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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/91

10:00 a.m., June 7, 1985

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
J. de Groote	H. G. Schneider
	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
	J. Hospedales, Temporary
	J. R. N. Almeida, Temporary
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	B. Jensen
	M. A. Weitz, Temporary
Y. A. Nimatallah	
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
N. Wicks	T. A. Clark
	N. Coumbis
	I. Angeloni, Temporary
Zhang Z.	

L. Van Houtven, Secretary
R. S. Franklin, Assistant
K. O. Baer, Assistant

Also present

IBRD: P. Bottelier, Latin America and the Caribbean Regional Office. Administration Department: R. Tenconi, Director; D. A. Anderson, D. S. Cutler, A. D. Goltz, J. D. Huddleston, J. G. Keyes. African Department: J. M. Jimenez. Asian Department: J. R. Marquez-Ruarte. Central Banking Department: S. P. Leite. European Department: H. Vittas. Exchange and Trade Relations Department: M. Guitián, Deputy Director; L. H. Duran-Downing, G. R. Kincaid, P. Neuhaus. Fiscal Affairs Department: M. Katz, F. Sanchez Ugarte. Legal Department: G. F. Rea, Deputy General Counsel; J. M. Ogoola. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: R. W. Groettum. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, P. Ewenczyk, J. Gil-Diaz, R. Incer, E. O. Kumah, J. P. Pujol, L. M. Valdivieso, F. van Beek. Bureau of Statistics: E. S. Heredia. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, D. Hammann, K. A. Hansen, G. Nguyen, T. Sirivedhin, A. Steinberg, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: M. B. Chatah, A. K. Diaby, V. Govindarajan, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, S. Kolb, M. Lundsager, J. A. K. Munthali, K. Murakami, E. Olsen, M. Rasyid, J. Reddy, D. J. Robinson, C. A. Salinas, M. Sarenac, A. A. Scholten, L. Tornetta, A. J. Tregilgas, E. L. Walker.

1. REPORT BY MANAGING DIRECTOR

The Managing Director noted that the Fund had for some time been involved in negotiations with Argentina aimed at developing an adjustment program that might be supported in part by Fund resources. On June 6, 1985, the main economic policy actions had been agreed between the Fund and the Argentine authorities that would in due course be translated into the technical language of a letter of intent and, later, a staff report and proposed performance criteria.

As Directors were aware, a number of governments were attempting to put together a bridging finance operation that would facilitate settlement by Argentina of at least a portion of the arrears on interest due to commercial banks, the Managing Director continued. While the Fund was not specifically involved in that effort, he had been informed in detail of the negotiations, the general thrust of which he was passing on to Executive Directors.

2. STAFF COMPENSATION - 1985 ADJUSTMENT

The Executive Directors, meeting in restricted session, gave further consideration to the decision on staff compensation adopted at EBM/85/86 (5/31/85) in light of the adoption of a different decision on the same subject by the Executive Board of the World Bank on June 4, 1985.

The Executive Board adopted the following decision:

Staff Compensation - 1985 Adjustment

1. Fund salaries at all levels will be increased by 2.6 percent with effect from May 1, 1985.

2. An amount equal to 0.5 percent of the salary bill as of April 30, 1985 will be set aside for use in connection with the implementation of the Job Evaluation Exercise. The modalities of the distribution of this amount as well as of the amount set aside in 1984 will be decided in light of the consideration by the Executive Board of the results of the Job Evaluation Exercise. The distribution will apply retroactively from May 1, 1984 for the amount set aside in 1984 and from May 1, 1985 for the amount set aside in 1985.

3. The estimated cost of the increase under paragraph 1 above would amount to $3,380,000 for FY 1986, and the appropriation for the Administrative Budget for FY 1986 shall be increased as follows:

Budget Category	Approved Budget	Additional Appropriations	Revised Budget
	(In U.S. dollars)		
1. Personnel expenses			
A. Salaries	97,060,000	1,980,000	99,040,000
B. Other personnel expenses	63,990,000	1,400,000	65,390,000
		3,380,000	

Adopted June 7, 1985

3. MEXICO - 1985 ARTICLE IV CONSULTATION; REVIEW UNDER EXTENDED ARRANGEMENT AND PROGRAM FOR THIRD YEAR

The Executive Directors considered the staff report for the 1985 Article IV consultation and the review and program for the third year under the extended arrangement (EBS/85/123, 5/13/85; and Cor. 1, 6/5/85). They also had before them a report on recent economic developments in Mexico (SM/85/148, 5/23/85; and Cor. 1, 6/5/85), together with an information notice on the real effective exchange rate of the Mexican peso (EBS/85/99, 4/23/85).

The staff representative from the Western Hemisphere Department noted that the staff reports had been prepared on the basis of developments and of information gathered by staff missions to Mexico City in late 1984 and early 1985. Even when the reports had been finalized, the staff had not received all the figures for the end of March 1985. However, in recent days, additional information had been received from the Mexican authorities indicating that all performance criteria had been met in the first quarter of 1985. The deficit of the nonfinancial public sector had reached Mex$416 billion in the period January-March 1985, remaining below the limit of Mex$430 billion established in the program. The interest accrued to the Bank of Mexico on claims in the nonfinancial public sector had reached Mex$801 billion as of the end of March 1985, which was also under the limit of Mex$805 billion established under the program. Net credit to the nonfinancial public sector from the monetary authorities had reached Mex$3,713 billion at the end of March 1985, compared with the limit of Mex$3,748 billion established under the program. The operations of financial intermediation by development banks and official trust funds had amounted to Mex$120 billion, which was under the ceiling of Mex$130 billion. Net domestic assets of the monetary authorities had expanded by Mex$122 billion, compared with the limit of Mex$127 billion in the program. During the first quarter of 1985, cumulative net foreign borrowing by the public sector had amounted to US$300 million, which was well within the limit of US$500 million set under the program, while international reserves had dropped by US$867 million, compared with the decrease of US$1 billion allowed for under the program.

Preliminary information for the first few months of 1985 indicated that the rate of growth of economic activity had continued to be strong, although it had slowed somewhat since the last quarter of 1984, the staff representative commented. The rate of inflation had decelerated further, as consumer prices were estimated to have increased by only 2.4 percent in May, compared with 3 percent in April, and an average of 5 percent a month in the first quarter of 1985. The recent increase in minimum wages had brought the increase in wages for 1985 to 53 percent, compared with 56 percent during 1984. The data showed that the balance of payments had been weaker than expected and that official reserves, although still very substantial, were somewhat below their level at the end of the first quarter of 1985; in addition, net domestic credit of the Bank of Mexico, which was subject to continuous testing, had been running close to its quarterly ceiling. Quotations in the parallel market had varied widely in the first few months of 1985, with the differential vis-à-vis the controlled market fluctuating between 11 percent and 30 percent. The differential between the controlled market rate and the parallel market rate had gone up and down, so that the 11 percent and 30 percent limits had represented the peak and the trough in the fluctuations. The most recent quotations of exchange rate differentials had shown a differential of a little more than 20 percent.

Mr. Ortiz made the following statement:

An overview of the adjustment process

The Mexican Administration that took office in December 1982 faced an extremely difficult challenge: setting forth and implementing a credible adjustment program capable of tackling effectively the enormous imbalances--both internal and external--accumulated during the previous years and averting a further deterioration of economic activity. The issue of credibility was important, since the traumatic events of 1982 had seriously undermined the public's confidence in financial policies and institutions.

Responding to the prevailing circumstances, the program adopted at the end of 1982 was both comprehensive and ambitious. The main immediate objectives were to bring inflation under control and to avoid major disruptions of the productive sector and of the payments system. The economic situation deteriorated so rapidly during the last few months of 1982, that the end-of-year figures were much worse than expected. The program's quantitative targets for 1983 were based on projections for 1982 that contemplated a 2 percent output growth, end-of-year inflation of 75 percent, and a public sector deficit of 16 percent of GDP. Also, the foreign exchange-denominated aggregates were projected utilizing an average exchange rate of Mex$96=US$1 and the average price of Mexican crude was estimated at US$28.7 per barrel. However, in 1982 GDP fell 0.5 percent; inflation reached almost 100 percent; the deficit was close to 18 percent of GDP; the average exchange rate in the controlled market was Mex$126 per U.S. dollar; and the average price of crude was only US$26 per barrel. In spite of the significant worsening of the initial conditions of the program, the authorities complied with the nominal targets--the public sector/GDP ratio was reduced to 8.5 percent--which clearly implied a more drastic adjustment than originally envisaged--already strict by any standards. The cost of the adjustment can be gauged by considering that GDP fell 5.3 percert--vs. a program forecast of zero growth--and minimum average real wages decreased 27 percent. On the other hand, balance of payments results greatly exceeded expectations while inflation--albeit reduced--stubbornly remained high.

Why has inflation not abated further in spite of the fiscal and monetary contractions? First, the large exchange rate depreciations of 1982 implied a considerable overshooting of the real exchange rate, as evidenced by the fact that the level of implicit protection turned significantly negative at the beginning of 1983 for most tradable goods. Domestic prices tended thus to rise quickly, producing cost-push inflationary pressures and a real appreciation of the exchange rate. Second, the adjustment of public sector prices and tariffs and the reduction of subsidies released repressed inflation. During 1983, the relative price of public sector goods and services increased 39 percent versus the rest of the goods. The discrete adjustments in the prices of key goods and the exchange rate induced important relative price changes throughout the economy, increasing the variability of inflation. The variance of the annual increase registered in the components of the price index in 1983 was 10 times greater than that experienced between 1972 and 1981, reflecting greater asynchrony in the process of price formation. Although this variance was somewhat reduced in 1984, it continued to exert significant influence on the inflation rate of that year. Presumably, the resulting leads and lags of price behavior increased the importance of inertial factors in the determinants of inflation, making it less responsive to contractionary policies. Third, through higher prices, firms tended to increase profit margins to cover a portion of the exchange losses and to amortize excessive debt. This was made possible by the generalized use of quantitative trade restrictions, which constituted an obstacle to the lowering of inflation by permitting the maintenance of oligopolistic conditions in domestic markets, as pointed out by the staff.

The strength of the adjustment process of 1983-84 can be appraised by the pace at which public sector debt was amortized in real terms. The high inflation rates experienced since 1982 resulted in an accelerated payment of the internal debt which, as shown in Table 1 (see Appendix), declined 6.4 percentage points of GDP between 1982 and 1984. On the other hand, the limited use of foreign credit and the appreciation of the real exchange rate resulting from the large overshooting that occurred at the end of 1982 were also reflected in a reduction of the external debt outstanding in relation to the size of the economy. The real indebtedness of the public sector--both domestic and external--was negative during 1983 and 1984. Fiscal revenues are utilized to amortize debt in real terms, since a portion of the nominal interest paid on the outstanding stock of debt corresponds in reality to an amortization payment. It is clear that the faster the pace of debt amortization, the fewer the resources that can be devoted to other current and capital expenditures. Thus, as seen in the table, capital and current expenditures--other than interest payments--were reduced by 3 percent and 7.4 percent of GDP, respectively, from 1982 to 1984, notwithstanding the substantial reduction in the collection of the inflation tax--2.3 percentage points of GDP--over the same period. Private firms' debt was also reduced substantially in real terms. Although no precise estimates are available, there is evidence that sizable amortization payments on external private debt to banks and other creditors took place during 1983 and 1984. Real internal debt was also considerably reduced: at the end of 1984, the real value of the stock of private firms' internal debt with commercial banks was almost 20 percent lower than the figure corresponding to December 1981.

Economic activity in 1984

During 1984, output growth, employment and the balance of payments performed better than expected. Although the adjustment process was continued and internal imbalances were further corrected, the public sector deficit ended up higher than originally envisaged. Inflation was also reduced, but not by as much as targeted.

Real GDP grew by 3.5 percent in 1984. The improved financial position of firms and the recovery of financial savings--which grew by 5.1 percent in real terms, stimulated by higher real interest rates--allowed a substantial increase in credit granted to the private sector--15 percent in real terms. Credit demand was also stimulated by a sharp fall in lending rates reflecting both lower inflation and reduced intermediation margins. On the aggregate demand side, exports were the most dynamic element, increasing by 10.7 percent in real terms, especially non-oil exports which grew by 18.7 percent in real terms. Investment was the second most dynamic component of demand, having registered a real increase of 5.4 percent. It should be noted that investment growth was the result of private sector activity, since real public sector investment fell for the third consecutive year.

Output growth and the behavior of real wages had a beneficial impact on employment: affiliation in the social security system rose by 4.3 percent. Real wages, on the other hand, registered a substantial fall. After the very sharp drop experienced in 1983, average real minimum wages fell an additional 7.4 percent in 1984, so that the cumulative average reduction since the adjustment program was launched reached 31.4 percent last year. My authorities strongly feel that the results of the first two years of the adjustment program were made possible by the responsible attitude of the trade unions and the acceptance of a drastic lowering of living standards by the general population, illustrated additionally by the drastic fall in per capita consumption since 1981--approximately 13 percent. Wage policy has certainly not contributed to inflation through expectations or any other mechanism. On the contrary, it has had a strong deflationary impact, helping at the same time to preserve the competitiveness of Mexican products, as evidenced by the evolution of unit labor costs. Expressed in foreign currency, these costs remained, on average, 48 percent lower in 1984 than in 1981.

Measured on a year-end basis, consumer prices rose 59.2 percent in 1984, a rate 21.6 percentage points lower than that registered in 1983. Even though the downward inflation trend continued, the reduction of the inflation rate was slower than expected and, by year end, it had leveled off. The difficulties encountered in lowering inflation during 1984 can largely be explained by the factors previously mentioned. Although the higher than expected inflation resulted in a real appreciation, the results of the balance of payments were positive. For the second consecutive year, trade and current account surpluses were obtained amounting to US$12.8 billion and US$3.9 billion, respectively, allowing for a substantial reserve accumulation.

In 1984 the public sector deficit was higher than programmed. The deviations were mainly the result of interest payments and other debt service-related expenditures which substantially exceeded the provisions made in the original budget. Investment expenditures, on the other hand, were lower than budgeted. In spite of the deviations that occurred at the end of the year, the economic deficit/GDP ratio was lower than in 1983, and the trend toward the correction of fiscal imbalances was maintained. It should be noted that approximately 80 percent of the financial requirements of the public sector were provided by internal sources, since only slightly more than half of the external financing contemplated under the program was actually utilized.

The increase in international reserves was the main determinant in the growth of the monetary base and of the monetary aggregates. At the end of 1984, the net external assets of the central bank represented 23.3 percent of the monetary base and 102.1 percent of currency in circulation. A year earlier, these figures were 17.2 percent and 81.7 percent, respectively. Net domestic assets declined by a larger amount than envisaged in the program, partially reflecting sterilization operations implemented by the central bank to reduce excess liquidity. Interest rate policy was managed flexibly, allowing for a recovery of financial intermediation and for an important increase in real credit to the private sector as reported earlier.

The program for 1985 and some recent developments

The program for 1985 aims at consolidating the gains made during the last two years in reducing internal and external imbalances, thus setting the conditions for the resumption of stable economic growth. To this end, my authorities are of the view that efforts have to be renewed in the struggle to abate inflation, though this has proved to be a most difficult task. The program envisaged is a strong one, especially in the light of developments during the last part of 1984 and the first few months of 1985. The likelihood of a slowdown in economic activity in some major industrial countries and the uncertain prospects for the oil market may cloud the balance of payments outlook, especially considering that the Government has decided to make very limited use of external credit. These considerations have prompted the authorities to take firm actions since the beginning of the year, geared to the correction of fiscal deviations and to the strengthening of the balance of payments in line with the program's goals. These measures have already shown some positive results, as evidenced by the compliance with the first quarter performance criteria and the apparent resumption of the downward trend in the annual inflation rate.

In addition to the fiscal measures described by the staff that strengthened the budget sent to Congress last November, the authorities have decided to cut an additional Mex$200 billion of public sector outlays in the remainder of 1985--this in view of the impact on the service of the internal public debt of higher domestic interest rates, and the adverse effect that the weakening of the oil market in recent weeks may have on the budgeted receipts of PEMEX (the petroleum company). Interest rates paid by banks on domestic deposits were raised very substantially in March in order to stimulate financial savings. Market-determined rates of treasury bills and other money market instruments have also increased sharply in response to the restrictive monetary actions undertaken in the form of placement of monetary regulation bonds. For instance, during the auction of treasury bills on June 4, the 90-day rate was 68.3 percent, a rate 19 points higher than the average rate for February. The more stringent monetary policy has resulted in a slowdown of the rate of growth of M-1 from 63.6 percent at the end of December to approximately 55 percent at the end of May.

My authorities are aware that substantial reforms in the area of commercial policies are needed to improve the efficiency of resource allocation and to strengthen the export sector. They are committed to continue efforts in the direction of trade liberalization. Since last December, the proportion of total imports exempted from permits has risen from 17 percent to 25 percent; the goal remains to raise this figure to between 35 percent and 45 percent by the end of the year. Additionally, in the course of the next few days, a new instrument Certificado de Importación para la Exportación (DIMEX) will be made available to exporters. These certificates will allow exporters--against the surrender of their foreign exchange to the monetary authorities--to import inputs for their own export products or those of their suppliers without permit and free of duties. A list of products covering about 29 percent of the total value of imports in 1984 is not covered under the DIMEX.

With respect to the exchange rate, the authorities have also followed a flexible policy. The rate of depreciation of the controlled exchange rate was raised from Mex$0.13 to Mex$0.17 per U.S. dollar a day in December 1983 and again to Mex$0.21 a day in March 1985. This rate is consistent with avoiding a further appreciation of the Mexican peso if the domestic inflation rate is kept around 45 percent during 1985, and will result in a real devaluation if the dollar depreciates against other major currencies. In fact, the peso has depreciated slightly in real terms measured against a basket of currencies of Mexico's most important trading partners during the last three months. On June 5, new rules on the operation of the casas de cambio (foreign exchange establishments) were announced with the aim of simplifying the present exchange rate system and improving the efficiency of the free market. Under the new regulations, Mexican banks will fully participate in the wholesale--or parallel--market through their affiliated foreign exchange establishments. The practical significance of this measure is that the free banking market rate will eventually be unified with the parallel market rate, and that the bid-ask spreads may significantly narrow in the short term. With the full participation of the banks, the free/parallel market will gain considerable volume and depth, and the volatility of the exchange rate may be reduced.

The economic recovery continued in the first quarter of 1985, albeit at a slower pace than during the last quarter of 1984. Industrial production increased 6.6 percent on an annual basis in 1985 (I) compared with a rate of 9.1 percent in 1984 (IV). The slowdown was generalized across all industrial activities--except for electricity generation--and the oil and mining sectors registered negative growth rates. Investment, however, continued growing at a rapid pace during the first quarter of the year (13.9 percent), reflecting a vigorous domestic production and increased imports of capital goods. In spite of the improved pace of economic activity registered since the second half of 1984, the level of industrial production in March is similar to the level corresponding to the first quarter of 1981; these figures illustrate the depth of the economic recession suffered during the adjustment period.

During the first four months of 1985, consumer prices increased 19.8 percent compared with a rate of 21.8 percent registered during the same period of 1985. The annual inflation rate has been declining since its April 1983 peak (117.3 percent). In November and December 1984, the rate of inflation reached 59.2 percent, increasing to 60.8 percent in January 1985, but resuming its downward trend thereafter to reach 56.5 percent in April.

Preliminary estimates indicate that a trade surplus of US$3.2 billion was obtained during the period January-April 1985, compared with a surplus of US$5.2 billion registered a year earlier. Current account data are only available for the first quarter; the figures corresponding to 1985 (I) and 1984 (I) are US$0.64 billion and US$2.1 billion, respectively. The reduction of the trade surplus (January-April) results from a very rapid increase of imports (39 percent) and a fall of oil and non-oil exports (7 percent and 15 percent, respectively). The rapid import increases are largely associated with the recovery of economic activity, especially investment demand. Imports of intermediate and capital goods have registered the highest growth rates. The more active domestic demand has also influenced the fall of non-oil exports, since an important portion of the export surge observed during the last two years resulted from the very depressed levels of internal consumption and investment. The appreciation of the exchange rate has also probably affected export decisions of some firms; although, as mentioned before, measured in terms of unit labor costs, the loss of competitiveness has been much smaller. The minimum wage increases granted on June 1 (18 percent) are compatible with the maintenance of substantial competitive margins given the present rate of depreciation of the controlled exchange rate.

In concluding, my authorities are of the view that the program for 1985 is indeed thorough, as it seems to reinforce and carry forth the economic adjustment begun at the end of 1982. Strong measures have been taken to prevent temporary deviations from endangering the objectives of the program. The recent measures taken in the areas of exchange rate and commercial policy show the commitment of my authorities toward economic liberalization and the removal of structural rigidities. Additionally, my authorities stand ready to take the necessary steps to continue the fight against inflation and to ensure the medium-term viability of the balance of payments.

Mr. Almeida commended the Mexican authorities for the significant steps they had taken to correct domestic and external imbalances. The Mexican experience was a good example of the positive results that could be achieved when the authorities kept in close touch with the people and were fully determined to carry out a well-defined adjustment program.

He wished to register three concerns, Mr. Almeida remarked. The first concerned the appropriateness of the program. The strictness of the 1985 program was evident in the staff report. The marginal rate of consumer price change had declined by 27 percent in 1984 and was expected to continue declining at the same speed in 1985. Fiscal receipts, measured in terms of the percentage decline in the public sector deficit in relation to GDP, would increase from 27 percent in 1984 to 34 percent in 1985. Nominal credit and fiscal flows would be below those of 1984 despite the decline in the GDP deflator. Thus, the third year of the extended arrangement would be at least as restrictive as the second year had been.

His second concern was related to exchange rate movements, Mr. Almeida said. Apparently, the Mexican authorities had scheduled a daily depreciation in the exchange rate for 1984 in accordance with their inflation projections; they believed that any deviation from that rate would send the wrong signals to the market, interfering with their goal of slowing down inflation. But their perceptions had changed, and since December 1984, the authorities had raised the daily rate of depreciation twice. Such increases were no longer considered a weakening of the effort to fight inflation but rather a signal that the authorities would no longer tolerate any loss in competitiveness, taking into account movements in relative prices in Mexico and abroad. With the present exchange rate policy, actual depreciation should be sufficient to offset a 43 percent rate of inflation.

A third area of concern was the medium-term outlook for exports, Mr. Almeida observed. Although he could understand the need for caution in projecting oil exports, a rate of increase of 8 percent a year for non-oil exports until 1990 seemed too conservative. As a result of those assumptions, the overall annual export growth rate would be only 5.3 percent a year, a figure that appeared low considering that nonpetroleum exports had increased by 26 percent in 1984 and that the authorities desired to maintain the medium-term competitiveness of the peso. It was probable that the current account surplus in the medium term would be higher than projected, facilitating import liberalization and permitting a higher GDP growth rate.

He could not agree with the staff that wage increases had contributed to cost pressures and inflationary expectations, Mr. Almeida stressed. Unit labor costs had been consistently below the rate of inflation since 1981; average real minimum wages had fallen by 7.4 percent in 1984 and labor productivity had increased in the past two years by almost 9 percent. As noted in Mr. Ortiz's statement, unit labor costs expressed in foreign currency had declined by 48 percent in the past four years, putting downward pressure on inflation and boosting non-oil exports.

Finally, he agreed that the program had been well designed and would probably be more effective in 1985 than in previous years, but he urged Mexico's main economic partners to contribute to the success of the program by relaxing protectionism and trade barriers and by adopting domestic policies that would ensure lower interest rates.

Mr. Ismael commended the Mexican authorities for the further remarkable economic and financial progress they had achieved during the second year of the Fund-supported adjustment program, which had been on track despite some slippages.

Inflation had been further reduced in 1984, but the adjustment in public sector prices and the increase in the size of wage awards in 1984 and in January 1985 had impeded progress in the scaling down of inflationary expectations, Mr. Ismael remarked. Thus, he urged the authorities to exercise great care in the midyear wage adjustment to ensure that wage policy was consistent with reducing inflation. The authorities' commitment to reducing inflation in 1985 would be particularly important in restoring confidence and achieving sustained economic growth.

Although the public finances continued to be strengthened in 1984, program limits on the overall public sector deficit had been exceeded, Mr. Ismael observed. Therefore, he welcomed the authorities' firm intention to cut back the public sector deficit from 6.2 percent of GDP in 1984 to 4.1 percent of GDP in 1985. Such cutbacks were essential in order to slow inflation, reduce foreign financing, and strengthen domestic investment. Considering the ineffectiveness of structural reform measures in increasing revenue in 1985, the brunt of the fiscal adjustment would fall on current expenditure, and appropriate measures had been adopted to cut expenditure in February and March 1985. The authorities' decision to forgo activating the contingency reserve in order to contain the overall deficit limit was encouraging.

Substantial adjustments had been made in the prices of public goods and services in 1984 and 1985, and the authorities intended to reduce or eliminate the operating losses of state enterprises, Mr. Ismael noted. He also approved of the measures being taken to reduce the public sector's involvement in a number of economic activities.

The authorities were following cautious monetary and credit policies and maintaining a positive real interest rate to generate savings, Mr. Ismael continued. The reduction of financial subsidies, the regulation of the volume of loans from development banks and trust funds, and the recent placement of monetary regulation bonds with commercial banks, were all steps in the right direction.

The performance of nontraditional exports continued to be impressive, arrears were being eliminated ahead of schedule, and net international reserves had increased by US$3 billion, Mr. Ismael noted. Despite the authorities' commitment to exercise flexibility in exchange rate management, there had been some concern that the margin for maneuver to maintain the currency's external competitiveness had been too thin. The authorities should monitor exchange rate developments closely in order to facilitate timely action and ensure the peso's external competitiveness; they should also continue to adjust the pace of the daily depreciation in light of circumstances.

Finally, although he welcomed the elimination of exchange restrictions, which had been imposed because of the accumulation of external payments arrears, he shared the staff's concern about extending the Fund's approval of remaining multiple exchange practices, Mr. Ismael said. Given the uncertainties prevailing in the exchange markets, he recognized that caution was needed in seeking further exchange rate liberalization and eventual unification of the exchange markets, but he urged the authorities to eliminate those remaining practices as soon as possible.

Mr. Dallara recalled that as the first major debtor to come to the Fund in 1982 for policy and financial support, Mexico had exhibited a number of very grave economic imbalances. In that year, real economic growth had been negative; inflation had approached 100 percent; the current account had been in deficit by $5.6 billion; the public sector deficit had amounted to almost 18 percent of GDP; the money supply had grown by 17 percent; and the peso had fallen by more than 86 percent in the exchange market during an extended period when the peso had not been reflecting market forces. The economy had been in a downward spiral.

During the first two years of the program, generally impressive progress had been made in re-establishing the basis for economic growth, financial stability, and a sustainable balance of payments position in the medium term, Mr. Dallara observed. Real GDP had increased by 3.5 percent in 1984, inflation had been cut substantially to about 60 percent in 1984, and the fiscal deficit as a percentage of GDP had been reduced to almost one third of its 1982 level. As was evident from Mr. Ortiz's statement, the performance targets for the end of March 1985 had been met, and inflation estimates were better than might have been expected. Nevertheless, prospects for 1985 were more uncertain than those which had emerged from the Board's previous reviews of Mexican economic policies.

In summarizing Mexico's performance during 1984, Mr. Dallara remarked that good progress had been made in real economic growth, employment, the balance of payments, and wage restraint. Improvements had been only fair in the area of savings, investment and the fiscal balance, and probably somewhat disappointing with regard to inflation, monetary restraint, and import liberalization. The targets for growth and for the current account surplus had both been exceeded, and the rate of employment had continued to improve since its upturn in the middle of 1983. The investment and savings ratios had been somewhat higher than expected, although both remained below the level considered necessary for the period ahead.

Although the fiscal deficit continued to decline, it had overshot the end-of-year ceiling for 1984, due in part to the delay in interest payments by the Government to the Bank of Mexico, Mr. Dallara noted.

Indeed, it appeared that the true deficit in 1984 might have been closer to 6.9 percent of GDP than to the reported 6.2 percent. The delayed interest payments would have to be made during 1985, adding to the deficit and necessitating the introduction of a new ceiling on interest payments to avoid a repetition of the problem in 1985. Nevertheless, he was impressed by the authorities' ambitious target of reducing the 1985 deficit ratio to 4.1 percent of GDP. The restrictive measures that had been taken in February and March were welcome, as was the additional cut of Mex$200 billion in public sector outlays in the remainder of 1985. One question remaining was whether the budgetary cuts were aimed at observing the 4.1 percent ceiling in the deficit/GDP ratio or whether they were meant to reduce the deficit ratio even further. Achieving the agreed budgetary targets would not only enable the authorities to maintain the progress they had established earlier but also strengthen the credibility of Mexico's overall adjustment effort.

Despite the staff's positive assessment of monetary developments in 1984, Mr. Dallara continued, monetary aggregates had exceeded expectations and some real deposit interest rates were still negative. While recognizing that the expansion had been concentrated generally over the latter part of 1984, he wondered whether the monetary aggregates could not have been more carefully managed. Although the real interest rate on 3-month deposits at the end of March 1985 had been positive, the rate had been negative at the end of 1984 along with a negative rate on 12-month deposits--a problematic situation considering the need to avoid capital flight. In addition, under the new bank law of December 1984, there appeared to have been a substitution of one kind of direct credit control for another through the termination of the requirement that bank reserves be on-lent to the Government and through the introduction of a portfolio investment requirement. It would be interesting to know the purpose of the change and the subsequent prospects for reducing direct credit controls.

Recent inflationary trends indicated that government wage policies had had visible psychological effects, Mr. Dallara observed. The sharp decline in real urban minimum wages and real wages in manufacturing in 1983 must have helped to strengthen the financial positions of enterprises and foster investment in job creation. Recently, however, the minimum wage had been increased by a further 18 percent, an action whose appropriateness or inappropriateness was difficult to assess without knowing whether further adjustments would be made during the course of the year.

While the process of import liberalization was often difficult at the beginning of an adjustment program, progress had been insufficient under the extended arrangement, Mr. Dallara considered. True, it was not uncommon in the initial stages of an extended arrangement for substantial emphasis not to be placed on import liberalization; but during the course of adjustment efforts, delays in initiating liberalization at an early stage would inevitably mean more substantial liberalization later. Thus, his chair supported a policy of liberalization not only because it improved economic efficiency, but also because it helped reduce inflation. He therefore expressed some disappointment that at the end of 1984 only about 17 percent of imports subject to licensing had been liberalized, and that the cumulative goal for 1985 was to increase that figure to only 35-45 percent. The liberalization of 25 percent of imports for the third and final year of the extended arrangement reflected significant progress, but it was not altogether clear that the target of 35-45 percent was adequate. Also, the authorities were giving priority to export-promoting schemes such as temporary import regimes, retention of some export proceeds, and duty-free import of some inputs. While recognizing the positive intent of such measures, there was a danger that they could end up substituting for an appropriate exchange rate policy.

Although Mr. Ortiz had stated that the real effective exchange rate had depreciated in the past three months, there had been a steadv real effective appreciation of the exchange rate in 1983 and a furth appreciation in 1984, Mr. Dallara commented. Based on unit labor costs, it was somewhat unclear whether the peso's competitiveness had actually eroded--there may even have been some margin for appreciation following the earlier sharp depreciation of the peso. In light of reserve developments, close monitoring of the rate and appropriate action would be critical to avoid the buildup of a problem. Considering the movement in consumer prices and the increase in the consumer price index in early 1985, the price target for 1985 did not seem fully realistic; new assessments should be made on that front to take account of the most recent positive developments. In addition, the Board should not approve Mexico's remaining multiple currency practices.

Despite a number of favorable developments in the external accounts during 1984, the Mexican authorities should adopt a more positive and definitive stance in that area, Mr. Dallara remarked. True, for 1985 a surplus of about $2 billion in the current account could be expected. Also, private short-term capital outflows had decreased from 1983, although the net outflow of $3.4 billion had been less favorable than envisaged. Imports had risen rapidly during the first part of 1985, and there was some doubt as to whether the increase in nonpetroleum exports of more than 16 percent could be achieved. The significant loss of official reserves in 1985 was also a cause of concern, as it might imply changes in the exchange rate policy. And, although the prospects for the balance of payments were not pessimistic over the medium term, more emphasis could be placed on the role of foreign direct investment in strengthening Mexico's economic growth. While the Mexican authorities had publicly indicated their desire to encourage greater inflows of foreign direct investment, their statements lacked credibility in light of the continued maintenance of such investment performance conditions as local content and export requirements.

In the second year of the extended arrangement, the failure to comply with the fiscal performance criteria had had no effect on disbursements to Mexico, since purchases had not been tied to end-December performance targets, Mr. Dallara observed. He was therefore pleased that the phasing arrangement had been corrected for the last year of the arrangement, in accordance with the guidelines adopted by the Executive Board.

In retrospect, it was clear from the staff reports and from Mr. Ortiz's statement that Mexico had made very good progress during the first two years of the extended arrangement, Mr. Dallara stressed. Although such progress had been heartening both for Mexico's own economic prospects and for the broader prospects of the world economy, the slippages that had occurred in late 1984 and early 1985 could lead to serious problems if they were not corrected. He hoped that the authorities would make the last year of the program another year of progress--not mixed but clear progress--in moving toward the sustainable, low-inflation growth that was at the heart of Mexico's economic objectives.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/90 (6/5/85) and EBM/85/91 (6/7/85).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/142, Supplement 1 (6/4/85) and EBAP/85/145 (6/4/85) and by Advisors to Executive Directors as set forth in EBAP/85/145 (6/4/85) is approved.

APPROVED: April 15, 1986

LEO VAN HOUTVEN
Secretary

Table 1: Inflation-Adjusted Public Sector Resource Flows

(In percent of GDP)

	1981	1982	1983	1984
Sources	36.6	62.7	27.7	27.4
Total revenue	29.4	34.2	37.0	34.0
Inflation tax	1.4	3.9	2.6	1.3
Other revenue	28.0	30.3	34.4	32.2
Real indebtedness	7.1	28.5	-9.3	-6.7
Internal	1.6	4.7	-4.3	-1.1
External	5.5	23.8	-5.0	-5.5
Uses	36.6	62.7	27.7	27.4
Total expenditures	36.6	62.7	27.7	27.4
Capital	13.4	10.6	7.7	7.6
Current	22.7	51.1	19.5	19.2
Real interest =	1.5	24.8	-2.3	-0.2
(Nominal interest	5.6	8.3	12.9	11.9
± Exchange losses	2.4	48.4	18.3	12.0
- Inflationary depreciation)	-6.5	-31.9	-33.5	-24.0
Other 1/	21.7	27.3	22.3	19.9
Memorandum items				
Stock of total public debt 2/	41.2	90.2	82.1	65.8
Internal debt	17.6	29.0	27.8	22.4
External debt	23.6	61.8	54.3	43.4

Source: Banco de México estimates.

1/ Includes extrabudgetary deficit.
2/ End-of-period figures.