional speculative pressures, which can be countered by other means. I would urge the authorities to set a definite timetable with respect to their goal of unification of the exchange rate, and not to wait until uncertainties have diminished.

The success of Mexico's adjustment policies under the new label will depend to a greater extent than in the past on structural reforms. It has to be recognized that the authorities have have made various commitments in the past to this effect, but actual developments have not always lived up to expectations. I am much heartened, however, by the decision of the authorities to join the GATT and standing by that decision despite the serious external deterioration resulting from lower oil prices. Moreover, more than in the past, the World Bank is involved in this process, which seems to increase the chances of success. A particular area that gives rise to concern is that the authorities do not seem prepared to change the statutory limit to foreign ownership. More flexibility in this area would certainly be conducive to the attractiveness of the country as a host for foreign direct investment and could significantly help the process of liberalizing the external sector.

I welcome the fact that the authorities are facing the debt problem in a spirit of negotiation and not confrontation. The corollary of the position taken by the authorities was that major policy changes were necessary, which the letter of intent recognizes. Many measures in that direction have been taken and more will certainly be needed. Even with full implementation of the program, the balance of payments outlook remains precarious for many years ahead.

In view of the crucial role of Mexico in the development of the international debt situation, and the unmistakable efforts made by the authorities, the Fund has to make every effort to reach an agreement that gives a reasonable chance of success for the period ahead. On that basis, I am prepared to support the proposed decision.

Mr. Foot made the following statement:

I am pleased that today we have the opportunity to approve, at least in principle, Fund support for Mexico's continued adjustment efforts. I should like to join previous speakers and Mr. Ortiz in noting with gratitude the immense amount of often high-pressure work by the Fund management and staff that has led to the current discussion.

The proposal before us is for major Fund involvement in a vital stage of the adjustment process of a major debtor. The proposed level of access is high--80 percent at an annual rate, and approximately 125 percent if augmented under the stand-by arrangement by the automatic mechanism outlined in the staff report--and would, if all drawn under the stand-by arrangement as we judge it should be, put total Fund holdings of the peso at over 400 percent of quota. In the view of this chair, it would be correct to describe this as exceptional Fund involvement, both in respect of the amount and of the automatic triggers relating to oil prices and to the rate of economic growth. My authorities accept that Mexico's current position justifies this exceptional treatment. This is not because of Mexico's dependence on oil--single commodity dependence is a feature of a sizable number of economies--but because of the importance of its orderly adjustment to the international monetary system, its record of cooperation with the Fund in recent years, its continuing recognition during that period of the need for successful adjustment, and its constructive approach to the problems of the last 18 months. As Mr. Ortiz emphasizes in his opening statement, this approach has not least been shown by the maintenance of punctual debt service payments under difficult circumstances.

In the circumstances it is appropriate that we should expect much from this program. One can readily list a number of encouraging features:

- The authorities have followed a positive and commendably flexible exchange rate policy, especially recently. The differential between the controlled and free rates is now small and given prevailing uncertainties, it seems desirable that there should be provision for continuation for now of the dual system along the lines proposed by the staff. I strongly agree with Mr. Polak that a timetable for the abolition of the dual system is a worthwhile priority.

- Mexico's commitment to continued trade liberalization, as exemplified by its negotiations with the World Bank and its prospective accession to the GATT--a key element of prospective success in adjustment.

- Deregulation within the economy, as shown by the steps being taken to rationalize and privatize nonstrategic public sector enterprises.

- The steps outlined in the staff report to encourage foreign investment.

However, there are areas of the program about which questions may be raised, an important one being the adequacy of the envisaged fiscal adjustment. Mr. Chairman, you yourself have repeatedly noted the importance of fiscal caution in a stabilization program. It is clear in this case that the scope for further expenditure cuts may be limited. But non-oil tax receipts in 1986 may be less as a percentage of GDP than in the period 1980-83. One would feel more sure that the revenue aspect would be rapidly addressed if there were firmer indications of exactly which of the proposed revenue-raising measures are to be implemented, and how that would be accomplished. The staff report merely lists measures that "may be taken." I would welcome any information from the staff on recent steps in this area. I would also note that, although I understand that it takes time to devise sensible tax increases or expenditure reduction measures, it is clear from the staff report and Mr. Ortiz's opening statement that the private sector's access to credit is very tightly constrained by the present fiscal deficit. If sustainable growth is to be achieved, it must be done by leaving room for the private sector to grow.

In my remarks on the fiscal position, I should make clear this chair's continued belief--as expressed on the occasion of our recent debate on inflation-adjusted measures of the fiscal position (Seminar 86/7, 6/9/86)--that by far the greatest importance should continue to be given to conventional measures of the fiscal deficit. Therefore, I was concerned to see that, despite the high level of access, we were not being offered at least indicative targets for conventional fiscal measures for 1987. I would welcome comment from staff on this aspect. As Mr. Polak has noted, inflation adjustments do not alter the reality of having to fund a deficit. Indeed, I find it an indirect and slightly ironic acknowledgment of this fact that one of the proposed ways of raising revenue--noted on page 15 of EBS/86/161, Supplement 1--is to tax companies on the inflation component of their interest payments. This component has hitherto been tax free and the change would seemingly alter the basis of corporate taxation in a totally opposite direction to that which the authorities judge most appropriate in viewing their own financial position

On the fiscal side, domestic and foreign confidence in Mexico would, in our view, be boosted by as early and as clear a set of fiscal changes as possible. We expect details in the end-year review. Only with a coherent framework in place will it be possible to finance next year's prospective fiscal deficit, which is currently put at the very high level of 13.7 percent of GDP, on reasonable terms. Seventy percent of next year's deficit is expected to be financed domestically, and it is vital that this finance be available readily and that it be as cheap as possible.

A second major question may be raised about the prospective path of wages and prices. We see that there will be short-term increases in public sector prices, and tariffs will temporarily add to the already high rate of inflation. What we do not see clearly is how policies will evolve to ensure the very important projected near-halving of the rate of inflation by end-1987. We would welcome a more detailed analysis of developments and prospects in the first review.

While we welcome and endorse the intention to continue a monetary policy designed to stem and reverse capital flight--one that will have flexible interest rates and will eliminate preferential rates--we would again note the importance of early and firm action to reassure domestic and foreign opinion. For example, a new savings instrument announced in late July offers yields in local currency linked to movements in the exchange rate. It appears that full details have still not been published and it is as yet impossible to buy the instrument, which is also subject to the official rather than the parallel rate. To reassure domestic opinion, it would clearly be helpful to have a date for the elimination of the official rate.

In sum, so far as the conventional aspects of the program are concerned, I urge the authorities to seize this opportunity and press ahead with adjustment on a wide variety of fronts, allowing no slippages from clearly enunciated policies, and thereby helping to condition favorably opinion, both at home and abroad, as quickly as possible. With regard to these critical structural issues, my authorities feel that they should be clearly scheduled, with favorable reviews later in the program being in large part dependent upon progress here.

I should now like to turn to the innovative elements of the proposed program: the oil price trigger; and the growth mechanism. I do not want to discuss these in detail today, because my authorities believe that they raise far-reaching issues and there needs to be adequate discussion of these issues in a general context, not related specifically to Mexico. My authorities attach great importance to this. In the meantime, my authorities stress that these contingency features cannot be seen as precedents for other programs.

I would like to ask a few questions about the oil price mechanism:

- What was the rationale for the choice of the lower and upper levels of US$9 and US$14, respectively?

- What is the expected price of oil in the third quarter?

- Could the staff confirm my understanding of the footnote on page 57 of EBS/86/161, Supplement 1, that if the volume of Mexico's oil exports falls below the reference levels, this will not lead to adjustment in program targets, either as a result of a conscious decision to curb output or for other reasons?

- Why was it decided not to make the triggers symmetrical?

With respect to the growth mechanism, the staff notes on page 29 of EBS/86/161, Supplement 1, that the potential release of funds related to this trigger would be a maximum of US$500 million and that these funds are expected to be secured in advance. Have the funds been secured?

It is clear that, irrespective of the period set for approval in principle, the time should be used for constructive discussions between Mexico and the banks. My own preference is that approval should run for 30 rather than 21 days, which would conform to the normal practice of the Fund.

If Mexico needs further Fund finance, I should record that my authorities consider any follow-up program should conform much more closely to normal Fund conditionality. I support the proposed decisions.

Mr. Goos made the following statement:

Given the number of reservations that I have, I should say at the outset that I approve the program. At the same time, I should like to apologize for the length of my statement, which should be taken as a reflection of our interest and our concern with the developments within the Mexican economy and its eventual stabilization.

In the final analysis, our support rests on the view that a successful solution to the existing problems can probably be found only in the framework of a joint effort by governments, the Fund, the World Bank, and international commercial banks. However, it also reflects our recognition of the efforts the authorities have undertaken in tackling the difficult situation in the aftermath of the 1981-82 crisis and after the oil price shock. Indeed, we do recognize that the authorities have made significant progress and that they have taken a number of steps, in particular in restructuring the public enterprise sector and in cutting back on consumer subsidies, as described in Mr. Ortiz's opening statement. Nevertheless, an overall assessment of the adjustment policies thus far reveals considerable flaws. In this regard, it appears most unfortunate that the authorities, having prematurely relaxed their adjustment toward the end of 1984, have missed the opportunity to address the domestic imbalances in a lasting manner and hence to strengthen the economy's resilience to external shocks. This shortcoming has to be borne in mind in today's discussion of the renewed worsening of Mexico's economic situation. The policy framework underlying the proposed arrangement in many important respects represents a considerable departure from the Fund's traditional program design. This raises difficult questions that might perhaps be discussed more usefully in a systematic manner on the occasion of the forthcoming review of the theoretical design of Fund programs. However, the following observations may be appropriate for this discussion.

My authorities feel that the degree of domestic demand restraint envisaged under the program is exceptionally limited, considering the acceleration of inflation and the growing public sector deficit. In their view, compared with that situation, the program appears to assign priority to the stimulation of overall economic activity accompanied by a large increase in net borrowing in an apparent attempt to overcompensate the underlying problems by way of higher economic growth. This undoubtedly constitutes a very risky adjustment strategy.

We certainly do not contest the theoretical possibility that the program would eventually meet with success if the structural reforms were implemented without delay and in a forceful manner, thereby creating strong incentives for self-sustained overall growth. This could provide an avenue for outgrowing the existing problems. Unfortunately, the prospects for such an outcome appear quite uncertain in the present circumstances of the country, an uncertainty that apparently is also shared by the staff, as evidenced in its repeated requests to the authorities in the staff report to closely monitor developments and remain alert to actual developments in various critical areas of adjustment that might require prompt correction of the policies envisaged under the program. Those requests appear all the more warranted because experience has shown that without prior stabilization of the fiscal situation and inflation, countries have consistently failed to achieve sustainable economic growth.

Against this background, and like previous speakers, we have considerable difficulties with the two innovative features built into the program--the oil contingency clause and the growth contingency clause, particularly the latter. In view of the uncertainty surrounding the program's eventual success, I would have preferred to decide on the question of possible additional financing on the occasion of the forthcoming program reviews--and this without prior commitment.

To be sure, the Baker initiative places considerable emphasis upon growth within the adjustment process. But it certainly does not imply any guarantee to ensure the attainment of minimum growth rate targets through the provision of external financial resources. Moreover, the manner in which the growth contingency clause is presented in the report appears to raise operational issues. The critical level of manufacturing production that would trigger the contingency clause would in all likelihood be established in December 1986, thereby coming very close to the end of the reference period from March 1986 through

March 1987. At such a late point in time, actual developments in manufacturing and production from the beginning of the period should provide the authorities and staff with sufficient information to enable them to project the growth rate over the total reference period with a small margin of error. Therefore, I feel that the establishment of a critical growth rate in December could eventually become a very difficult exercise, the outcome of which might be largely determined by political opinion on the appropriateness of additional financing.

We do not, of course, ignore the difficult circumstances that might have motivated the specific program design in the case of Mexico, circumstances characterized by grave natural calamities and large losses of export earnings owing to the decline in oil prices. However, these special characteristics clearly imply that the contingency clauses do not lend themselves to becoming examples for other stand-by arrangements. In any event, we hope that such contingency clauses will not be further contemplated before the conclusion of the Board discussion of the theoretical aspects of program design.

Concerning more specific aspects of the arrangement, like Mr. Polak, I note that the pace of adjustment envisaged by the authorities for the coming years appears very slow. Even under rather optimistic assumptions, the external current account will continue to show sizable deficits until 1991, implying that foreign debt continues to show a rising trend. Even with relatively high annual growth rates of 4-5 percent, key external debt ratios will have deteriorated considerably by 1991 compared with 1985.

Another area of concern is the prospective performance of gross national savings. Although it is true that the expected increase in the domestic savings ratio by 1991 would constitute an improvement over 1985--as emphasized in the staff report--one has to note that this increase would fall short of even restoring the ratios that prevailed in 1983 and 1984.

We also have considerable reservations about the use of the so-called operational deficit and primary balance concepts. These concepts tend to obscure the necessary extent of adjustment. Obviously, as the staff notes, it is the total public sector deficit, including interest payments, that needs to be financed regardless of the definition of the deficit. It might be recalled that I had elaborated on this topic rather extensively at the Board seminar on inflation and the measurement of fiscal deficits (Seminar 86/7, 6/4/86). Interestingly enough, the staff in its paper on the theoretical aspects of the design of Fund-supported programs (SM/86/162, 7/2/86) emphasizes that "the operational deficit may seriously underestimate the monetary and aggregate demand consequences of government financing operations."

The shortcomings of the operational deficit approach are also evident if one examines the calculations of the deficit for 1982. These calculations produce the rather strange result that the imputed amount for the inflation component of interest payments subtracted from the deficit exceeds the amount of actual interest payments. Accordingly, the calculations show a fictitious decline in the overall operational deficit. Such an outcome, which apparently relates to the negative level of interest rates in 1982, appears to be a rather misleading guide to fiscal policy. It would be helpful if the staff commented on this issue.

We appreciate the position of the authorities that with the economy already in recession it would not be feasible to compensate immediately and fully for the loss in oil revenue through adjustment measures alone. Nonetheless, a more ambitious fiscal adjustment than the 3 percent envisaged over 18 months would have appeared more commensurate with the magnitude of the imbalances. Obviously, one can look at the extent of the adjustment in various ways. Thus, for example, one has to note that the oil price shock and related repercussions on the economy would have raised the PSBR to above 23 percent of GDP on the basis of unchanged policies, while as a consequence of the measures already implemented, the PSBR would be contained to less than 17 percent in 1986. These figures--and the figures also detailed in Table 14 of the staff report--undoutedly attest to the considerable efforts made by the authorities.

Nonetheless, the outcome certainly has to be assessed against the actual and remaining size of the imbalances. In our opinion, a PSBR of 17 percent is clearly unsustainable. It is in this light that we have serious reservations about the adequacy of fiscal stabilization under the program. In this context, one should note that even prior to the oil price decline, the overall deficit had already risen by 3 percent of GDP over the period 1984-85.

These aspects of fiscal developments also have to be seen against the background of the continued excessive absorption of domestic savings by the public sector. This involves the question as to whether the resources available to the private sector would suffice to finance the restructuring of the public enterprise sector, including the privatization that is emphasized so much under the program. These concerns are reinforced by the very pronounced divergent trends in credit expansion to the private and public sectors since early 1986, which has put the private sector at a clear disadvantage. Similarly, the medium-term scenarios in Table 15 of the staff report are difficult to reconcile with the Government's stated intention to reduce the role of the public sector.

It appears quite unsatisfactory that the fiscal objectives as mentioned in Mr. Ortiz's opening statement are projected to be met mostly with revenue measures while total expenditures will be cut in relation to GDP by 0.5 percent. This distribution of the adjustment burden apparently rests on the view that the margin for action on the expenditure side would be rather limited, given the reductions that have already occurred in recent years. Accordingly, the staff report stresses that total public expenditure excluding interest payments declined by more than 10 percentage points of GDP from 1982 to 1985. Although this decline is certainly most impressive and highly commendable, it warrants some qualification. Most of the deficit reduction in the order of more than 8 percent of GDP had already been achieved from 1982 to 1983. The reduction from 1982 to 1986, including interest payments, would correspond to a modest gain of 3.7 percent. Moreover, in assessing the appropriateness of the fiscal policy mix, we are concerned that additional tax increases entail the risk of paralyzing the domestic economy.

Seen against the trend in monetary expansion since 1982, the rather pronounced growth of monetary aggregates envisaged for 1986 is not without risk, particularly if one considers the disquieting inflation rate of more than 100 percent. Like Mr. Polak, I would have preferred to have seen more active use of monetary policy as an instrument in fighting inflation. In this context, it is disappointing that the program contains only a noncommittal inflation target. This, too, can be taken as a reflection of clear priority assigned under the program to economic growth at the expense of more vigorous financial stabilization. In any event, the introduction of market-determined interest rates and the reduction of financial subsidies are undoubtedly essential for financial stabilization, and I would encourage the authorities to accelerate the measures contemplated in this area.

I welcome the substantial narrowing that has taken place this year in the spreads between the exchange rates in the free and controlled markets. However, like previous speakers, we would have thought it appropriate that the Government commit itself to a firm schedule for the early elimination of the dual exchange market, all the more so since that market has already been in operation for four years.

After a long history of protection of domestic industry, the authorities' commitment to trade liberalization, including Mexico's accession to the GATT, is one of the most encouraging features of the adjustment effort. The substantial reduction in quantitative import restrictions in 1985 is commendable. Nonetheless, the degree of protection through tariff and nontariff barriers will remain very high, with only a gradual further opening of the economy in the foreseeable future. Accordingly, the prospects for rapid restructuring of the economy in the wake of further strong trade liberalization efforts appear to be rather limited.

Promotion of foreign direct investment is undoubtedly an important aspect of external adjustment. Therefore, it is disappointing to note the decline in foreign direct investment flows over the past two years, as well as the assessment on page 35 of the staff report that such flows are projected to show only some growth until the end of 1987. Some observers believe that even the staff's projection may be overly optimistic. Nonetheless, one has to recognize the progress achieved in liberalizing the investment regime, notably the welcome improved access to the Mexican market for projects with 100 percent foreign ownership and for export-oriented undertakings. However, since much of that progress seems to be based only on a more liberal or more exceptional application of the Mexican investment law, I wonder if a more fundamental reform of the law itself would not enhance foreign investors' confidence in a more sustainable and lasting manner.

Similar considerations with regard to the potential contribution to the adjustment effort apply to measures aimed at preventing and reversing private sector capital outflows. In this regard, the staff report states on page 35 that nonidentified capital flows are projected to decrease from US$2.5 billion annually in 1985 to about US$0.5 billion annually in 1986-87. Does this projection imply that there will be no real turnaround in capital flight? It would be useful if the staff commented on this issue.

I would like to associate myself with the staff's observations regarding the structural component of the program, especially where they stress the critical importance of public expenditure restraint, trade liberalization, and foreign direct investment. I also believe that in the final analysis, the solution to Mexico's problems lies in the transformation of the economy from import substitution to export orientation, with the latter of course focusing on the non-oil sector. Unfortunately, after reading the staff reports, I have been left with the impression that the necessary restructuring process will remain rather slow for the coming 18 months. A policy stance combining weak domestic demand management with rather modest structural improvements, while at the same time aiming at relatively high economic growth rates, will remain sustainable only with a continued sizable increase in foreign debt. Such a policy stance, if maintained, would give rise to serious concerns about Mexico's solvency in the longer term.

I would strongly recommend that the authorities reconsider their adjustment strategy with a view to aiming at an accelerated reduction of domestic and external imbalances by taking advantage of every opportunity that might present itself. In such a process, I believe that the authorities would be well advised to lower their ambitious growth objectives to levels that would be more commensurate with the extraordinary high foreign debt burden. I support the proposed decision on the stand-by arrangement and its approval in principle.

Mr. Sengupta made the following statement:

Mexico's request for a stand-by arrangement is guided by considerations of not only overcoming external imbalances created by the sharp drop in the price of oil--a major export item for Mexico--but also making an adjustment effort that would place it on a path of steady growth with diversification of exports. The fall in oil prices has resulted in a loss of domestic savings equivalent to the total domestic production of the economy. The program has important elements of strict fiscal and monetary discipline, as well as structural and supply-oriented policies. Therefore, we support the proposed decision and hope that this approval in principle will help in obtaining the critical mass needed for the program to succeed.

The economic performance of Mexico during 1985 was somewhat mixed. There was a deceleration of growth of output, a slowdown in domestic real investment, and a worrisome continuing high inflation rate. There was a large increase in central government expenditures and net credit to the public sector. Net international reserves declined and direct capital outflows were substantial. There was a marginal surplus on the current account.

However, Mexico was in a good position to reduce slippages in performance. In 1985, the country was in the third year of an extended arrangement and, therefore, could work out corrective measures by the middle of the year, including cuts in expansion of domestic bank credit, flexible management of exchange and interest rates, authorization for commercial banks to operate in the parallel exchange market, adoption of the management flow system of exchange, and liberalization of import tariffs. These provided a good basis for the proposed structural adjustment program, which would be supported by an 18-month stand-by arrangement. The fiscal effort envisaged under the program is significant. We welcome the intended structural reform of the tax system and the measures in the area of tariff and expenditure cuts.

The most important aspect of the proposals is the change in the methods of evaluating and monitoring fiscal policy. This is perhaps the first time that the Fund has agreed to use the concepts of operational balance and primary balance in the context of a stand-by arrangement. Clearly, the change from the conventional balance concept should be helpful in evaluating the fiscal effort in real terms because the new concepts exclude the effect of inflation on public expenditure. However, since the aim of the authorities' policy is the elimination of inflation and the stimulation of growth, together with the improvement in the current account balance, it is not clear how useful the new concept will be. It would be helpful if the staff commented on the subject and the conditions under which such deficit concepts could be used in other Fund-supported arrangements. The structural policies, especially those relating to trade, are major ones but this is not a wholly riskless strategy, given the general protectionist environment and the terms of trade position.

The fiscal and monetary restraint policy that would liberalize trade and reduce the size of the public sector is expected to provide financial stability and insulate the economy from further shocks of the oil market. In any event, given the size of the adjustment effort, it will be necessary to ensure that the program does not go off track owing to negative developments over which the authorities have little or no control. The rationale for the contingency mechanisms is thus clear and worthy of support.

Of the two contingency mechanisms, the one relating to oil price changes would be of great importance for developing countries seeking Fund support when imbalances in external payments occur owing to the fall in prices of non-oil primary commodities. It is best to incorporate this mechanism in most future stand-by arrangements, since it will provide more room for financial maneuverability. The possibility of including such a mechanism in ongoing stand-by arrangements with countries that depend critically on them might also be examined. Even if such an explicit inclusion is not made in the arrangements as such, it should be possible to work out in an accounting framework the various outcomes if such a contingency mechanism were adopted. The results of such an accounting exercise will guide the Executive Board in the examination of programs or of performance criteria.

There seems to be much uncertainty about the economic growth contingency since the critical mass of the financing arrangement for Mexico has not yet been reached. Although the Fund may not be financially committed to such a mechanism at this stage, it should be possible to keep the option open, especially if the Fund feels growth should be assured in the adjustment program by utilizing such a mechanism. This flexibility will help the Fund to overcome the bias of its programs and to promote adjustment with growth.

As to the medium-term scenario, there are far too many uncertainties in Mexico's case because the capital flight problem has been serious and the inflation rate has been very high. Even if one were to agree with all the assumptions made in the staff report, the resource gap may well turn out to be larger than anticipated because the adjustment effort required during the medium term would be such that the incremental savings to income ratio would have to be over 40 percent over the 1987-1991 period. Although Mr. Goos believes that the gross savings ratio is not adequate, it should be noted that there are limitations in practice that should be kept in mind. It should also be kept in mind that the growth rate in non-oil products has been substantial in real terms; it would be helpful to know how the staff arrived at the growth figures--whether they were based on some prediction of past behavior or on the basis of detailed analysis of the different types of export products that the staff hoped the authorities would be able to encourage. The behavior of private capital flows--the most uncertain element in the scenario--would very much influence the outcome. In this respect, since confidence in Mexico's performance would be critical, the request for a stand-by arrangement would certainly aid Mexico more than is apparent.

Despite all our efforts and approval of the stand-by arrangement in principle, a question may be raised about the alternatives should bank financing not be sufficient for Mexico's needs. In his opening statement, Mr. Ortiz states that his authorities have sought to arrange debt service payments to banks in accordance with Mexico's ability to pay under the terms of adjustment, and have requested more favorable debt financing terms in the medium term. It would be useful to have more details on this aspect and on the progress of the negotiations with the banks. It would be useful to examine the range of actions that the Fund and other bilateral creditors and donors could take in such a situation to influence banks to take a positive view on the financing arrangement.

There has already been much speculation in the press that Mexico will provide the first test of the Baker debt initiative. If this test fails owing to the banks' reluctance and hesitation, international adjustment for highly indebted countries will be extremely difficult. We hope that the banks do not act in the manner detrimental to international adjustment.

In supporting this program, I would like to express my constituency's full support for the way in which you, Mr. Chairman, have conducted the negotiations.

Mr. Rye made the following statement:

In my opinion, today's discussion presents the Executive Board with some very serious issues. Like Mr. Polak, I have found it difficult to conclude that the Mexican adjustment program is adequate enough to deal with the crisis that the country faces. In particular, I would have expected to see more prior actions and less of the program expressed in the form of good intentions for the future.

One starting point might be to note that the previous program was well on the way to being derailed before the earthquake of September 1985 and the subsequent sharp decline in oil prices.

Charts 9 and 10(b) of the staff report are particularly instructive. These show that toward the end of 1984, interest rates had lost much of their attractiveness compared with foreign interest rates--taking exchange rate movements into account--and remained negative in real terms, and that the real effective value of the peso had been allowed to appreciate throughout 1983 and 1984. Also striking is the much greater than programmed increase in net domestic credit in 1985, as shown in Table 9 of the staff report.

This background certainly adds weight to the view that the key elements of the new adjustment program for Mexico will again need to be monetary and fiscal restraint and a competitive exchange rate policy.

As to fiscal policy, in terms of the conventional measure of the fiscal position, a deficit equivalent to nearly 17 percent of GDP is projected for 1986. This is substantially higher than the 5 percent figure that had been programmed for 1985, and the 10 percent outturn which was instrumental in upsetting the program under the extended arrangement. The acceleration of inflation in Mexico has complicated the task of assessing fiscal policy, and the alternative measures of the fiscal balance used by the staff and the authorities can be helpful. However, those measures do need to be interpreted with some caution.

In this regard, I have two related points. First, at a time when monetary policy is directed toward achieving a fall in inflation--this has yet to be reflected in inflationary expectations and thus in nominal interest rates--real interest rates will tend to rise and ceteris paribus so will the operational deficit. Table 6 of the staff report shows that there is indeed an increase in real interest payments envisaged for 1986 compared with 1985. In my opinion, if Mexico's disinflation policies are to be successful, there will have to be a further increase in interest payments in 1987.

My second point, which relates as much to the primary balance concept as to the operational balance, is that interest rates--and thus payments--in 1984 and 1985 were below desirable levels. Thus, an improvement in the non-oil primary balance between 1985 and 1987 will be required not only to correct for the deviations in fiscal policy in 1985 and for the loss of oil revenues, but also to offset the necessary increase in real interest payments.

Mexico has moved to eliminate the inflation component of interest payments by corporations as a deduction from income assessable for income tax. Although I can understand the logic of this measure, it represents only a partial correction for the effects of inflation on the corporate tax system. As I understand it, most of the supporters of measures allowing for the effects of inflation in defining tax assessable income also argue that inventories and depreciation of capital assets should be viewed in terms of current rather than historic costs. It is not whether these provisions are in the tax system already or whether the authorities intend to make them. If not, there might be some reason for concern that investment and business activities would suffer.

I am doubtful about whether the fiscal policy proposals are adequate. Two considerations suggest to me that some further adjustment might be beneficial. First, the operational deficit as a percentage of GNP is projected to be larger in 1986 than in 1985, a year when fiscal policy was clearly inadequate. Second, it would be helpful to minimize the pressure on monetary policy from the first side to the greatest extent possible.

I share Mr. Polak's doubts about the adequacy of the authorities' approach to monetary policy, in particular whether it will do enough--or even anything--to combat Mexico's growing inflationary crisis.

This brings me to some general observations on the "growth" and structural elements of the program. First, I fully endorse the trade liberalization program. This should help considerably in leading to a more efficient allocation of resources in Mexico. I should emphasize that Mexico's trading partners must reciprocate in this area. Second, I see exchange rate policy as playing a key role--perhaps the central role--in promoting sustainable growth in Mexico as the economy is opened to the pressures of competition from abroad and faces the need to build international competitive industries that will substitute for the losses suffered in the oil sector. It is clear from the staff papers that non-oil exports are responsive to changes in the real effective exchange rate. But it is not clear whether the present real effective rate, which is at about the level achieved at the earliest stage of the extended arrangement is adequate, given the adverse developments in the terms of trade and the moves toward import liberalization since 1983. I also wonder whether a quick move to unify the rate might not help to remove uncertainties, especially as the differential between the rates is at present relatively small.

I note with surprise that, despite the authorities' expressed intentions to liberalize the foreign investment regime, no allowance is made in the medium-term scenario for an increase in these flows.

The statement that "continued negative private capital flows over the period through 1991 reflect the authorities' cautious stand as regards reliance on possible capital reflows until the beneficial effects of the economic program are consolidated" suggests that these flows are not expected to increase before 1991. It also suggests some lack of faith by the authorities in their own adjustment efforts, which is not an encouraging sign.

I would encourage the authorities to make every endeavor to realign public sector tariffs and prices to reflect true resource costs. Some steps have been taken, but clearly more remains to be done, including ensuring that prices and tariffs are adjusted for inflation. While it is understandable that the authorities wish to maintain tariffs for some essential services at subsidized levels on account of the needs of low-income groups in the community, I would encourage careful scrutiny of each of these areas with a view to realigning tariffs and providing welfare assistance more selectively and directly through the budget.

As to the novel contingency provisions of the program, I should make it clear that I am not against innovation in program construction, provided the implications--particularly of the precedents set--are carefully thought through. I should be happy indeed if it could be demonstrated that this has been done in Mexico's case.

From the Fund's point of view, the supplementary capital expenditure mechanism might be regarded as the less important of the two innovations, since it appears that its activation will not require additional funding from this institution. It is more a matter for the World Bank. Nonetheless, the mechanism gives rise to some difficult questions of principle.

At the broadest level, the question is whether it is sensible or practical to underwrite a given rate of growth. And since when have we taken the view that more government spending automatically means more growth? Under what circumstances is such a provision to be incorporated in programs--that is, what are the bounds, if any, to the precedent being set?

On a more practical note, will the mechanism be triggered automatically, irrespective of the cause of the shortfall in manufacturing production? For example, the shortfall may conceivably reflect a major outbreak of industrial unrest.

Another possibility is that production may be adversely affected by wage cost pressures. Wage restraint was, of course, a key factor in securing increased output under the extended arrangement. The staff rightly observes on page 45 of its report that "substantial attention will need to be focused in the area of wages, if competitiveness is to be maintained and inflation reduced." However, little or nothing is said about wages and wage policies elsewhere in the report. This may be a matter of quite imminent concern. I understand that the Confederation of Mexican Workers regards the 25 percent wage increase granted on June 1 as "inadequate," and that moves are under way to secure a 55 percent increase in the minimum wage effective October 1.

A procedural question concerns the role of the Board in determining what the trigger should be. Paragraph 9 of the technical memorandum of understanding states that "the adjustment will become operative if, after March 31, 1987...the 12-month rate of change in the index of manufacturing production ending in March 1987 has not reached a level agreed upon during the first review under the stand-by arrangement." Will the Board be asked to approve the trigger? Is this likely to be acceptable to the World Bank and commercial banks in view of the fact that it is they and not the Fund who will be providing the finance under this contingency mechanism?

The other contingency mechanism relating to the price of oil at least has the merit of simplicity. The main concerns have to do with its precedent-setting nature. As I understand it, the mechanism is justified on two grounds: Mexico's high degree of export dependence on a single commodity; and the fact that oil prices are particularly volatile.

It seems to me very clear that if we approve this program as presented to us, contingency mechanisms of this kind cannot be--and indeed ought not to be--confined to Mexico. There are many member countries heavily dependent on a single commodity for their export receipts--in a good number of cases, they are as heavily dependent on oil as Mexico. Equally important, many of these commodities are subject to sharp price fluctuations.

All these considerations give rise to numerous questions. Among the more important are whether it is envisaged that such a contingency mechanism will become a regular element of arrangements for such countries in the future; what degree of dependence on a single commodity and what extent of price fluctuation is necessary for such a mechanism to be put in place; and whether it ensivaged that such mechanisms might apply in relation to other uncertainties, for example, shortfalls in donor support. If answers cannot be given to these questions, then I would have to say that I think we are opening up a Pandora's box, the contents of which might prove exceedingly awkward to handle. It seems to me that this subject requires a full-scale Board discussion on the basis of a carefully considered staff paper.

I do not question the seriousness of Mexico's balance of payments problem but I am not by any means convinced that the strength of Mexico's adjustment efforts is adequate. In particular, I attach much importance to early implementation of the promised "structural reform of the tax system," and of further adjustments to prices and tariffs following the "careful consideration" that is to be given to "several specific tariff categories." Also important is the "general intention to keep the revenues of the public enterprises under close watch," as is the intention to achieve "further reduction" of parastatals "in the coming months" and "to raise the levels of efficiency and productivity of the [remaining] strategic and priority firms of the public sector." I have already referred to the probable need for further actions on the exchange rate. The authorities will need to be resolute in implementing their policies if Mexico's adjustment program is to succeed in preventing the country's external position from becoming worse.

Finally, there is the question of approval of this program "in principle." I do not wish to belabor my considerable doubts about this question. However, I wonder what our position would be if, after having made such a decision, the banks and the authorities were only able to reach agreement via modifications to the program, for example, by dropping the banks' participation in the contingency mechanisms. Would such an outcome not leave the Board in a rather awkward position?

I have had great difficulty coming to a decision on this matter. I acknowledge the magnitude of Mexico's difficulties and the need for international assistance, including Fund assistance, to overcome them. So I do not think it right to oppose the program outright despite its substantial inadequacies and uncertainties. Subject to such answers as it may be possible to give to the many questions I have raised, I think that at this stage my proper recourse is to register an abstention.

Mr. Fujino made the following statement:

The new economic program for Mexico is a major step forward in addressing imbalances magnified by the sharp fall in oil prices, and the support that is expected to be provided by the international financial community includes a number of new features dealing with the present phase of the debt problem.

Prior to the drop in oil prices early this year, the previous stabilization program had already encountered difficulties in fiscal, monetary, and external areas. Fiscal policy was loosened, causing monetary expansion and reserve losses. Corrective measures introduced in July 1985, although effective in many respects and particularly in the exchange rate adjustment, was not adequate enough to restore balance in the economy to the level envisaged under the extended arrangement. In the meantime, economic growth faltered, inflation accelerated, and external balances became unfavorable. Further adjustment was clearly needed, and that need was further strengthened by a sharp decline in petroleum prices.

The twin objectives of balance of payments adjustments and long-term sustainable economic growth are not mutually exclusive, but indeed reinforce one another. The restoration of confidence in the management of the economy is an essential condition for securing the external support needed for the implementation of growth-oriented policies. At the same time, new measures included in the program would work to cushion the impact of further unfavorable developments and the need for severe adjustment for continued growth. The economy now has to adjust to the reduced level of oil prices in a constructive manner, and this will require an expansion of the private sector. Fiscal retrenchment serves the purpose of achieving this required change in the economic structure as well as balance of payments adjustments. The high rate of inflation has tended to divert private investment to unproductive uses. Accordingly, tighter monetary policy would have a salutary effect not only on financial stability, but also in enhancing the efficiency of investment through a reduction in the rate of inflation. The flexible exchange rate policy and encouragement of direct investment are also intended to address both the financial and structural problems of the economy.

Indeed, the new program represents one of the first examples in which the growth-oriented debt strategy advocated by Secretary Baker is applied on a large scale. In addition to the adjustment efforts by the authorities themselves, developed countries and multilateral financial institutions have agreed--and commercial banks are expected to agree--to cooperate in providing financial support to the program. Given the magnitude of the imbalances, adjustment will not be an easy task, but will be closely watched by the international financial community and will have significant implications for its assistance to other countries. The deep involvement by the World Bank is particularly welcome. The financial commitment by the Bank is expected to amount to US$2 billion this calendar year, and its loans to cover various policy areas related to growth and supply-side measures, including import liberalization, industrial recovery, and technology development.

A major issue relates to the speed of adjustment and inclusions of two contingency mechanisms. Given the magnitude of adjustment that has already been made and the size of the required adjustment, I have no major difficulties with the strategy chosen by the authorities to implement adjustment policies over a somewhat extended period with external assistance. However, it is clear that where external assistance is not consistent with the medium-term balance of payments liability, adjustments will have to be made in a relatively short period. The speed of adjustment has to be carefully selected on a case-by-case basis.

In this context, I have some concern about the objective of reducing the rate of inflation. Inflation has continued to remain at a very high level for some time, and it will be only in late 1986 that there will be a reduction of inflation. Because of extensive price correction measures, it is understandable that the rate of inflation will not subside immediately. In view of the importance of the issue, however, I wonder whether more ambitious goals could not have been set and, as Mr. Foot and Mr. Goos have mentioned, additional clear policy measures have been stipulated for the reduction of the rate of inflation. Any further comment by the staff would be appreciated.

I support the two contingency mechanisms. However, care should be exercised to ensure that such mechanisms do not lead to a weakening of the adjustment efforts. The two contingency clauses should be applied only when the authorities adhere to the adjustment program and only for the purpose of avoiding well-identified sources of unfavorable developments leading to slippages.

With respect to fiscal policy, the Board discussed in detail the appropriateness of using the concept of an operational balance on the occasion of the seminar on the measurement of fiscal deficits (Seminar 86/7). While I do not favor exclusive reliance on such a concept, it could be a useful measure of the fiscal deficit if used together with other measures. In Mexico's case, the operational balance is expected to show a small surplus in 1987--compared with a deficit of 2.1 percent of GDP in 1986--if the real interest rate component does not exceed the levels of 1985 and 1986. If measured by the primary balance, excluding revenue from oil exports, the total fiscal efforts over the 1986-87 period would amount to 6.5 percentage points of GDP. These figures indicate that the envisaged fiscal adjustment is very large, but at the same time the overall PSBR expected for 1986, equivalent to 17 percent of GDP, also underscores the need for stronger efforts in the future. It is encouraging to note in Mr. Ortiz's opening statement that the backbone of the adjustment is a sharp reduction of public sector deficits. In this connection, I think that the staff is correct in stating that if there were to be a significant rise in the real interest burden, its effects would need to be taken into account in the formulation of policies.

As to tax policies, I welcome the authorities' intention to proceed with a structural reform of the tax system. Among other things, distortions on tax revenues arising from inflation should be corrected as soon as possible. The pricing policies of public corporations should be based on a cost-recovery basis. In this context, I note the example of the Mexico City metro given on page 5 of Mr. Ortiz's opening statement. That program envisages a welcome reduction in current spending, while maintaining the level of capital outlays. The Government has implemented a large-scale restructuring of the parastatal sector and such efforts should be continued during the program period and beyond.

The tightening of fiscal policy and the resumption of the use of external credits by the public sector should contribute to reduced expansion of overall credit, while making room for private credit. While credit expansion and lower interest rates may have appeared stimulative at first sight. the resulting inflation has had an unfavorable effect upon the efficiency of investment. Containment of inflation, therefore, has to be seen as one of the primary objectives under the growth-oriented adjustment program. In this connection, it is important to ensure that interest rates be determined by market forces. I welcome the authorities' commitment to reduce the scope for preferential credits provided by national development banks and official trust funds.

I underline the importance of flexible exchange rate policy both for promoting external adjustment in the short term and the nonpetroleum export sector in the long term.

I welcome the liberalization measures that have been taken and the authorities' commitment to continue trade liberalization. In this connection, the authorities' decision to join the GATT is particularly noteworthy.

With respect to direct investment, the authorities' policies seem to be somewhat selective and not totally liberal. This seems to be particularly apparent in the authorities' attitude toward debt/equity swap operations. I would appreciate any information from the staff on this.

The decline of capital outflow is a welcome development and it is expected that further improvement, or even reversal, of the flow could be attained in due course. The prospects for the balance of payments position over the medium term remain precarious and require continued external finance of considerable magnitude. Under the circumstances, creditors need to be assured of the authorities' strong determination to implement adjustment in order to provide continued assistance. The present program incorporates two fallback mechanisms to ensure full implementation of the program in the face of unexpected developments. There is no room for additional slippages. I would also like to add that there are aspects of the details of the program that need to be worked out and a further close exchange of views would be important.

I would like to make two observations of a procedural nature. First, on the use of the compensatory financing facility to which Mr. Polak referred and which is intended to augment the stand-by arrangement in the contingency mechanism for oil prices. I understand that paragraph 4 of the proposed decisions for the stand-by arrangement does not constitute the approval of compensatory financing by the Board, but represents only the expectation of the use of compensatory financing in the case of oil contingency. I would like to have confirmation by the staff on this point. If the Board were to give outright approval for compensatory financing for Mexico, that would be a significant departure from established procedures, since no shortfall estimates based on actual figures have been given in the staff report. I assume that such estimates, as well as an assessment by the staff of whether the "beyond the control" requirement is met, will be provided by the time we discuss the actual use of the compensatory financing facility by Mexico.

Second, I very much regret the fact that assurances by commercial banks on their participation in the financing package have not been obtained and that today's decisions have to be made on an approval "in principle" basis. I have some reservations as to whether today's case strictly meets the guidelines set by the Board for "approval in principle."

Further, there seems to be dissatisfaction among the commercial banks about the respective shares of public and private creditors to fill the financing gap and the way the negotiations are proceeding. There could also be doubts as to whether the approval in principle would facilitate the negotiations. In order to reach the expected agreement, a constructive and cooperative attitude on the part of the participants is highly recommended. Although the issue is basically a matter to be left to the participants, the Fund will have an important role to play in facilitating a successful solution to these difficult negotiations through appropriate advice.

With these strong expectations, I can support the proposed decision of approval in principle.

I would also like to welcome the new economic program and strongly anticipate that with the successful implementation of the program, the economy will regain stability and sustained growth.

Mr. Nimatallah sought clarification of Mr. Fujino's statement that he would support the program in principle if it did not contain an approval of the oil contingency mechanism. He noted that the proposed decision clearly stated that purchases by which the amount of the arrangement would be augmented would be regarded as compensation for export shortfalls.

Mr. Fujino replied that he merely sought further detail on the amount of shortfalls envisaged. He expected the contingency mechanism to work, but the approval in principle was a departure from traditional procedure.

The Deputy Director of the Exchange and Trade Relations Department said that he wished to clarify the relationship between paragraph 1 and paragraph 4 on the decision on the stand-by arrangement. Paragraph 1 indicated that the amount of access under the stand-by arrangement could be augmented to US$2.2 billion. Paragraph 4 indicated that, should augmentation take place--for example, on account of an export shortfall leading to a request for compensatory financing--then that augmentation would be counted as part of the access under the compensatory financing facility. The decision did not imply that the Board was asked to approve in principle a request for compensatory financing.

Mr. Abdallah made the following statement:

I welcome the opportunity to discuss Mexico's program for various reasons. This chair sympathizes with the Mexican authorities, who have faced severe problems since 1985, in particular the earthquakes in September, which caused considerable loss of life and property and pushed Mexico a long way from the adjustment course it was then following. The Executive Directors were encouraged by the fact that the Fund was able to respond with emergency assistance amounting to SDR 291 million.

With the subsequent collapse of oil prices, the authorities were confronted with another adverse situation that threatened to undo not only the economic gains of the past few years, but also the social fabric of the country itself. I note that petroleum exports have fallen dramatically--from US$15 billion in 1985 to an estimated US$5.6 billion in 1986--and are now projected at US$6 billion for the next year. As mentioned in Mr. Ortiz's opening statement, "the oil shock is equivalent to the total agricultural production of the country; in terms of the budget, it exceeds the total wage bill of the Central Government plus the parastatal sector." This has clearly set in motion a chain of events leading to sharp increases in the domestic price structure, unbearable external pressures, and a sharp contraction in the tempo of economic activity. Thus, although the rate of inflation stood at about 64 percent in 1985, it accelerated to 115 percent in 1986, while the external current account plunged from a surplus position to a deficit, equivalent to 2.6 percent of GDP in 1986. The rate of growth of GDP turned from 2.7 percent in 1985 to -4.0 percent in 1986.

The adjustment effort and the level of external financing that were required were beyond Mexico's means, especially in view of the high level of the country's indebtedness. I am, therefore, pleased to see that the Fund has faced the Mexican case with appropriate flexibility with respect to the design of the program and its concerted efforts to secure financing.

I would like to discuss three specific aspects of the stand-by arrangement.

The first is the program's combination of adjustment with growth. Since the objective is to diversify production, which requires medium-term structural measures, the authorities would not be able to make sudden adjustment for the loss of oil revenues without seriously jeopardizing growth potential. Hence, they would have to hold down the external current account deficit during the program period in 1986 and 1987 to 2.6 percent and 2.2 percent of GDP, respectively, while stimulating GDP growth to 3.5 percent in 1987. It is to be hoped that adequate international support will be forthcoming, so that the authorities' objective of increasing the rate of growth steadily to 6 percent by 1991 is achieved. The authorities are to be commended for their fiscal effort, involving a reduction in expenditure and tightened tax measures, which have led to the reduction of the PSBR by about 6 percentage points of GDP in 1986. Equally commendable is the ongoing government policy of divestment from nonpriority and nonstrategic projects, which should reduce budgetary deficits and promote economic efficiency. It is noteworthy that the pursuit of a flexible exchange rate policy is playing an important role in stimulating nonpetroleum exports and in curbing demand for imports, thus gradually improving the balance of payments position. A combination of fiscal, monetary, exchange rate, and structural measures is expected to decelerate the rate of inflation by nearly half in 1987.

The second innovative feature of the program is the combination of a stand-by arrangement with two contingency mechanisms, one of which is to ensure that if the price of oil falls below US$9 a barrel, automatic adjustment will be made to the quantitative performance criteria to ensure that the program remains on track so long as the authorities play their part. At the same time, if the price of oil rises above US$14 a barrel, external financing will be reduced in proportion to the additional revenue. This chair welcomes such flexibility and hopes that it will be applied to similar situations in other countries where programs depend on a world commodity price that is difficult to predict. One example is Zambia's dependence on copper prices, which have consistently fallen below the estimates made by the Fund and World Bank staff, much to the detriment of Zambia, which has a good record of cooperation with the Fund.

Another welcome example of flexibility in the Mexican program is the growth contingency mechanism, whereby a set of projects will be activated next year if, after implementing the measures under the stand-by arrangement, growth is not generated. This is a constructive innovation, given that the projects will be appraised well in advance with World Bank technical assistance and that the US$500 million for this contingency mechanism will be externally funded, thereby ensuring that the mechanism does not generate inflationary pressures.

The third point with regard to this program concerns the financing arrangement. In this regard, I wish to reiterate my support for the position taken by the Board when it agreed to consider the Mexican request in principle in order to send the right signal to other sources of finance and to facilitate early finalization of the multifaceted financial package. This procedure will also pave the way for the Paris Club meeting, to discuss debt rescheduling, which is expected to take place in mid-September.

Given the level of external current account deficits in 1986/87 and the need to build up gross foreign reserves to cover 6.5 months of imports by end-1987, net inflows--in addition to Fund resources--should equal US$10.6 billion, half of which is expected from commercial banks. Indeed, the commercial banks are expected to provide substantial financing until 1991. The contribution of the World Bank and the Fund will be considerable. The World Bank's commitment, expected at US$2 billion annually from 1986 to 1988, has been described by the staff as "unprecedented." The Fund contribution of SDR 1,400 million is significant, particularly in view of the fact that an additional amount is contemplated under the contingency provision in the form of compensatory financing.

I wish to commend the staff once again for the flexibility that has been shown in designing the package, and I strongly hope that similar treatment will be extended to other countries in similar circumstances. I support the proposed decisions.

Mr. Massé made the following statement:

Mexico has faced difficult circumstances, both externally and internally, over the past four years. Following the foreign exchange crisis in mid-1982, the authorities implemented an adjustment program which yielded many positive results during 1983-84 under an extended arrangement with the Fund. Unfortunately, slippages emerged in a number of areas during 1985, including public finances, exchange rate adjustment, and credit restraint. These slippages pushed the extended arrangement well off track. Although the authorities took a few compensatory measures, notably through a more flexible exchange rate policy, the recent abrupt decline in oil prices created an unsustainable situation and brought Mexico's financial difficulties to a head.

It is in this context that I welcome Mexico's request for a stand-by arrangement. Clearly, Mexico must implement far-reaching measures not only to strengthen its external accounts and restore creditor confidence, but more importantly to re-establish the conditions for sustainable economic growth. This program rightly emphasizes both demand management and supply-enhancing policy changes, and seeks to strike a balance between adjustment and external financing. We welcome the array of proposed reforms in key structural areas, which include measures to increase the efficiency of the public sector, rationalize the price structure to strengthen the influence of market forces, liberalize trade, and encourage increased flows of foreign direct investment.

The stand-by arrangement has been designed to include significant financial support from external creditors, so that economic growth will not be hampered while the structure of the economy is undergoing changes. The demands on creditors are exceptional and extend over the medium term. In order that creditor confidence not wane, it is crucial that Mexico implement this program vigorously and that these measures be extended beyond the life of the stand-by arrangement to allay the apprehension of creditors about the efficient use of their increased exposure.

However, I am concerned that a number of measures under the program have not been specified in sufficient detail and that uncertainties exist with respect to the magnitude and timing of many of the adjustment measures. Further, it should be emphasized that, even if fully implemented, the policies described in the staff report might create the necessary conditions for a resumption of economic growth, but cannot guarantee that Mexico will establish a strong medium-term growth pattern. Although the contingency mechanism with respect to public sector investment outlays is innovative and conforms to the spirit of the Baker initiative, it cannot guarantee medium-term growth. Sustainable growth will depend upon the generation of strong domestic savings, the creation of attractive investment opportunities, and, most importantly, a stable investment climate, including reasonably favorable world trade prospects. Therefore, no room for deviation can exist if the authorities' ambitious medium-term targets are to be reached.

Mexico has incurred high rates of inflation, and it is worrisome that the authorities have not committed themselves to an inflation target for 1987. Equally disconcerting is the year-end inflation rate of 115 percent forecast for 1986. In these circumstances, monetary and credit policies must achieve a reduction of inflation while remaining conscious of the international reserve target; and careful monitoring is also necessary. The current high level of real interest rates appears unavoidable in limiting pressure on international reserves and will remain necessary until public confidence is strengthened and inflationary expectations are reduced.

Although I recognize the onerous burden of interest on the public debt linked to the high rates of inflation, I have doubts that the proposed fiscal effort is sufficiently ambitious. Although the operational balance and primary balance concepts can be useful supplements in measuring fiscal adjustment in circumstances of high inflation--and through these measures there will be a tangible strengthening of the fiscal position--the importance of the PSBR has been given inadequate weight in the stand-by arrangement. This is particularly true where very high interest rates are needed to persuade savers to purchase government obligations, and where these high interest rates are themselves a function of shortcomings in previous policies and uncertainties about the sustainability of a policy path. Given those uncertainties with respect to policies and inflation, we would expect a very close monitoring of developments to keep the PSBR as low as possible. A considerable reduction in the PSBR would seem warranted in 1987, and the authorities should be prepared to take further measures as appropriate.

On the revenue side, I welcome the proposed tax reforms aimed at correcting distortions and improving the efficiency of the tax system. Public sector prices and tariffs must not be allowed to slip in real terms, and the authorities will have to make adjustments at frequent intervals. We would have preferred greater detail in the staff report on the price adjustment process.

As to expenditures, the emphasis should be placed on strict control of total expenditures and concurrent change in the composition of outlays to permit faster growth of capital investment. This will require strong efforts to limit increases in wages and salaries and to reduce government transfers in the form of subsidies. Continued progress must be achieved in restructuring parastatals, including industrial reconversion plans for sugar, fertilizer, and steel. We expect a full account of these structural measures during the program reviews.

Mexico's exchange rate policy since mid-1985 has successfully restored external competitiveness to near-1983 levels and has narrowed the differential between the controlled and free peso rate. The maintenance of exchange rate flexibility is crucial for export diversification to take place. The authorities will need to take into account external competitiveness, the terms of trade, and balance of payments targets, and not allow any erosion of the present position. We had expected greater detail from the staff on how this process would be initiated. We would encourage the authorities to unify the exchange market as soon as possible, which would be a clear and unambiguous signal to exporters and to Mexican citizens holding capital abroad that exchange rate flexibility would be vigorously maintained. Such flexibility might eventually attract back to Mexico capital that had been transferred abroad in recent times.

Similar strong efforts are needed to promote efficient diversification of exports and to further liberalize trade to induce local industry to compete more aggressively at home with foreign producers. We welcome the reduced list of items subject to quantitative import restrictions and the tariff modifications. We also view Mexico's membership in the GATT as a very positive indication of the country's long-term commitment to an open world trading system.

This program contains a special financing mechanism which would respond to a significant weakening of world oil prices. While this mechanism is new, in some respects it is little more than a formalization of review procedures which have appeared in other programs where external conditions were uncertain. In this case, the mechanism must be regarded as specific to Mexico's circumstances because of the mix of financing and the amount of commercial bank credit involved. Certainly, activation of this mechanism must be closely tied to meeting the performance criteria under the program, and should be regarded as an exceptional response to exceptional circumstances.

As to the approval of the stand-by arrangement in principle, I have not reached a firm judgment on the time period for finalization of external financing. I can see potential costs and benefits of both a shorter period, such as three weeks, or a longer period, which would take us beyond the Annual Meetings. Therefore, I would prefer to hear the views of others before deciding.

I support the stand-by arrangement, which is a workable compromise under the extremely difficult conditions facing Mexico. I wish the authorities success, but I must emphasize that the confidence of external creditors, as well as the authorities' credibility, is dependent on the successful implementation of this program.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/147 (9/5/86) and EBM/86/148 (9/8/86).

2. ROMANIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Acting Managing Director dated August 29, 1986 on Romania in EBS/86/205 (8/29/86) is noted. It shall be placed on the agenda of the Executive Board for a date during the 1986 Annual Meetings.

2. The Fund urges Romania to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects Romania. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8383-(86/148), adopted
September 5, 1986

3. SUDAN - SETTLEMENT OF OVERDUE FINANCIAL OBLIGATIONS AND TERMINATION OF SUSPENSION OF RIGHT TO USE SDRs

The Fund decides that the suspension of the right of Sudan to use SDRs, as provided in Executive Board Decision No. 8253-(86/63) S, adopted April 16, 1986, is terminated with effect on August 28, 1986. (EBS/86/209, 9/4/86)

Decision No. 8384-(86/148) S, adopted
September 5, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/213 (9/4/86) is approved.

APPROVED: May 14, 1987

LEO VAN HOUTVEN
Secretary

ANNEX

Implicit Resource Transfer Resulting from Terms of Trade Movements

(In billions of U.S. dollars)

	1982	1983	1984	1985	Jan.-June 1986
Exports of goods and services					
At current prices	26.1	27.2	30.1	27.7	10.6
At 1980 prices	29.2	33.7	35.0	34.2	16.5
Implicit transfer	3.1	6.5	4.9	6.5	5.9
Imports of goods and services					
At current prices	20.3	12.8	16.2	18.8	8.6
At 1980 prices	18.0	11.1	13.7	15.8	7.3
Implicit transfer	2.3	1.7	2.5	3.0	1.3
Interest payments					
Current payment	12.2	10.1	11.7	9.9	4.4
Payments at 1980 interest rates	11.6	12.3	12.5	12.5	6.4
Interest rate effect	0.6	-2.2	-0.8	-2.6	-2.0
Total terms of trade-related resource transfer	6.0	5.0	6.6	6.9	5.2

Source: Banco de México, based on newly available series on unit import and export prices.