MASTER FILES
ROOM C-525

0404

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/129

10:00 a.m., August 27, 1990

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
	L. E. N. Fernando
C. S. Clark	D. Powell, Temporary
Dai Q.	
T. C. Dawson	B. S. Newman, Temporary
	J. Prader
E. T. El Kogali	
	F. E. R. Alfiler, Temporary
	R. J. Lombardo
	E. C. Demaestri, Temporary
	P. O. Montórfano, Temporary
L. Filardo	
R. Filosa	
M. Finaish	
M. Fogelholm	
M. R. Ghasimi	
G. Grosche	B. Goos
J. E. Ismael	
	L. M. Piantini
	F. A. Quirós, Temporary
	J.-F. Cirelli
Mawakani Samba	C. V. Santos
	P. Wright
	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
B. R. Burton, Assistant
T. S. Walter, Assistant

Also Present

IBRD: R. Kanchugrer, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; E. Brau, Deputy Director; M. A. El-Erian. Legal Department: J. L. Hagan, A. O. Liuksila. Research Department: E. L. Rojas-Suárez. Secretary's Department: C. Brachet, Deputy Secretary; G. Djeddaoui, R. S. Franklin. Treasurer's Department: W. L. Coats, Jr. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; S. A. Coorey, O. Gronlie, M. Kabedi-Mbuyi, E. R. J. Kalter, H. E. Khor, C. S. Lee, C. M. Loser, C. I. Medeiros, M. A. Pinon-Farah, E. Sumar, E. C. Suss, E. Williams. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. B. Chatah, G. García, Z. Iqbal, J.-L. Menda, A. Napky. Assistants to Executive Directors: T. S. Allouba, T. Berrihun, C. Björklund, B. Bossone, B. A. Christiansen, H. E. Codrington, A. Fanna, S. K. Fayyad, B. R. Fuleihan, J. Gold, S. Gurumurthi, M. A. Hammoudi, M. E. Hansen, A. Iljas, C. J. Jarvis, P. Kapetanovic, R. Marino, G. Montiel, M. Nakagawa, D. Saha, H.-J. Scheid, C. Schioppa, M. J. Shaffrey, C. M. Towe, S. von Stenglin, J. C. Westerweel.

1. MEXICO - 1990 ARTICLE IV CONSULTATION AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1990 Article IV consultation with Mexico and the review under the second year of the extended arrangement with Mexico approved on May 26, 1989 (EBS/90/144, 8/8/90; and Cor. 1, 8/24/90). They also had before them a background paper on recent economic developments in Mexico (SM/90/169, 8/20/90).

The staff representative from the Western Hemisphere Department said that recent developments in oil markets had raised the possibility that prospects for the Mexican economy would differ from those indicated in the staff report. Forecasting international oil prices for the ensuing months and their impact on the Mexican economy would be difficult to do with any degree of certainty. Developments elsewhere resulting from the recent oil price changes might also affect the Mexican economy. Some of those matters would be explored shortly as part of the world economic outlook exercise.

However, for illustrative purposes, if the price of the Mexican oil mix was US$25 a barrel--the equivalent of US$29 for the benchmark West Texas Intermediate--in the second half of the year, the value of oil exports in 1990 would be US$2.6 billion, or 1.2 percentage points of GDP higher than envisaged in the program for 1990, the staff representative explained. However, the program had been designed so that all the improvement--except for US$675 million allowed for in the operation of the band in the oil price adjustment mechanism--would be reflected in a strengthening of the fiscal accounts and in higher net international reserves. On an annual basis, if the price of Mexican oil remained at US$25 a barrel, the effect on export earnings would be positive--equivalent to 2 1/2 percent of GDP. A revised projection of the impact of oil prices on the Mexican economy would take other elements into account, such as the possible effects on interest rates and on the demand for other Mexican products by trading partners as a consequence of the higher oil prices.

Mrs. Filardo made the following statement:

> The staff papers presented for the 1990 Article IV consultation with Mexico and the review under the second year of the extended Fund facility describe adequately recent economic developments in Mexico. The Mexican authorities appreciate the staff's endorsement of Mexico's economic policies and their vote of confidence on the authorities' readiness to respond quickly to any adverse development.
>
> Mexico's economic performance has been under close review by this Board over the past two years; therefore, I will briefly refer to economic developments in the first half of 1990 and to the major policy actions undertaken since last April's Board meeting on

Mexico, and elaborate on some of the policy issues contained in the staff's appraisal--namely, recent trends in the balance of payments and competitiveness, and the evolution of financial markets, including recent changes in banking regulations and the strength of commercial bank portfolios.

Economic developments during the first half of 1990 are very encouraging. Economic activity is picking up, supported by favorable developments in agricultural and mining output, and strong fixed investment. Employment is growing. Public finances have strengthened markedly with the public sector borrowing requirement, the primary surplus and the operational balance stronger than programmed. Increased tax revenues and continued expenditure restraint, combined with the decline in domestic interest rates, greater availability of external financing and the conclusion of the debt agreement with commercial banks, have contributed to this outcome. Private sector financial savings continue to grow in real terms while commercial bank credit to the private sector is increasing in line with the economy's capacity to absorb it.

Corrective public sector price adjustments have produced a once-and-for-all price increase leading to higher inflation during the first half of the year. However, these adjustments have set the preconditions required for traversing to a lower inflation path in the coming months. The international reserve position has strengthened substantially, as favorable expectations have produced considerable net private capital inflows. Recent increases in the price of oil, coupled with a deceleration in the rate of growth of imports and sustained performance of non-oil exports, have fortified the prospects for the current account of the balance of payments. These favorable developments are the first indications of the benefits derived from an adjustment effort sustained over several years and the implementation of consistent macroeconomic policies.

During the past three months the Mexican Government has undertaken many important policy actions directed at deepening the stabilization effort and the process of structural change. Among the most important were the announcement on May 2, 1990 of the intention to privatize commercial banks which had been nationalized in 1982, the renewal of the Pact for Stability and Growth (PECE) toward the end of May, and the announcement, in June, of the initiation of negotiations to establish a free trade area between the United States and Mexico.

The announcement of the privatization of commercial banks had an immediate positive effect on investors' expectations leading to important capital inflows and a dramatic decline in interest rates. The interest rate on the leading instrument in the financial markets has declined by about 15 percentage points since the announcement of the bank privatization to a level of 29 percent. The decline in nominal interest rates has reduced real interest rates to about a 9 percent annual rate in June 1990 from an average real rate of about 35 percent in 1989. In the stock market, the value of the banks' shares skyrocketed. Recently, the monetary authorities have announced the specific guidelines under which the banks will be privatized.

The resources derived from the sale of banks will boost the public sector's financial position. The authorities are fully aware of the nonrecurring nature of these revenues; therefore, they will be used primarily to continue reducing the public debt. In 1989, net total public debt amounted to 58 percent of GDP, of which 40 percent corresponds to external debt and 18 percent to domestic debt. From 1986 to 1989, public debt has decreased by 23 percent in real terms. Any further reduction in the debt burden, coupled with the maintenance of strong public finances through their favorable effect on domestic financial markets, will make room for higher levels of private investment and will contribute to a further reduction of the inflation rate.

The renewal of the PECE on May 27, 1990, and the policy actions that accompanied it, seek to advance further the reduction of macroeconomic imbalances and to achieve the goals of consolidating price stability, obtaining a sustainable rate of economic growth, and improving the living standards of the Mexican people, particularly the poorer segments of the population. The main policy actions undertaken were to reduce the rate of depreciation of the peso with respect to the U.S. dollar, and to maintain minimum wages unchanged. These actions were complemented with an important adjustment in the price of gasoline and electricity and the agreement by enterprises to absorb within their profit margins the rise in costs that these measures might entail. While the immediate effect of these actions is a once-and-for-all increase in prices, over time--through their favorable impact on public finances--they will induce a fall in domestic interest rates and eventually lead to a reduction in the underlying rate of inflation.

The announcement of the free trade agreement gave a further boost to confidence among foreign investors and exporters. This action has been interpreted by the market as a signal of Mexico's commitment to free trade. In the past, exporters and producers have been worried that a balance of payments problem could lead to a reversal of trade liberalization. An agreement of the sort being sought gives assurance to investors about the permanence of trade liberalization. This agreement, by allowing Mexican exporters free access to a larger market, will increase productivity and enhance the competitiveness of the economy.

In order to advance the objective of attaining price stability, the Mexican authorities reduced the nominal rate of depreciation from Mex$1 to Mex$0.8 daily. This action was supported by a tightening of the fiscal stance and by maintaining minimum wages unchanged. The exchange rate action will effectively lower the floor of inflation from 15 percent to 10 percent per annum. There has been some concern that this measure, combined with the recent corrective price increases in public sector goods and services, might affect the competitiveness of Mexican firms or industries. However, to date there is widespread evidence that, on average, competitiveness has been maintained. During the preceding year and a half, the real exchange rate based on producer prices has been very stable. Even when competitiveness is measured using the consumer price index, which includes nontradable services like rents and tuition, the peso has appreciated in real effective terms by only 2.5 percent over the last year.

The competitiveness of Mexican firms can be better assessed by looking at the evolution of domestic production costs vis-à-vis those of foreign firms. From May 1989 to May 1990, unit labor costs increased by almost the same amount in the United States and Mexico, while productivity increased considerably in Mexico's manufacturing sector. In addition, it is worth recalling that the level of wages in Mexico is only a small fraction of that of the United States. With respect to imported inputs and intermediate goods, trade liberalization has closely linked their price to that prevailing in international markets. Finally, financial costs have been reduced considerably, reflecting the dramatic fall in domestic interest rates. Therefore, all the evidence shows that there has been no loss in competitiveness over the past year. Moreover, the outlook is that a lower rate of depreciation over the coming months will also lead to lower wage increases which, together with declining financial costs, will enhance the competitiveness of Mexican firms.

The conclusion of the debt agreement with commercial banks and the declining proportion of petroleum in total exports has reduced Mexico's vulnerability to exogenous shocks, such as increases in international interest rates or decreases in oil prices. These structural changes in the balance of payments, coupled with a strong fiscal position, have contributed to the enhancement of the role of the exchange rate as a nominal anchor in the economy. This is particularly the case now that the impact of trade liberalization on imports seems to be finally tapering off. Recent estimates show that imports will grow about 12 percent during 1990, after growing by 24 percent in 1989 and 55 percent in 1988.

Another important development in the current account of the balance of payments is that regarding interest payments. The debt agreement with commercial banks will reduce interest payments on external debt by US$1.8 billion in 1990 from 1989 levels. All these factors will contribute to a reduction in the current account deficit in 1990 compared with 1989. Based on projections made before the increases in the price of oil, the current account deficit in 1990 will amount to about US$5 billion, or 2.2 percent of GDP. This amount is similar to that observed during the 1960s, a period when Mexico enjoyed the greatest economic stability in its history.

Recent trends in the capital account of the balance of payments show that by the end of 1990, it will register a surplus greater than the expected deficit on the current account. Foreign direct investment, external credit, and capital repatriation are all expected to exceed the values observed in 1989. In addition, there have been important foreign capital inflows to the Mexican stock market. During the first seven months of the year, an estimated inflow of US$1.6 billion can be attributed to this phenomenon. It is worth mentioning that the greater part of capital inflows has taken place at a time when domestic interest rates have been decreasing and when the prospects for the oil market were uncertain, underscoring the fact that there has been a dramatic reduction in the "country risk premium" demanded by foreign investors in Mexico.

The overall outcome of the balance of payments has been much stronger than anticipated under the program. During the first seven months of this year, the international reserve position has improved considerably, notwithstanding the US$1,374 million that Mexico had to spend out of its own reserves on enhancements under the debt agreement. The strong reserve position has also allowed the prepayment of the bridge loans received in connection with the debt agreement.

In general, the balance of payments shows a healthy dynamics in which private capital inflows are financing imports, particularly of capital goods. This reflects a favorable investment climate, which will contribute to increased productive capacity, primarily in the export sector, which for several of the reasons mentioned above enjoys very good prospects.

During 1989, credit to the private sector grew rapidly, reflecting a re-intermediation of transactions that were already taking place off the banks' balance sheets, the low leverage in firms' financial positions, and greater confidence among investors and consumers. During the first half of 1990, growth in commercial bank credit to the private sector has slowed down, showing an increase in real terms of 9 percent, compared with 20 percent during the same period a year earlier. This growth rate reflects more faithfully the "true demand for credit" free of accounting distortions.

In spite of recent declines in nominal and real interest rates, private sector financial savings continued to grow in real terms in the first half of 1990. This trend in financial savings, given the projected balance of payments and fiscal outcomes, provides enough room for accommodating the increase in credit to the private sector contemplated for the rest of the year without exerting pressure on prices or interest rates.

As part of the effort to liberalize financial markets, Mexico began implementing a thorough financial reform on November 1988. Under the new banking rules, Mexican banks are allowed to determine interest rates and maturities on both deposits and loans freely, and to choose the best investment alternatives for such resources with the sole condition of maintaining a 30 percent prudential liquidity ratio. In a parallel fashion, the authorities have strengthened the supervision of commercial banks ahead of their privatization, including procedures for portfolio risk assessment and the implementation of risk-adjusted provisioning requirements.

The portfolios of commercial banks have improved substantially since the onset of the debt crisis in 1982. In December of that year, the index of nonperforming assets was 5 percent, while in December 1989 that index had a value of only 1.4 percent. Similarly, the banks' financial health has improved dramatically. In 1983, nonperforming assets amounted to 240 percent of banks' capital, whereas at the end of 1989 these represented only 36 percent.

After several years of correcting internal and external imbalances and structural problems, a solid and stable macroeconomic framework is emerging in the Mexican economy. Strong public finances act as the centerpiece of the framework. On the external side, a stronger balance of payments reinforces the sustainability of monetary and exchange rate policy. Admittedly, some risks remain. However, the outlook is much brighter than only a few years ago.

Extending her remarks, Mrs. Filardo said that she wished to share her impressions of how the Fund should respond to the changing circumstances brought on by the Middle East crisis, and the impact of the crisis on Mexico's economy and its program with the Fund. The oil price increase was a dubious blessing to oil exporting countries such as Mexico. After the oil price increases of the 1970s, many countries had diversified their economies to make them less vulnerable to external shocks. In addition, given the debt situation, both industrial and developing countries would find it more difficult to finance oil imports.

At the time the staff report and the background paper were issued, the main concern of the authorities and the staff had been the declining price of oil and the impact on the balance of payments, Mrs. Filardo noted. Mexico's performance under the extended arrangement had been encouraging even before oil prices reversed their direction downward. The adaptation of economic policies to changing circumstances and the agreement reached on a financing package with Mexico's external creditors had reinforced the authorities' efforts to consolidate their macroeconomic policies and structural reforms.

Their success was borne out by the significant amount of capital repatriation and direct foreign investment that had occurred, Mrs. Filardo remarked. Nevertheless, although exports had increased and the ratio of debt to GDP had improved--a trend that was expected to continue--the amount of debt was still substantial. As a result, the Mexican authorities had decided to use the windfall gains from the oil price increase to reduce debt, strengthen international reserves, and enhance the programs for alleviating poverty that had been described in the background paper.

Mr. Quirós said that Mexico had continued to make good progress with its overall policies to achieve its basic objectives of output and real income growth, reduced inflation, increased investment, and a strengthened balance of payments. Performance during the second year of the arrangement had been positive. The staff estimated that Mexico had observed all the quantitative performance criteria for end-June 1990. GDP was now estimated to grow by 3 percent in 1990, compared with 3.5 percent projected earlier, while the rate of inflation was expected to be in the vicinity of 25 percent throughout the year.

In the medium-term framework, GDP was projected to increase from 3 percent in 1990 to 6 percent in 1993, and remain at that rate through 1995, Mr. Quirós observed. At the same time, the rate of inflation was assumed to fall from 23 percent to 8 percent between 1990 and 1993, and to continue to decline, dropping to 6 percent by 1995. It would be interesting if the staff could elaborate on the assumptions behind the projections for the medium-term scenario contained in Table 15 on page 33 of the staff report.

Three major events had taken place during the period May-August 1990, Mr. Quirós continued. The first had occurred on May 2, when the Mexican Government announced the re-establishment of private sector banking. An important decision, it would assure the injection of much-needed new capital into banking institutions, as the Government would be putting up for sale a large share of the bank stocks it currently held, creating additional funds to use, inter alia, to increase required infrastructure investment.

Second, on May 27, 1990 a new extension of the Pact for Stability and Economic Growth was signed, Mr. Quirós noted. The Pact provided for a slower depreciation of the peso with respect to the U.S. dollar; no increases in minimum wages; a linkage of future wage increases to productivity; adjustments in certain prices of gasoline and electricity for industrial use; and an agreement by enterprises to absorb the increased costs resulting from public sector price adjustments.

Third, the world events felt by everyone during the recent weeks had had a strong repercussion on the market behavior of oil prices, Mr. Quirós remarked. Oil prices were of crucial importance to all countries, but were particularly important for Mexico's economy, which derived over 30 percent of its income from oil exports.

Management of the exchange rate would be determined largely by the impact of devaluation on inflation and the increased value of oil, Mr. Quirós commented. The authorities seemed to be willing to accept a real appreciation of the peso as long as it contributed to lower inflation. One could assume then that the expected income from oil exports plus capital inflows would compensate for any current account imbalance.

Mexico had been able to negotiate bilateral agreements in steel, textiles, and other industries, and had been focusing recently on a more comprehensive free trade agreement with the United States that should provide Mexico reciprocity for its trade liberalization policies of the past few years, fair treatment for Mexico's products, and additional foreign investment, Mr. Quirós noted. There was one major risk that needed to be considered for the future; it was directly related to the expected behavior of private investment. Price controls and the opening up of the economy seemed to have reduced profit margins, while interest rates had remained high in real terms--a situation that could create difficulties for some private investment in the future. Consequently, further reductions in price controls seemed in order.

It was clear to his authorities that Mexico's commitment to adjustment was permanent, Mr. Quirós concluded. The economic program was demanding, but the country was meeting every challenge with strong determination. His chair supported the Mexican authorities' request.

Mr. Dawson made the following statement:

> We share the staff's assessment that Mexico is making very good progress under its extended arrangement. We are particularly impressed by the strong fiscal performance during the first half of the year. The sharp decline in domestic interest rates, strong private capital inflows, and the substantial increase in international reserves are also very encouraging, and reflect the financial market's very positive reaction to Mexico's monetary,

fiscal, and structural reform program. This renewed confidence in the Mexican economy is a very hopeful sign for Mexico's long-term adjustment.

Mexico's strong performance and good prospects as they are reported in the staff report and background paper are particularly impressive, since they do not take account of recent developments in the international oil market. As with many of the Fund documents we will consider in the coming weeks, this paper is dated in some key respects. With the benefit of hindsight, it is curious to note, for example, that oil price developments only a short time ago led the staff to calculate new targets on the basis of an expected decline in the price of oil in the second half from US$15 per barrel to US$13.5 per barrel.

Higher oil prices could brighten Mexico's prospects considerably, assuming no other offsetting external shocks, and thus should offer the opportunity for even faster adjustment. In this connection, the program's provision for upward revisions in the fiscal and other program targets in the event that oil prices average US$16.50 or more for the year is most welcome.

In the meantime, with higher oil revenues, and pending upward revisions in the fiscal targets, we believe that the Mexican authorities should be seeking to increase the existing margins on the primary fiscal balance. If the fiscal targets are revised, it should also be possible to outperform the new targets. Given the considerable uncertainty about future oil prices, these margins could be helpful either as protection against potential adverse developments, or as a "head start" toward a more ambitious adjustment path. In this regard, it would be helpful to hear the staff's views on whether the projected overrun of 0.6 percent of GDP on noninterest expenditures in 1990 is compatible with maintaining the existing margins on the primary fiscal balance.

Turning to Mexico's performance under the program, our major concern involves the deterioration in Mexico's trade performance. Although the growth of imports is slowing, it still substantially exceeds export growth. We are concerned that continued growth in imports reflects not just the effects of trade liberalization and strong private sector investment in Mexico, but also the declining competitiveness of the peso. I would be interested in knowing how much the peso is projected to appreciate in real terms against the dollar for all of 1990 and for 1991 and whether this amount of real appreciation against the dollar is consistent with the existing medium-term projections for the trade balance.

The prospect of higher oil prices also raises a concern that the immediate, and possibly rather large, positive effect on oil revenues may detract attention from the longer-term need to ensure competitiveness of non-oil exports. Of course, we hope that other factors cited by the authorities and in Mrs. Filardo's statement as contributing to increased competitiveness will materialize. However, we would encourage the authorities to keep developments concerning the exchange rate and competitiveness under close review.

Before closing, I would like to commend the Mexican authorities for their efforts on structural change, which continue to play such an important part in the turnaround in Mexico's performance and prospects. Among the many important reforms under way, we particularly support Mexico's decision to privatize commercial banks. As the staff has noted, this announcement has already had a very positive effect on market confidence; over the longer term, the privatization of banks, along with the development of appropriate bank supervision, should also contribute to the development of the financial system in general. With respect to other financial issues, we agree with the staff that the authorities should eliminate disincentives to holding longer-term financial instruments--both to promote sound financial market development and to reduce Mexico's vulnerability to short-term capital outflows. We also welcome the reintroduction of debt-equity swaps as an additional tool for debt reduction and are happy to see that a substantial US$1 billion in claims were successfully converted in the first auction.

In conclusion, we are generally encouraged by developments in the Mexican economy since the last review. While risks remain, some of them may, for the time being, be upside risks. Accordingly, we hope the Mexican authorities' stated readiness to respond to adverse developments will be matched by their alacrity in accepting opportunities for more ambitious adjustment.

Mr. Cirelli made the following statement:

I want to stress at the outset our continued satisfaction over the remarkable performance by Mexico in implementing a strong adjustment program. At the time of the last review, we commented on the main reasons for this success--namely, the rapid pace of internal and external liberalization, accompanied by very strict fiscal and monetary policies. I concur with Mrs. Filardo's statement that the adjustment effort has been sustained and even reinforced in recent months.

Looking back at 1989 and the first half of this year, it seems that Mexico is now on the right adjustment path: GDP growth in terms of volume continues to be sustained; inflation will be higher this year, but mainly owing to major relative price corrections and the relaxation of price controls; the public sector borrowing requirement has been dramatically reduced; and the current account deficit is easily financed, not only through short-term capital, but also by ample direct investment. Furthermore, at the beginning of the year, the authorities demonstrated their commitment to react promptly to unexpected developments; monetary policy was tightened and fiscal restraint exceeded what was envisaged in the program. In the second quarter, the dramatic decline in real interest rates was a remarkable development.

We believe that Mexico is now in an excellent position to face future challenges. I will focus my comments on three points: exchange rate policy, macroeconomic policies in the context of the recent increase in oil prices, and structural policies.

With respect to the exchange rate policy, this chair fully supports the policy which has been conducted since 1987 and the recent move to reduce the rate of depreciation of the peso vis-à-vis the U.S. dollar from an annual rate of 13 percent to 10 percent annually. I do not share the view expressed by Mr. Dawson with respect to the authorities' decision on the depreciation rate, which appears to have been much debated in Mexico itself, and between the staff and the authorities. We share the authorities' views and believe that the policy conducted so far has met with great success. First, it has provided a useful anchor to price and wage expectations. Accompanied by stringent fiscal and monetary policies, it has contributed to the dramatic decline in the rate of inflation from 130 percent in 1987 to 20 percent in 1989. Second, despite some appreciation in real terms since January 1988, the exchange rate policy has not prevented a major diversification of the economy--oil exports were 30.5 percent of total exports in 1989, compared with 64.5 percent in 1985.

Furthermore, we believe the authorities' decision is fully justified when examining recent developments. I share the arguments presented by Mrs. Filardo. Let me only stress the following. First, the appreciation of the real effective exchange rate has been very moderate since the beginning of 1989. Looking at Chart 12 of the background paper, it even appears that, in terms of unit labor costs, the real effective exchange rate during the first half of the year was below the average of 1989. Second, despite some slowing down in 1989, exports of nonpetroleum products continued to grow by 10 percent in volume. We therefore believe that this decision to reduce the rate at which the peso is depreciated is a step in the right direction, which should lead the authorities toward a more stable exchange rate and contribute to the disinflation process if sustained by strict internal financial policies.

Another important element in assessing Mexico's present situation and prospects is the recent surge in oil prices and its consequences on macroeconomic policies. Recent developments in the oil market--should they persist--make obsolete most of the projections in the staff report. These events, however, constitute a mixed blessing for Mexico. On the one hand, they will strengthen the fiscal as well as the external position, but on the other hand, they could imply a reduction of growth in the economies of Mexico's main trading partners and higher interest rates. However, the increase in oil prices could be temporary; thus, the authorities should be cautious not to depart from their present policies. We welcome the authorities' position that any additional revenues coming from the increase in oil prices should be saved and used to further reduce the public sector borrowing requirement. Such a policy should have a dramatic impact on the economy through a further reduction in interest rates and the end of all financing of the public deficit by the banking sector. This course of action is guaranteed through the end of the year by the contingency mechanism which is built into the program; it provides that any additional revenues resulting from an oil price above US$16.5 a barrel should be added to the reserves, and additional fiscal revenues used to increase the primary surplus. In negotiating the program for next year--and provided recent trends continue--we would urge the authorities to take advantage of these windfall gains to complete the reduction of the public sector borrowing requirement more rapidly.

Another fiscal policy concern is the use of the substantial revenues that will stem from the divestiture of public companies--in particular, the commercial banks. I fully support the authorities' intention--expressed in Mrs. Filardo's statement--to use these revenues to continue reducing the public debt, and therefore strengthening public finances further. Necessary public investments in critical areas such as education, health, and infrastructure could then be implemented more rapidly.

The authorities should take advantage of the present situation to accelerate the pace of fiscal adjustment, thereby alleviating the burden which weighs on monetary policy and helping reduce the level of real interest rates, which, despite their dramatic decline, were still at about 9 percent in annual terms in June.

Turning briefly to structural policies, I would like to commend the authorities for the broad range of reforms they have introduced. Trade liberalization has been impressive. The program of privatization has been intensified with the recent divestitures of some of the largest enterprises and the announcement of the privatization of commercial banks. The reform of the tax system has met with great success. I particularly welcome the major steps which have been taken to remove major impediments to foreign direct investment. Foreign direct investment should pick up, making Mexico's external position less fragile. The staff mentions that new registrations "in the pipeline" amounted to US$5.4 billion at mid-1990. Nevertheless, I would encourage the authorities to pursue the reform and modernization of the financial sector actively, in particular with a view to better secure private sector financing, and to foster long-term savings, which are clearly needed.

Lastly, the authorities have announced their intention to pursue the establishment of a free trade agreement with the United States. Given the far-reaching implications of such a decision, I would appreciate it if the staff could elaborate on this issue, maybe at the time of the next report. Some preliminary views would be appreciated. Under the present circumstances, I will not comment on the medium-term scenario. The next review could provide the opportunity to explore the consequences of recent developments in the medium term.

Mr. Yamazaki made the following statement:

At the previous Board discussion on Mexico's extended arrangement in January, I started my address by saying "I am impressed by the rapid improvement in the Mexican economic performance in 1989." Today, I would like to refer to the same words for the very encouraging Mexican economic performance in the first half of 1990.

This satisfactory achievement should be attributed, first, to the laudable adjustment efforts taken so far by the Mexican authorities since the outset of the Pact for Economic Growth and Stability (PECE), which was launched in December 1988. The better than projected performance in the fiscal field in the first half of this year clearly stems from the corrective and tight measures adopted under the Pact. From this point of view, I am very much encouraged by the authorities' decision in May 1989--as mentioned by Mrs. Filardo in her statement--to renew the PECE, and to continue the restrained stance of Mexican fiscal policy in the future. I agree with the staff's view that the authorities should avoid any additional discretionary spending that would reduce the margin on the primary surplus and that a tighter than programmed fiscal stance would seem warranted as an appropriate mechanism to protect the balance of payments in Mexico.

A continued strong financial position is also needed to reduce the burden on monetary policy in the latter part of this year. Since we have observed a fragile situation with respect to containing inflation--despite the favorable developments in nominal and real interest rates and net domestic assets of the monetary authority in the first half of 1990--every possible measure should be employed to prevent the resurgence of inflation. These measures should include careful monitoring of exchange rate developments, although I acknowledge the difficulty of keeping a balance between the competitiveness of Mexican industries and the strength of the currency to prevent importing inflation.

Turning to the external sector, the disappointing current account deficit, which was wider than projected, was more than offset by the vigorous trends in the capital account of the balance of payments. As Mrs. Filardo mentioned, this illustrates quite clearly that there has been a dramatic reduction in the "country risk premium" in Mexico.

At this stage, a certain dynamic movement in the Mexican economy seems to have been activated. The effect of structural policies that the authorities have been implementing is one indication. A wide spectrum of structural adjustment measures in recent years, including divestitures of major public enterprises, a privatization plan for commercial banks, and financial liberalization, clearly have led to increased capital formation in the private sector and vigorous capital inflows into Mexico, thereby stimulating the momentum for growth. In this connection, I am of the view that further measures should be taken by the Mexican authorities to stimulate domestic savings. In order to sustain the growth momentum and a stronger external position, further accumulation of domestic savings would be required, taking into account the considerable decrease in gross national savings, especially in the private sector.

Another indication is the favorable conditions provided by the successful financing package for commercial banks, effected at the end of March 1990. Mexican economic performance in the first half of this year would provide a successful example in line with the so-called new debt strategy.

Having mentioned all these points, however, I must say that the Mexican economy is still fragile, especially under current uncertain world economic conditions. Uncertainty exists in the price of crude oil, which is a major export item from Mexico. Uncertainty also exists with respect to the flexibility of the world economy in responding to the unfavorable situation we are facing at this moment. All these uncertainties could totally change the scenario of the authorities and that of the staff. Under these circumstances, deliberate continuation of the efforts made by the authorities so far seems the most prudent course of action.

Mr. Goos made the following statement:

I, too, share the positive assessment by the staff of the implementation of the existing arrangement so far this year, and also find myself in broad agreement with the staff's policy recommendations. Now, rather than going into all the details of both the generally commendable achievements and further policy requirements, I shall be brief and only offer a few selective comments.

First--and consistent with the concerns I expressed in the two previous Board meetings on Mexico's adjustment program--I should like to endorse the staff's fiscal policy recommendations strongly. The much worsened inflationary outlook and the continuing weakening in the external current account as presented in the staff report suggest that the containment of cost and price pressures ought indeed to be given the highest priority. This objective should be pursued in an uncompromising manner, leaving no doubt about the authorities' commitment to financial stabilization. I think it would be disastrous if the higher inflation rates were allowed to work their way into higher inflationary expectations, given the adverse effects of such an event on domestic interest rates and public finances.

I noted, of course, from Mrs. Filardo's statement, the revised projections for the external current account. I also took note of the staff's tentative projections of the impact of the recent oil price increase on the external situation of Mexico. But, first, as others have said, the durability of the recent price increase remains to be seen; second, if it turned out to be durable, one would certainly hope that the improvements would be used to strengthen, rather than relax, the pace of adjustment.

The case for more restrictive demand management policies is underlined, I believe, by the indications in the staff paper of existing capacity constraints in the productive sector, continued strong domestic demand for manufactured goods limiting the export potential for such goods, and wage pressures. Against this background, I wonder whether fiscal stabilization should not be supported by efforts aimed at containing the expansion of private sector credit below the rate envisaged under the revised program. After all, I found it quite difficult to understand why the rate of credit expansion should be allowed to double from the original program target, even though prospects are for a significant weakening of inflation and current account performance. Further tightening of the credit supply to the private sector would also appear justified in view of the staff's concerns about the quality of commercial bank portfolios--indicating that some of the available funds are being used for inefficient purposes. Here, too, I noted from Mrs. Filardo's statement that that problem might be less acute today than in previous years. This aside, I generally feel that at a time of financial reintermediation, when the need for additional credit is particularly difficult to gauge, the appropriateness of the credit supply ought to be kept under continuous review and assessed against the actual inflation performance. Maybe the staff would care to comment on this issue.

This brings me to exchange rate policy, where, like Mr. Cirelli, I should like to associate myself with the views of the Mexican authorities as presented in the report and in Mrs. Filardo's statement. Exchange rate action, to be sure, should not be ruled out in case of a fundamental weakening of external competitiveness, but in the absence of such a weakening, the exchange rate, if supported by appropriate financial policies, can indeed play an important role as a nominal anchor--in particular, at a time of production bottlenecks and still strong domestic demand.

Finally, I was struck by footnote 2 to Table 16 on page 34 of the staff paper indicating that Mexico's external position might remain dependent on exceptional financing throughout the medium-term projection period. This, of course, would raise serious doubts about the adequacy of the agreed course of adjustment, and also raise doubts about the appropriateness of Fund financing. I, therefore, would welcome the staff's clarification. With these remarks, and subject to a satisfactory response to this last question, I can support the proposed decision.

Mr. Filosa made the following statement:

Mexico continues to make steady progress along the road of adjustment. All quantitative performance criteria for March 1990 have been observed, and various signs--such as the declining rate of interest, the large capital inflows, and the healthy investment activity--clearly indicate an improvement in economic confidence. Crucial to this achievement have been the good performance of fiscal variables, which have outperformed targets during the first quarter of the year, and the agreement reached with the banks and its beneficial effect on expectations, which is now being fully felt. But it is the authorities' continuing commitment to adjustment, which, I believe, is determining the overall success of the program. Their commitment became especially evident at the beginning of this year, when they engineered an increase in interest rates to counter pressure on the balance of payments and prices, thus restraining inflationary expectations. I am convinced that without that strong stance, we would not be witnessing the present decline in interest rates--a decline which denotes not only an improvement in inflationary expectations, but also a significant decline in the risk premium on Mexican financial assets. Given the authorities' strong commitment to adjustment and the Mexican economy's overall positive performance, this chair fully supports the proposed decision.

Having made these general remarks, I would like to focus my attention on three issues of special interest in the case of Mexico--the performance of prices in 1990, the exchange rate policy, and the financial system in Mexico.

First, with respect to the performance of prices in 1990, I would like to stress that this is the only part of the program in which achievements have fallen short of expectations. It now appears that an inflation rate above 22 percent will be realized for the year as a whole, against an expected rate of 15 percent. The staff attributes this upsurge in inflation to the fact that controlled and public sector prices were higher than originally planned. Nevertheless, I wonder whether the extra adjustment in controlled and public prices fully explains a rate of inflation which is 7 percentage points higher than the level of inflation targeted in 1990.

I would tend to believe that additional factors have been at work. In the presence of capacity constraints, the higher level of private consumption caused by increasing wage rates might have compounded the inflationary pressures of public price adjustments. This explanation is also supported by the results of the revised medium-term scenario presented by the staff, which indicates that the inflation path now envisaged for the period 1990-94 is consistently higher than the inflation path designed at the time of the first review. This deterioration in the medium-term inflation outlook cannot be explained by the adjustment in public prices which took place in January 1990, since that adjustment should have, broadly speaking, "once-and-for all" effects. Instead, the less favorable inflation outlook can find its origins in the lower investments to GDP ratios and higher consumption levels which are now expected to prevail in the medium term. I would therefore welcome the comments of the staff on the possible role that wages and private consumption might have had in determining the higher inflation during the current year.

The problem of inflation leads me to discuss the second point on my list, namely, the exchange rate policy of the Mexican authorities. It is indisputable that, ceteris paribus, the reduced pace of depreciation and the recent acceleration of inflation could well affect external competitiveness. However, I believe that it is legitimate to question the ceteris paribus assumption in the case of Mexico, where inflation still has a strong inertial component.

Thus, to the extent that a slower rate of depreciation has a positive impact on inflationary expectations, a more stringent exchange rate policy might well lead to a lower rate of inflation and, therefore, reduce the need for continuous depreciations. In the case of Mexico, I also believe that the timing of the decision is basically correct. In fact, the fiscal adjustment is well advanced, and the prospects for continuous inflows of capital appear increasingly favorable after the conclusion of the agreement on external debt and the announcement of the privatization of domestic banks. Therefore, I associate myself with Mr. Cirelli and Mr. Goos in giving my support to the Mexican authorities' exchange rate policies.

Finally, let me touch on the situation of the financial system in Mexico. The staff makes references in the report to the fact that the quality of banks' portfolios might be declining as a result of financial liberalization. Nevertheless, I could not find, either in the main report, or in the background paper, arguments or data which could support the staff's proposition. As a matter of fact, the only data provided by the staff on private sector credit show that a normal process of banking reintermediation is taking place within a strengthened supervisory framework. Furthermore, as indicated by Mrs. Filardo in her statement, a substantial improvement in the index of nonperforming assets has been recorded from 1982 to December 1989, and I understand that this trend has not been reversed in the past few months. In light of the fact that financial liberalization does not necessarily imply an increase in the riskiness of banks' portfolios, I would have preferred to see a more detailed presentation and analysis of the argument posed by the staff.

The staff representative from the Western Hemisphere Department said that, as Mr. Filosa had indicated, demand--spurred by a relatively rapid increase in wages--had certainly been an element affecting price performance in late 1989 and early 1990. However, the authorities had reacted at the time by tightening financial policies, as reflected in higher interest rates and an improvement in the fiscal accounts relative to the program. Nonetheless, inflation had remained somewhat higher than expected, as the staff report indicated.

The corrective price adjustment described in the staff report was a significant element in that the extent of price controls might have been underestimated by both the authorities and the staff; therefore, liberalization had had a greater impact on consumer prices than had been expected, the staff representative remarked. The increase in producer and wholesale prices was considerably smaller; the difference between the two price indices suggested that the underlying rate of inflation was declining relative to what had been observed in the first half of the year.

With respect to public finances, the 0.6 percent overrun in expenditure reflected certain aspects of the tax system--in particular the tax sharing arrangement with the states where, when certain taxes increased, part of the increase in revenues went to the state governments, the staff representative explained. That state share was shown as an expenditure of the public sector, owing to the way the accounts were kept, but, in fact, the net impact was positive. The staff had included the 0.6 percent overrun in its projections, and believed that the margins in the fiscal program could easily be maintained, given the performance of non-oil revenues, the staff representative continued. Non-oil revenues were performing very well, so even without oil, the margins could be maintained, although discipline on expenditures for the remainder of the year would still be needed.

As to credit growth in the private sector, the process of reintermediation in 1989 and 1990 had seen a formalization of operations that had previously taken place outside the official banking system--in fact, outside the balance sheets of the commercial banks, the staff representative commented. Hence, as the financial system was liberalized, transactions managed by the commercial banks, but off the balance sheets, were incorporated into the balance sheets and contributed to the growth of credit.

A second element in the growth of credit to the private sector was the continuation of the Bank of Mexico's tight monetary policy, the staff representative remarked. That policy was reflected in the maintenance of significant margins in the Bank of Mexico's net domestic assets, and preliminary indications were that those margins had increased in June and subsequent months; therefore, the Bank of Mexico had continued to pursue a very cautious monetary policy. Credit aggregates were still controlled through the net domestic assets concept. In keeping with a tight monetary policy, interest rates had increased at the beginning of the year, and then declined, partly owing to a changed perception by the markets of the prospects for the Mexican economy. Given those factors, the staff was of the view that the increase in credit to the private sector was consistent with the maintenance of a tight monetary policy. In addition, on the basis of information through July, net international reserves--an indication of the outcome of the monetary authorities' policies--had continued to increase beyond what was shown in the staff report, which was further evidence of the monetary authorities' judicious use of instruments to restrain demand.

Concerning the issue of the real effective exchange rate and the prospects for the remainder of the year and for 1991, the staff's projections for the period were based on a constant real effective exchange rate, the staff representative noted. The projection for inflation for the remainder of the year was about 8 percent, and the exchange rate depreciation for the remainder of the year about 5 percent. The difference of about 3 percent could be attributed to foreign inflation and the depreciation of the U.S. dollar relative to other currencies, both of which also affected the calculation of the real effective exchange rate. Developments so far had been consistent with that situation. Oil price increases could affect the calculations and even the underlying variables to produce very different results, but it was too early to tell.

As to the need for restructuring external debt in the medium-term projections, no formal restructuring of official debt or debt with commercial banks was implied, the staff representative observed. The reference had been to a projection of capital flows with exposure maintained or increased somewhat.

The negotiations for a free trade agreement between the United States and Mexico had just started, and a comprehensive assessment could be made only later in the year, the staff representative noted. The Mexican authorities had entered into the negotiations with the idea that such a pact would certainly open markets, but it would also impose discipline, domestically, to the process of liberalization. In their view, the trade liberalization process started in the 1980s would be consolidated and difficult to reverse in the context of a free trade agreement with the United States, with comprehensive reductions in tariff and nontariff barriers by both sides.

Looking at inflation and GDP growth over the medium term, the staff representative said that the rate of growth in GDP was projected to increase from 3 percent currently to 6 percent in the future, owing to the fact that structural changes would start having their effect on the economy as they became entrenched. Consequently, private savings and investment would expand. There was, in fact, an improvement in the efficiency of capital with respect to the projections that had been made by the staff; therefore, the rate of growth could be consistent with the somewhat lower rate of investment. Inflation would not come down overnight. Fiscal and monetary policies, together with the exchange rate policy, would have to provide the framework for a decline in the rate of inflation, but events elsewhere would also have an impact.

Mr. Al-Jasser said that the Mexican authorities had made impressive progress in the implementation of the extended arrangement. The economy had responded well to the strengthening of financial and structural policies earlier in the year. While he generally endorsed the staff appraisal, he would like to stress three issues. The first was the exchange rate policy and the corresponding staff position. Undoubtedly, a competitive exchange rate was critical for the success of the adjustment program. However, he was not persuaded by the staff's contention that the recent increases in domestic prices--which incidentally reflected the desired price corrections--should have led to a more accelerated pace of depreciation. In that context, he agreed with Mrs. Filardo. Such a step could have triggered the exchange rate-domestic price spiral which should be avoided at all costs. Moreover, he would not be alarmed by a modest appreciation of the real effective exchange rate; after all, an appreciation would reflect enhanced economic efficiency and was a correction of the speculative overhang. In any event, a response to differential inflationary pressures should be sought in restrictive fiscal and monetary policies, where such pressures were likely to emerge, rather than by tampering with the exchange rate. Moreover, it was undesirable to seek an exchange rate adjustment in anticipation of domestic price increases. On a more general plane, he wished to emphasize that an overly activist attitude toward exchange rate adjustments in individual countries might not be consistent with global stability and international equity. Therefore, it is highly desirable that the staff should consider, among other factors, potential effects on other countries when recommending exchange rate changes to individual countries.

The second issue concerned structural reforms, especially of the public financial sector, Mr. Al-Jasser remarked. Privatization of public enterprises seemed to have been associated with an excessive increase in commercial bank credit to the private sector, and might have led to a weakening of the quality of banks' asset portfolios. Hence, enhanced supervision to strengthen banks' financial positions was appropriate, but should not ultimately lead to delays in privatization or in increased controls over lending operations.

The medium-term outlook for the Mexican economy was difficult to assess in view of recent oil price developments, Mr. Al-Jasser concluded. Any future policy responses would obviously be conditioned by those developments and would have implications for external debt servicing. However, as the staff had alluded, continued tight financial policies would be needed to restore a better balance between national savings and investment. It was not clear how the required almost 50 percent increase in the ratio of savings to GDP would be achieved over the next five years. In particular, if domestic real interest rates continued to decline, private savings could be hurt. He supported the proposed decision.

He would appreciate additional comments from the staff on the question by Mr. Goos on whether the staff considered the real effective exchange rate to be high, and whether a devaluation was needed as a result, Mr. Al-Jasser said. If so, he wondered whether an inflationary bias would be internalized.

Mr. Demaestri made the following statement:

I would like to emphasize that Mexico's performance under the extended arrangement with the Fund has been very positive and that the commitment of the Mexican authorities to the economic program supported by the Fund is commendable. In addition, the current positive fiscal stance and petroleum price increases provide the Mexican authorities with well-deserved room for maneuvering financial policies. Undoubtedly, the completion of this program review should be approved, and I support the proposed decision.

I am in broad agreement with the staff's appraisal and policy recommendations. For emphasis, I would like to elaborate on two main issues which, I believe, are interrelated--first, the prospects of savings and investment, and, second, the process of financial market liberalization.

Improvement of domestic savings and investment--as clearly shown in the medium-term scenario prepared by the staff--is crucial if Mexico is to achieve strong and sustained economic growth. In order to realize the rates of real GDP growth projected in that scenario, a substantial increase in private sector domestic investment and savings is required. For instance, private sector savings are projected to increase more than 60 percent in real terms in the three-year period between 1990 and 1993. But what we are now seeing, in fact, is a decrease in private sector national savings, which have been declining for two years. To me, this large increase in private savings would seem very difficult to achieve, even under the assumption that economic progress continues and the Mexican authorities successfully implement the program as expected.

If the projected private sector savings increase is not achieved, either the domestic investment and growth objectives will not be reached, or more external savings will be required. Although financial savings are increasing as a consequence of the process of financial liberalization, this increase might not be large enough to realize the required increase in national savings. Discussing savings leads me to my second point, the process of financial liberalization.

I would like to emphasize two issues related to the process of financial liberalization in Mexico. First, I would like to underscore that the timing for this process has been very good. The Mexicans first worked on correcting domestic imbalances and improving the fiscal and monetary stance of the economy. Then they decided to liberalize interest rates and the operations of financial markets. And lastly, they have decided to privatize the commercial banks. This approach is commendable. Had the Mexicans liberalized the financial system and privatized the commercial banks simultaneously, it could have implied less control by the authorities of the process of growing domestic credit associated with the sharp increase in financial savings.

Private sector behavior in the context of a changing financial system and fast growth in deposits and credit could have led to a deterioration in the financial structure of the Mexican economy. Furthermore, it is possible that the divestiture of public banks could provide more resources to the Mexican public sector in the current circumstances than in the past, when the financial system was smaller and perhaps less profitable. In addition, it could also have been dangerous to liberalize the financial market and privatize commercial banks without first improving the fundamentals of the economy. Negative experiences of financial liberalization in other developing countries provide good arguments in favor of the Mexican approach.

My second point with respect to financial liberalization in Mexico is related to the staff's cautionary statements about possible weaknesses in commercial banks' portfolios associated with the large increase in credit to the private sector observed during the past two years. As this point has already been considered, I will not elaborate on it. In any case, I would like to support the staff recommendation to the authorities that the supervision of commercial banks be strengthened ahead of their privatization.

Finally, I will briefly refer to three other points concerning the Mexican economic program on which I have some questions. The first point relates to the sustainability of the Pact for Economic Solidarity (PACTO) and the lifting of price controls. The Mexican authorities have been liberalizing certain prices--an action which the staff viewed as one of the main causes of the higher price increases observed this year. I would like to know whether the staff sees this lifting as a gradual way out of the price controls, which are an important component of the PACTO. I would also like to know the current effects of lifting the price controls on wage negotiations.

Second, I would also like to receive clarification from the staff with respect to the financial package agreed upon between Mexico and its commercial bank creditors. The staff pointed out that the exchange of instruments under the financing package reflected a larger share of discount bonds at the expense of new money--primarily because of changes in the choices made by Mexican banks, which, I understand, are under the control of the public sector. I wonder whether the staff would like to comment further. In particular, I wonder whether the Mexican banks' behavior was the result of their own decisions, or whether any macroeconomic considerations influenced their behavior.

My last point refers to the possible uses of increased resources stemming from higher international petroleum prices. I concur with the staff and the Mexican authorities on the appropriateness of devoting the proceeds from sales of public enterprises to increase domestic investment and/or diminish public sector debt. I believe that this approach should also be applied to any permanent resources that Mexico could obtain from a better balance of trade as a consequence of increases in petroleum prices. If the increases in the price of petroleum currently resulting from the crisis in the Middle East bring a permanent increase in the

Mexican terms of trade, my chair believes that these increases should also be devoted to improving domestic investment and reducing public sector debt.

Mr. Wright made the following statement:

Mexico's adjustment program is clearly going well; there has been a further consolidation of the fiscal position and an acceleration of the authorities' program of structural reforms. The debt reduction agreement negotiated with the commercial banks also seems to have had clear benefits, although they are difficult to quantify precisely. Mexico is a clear example of a combination of strong adjustment policies and an improvement in the external debt situation bringing about an increase in confidence and improving the prospects for the country.

We have already had a very comprehensive discussion. I have a number of points, however, which I hope may add to those already made by previous speakers.

On inflation, the paper and the earlier discussion all suggest that this problem may be proving fairly intractable in an underlying sense--that is, even allowing for the effects of additional price increases. Moreover, the forecasts for the rate of inflation in the medium-term scenario look relatively unambitious. In this light, any slippages are likely to be damaging to the credibility of the authorities' anti-inflationary stance.

I might, in this connection, add my voice to the concern about the rapid rate of credit growth to the private sector. An increase of 9 percent in real terms in the first half of this year, although much lower than last, is still uncomfortably high. Mrs. Filardo, in her statement, and the staff remind us that there is a substantial process of reintermediation going on, that interest rates remain high in real terms, and that the central bank is pursuing a cautious monetary policy. All of this is reassuring, but the important point is that because there are no benchmarks for assessing the amount of monetary growth which is noninflationary at times of structural change, such growth needs to be watched carefully.

There is a clear difference of opinion between the staff and the authorities and in this Board on policy on the real exchange rate. The increase in oil prices will clearly strengthen Mexico's external position and tend to tip the balance in favor of the authorities' policy. However, the Mexican economy has been undergoing a process of transformation from an economy heavily reliant on oil exports to one with a broader industrial base.

Notwithstanding my concern about inflation, I share Mr. Dawson's view that the authorities should think very carefully before jeopardizing this process by allowing the competitiveness of Mexico's other export industries to be undermined.

The nominal exchange rate has an important role in maintaining competitiveness; however, it is imperative that domestic inflationary pressures are addressed and that nominal depreciation is not seen as a way to avoid dealing with them. Provided the domestic impetus to inflation is sorted out, I would be hopeful that controlled and judicious depreciation need not prove inflationary. I might note in passing that I share Mr. Goos's concern about the reference in the staff paper to capacity constraints in Mexico. Although these are reported to have receded, the emergence of such constraints could have serious implications for inflation and the diversification of activity. Perhaps the staff could comment on this.

Other speakers have concentrated largely on the fiscal consequences of higher oil prices. There is a danger that the increase in world oil prices will further increase distortions in the Mexican economy. Domestic prices of petroleum derivatives have fallen significantly in real terms since 1988, and the 7 percent increase in gasoline prices agreed in May was significantly below the rate of inflation. As a consequence, domestic consumption of petroleum derivatives has been increasing steadily and may be crowding out exports. There is obviously a significant opportunity cost here, which will increase to the extent that domestic petroleum prices do not rise in line with world oil prices. Indeed, unless domestic petroleum prices are increased quite sharply, distortions in the economy more generally will be intensified.

PEMEX's obligations to supply oil to the subsidized domestic market are also affecting its own finances. I note that investment has been cut back over the past couple of years, and that production is now suffering from capacity constraints. This reinforces the case for an increase in the prices of domestic petroleum products. I would suggest that at the very least the differential between world and domestic petroleum prices that prevailed before the recent oil price increases should not be increased. Ideally, it should be reduced, although I can understand the political difficulties in the way of achieving this.

Like others, I welcome the authorities' recent moves to reform the financial system, and in particular their intention to privatize previously nationalized commercial banks. There are two points I would make about the process, however. First, I hope that the rules governing the allocation of shareholdings are not excessively restrictive. I understand that there are to be strict limits on both individual shareholdings and on foreign ownership and that foreigners will be able to hold only nonvoting stock. Although it is easy to understand the reasons for restrictions of this sort, it is clearly important that they do not have the effect of deterring potential investors, reducing the proceeds from privatization, or weakening shareholder control over the managements of the newly privatized institutions.

My final point concerns the sequencing of the proposed financial sector reforms. It is important that the authorities have an appropriate regulatory framework in place before privatization. It is also important that the accounts of financial institutions that had been privatized are fully sorted out. Certainly, the authorities should avoid the situation in which they have to assume substantial contingent liabilities in order to get the institutions off their hands.

Mr. Prader made the following statement:

Aside from the ambiguities introduced by recent developments in the price of oil into what was formerly an almost clear picture of the Mexican economy's immediate, short-term, and even medium-term outlook, I think we may take considerable comfort from the past six months' performance. Substantial improvements in the conduct of fiscal policy, the confidence born of success in the debt-reduction operations, the announcement of free trade negotiations with the United States, and the plan to privatize the commercial banks have all contributed to the favorable climate which has characterized 1990--up until the events of August 2 cast doubt on the stability of external factors. Relative prices had to be adjusted in connection with the deepening of structural reforms, but the adjustments were neither large nor of a nature to require revision of the program targets, as has been vigorously pointed out in Mrs. Filardo's statement.

The direction of the effects on the world economy of this month's serious developments is predictable, but their magnitude and durability are not, depending as they do on the response of individual players and the degree of coordination among them. These uncertainties are of such a nature that they hamper the credibility of even a multidimensional, multivariable analysis of their costs and benefits for Mexico. Let me briefly discuss some of the uncertainties with respect to the movement of exogenous variables affecting the stance of economic policies, and the difficulties of assessing the costs and benefits to the Mexican economy of a substantial increase in the price of oil and its major consequences in other areas.

First, because a substantial portion of Mexico's external debt is still quite sensitive to international interest rates, if the example of the Japanese commercial banks is followed by banks in the other industrial countries, Mexico will have an extra burden to cope with in terms of both the budget and the balance of payments position.

Second, in view of Mexico's continued reliance on a controlled price system and the high upward elasticity of inflationary expectations in response to announced price increases and public tariff corrections, how feasible is it for the Government to adjust the domestic price of oil to reflect changes in the world market? If such an adjustment were gradual, it would subsidize not only Mexican consumers, but also those in the border towns of neighboring countries. If it were substantial, it could create a surge in inflationary expectations and increase the pressure on monetary policy to contain inflation. If a further tightening of monetary policy became necessary, what would be the effects of the resulting peso appreciation on Mexico's exporting sectors, especially in view of the expected slowdown in the economies of Mexico's main trading partners? Considering the still high ratios of nonperforming assets to capital of Mexico's commercial banks, and their exposure to the exporting sectors, a monetary tightening might slow the pace of financial deregulation and the privatization of commercial banks. If so, would the capital inflows encouraged by the higher interest rates be sufficient to offset these effects? And in view of the medium-term importance of the export sectors in leading the adjustment of the whole economy, should they be supported by other incentives?

Still on the adjustment of domestic oil prices, would such adjustment enhance the fiscal and balance of payments positions by creating additional exporting capacity? To what extent would fiscal policy be affected by a streamlining of tax reductions to compensate for the losses of wage earners and expand opportunities to choose suitable consumption patterns in line with changed relative prices? And would public acceptance of such a mechanism help to ease rigidities during deregulation of the pricing system?

On the benefits side, it is somewhat clearer that in the present policy environment a rise in the price of oil will have a strengthening effect on the fiscal and external position, and lead to a better reserve position for the Bank of Mexico. The key factor, of course, is the utilization of the additional revenues. Should these funds be set aside until global relative prices attain a new equilibrium, facing a mild recession during the wait with some resilience; or should they be used for economic growth, which--given existing capacity constraints--would involve more risk on the inflation front? In this context, it is reassuring to hear

Mrs. Filardo's announcement today that the oil price increase will be prudently managed. I also take note of the staff's confirmation that all of the oil price improvement will be reflected in a strengthening of the Fund program. Nevertheless, because important variables lie outside the control of the authorities, circumstances could always force changes in their position; in particular, the actions the major industrial countries are going to take are not foreseeable. In the absence of any clarity on the latter point, is important for the authorities to use the greatest caution in their daily operations in order to avoid distortions in the delicately balanced domestic markets and to stay within the margins of the program until the dust settles.

I support the proposed decision.

Mr. Ismael said that he joined earlier speakers in commending the Mexican authorities for their broadly successful adjustment efforts under the extended arrangement. He was pleased to note that those efforts had contributed to a substantial improvement in the overall economic performance over the past two years. It was therefore important that the authorities continue with their firm implementation of financial and structural policies envisaged under the program, thereby building on the progress achieved so far. Particular attention should be given to reducing the rate of inflation further and improving the external position, which remained fragile.

The sharp increase in inflation earlier in 1990 was due largely to once-and-for-all public sector price adjustments, Mr. Ismael agreed. But there was, of course, no guarantee that there would be no further adjustments in public sector prices in the future. He was therefore pleased to note that monetary policy during 1990 was projected to be tighter than programmed.

On the external front, he was pleased to note that international reserves were expected to increase in 1990, owing primarily to an expected further increase in private capital inflows, including portfolio investment and capital repatriation, Mr. Ismael remarked. The result so far had been a gradual decline of real domestic interest rates. The perceived reduced risk and the daily depreciation of the peso by 0.8 percent since the beginning of 1989 had induced repatriation of flight capital and renewed interest on the part of foreign investors. He had no information on how returning funds were being applied, but had the impression that funds were remaining liquid and could be susceptible to a reversal of sentiment. In other words, Mexican capital possibly had not yet committed itself to long-term investment. He asked for comments by the staff or Mrs. Filardo. In addition, he asked to what extent the renewed interest on the part of foreign investors had been converted into productive investment.

In view of the results achieved so far and the projected tighter monetary policy in 1990, he tended to agree with Mrs. Filardo that a large peso adjustment was not needed, Mr. Ismael stated. Nevertheless, he also agreed with the staff that exchange rate developments should be monitored closely. That capital continued to return to Mexico--and the economy performed strongly in consequence--was of great importance. Only in such a way would the relief achieved by the Brady Plan, above and beyond a conventional rescheduling, help break the vicious circle of balance of payments decline and debt accumulation. He supported the proposed decision.

Mr. Clark said that he would like to join other speakers in commending the Mexican authorities for their capable economic management under the program, and offered his chair's support for the proposed decision. Like other speakers, he had some serious concerns about the prospects for inflation, both in the short and medium term. He had been struck, as had others, by the medium-term scenario, which included a projection of growth rising to 6 percent, and staying at that high level, while a steady and substantial reduction in inflation was provided. Although he certainly could accept the role of expectations in terms of the inflation situation in Mexico, an economy growing at 6 percent for sustained periods might face some real resource constraints and, therefore, inflationary pressures. This highlighted the importance of the staff's response that nothing could be automatic and the supply side of the economy would have to respond in terms of the necessary increases in investment and savings. At the same time, he emphasized that to obtain the expectational response needed, there would have to be an appropriate policy framework based on very strict fiscal and monetary conditions.

Moreover, he also had some concerns about the prospects for inflation in the short term, as the numbers seemed to indicate that in the first six months of the year, the cumulative increase was about 15 percent; a simple extrapolation would put the rate for the year at roughly a little over 30 percent, Mr. Clark observed. The authorities' target was 23 percent for the end of 1990, which clearly would require a rate of less than 7 percent in the second half of the year. Other Directors had also expressed concern that the correction in inflation and inflationary expectations was substantial, notwithstanding the role of regulated prices in early 1990.

The agreed wage freeze would come to an end in February of 1991, and the head of the confederation of Mexican workers had already indicated he would be seeking a 10 percent increase in wages, Mr. Clark noted. Therefore, the key challenge in terms of expectations with respect to inflation in the whole transition--or as Mrs. Filardo said, the traversing to a lower inflation path--in the second half of the year and again in 1991 would be wage restraint, along with the need to ensure satisfactory tightening of monetary and fiscal policies in that transition, notwithstanding the impact of higher oil prices.

Mr. Fernando said that several observations had been made on the impact of higher oil prices on the Mexican economy and the opportunity they presented for the authorities to intensify and accelerate the adjustment process. Naturally there were major uncertainties with respect to the availability and the price of oil. Mrs. Filardo considered that the price increase was a negative factor. Nevertheless, an immediate benefit was a substantially higher level of earnings for oil exporters. At the same time, there would be an immediate cost for non-oil producers. Given a higher price for oil, the Mexican authorities should consider a management strategy for the economy that could soften the burden on countries adversely affected. Continued sound stabilization policies could further strengthen the return of flight capital. Mexico could consider using the additional resources to reduce its outstanding public sector external debt. To the extent that oil exporting countries contributed to the resolution of the debt problem in that way, a greater capacity would be created within the debt strategy to alleviate the debt problems of heavily indebted non-oil producing countries--particularly those with a high level of official debt, which would be looking for greater relief as pressures on their balance of payments intensified. Higher real interest rates were in prospect and could neutralize some of the benefits of higher oil prices accruing to heavily indebted countries--an important consideration that should be tempered by the prospect that even before the present problems, there had been an expectation of higher real interest rates. The adverse effects of the Middle East crisis on developing countries included not only higher oil prices, but also disruptions to particular export markets and services, such as worker remittances. He would welcome any comments on the policies and prospects for strengthening the debt strategy if oil exporting countries with significant external debts used their additional oil revenues to reduce their external debt.

Mr. Hogeweg said that, like other Directors, he greatly admired the policies pursued in Mexico and fully supported the proposed decision. He would like to comment specifically on the views of the staff and the authorities on exchange rate policy. He strongly sided with the authorities in their endeavor to enhance the role of the exchange rate as a nominal anchor and agreed with the remarks to that effect by Mr. Cirelli, Mr. Goos, and Mr. Filosa. The lower rate of depreciation would--as Mrs. Filardo had put it--effectively lower the floor of inflation from 15 percent to 10 percent per annum and would have a key role in reducing inflationary expectations--an appropriate result, given the emerging stable macroeconomic framework in Mexico.

The authorities were evidently fully aware of the need to safeguard Mexico's competitiveness, but presented convincing arguments as to why competitiveness was not threatened by their exchange rate policy, Mr. Hogeweg noted. The staff's thinking seemed to equate immediately competitiveness with exchange rate depreciation, and a slower pace of depreciation, with risks for competitiveness--even in the case of Mexico, where the economy had performed strongly. Of course, there had been cases in which unwarranted nominal exchange rate stability had led to disaster. Such experiences might condition that kind of thinking, but Mexico should not be included in that category. He would have liked the staff to acknowledge that in Mexico's case steps toward exchange rate stability could be highly beneficial and inspire confidence, thereby strengthening the balance of payments, including capital flows. In short, he liked the confidence-based view of the authorities better than the staff reasoning advocating depreciation in order to strengthen the current account in view of volatile capital flows, which themselves might respond positively to greater exchange rate stability.

Mr. Fogelholm said that he, too, commended the Mexican authorities for the progress achieved under the program to date. He could also broadly endorse the staff appraisal, with one question--the same one that had just been raised by Mr. Hogeweg and others with respect to the exchange rate policy. In effect, he would like to ask the staff to elaborate on their response to Mr. Al-Jasser with respect to how the staff viewed competitiveness as portrayed in Mrs. Filardo's statement. One could almost say that the current situation would allow the authorities scope for firmer support of the exchange rate. Together with trade liberalization, that would also tend to increase the discipline of the economy. Two anchors and a more stringent trade policy would result. He would appreciate the staff's comments on the scope for a more stringent foreign exchange rate policy.

The staff representative from the Western Hemisphere Department said that savings performance was difficult to forecast over the medium term. It had to be analyzed on the basis of the ongoing structural changes. Two important considerations were the decline in real interest rates and capital repatriation as an apparent substitute for domestic savings. First, with real interest rates having fallen, a negative effect on domestic savings would, in principle, be expected. However, in Mexico's case, the lower rates had reflected more than anything else a reduction in risk perceived by the market; the risk premium that had been in existence in Mexico since 1988 was being reduced, owing to the authorities' economic policies and the completion of the financial package with commercial banks. All those elements were, in fact, leading to a reduction in interest rates, without necessarily a reduction in savings. In addition, capital inflows increased sharply after interest rates were reduced in the period April-May 1990.

Second, capital repatriation might have replaced domestic savings, the staff representative commented. Although such a substitution needed to be explored further, the observation had been made that a significant proportion of the capital inflows had been in the form of capital repatriation. Most of the capital flows in recent months had been not so much in short-term instruments, but rather in the form of capital repatriation and direct investment, which had increased markedly compared with 1989. Furthermore the average maturity of investments in financial instruments had increased in recent months, indicating growing confidence in the economy.

Price performance was critical to the program, the staff representative remarked. With respect to the point raised about the link between price performance and wages, the staff had observed, first, that wage increases were determined in a variety of ways. The minimum wage had not been increased at the time of the renewal of the pact. Wages in the public sector had been very moderate, except for particular areas like teachers' pay, where increases had been significant. Wages determined by negotiation in the private sector had increased fairly steeply in late 1989 and early 1990. However, after prices had been adjusted and the underlying rate of inflation had declined, such settlements had tended to be lower, as indicated in the staff report.

As to wage developments expected after January 1991, the staff had not yet discussed with the authorities their plans for 1991 with respect to prices, wages, and the exchange rate, the staff representative said. However, the authorities clearly intended to continue reducing the pace of inflation.

In that respect, they had used, and would continue to use, the exchange rate as an anchor, the staff representative noted. Several Directors had commented on that policy. The exchange rate provided a floor for inflation. However, the concerns expressed by the staff were related to the fact that inflation had tended to be somewhat higher than indicated by the floor provided by the exchange rate; therefore, the staff had pointed out the need for caution in the months to come. The authorities were well aware that, in order to be consistent, their exchange rate policy had to be accompanied by very tight financial policies--particularly fiscal policies. However, given current circumstances and the past performance of the external sector, the staff was of the view that the exchange rate should be analyzed and developments in foreign exchange markets reviewed very carefully in order to avoid the emergence of a weakening of exports, and concomitantly, a weakening of the current account that would result in balance of payments problems. Such problems had not yet developed, but the authorities should exercise caution and follow a consistent set of policies.

The authorities had acted very prudently in their management of credit and the privatization process for commercial banks, the staff representative observed. They had been putting in place a control system to monitor the quality of portfolios even before privatization procedures had commenced, and the staff believed those measures should be a sufficient safeguard against a weakening in the creditworthiness of the commercial banks. The staff had urged the authorities to have that process firmly in place at the time of privatization. As indicated in Mrs. Filardo's statement, the commercial banks had been found to be in good health. However, the privatization process was very complex. It was, in fact, uncharted territory in the sense that privatization of commercial banks and a greater process of financial intermediation by commercial banks was happening at a time when the private sector was expanding and investing again; therefore, regular reviews would be required for the duration of the privatization process.

In choosing a financial package which reflected a larger share of discount bonds at the expense of new money, the Mexican commercial banks acted as separate entities, the staff representative from the Western Hemisphere Department commented. There had been no macroeconomic consideration. If anything, the economic authorities had an interest in having new money provided, but Mexican banks--taking into account their sources of financing and certain tax considerations--had decided to move more in the direction of debt reduction instead of new money. Because their decision had no impact--positive or negative--on the guarantees on the collateral needed for the package, it did not have any adverse effect on the package itself.

Mrs. Filardo said that in implementing a stabilization program in combination with a structural adjustment program, the exact results could not be projected. The projections were the economic framework under which the program was expected to develop. In looking at the history of the Mexican economic program, the important thing to note were the trends.

Directors had mentioned the exchange rate policy, inflation, exceptional finance, an oil price impact, and other issues, Mrs. Filardo remarked. With respect to exchange rate policy, there were undoubtedly two schools of thought. In the Board, the European Directors--based on their excellent experience with the European Monetary System and its use as a nominal anchor--had praised the Mexican authorities for implementing such a policy. Nevertheless, determining the right exchange rate was difficult when a country had implemented so many structural reforms at the same time. The balance of payments result showed that nonpetroleum exports had been increasing continuously since 1985, when they had stood at US$8.2 billion; in 1989 they had reached US$18 billion. Hence, the increase in nonpetroleum exports was an indication that the country had been competitive. Of course, one could also be concerned about the increase in imports, but imports were necessary for production and re-exports. The same type of situation had happened in Korea, Taiwan, and many other countries that had diversified their economies and increased their exports.

In the past, Mexico had had a floating exchange rate, and inflation had risen to nearly 200 percent, Mrs. Filardo recalled. With the social pact, the Mexican authorities had been able to use the exchange rate as a nominal anchor and to achieve price corrections within the framework of the program. The inflation rate had improved tremendously.

With respect to the oil price impact, assessments of the situation had been made on the assumption that current oil prices would be maintained, Mrs. Filardo noted. However, countries that were going to increase production faced a dilemma. Additional production to replace oil that was no longer in the market in order to reduce prices would have a fiscal impact. Additional resources would have to be employed to increase production. Both the benefit for the world economy and the benefit or the adverse impact on the oil exporting country needed to be assessed. Directors had rightly emphasized that oil exporting countries like Mexico should strengthen their fiscal and monetary policies. She, too, would like to refer to footnote 2 to Table 16 on page 34 of the staff report--the same footnote that Mr. Goos had mentioned--to make the point that Mexico would continue to need exceptional financing. Looking at Table 82 of the background paper, which showed the total public sector debt of Mexico, one realized that US$135 billion of total debt was certainly a very significant amount. Mexico had been reducing its debt in terms of GDP and exports of goods and services, but it was still very large in absolute terms. Any windfall should be used to reduce the debt overhang further. It was useful to consider what oil exporting countries like Mexico and Venezuela should do to benefit the world economy or to avoid serious repercussions on their own economies.

Many Directors had referred to the financial sector reforms and the increase in credit to the private sector, Mrs. Filardo said. The program's objective was to increase private sector credit. It had expanded too rapidly, but a tremendous disintermediation owing to corrections and structural reforms had been taking place in the financial sector. The Government had been demonstrating its seriousness in the implementation of policies aimed at strengthening the financial sector that was so fundamental for stabilization, and for the future of the Mexican economy.

The Chairman made the following summing up:

Executive Directors warmly commended the policies pursued by the Mexican authorities and agreed that Mexico has made significant progress in addressing its macroeconomic and structural problems under the economic program supported by the extended arrangement with the Fund. These gains have reflected the financial policies pursued by the authorities, the acceleration of structural reforms, and the completion of the financial package with commercial banks, together with their favorable effects on confidence.

Directors observed, however, that the upturn in inflation in the first half of 1990 and the possible implication for economic activity were sources of concern. They noted the actions taken by the authorities to relax price controls, adjust public sector prices and tariffs, and decelerate the rate of depreciation of the peso. Directors observed that the wage-price pact was scheduled to expire in early 1991. Against that background, Directors cautioned that the actions of the Mexican authorities would be consistent with a moderation of inflation only if they were supported by the continuation of current tight financial policies.

Most speakers generally supported the thrust of Mexico's revised exchange rate policy provided that it was supported by current financial policies. A few speakers, however, while acknowledging that the recent exchange rate policy could help curb inflationary expectations if combined with tight financial policies, stressed that the authorities had to strike a careful balance between the need to guard against any weakening of competitiveness and avoid increasing external vulnerability.

Directors observed that the public finances had strengthened further in 1990, with all measures of the fiscal balance showing a better than programmed performance through midyear. Nevertheless, Directors were generally of the view that there was no room for a relaxation of fiscal policy, given the importance of curbing inflation and assuring a satisfactory external performance. In this regard, Directors expressed their satisfaction with the contingency mechanism, included in the arrangement with the Fund, whereby additional export revenues resulting from the recent oil price increase, beyond an agreed threshold, would be used to strengthen the fiscal position and the country's net international reserves.

Directors noted that public sector revenue is likely to be boosted in the near term by proceeds from the divestiture of several large public sector enterprises and the privatization of commercial banks. Directors supported the authorities' intention to devote the proceeds from sales of assets to raise investment and reduce domestic debt in view of the nonrecurrent nature of these resources.

Directors were in general agreement with the conduct of monetary policy, which continued to be geared toward lowering the rate of inflation and supporting the balance of payments objectives of the program. Some Directors, however, expressed concern about the rapid growth of credit and the monetary aggregates in late 1989, but it was noted that this development probably reflected in large part the reintermediation of transactions that were taking place off the banks' balance sheets. Directors took note of the intention of the authorities to strengthen supervision of commercial banks ahead of their privatization, which would help preserve the quality of banks' portfolios.

Directors noted Mexico's recently completed financial package with commercial banks and the resulting reduction in its debt and debt-service payments. Directors agreed that, in combination with the broad based structural reforms being implemented and the stance of existing financial policies, the financial package could help strengthen public sector savings and foster the conditions for increased private sector investment and sustained growth of output and employment over time.

In conclusion, it is clear that the Directors will wish to take the opportunity of the next review of the Mexican program to come to a more precise appraisal of the impact of the changing world oil situation on economic activity and the balance of payments. Directors will then also have an opportunity to focus on the outlook for inflation, the strength of financial policies, and the appropriateness of exchange rate policy. The wish of several speakers to have on that occasion a clearer view of the proposed trade agreement with the United States has been noted.

It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. Mexico has consulted with the Fund in accordance with paragraph 3(b) of Executive Board Decision No. 9356-(90/12), adopted January 29, 1990, and paragraph 2 of the Technical Memorandum of Understanding attached to the letter of March 19, 1990 from the Secretary of Finance and Public Credit of Mexico and the Director General of the Bank of Mexico, in order to review with the Fund the implementation of the economic program for 1990 and to establish a performance criterion on net foreign borrowing by the public sector for end-December 1990.

2. The letter of August 2, 1990 from the Secretary of Finance and Public Credit of Mexico and the Director General of the Bank of Mexico shall be annexed to the extended arrangement for Mexico, and the letter and the attached Technical Memorandum of Understanding dated January 15, 1990, as modified by the letter and the attached Technical Memorandum of Understanding of March 19, 1990, shall be read as modified and supplemented by the letter dated August 2, 1990.

3. Accordingly, the limit on the public sector's net use of foreign credit for end-1990, referred to in paragraph 4(a)(vii) of the extended arrangement for Mexico, shall be as specified in the letter dated August 2, 1990.

4. The Fund decides that the review contemplated in paragraph 3(b) of Executive Board Decision No. 9356-(90/12), adopted January 29, 1990, has been completed.

Decision No. 9522-(90/129), adopted
August 27, 1990

2. EL SALVADOR - 1990 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the 1990 Article IV consultation with El Salvador, and El Salvador's request for a 12-month stand-by arrangement in an amount equivalent to SDR 35.6 million

(EBS/90/145, 8/8/90). They also had before them a background paper on recent economic developments in El Salvador (SM/90/171, 8/21/90).

The staff representative from the Western Hemisphere Department noted that the staff had been in touch with the authorities on the likely impact of the recent increase in international oil prices on their economic program. If the oil price averaged about $25 a barrel for the remainder of 1990, the impact on El Salvador's program for 1990 would be small, because the program had sufficient margin to accommodate that deviation, as the oil price assumed for the period through July 1990 was higher than the one that had in fact prevailed. Consistent with the authorities' broad intentions on controlled prices expressed in the letter of intent, the authorities were expected to allow the full domestic pass-through of the increase in international oil prices. The impact of the increase in oil prices on the program for 1991 and the required policy measures would be discussed during the staff mission for the review under the proposed stand-by arrangement, which was scheduled for the end of 1990.

Mrs. Filardo made the following statement:

> My Salvadoran authorities would like to express their appreciation to the staff for its assistance and cooperation during the long process of discussion and negotiation on the design of a medium-term strategy for El Salvador aimed at re-establishing internal and external equilibrium and achieving sustainable economic growth and price stability. During this period, the staff mission was in El Salvador when the country faced a most difficult political situation that had to be solved with military support. My authorities regret this situation and also would like to recognize the staff's patience, courage, and continuous support.
>
> The authorities also wish to inform the Board about the constructive assistance from other Departments in the Fund. They are of the view that technical assistance is a valuable element in the design and development of the program, especially in certain specific areas. Therefore, they wish to reiterate their desire to continue receiving such assistance.
>
> El Salvador is located in the Central American region that for so many years has been seriously affected by military conflict, both with a neighboring nation and guerrillas within the country. This has had an adverse impact on the development of economic activity and has produced serious political and social unrest. El Salvador also suffered an earthquake in 1986, further aggravating the country's economic and social situation. In addition to the armed conflict and the natural disaster, El Salvador experienced various serious external shocks with the decline by 58 percent in coffee exports from 1986 to 1989, which constituted 72 percent of total exports, and a reduction of official transfers

by 25 percent during the same period. These dramatic events produced continuous external and internal imbalances in the economy and caused great difficulty in managing the country's economic and political situation.

Before the new Government took office in June 1989, President-elect Cristiani and his team visited the United States and met with Fund management and staff. On that occasion they expressed their intention to design and implement a medium-term growth-oriented adjustment program to be supported by the Fund. Since the new Government took office, it has initiated the implementation of comprehensive economic measures and negotiations with the Fund, the objectives of which are contained in the memorandum of economic policies attached to the letter of intent in the staff report. In this process, the authorities have demonstrated their determination to lead the country in the right direction. In a certain sense, for a year they have been under a monitoring program with the Fund, proving their commitment to the program's implementation. Also, during this period, free elections were held in Nicaragua and peace negotiations, under the auspices of the United Nations were initiated between the Salvadoran Government and the guerrilla group. Therefore, it is expected that the political situation in the region, while still fragile, will continue to improve and thus facilitate the implementation of El Salvador's economic program.

The economic developments in recent years are very well described in the staff papers, and the main objective of the program in the memorandum of economic policy. Therefore, I will emphasize some main aspects of the program, the major policy actions undertaken during this year, and the main constraints on, and risks to, the program's implementation.

The new Administration faced an economic situation with the following characteristics: negative real GDP growth; a high rate of inflation; an overvalued currency; a nearly 10 percent current account deficit; a 5.9 percent overall deficit of the consolidated nonfinancial public sector; and external arrears to bilateral creditors and the World Bank and Inter-American Development Bank, and internal arrears to the domestic banking system. In view of the disequilibria and structural problems, the authorities stood ready to design a medium-term growth-oriented adjustment program, taking into consideration the fact that stabilization has a serious impact on the poorer sector of the population, for which they have designed a social program, supported by the World Bank and the IDB, aimed at alleviating poverty, and improving nutrition, education, and health services for low-income groups.

With regard to the economic policies, the program envisaged: (a) a comprehensive tax reform, the introduction of a value-added tax, correction of public sector prices, and improvement of the efficiency of public enterprises; (b) a major reform of the trade and exchange system; (c) flexible implementation of interest rates, elimination of credit allocation, and the privatization of state banks and nonbank financial institutions; and (d) a tightening of government expenditures and a prudent incomes policy. All measures envisaged under the program for the period under review have been implemented; nevertheless, major structural problems have to be solved, like the restructuring of public sector enterprises and the reform of the financial system. In this regard, my authorities are aware that fiscal correction is fundamental to support good management of monetary policy. They are also conscious of the importance of strengthening the Superintendency of Banks as a first step to financial reform.

The support of the international community for the good implementation of the Salvadoran program is fundamental, especially as its major donor is reducing its external assistance to El Salvador in the medium term. As a demonstration of their goodwill in supporting El Salvador, Venezuela and Mexico have been giving strong support to the Central American countries through the renegotiation of debt with various agencies and through the extension of the Santo Domingo Agreement, under which concessional financing for oil exports was provided by these countries. It is expected that, after the approval of the stand-by arrangement by the Board, the authorities will initiate negotiations with the Paris Club in early September, when they expect to obtain major debt relief from official creditors. It is expected that multilateral institutions will also be ready to support the efforts of the authorities.

El Salvador's economy is most vulnerable to external shocks; therefore, the declining coffee prices, the present situation in the Middle East, and the possible impact of the oil price increase on the world economy, on inflation and on international interest rates are a cause for major concern. My authorities are aware that political stabilization in the country and in the region are crucial for the good implementation of the program. Also, the adjustment process and structural changes should be continuous to be able to adapt to the changing circumstances in the world. Notwithstanding their commitment, one has to recognize that adjustment has a limit of tolerance, and that the international community should be ready to bolster the program with adequate financial resources, which will encourage the authorities to implement a stronger adjustment program.

Finally, my authorities wish to reiterate their commitment to cooperate with the international community by implementing their comprehensive program and reaffirming their recognition of the preferred credit status of the Fund.

Mr. Piantini made the following statement:

We would like to commend the Salvadoran authorities for their firm perseverance and bold determination in pursuing the implementation of structural and macroeconomic measures in spite of intensified internal security problems and the continued sharp deterioration in their terms of trade. These factors adversely affected economic growth in 1989. After a relaxation of financial policies during the first part of that year, the incoming Administration's tight monetary and fiscal policies helped restrain the rapid rise in the inflation trend. Nevertheless, during 1989, net public credit to the banking system increased by 3.7 percent of GDP, the inflation rate peaked at 23 percent, and the external current account deficit widened to 9.4 percent of GDP.

To face these macroeconomic disequilibria and to eliminate structural rigidities, the authorities have launched a medium-term, growth-oriented adjustment program, which is ambitious in its macroeconomic objectives and profound in its microeconomic transformation.

The overall deficit of the public sector is projected to be halved in terms of GDP by 1991, to allow for a significant reduction--by two thirds--in the inflation rate. Economic growth is expected to increase by more than population growth, and the external current account deficit to be reduced by two fifths. External arrears will be eliminated, and relations with external creditors will be normalized.

Regarding structural reforms, the exchange rate system has been unified and liberalized. Price controls on 226 products were eliminated. The import tariff maximum rate was reduced sharply, from 290 percent to 35 percent, all import restrictions were removed, and public monopolies on sugar and coffee exports were eliminated. Furthermore, nationalized commercial banks and other public enterprises will be liquidated or privatized, and, with the Fund's technical assistance, the Government is working on developing a stock exchange and securities market and will give more autonomy to the Central Reserve Bank.

To support their program, the authorities are asking for financial assistance from the Fund under a stand-by arrangement. We fully endorse the proposed decisions.

The success of the program lies in the substantial improvement of the fiscal outcome. At the same time, additional expenditures will be necessary to meet required investments and social programs designed with World Bank and IDB assistance to repair the enormous damage to the infrastructure by the prolonged domestic conflict, and to tackle widespread poverty in the country. To attain these objectives, the authorities' efforts should be focused on strengthening public revenues, which are still at very low levels. Therefore, the introduction of a value-added tax system and of legislation to reappraise property values should be implemented soon. Other measures, such as excise taxes to penalize luxury consumption, could be helpful. We welcome the measures taken to enhance tax collection where high penalty rates should be introduced to help avoid tax evasion. Also, keeping realistic public price and tariff policies would be a key factor in meeting the fiscal targets.

The Government plans to take over part of the domestic bank debt and certain bonded debt of state enterprises. This requires a strict expenditure policy to keep inflation under control in face of an increase in interest payments.

On monetary policy, we caution the authorities about the expansionary effects of both the purchase by the Central Reserve Bank of the nonperforming portfolio of the commercial banks and the operational losses of foreign exchange selling guarantees at the previous exchange rate. It seems to us that to offset possible pressure on prices and reserves that could jeopardize the program, the authorities should implement a market-determined interest rate policy and dismantle the credit allocation mechanism to foster savings and to allow for a better allocation of financial resources. Bank liquidity could best be controlled through strong enforcement of reserve requirements, and the performing portfolio of banks should be strengthened through a more active interest rate policy.

On incomes policy, a prudent wage policy will be an important element to keep inflation under control and maintain export competitiveness. It seems to us that the authorities should take advantage of the sharp rise in world petroleum prices to liberalize domestic prices.

On the exchange and trade systems, a tight financial policy would be a key factor in maintaining a stable exchange rate. Given the country's thin exchange market, it would seem that the Central Reserve Bank may be pressed to intervene in the market in special circumstances to smooth the wide swings in the rate that could be produced by uncertainties and speculative movements.

The medium-term scenario emphasizes adjustment and a realistic exchange rate to foster and diversify exports. However, it also shows that the country will depend on concessionary financing and debt relief throughout the period until 1995. In this respect, we welcome the strong financial support given to El Salvador by Mexico and Venezuela.

Regarding financing, we would like to hear some comments from the staff on the following points. First, the staff points out, on page 25 of the staff report, that El Salvador will not require debt relief from official creditors after 1991. However, Table 9 shows that official debt service will represent 40 percent of total debt service, which will average 25 percent of exports between 1992-95. In addition, the staff projects a financing requirement of $850 million throughout the period to close the financing gap and to keep gross international reserves at some five months of imports. We would like to know how this gap will be closed. Second, we have stressed repeatedly that the Fund must take risks in its financial support to indebted middle-income countries which do not have access to other financial sources as a means to help them restore external viability. However, we are facing again a case involving a country with a very strong economic program, but lower than average access. Third, coffee prices have declined sharply since 1986, and, as the staff notes on page 19, they are projected to drop 36 percent for the whole of 1990. Therefore, we wonder why the authorities are not making use of the compensatory and contingency financing facility.

Mr. Montórfano made the following statement:

El Salvador is one of the smallest countries in Central America, with a population density of more than 240 persons per square kilometer and a not very high rate of population growth--1.3 percent. It has for a long time faced a guerilla offensive, and, under the auspices of the United Nations, the Government has tried to reach an agreement with the guerilla factions on a peace treaty. This kind of situation creates difficulties for any economic program and for the further development of the country.

Despite the armed conflict, real GDP growth in the country averaged about 1.5 percent a year during the period 1985-89. There were adverse external developments, a severe earthquake occurred in 1986, and there were shortcomings in the policy response to these developments.

The rate of inflation was 23.5 percent during 1989, and the external current account deficit reached 9 1/2 percent of GDP. The present Government adopted policies aimed at correcting the external and internal imbalances faced by El Salvador in the framework of a strategy based on increased reliance on market forces, and the authorities have established the basis for a comprehensive adjustment program for 1990.

The authorities are conscious of the problems in the country and they are on the right path to implementing an economic program to overcome the adversities. They are designing an economic program in the context of a medium-term adjustment strategy that includes: reform of the exchange and trade systems, fiscal policy, simplifying the complex system of credit allocations, and price liberalization to achieve very important results while benefiting the social sector, which could alleviate the problems of the country.

The agricultural sector's main exports are coffee, sugarcane, and cotton. Export performance was weak during the period 1985-89, owing to generally weak international prices for Salvadoran exports, the adverse impact of the armed conflict, an overvalued exchange rate, and, in some years, unfavorable weather conditions. Coffee continued to be the largest source of merchandise export earnings, which represented 46 percent of total exports of the country in 1989.

The Government has embarked on a tax reform aimed at strengthening the revenue base and reducing disincentives to save and invest, and it has started to improve the operating efficiency of the public enterprises. The authorities should follow revenue developments with additional fiscal measures, while reducing expenditure to ensure the success of the program's fiscal objectives.

The difficult social and political situation that El Salvador is experiencing is evident, and it is clear to us that El Salvador is facing a very complex situation, with armed conflict, financial necessities, structural rigidities, and, therefore, serious social and political problems. El Salvador requires not only Fund support, but also support from the international financial community.

We hope that, with a new program and financial support, the authorities will have the opportunity to start the needed adjustment.

This chair has on several occasions expressed its wish for success in the continuing effort to reach a solution to the political problems and to improve the economy through the implementation of a program to reduce the inflation and unemployment, expand export products to achieve a better equilibrium in the balance of payments, and gain a better standard of living for the population. We support the proposed decisions.

Mr. Newman made the following statement:

Despite an ongoing internal conflict, El Salvador is implementing a wide range of measures to stabilize the economy and to begin the process of reform that will provide a sound basis for increased growth as the security situation improves. The measures already implemented, including many recommended by the Fund in the context of last year's Article IV consultation, are beginning to have a beneficial impact. The proposed stand-by arrangement will build on this foundation and extend the reform effort into 1991.

The reduction of the fiscal deficit to levels that can be financed without recourse to bank lending is at the heart of the reform effort. The measures to increase government revenue will reverse the recent decline, which contributed so greatly to the economic imbalances and inflation of the past few years. However, we are concerned that the bulk of the revenue gains are to be achieved primarily through increased collection efforts, which may be difficult to sustain in current circumstances. Therefore, we share the staff's view on the importance of having in place effective contingency measures in the event that revenue shortfalls emerge. In this regard, we would be interested in learning whether the timetable for implementing the value-added tax, scheduled for 1992, might be accelerated.

There would also appear to be scope for a greater effort to curb government spending. With defense outlays accounting for 25 percent of total spending, room for substantial expenditure reduction may have to await the "peace dividend." However, the recent wage increase should be offset by cuts in other expenditures. In this regard, we are concerned that the authorities' ambitious program to clear domestic arrears and to refinance and restructure the public enterprises and banking institutions involves very substantial budget costs. The budget impact of this program could be reduced by increasing the financial surplus of the public sector enterprises by raising charges to levels that fully cover costs and provide an adequate margin to finance needed investment. In this connection, we would be interested in learning about plans to reduce the very large railroad subsidies through appropriate price increases. Similarly, we would note that telephone charges have not been increased since 1977, and that the recent increase in electricity rates, while welcome, was inadequate to cover higher operating costs.

The improved fiscal position will reduce pressure on bank financing of the deficit and leave room for a substantial expansion of lending to the private sector. However, in view of the continuing inflationary pressures, it will be important to maintain tight monetary policies. The recent increase in interest rates is an important step toward achieving positive real rates but must be complemented by financial reforms to improve the effectiveness of monetary policy. We would urge the authorities to accelerate the process of removing interest rate ceilings and the credit allocation mechanism in order to increase reliance on market-based interest rates as a means of allocating credit.

The program also envisages a sharp reduction in the current account deficit in 1990-91 based on the adoption of a more competitive exchange rate and recovery in coffee production. The continued, albeit more modest, improvement over the medium term depends importantly on a rapid increase in nontraditional exports. This highlights the importance of pursuing a flexible exchange rate policy complemented by prudent monetary and fiscal policies to maintain El Salvador's competitive position. The recent trade reform and decision to join the GATT are useful steps which will contribute to a more efficient allocation of resources and facilitate access by El Salvador to new markets outside the Caribbean region.

Nevertheless, El Salvador's external position will remain vulnerable over the medium term to developments in commodity markets, and continued external financing will be needed. The adoption and effective implementation of the Fund program represents a critical first step toward the resumption of more normal financial flows from donors and the multilateral development banks. While some further Fund support for the reform effort may be required in the near term to help catalyze external financing, we do not believe that El Salvador poses a greater risk than other countries where the Fund's exposure is much larger. The authorities have demonstrated a commitment to reform, and El Salvador's payment record to the Fund is generally a good one, despite the difficult security situation. Moreover, arrears to other international financial institutions have been cleared, opening the way for substantial new financing once the Fund program is in place to provide the necessary macroeconomic framework. Finally, the amount of resources being sought from the Fund is modest--less than the average Fund program--and will be used to increase reserves. In these circumstances, we believe that the risks associated with the proposed program are reasonable, and that the program represents a strong effort on the part of the authorities which deserves support.

Ms. Powell made the following statement:

The staff notes that in the last five years, economic growth in El Salvador averaged around 1.5 percent a year, and the external position deteriorated--a result of armed conflict, adverse external developments, and political uncertainty. The new authorities in El Salvador should, therefore, be congratulated for the initiative they are taking to reduce imbalances and secure stronger economic growth in that country. By their recent actions, which included a tightening of monetary policy and the unification of the exchange rate, the authorities have shown a strong commitment to this process, and the program they have outlined for 1990 and 1991 deserves our support.

It is clear that the ability of the authorities to successfully implement this program will depend critically on a resolution of the military conflict. The security situation has obvious implications for the real economy, inflation, public sector finances, and movements in the exchange rate. It is in this context that the authorities must set realistic, but challenging, targets for their policies. Given the recent growth record, we wonder whether the real growth targets of 2-3 percent in 1990 and 1991 could be more ambitious.

Consistent with the objectives of lower inflation and an improved balance of payments is the intention of the authorities to reduce the overall fiscal deficit from 6 percent in 1989 to under 3 percent in 1991. This will require a tremendous effort on the revenue side, and we can endorse measures intended to rationalize the system of exemptions and tighten collection procedures. We also welcome the changes made in the stamp tax as a prelude to the planned introduction of a value-added tax in 1992. However, given that the revenue yield of the economy has been falling steadily since 1985, it may be that consideration will have to be given to raising tax rates, if fiscal targets are to be achieved. This is especially true given the uncertain prospects surrounding expenditure restraint and the prospect of a peace dividend.

In this regard, it should be noted that, although expenditure as a proportion of GDP has shown some decline, it has not matched the decrease on the revenue side. Admittedly, a great deal will depend on military outlays, which already account for 25 percent of total expenditure. If the authorities are forced to maintain such a high ratio, they must do their utmost to keep a tight rein on nonmilitary spending, and we are pleased that the general thrust of their policies appears to be guided by this realization. We support the continued freeze on civil service employment, as well as the programs to encourage early retirement, and to more directly target public assistance to needy groups. Notwithstanding the financial constraints, we support the projected increase in capital expenditure as being conducive to the realization of the higher growth targets.

Turning to state enterprises, it would have been useful if intentions regarding the future of nonviable entities were more definitive. The report makes reference only to financial restructuring, but perhaps the staff or Mrs. Filardo could elaborate on what possibilities there may be for divestiture.

After a period of loose monetary policy in 1989, the authorities have now committed themselves to a tighter approach. A tightening of credit policy accompanied by a reduced fiscal deficit will help to achieve the objective of allowing more financial resources to be made available to the private sector. However, the response of the private sector will depend to a large extent on the efficiency of financial intermediation in El Salvador. In this connection, the proposed operational improvements, and the deepening in the financial system, are welcome. However, while the plan to purchase certain nonperforming assets of commercial banks may be necessary, it is not the best way to impress upon these institutions the need for better loan standards and collection procedures. The sizable outlays and interest payments for this operation are not to be ignored, and we would urge extreme caution in implementing the proposal, and, clearly, a strengthening of supervision is also necessary. Moreover, we would urge the authorities to adopt a more definite time frame for the realization of market-determined interest rates and the privatization of nationalized commercial banks and other financial institutions.

The external sector is extremely vulnerable to the movement in coffee prices, which are not expected to recover before 1991. Accordingly, external viability during the program period will depend critically on the availability of foreign financing. We endorse the staff's conclusion that such financing requires a normalization of relations between El Salvador and its creditors. However, the staff may have taken a rather optimistic view of this situation in assuming that all external payments arrears will be eliminated by the end of this year. Perhaps the staff could comment.

Finally, we would like to emphasize that a chronic lack of reliable economic and financial statistics is not in the best interest of economic management in El Salvador. We would encourage the authorities to accord a much higher priority to this area.

In sum, we believe that the program before us represents a serious effort to tackle major imbalances. We also believe that, given the uncertainties about the outlook, particularly the prospects for peace, and the likelihood of further requests for Fund support, the proposed access is appropriate. We can support the proposed decisions.

The staff representative from the Western Hemisphere Department said that the medium-term financing requirement should be seen in the context of the country's project pipeline; there were only a few projects remaining in that pipeline. For that reason, the capital account was projected to become negative after 1990-91. The staff and the authorities believed that the financing requirement would be filled without the need for further debt relief from creditors; it would be filled from the catalytic effect of the Fund's involvement and through financial assistance from the Inter-American Development Bank, the World Bank, and major bilateral creditors.

The authorities had eliminated the monopoly of some public sector enterprises on the exportation of some of El Salvador's major exports, which should improve prices being given to farmers, the staff representative remarked. The telephone company had not adjusted domestic tariffs for some time, largely because revenue from incoming calls from abroad made up about 80 percent of the operation of the telephone company, and such revenue had increased from the adjustment in the exchange rate allowing thereby domestic telephone rates to remain unchanged for the time being. But there was no doubt that some increase in domestic rates would be appropriate. As to the railroad subsidy, the authorities had undertaken to adjust the fares of the railroad sometime toward the end of 1990. With regard to the timetable on the privatizing of public sector enterprises, the authorities had focused on financial reforms leading to eventual privatization of the nationalized commercial banks as the most important objective that they would like to achieve for the moment.

All of El Salvador's arrears at the beginning of 1990 had been to official creditors and multilateral institutions, the staff representative from the Western Hemisphere commented. The arrears to multilateral institutions had all been cleared, and arrears to official bilateral creditors were expected to be dealt with in the context of Paris Club rescheduling in September 1990. As to the remaining arrears, with non-Paris Club creditors, agreements had been reached in principle to reschedule them; most of those arrears were with Mexico and Venezuela.

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/90/128 (8/10/90) and EBM/90/129 (8/27/90).

3. CAPE VERDE - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1990 ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 1990 Article XIV consultation with Cape Verde, in the light of the 1990 staff report on the interim Article IV consultation discussions with Cape Verde conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on payments and transfers for current international transactions described in SM/89/154 are maintained by Cape Verde in accordance with Article XIV, Section 2. The Fund encourages Cape Verde to continue to liberalize the exchange system as soon as possible. *(SM/90/157, 8/8/90)*

Decision No. 9523-(90/129), adopted
August 15, 1990

4. CYPRUS - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - EXCHANGE MEASURES SUBJECT TO ARTICLE VIII

1. The Fund takes this decision relating to Cyprus' exchange measures subject to Article VIII, Section 2(a), in the light of the 1990 staff report on the interim Article IV consultation discussions with Cyprus conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The limits imposed by Cyprus on the availability of foreign exchange for travel abroad constitute exchange restrictions subject to approval by the Fund under Article VIII, Section 2(a). The Fund notes the intention of the authorities to remove these restrictions in the near future, and, in the light of the circumstances of Cyprus, grants approval for their retention until the completion of the next Article IV consultation with Cyprus or October 13, 1991, whichever is earlier. (SM/90/158, 8/9/90)

Decision No. 9524-(90/129), adopted
August 16, 1990

5. CZECH AND SLOVAK FEDERAL REPUBLIC - MEMBERSHIP - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/90/211, Sup. 1, 8/21/90) on the canvass of votes of the Governors on Resolution No. 45-6, with respect to membership for the Czech and Slovak Federal Republic, approved by the Executive Board (EBM/90/117, 7/20/90) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes	896,907
Total negative votes	0
Total votes cast	896,907
Abstentions recorded	0
Other replies	0
Total replies	896,907
Votes of members that did not reply	42,168
Total votes of members	939,075

Decision No. 9525-(90/129), adopted
August 21, 1990

6. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

The review of Liberia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9396-(90/50), adopted March 30, 1990, is postponed to a date to be determined by the Managing Director, when, in his judgment, there is once again a basis for evaluating Liberia's economic and financial situation, the stance of economic policies, and its cooperation with the Fund and in any event not later than February 28, 1991. (EBS/90/146, 8/13/90)

Decision No. 9526-(90/129), adopted
August 24, 1990

7. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/90/173, Sup. 2, 8/21/90) on the canvass of votes of the Governors on Resolution No. 45-4, with respect to direct remuneration of Executive Directors and their Alternates, and on Resolution No. 45-5, with respect to benefits of Executive Directors and their Alternates, approved by the Executive Board (EBM/90/107, 7/9/90) for submission to the Board of Governors. The Governors' vote on Resolution No. 45-4 is recorded as follows:

Total affirmative votes	694,428
Total negative votes	179,433
Total votes cast	873,861
Abstentions recorded	13,747
Other replies	0
Total replies	887,608
Votes of members that did not reply	51,467
Total votes of members	939,075

Decision No. 9527-(90/129), adopted
August 21, 1990

8. 1990 ANNUAL MEETINGS - OBSERVERS

The Executive Board approves the proposal to invite Switzerland to attend the 1990 Annual Meetings of the Boards of Governors of the Fund and Bank as an observer, as set forth in EBD/90/235 (8/8/90).

Decision No. 9528-(90/129), adopted
August 10, 1990

9. 1990 ANNUAL MEETING - FORMAL NOTICE AND BRIEF AGENDA

The Executive Board instructs the Secretary to communicate the formal notice and brief agenda for the 1990 Annual Meeting by cable and by airmail letter to all Governors and Alternate Governors. (EBD/90/233, 8/7/90).

Adopted August 10, 1990

10. 1990 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning representation expenses at the time of the 1990 Annual Meeting as set forth in EBAP/90/218 (8/9/90).

Adopted August 15, 1990

11. RULES AND REGULATIONS AMENDED SINCE 1989 ANNUAL MEETING

The Executive Board approves the letter to the Chairman of the Board of Governors submitting for review by the Governors the text of the amendment to the Rules and Regulations adopted since the 1989 Annual Meeting and the proposed resolution for the Board of Governors, as set forth in EBD/90/258 (8/21/90).

Adopted August 23, 1990

12. ANGOLA - TECHNICAL ASSISTANCE

In response to a request from the Angolan authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/238 (8/9/90).

Adopted August 15, 1990

13. ANGOLA - TECHNICAL ASSISTANCE

In response to a request from the Angolan authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/254 (8/17/90).

Adopted August 22, 1990

14. BULGARIA - TECHNICAL ASSISTANCE

In response to a request from the Bulgarian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/264 (8/21/90) and Correction 1 (8/22/90).

Adopted August 24, 1990

15. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the Chinese authorities for technical assistance in the legal field, the Executive Board approves the proposal set forth in EBD/90/255 (8/20/90).

Adopted August 24, 1990

16. CZECH AND SLOVAK FEDERAL REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the State Bank of Czech and Slovak Federal Republic for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/243 (8/13/90).

Adopted August 17, 1990

17. ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request from the Egyptian authorities for technical assistance in the area of the exchange system, the Executive Board approves the proposal set forth in EBD/90/246 (8/15/90).

Adopted August 21, 1990

18. ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request from the Egyptian authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/257 (8/20/90).

Adopted August 24, 1990

19. FIJI - TECHNICAL ASSISTANCE

In response to a request from the Fiji authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/262 (8/21/90).

Adopted August 24, 1990

20. MALTA - TECHNICAL ASSISTANCE

In response to a request from the Maltese authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/247 (8/16/90).

Adopted August 21, 1990

21. POLAND - TECHNICAL ASSISTANCE

In response to a request from the Polish authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/237 (8/9/90).

Adopted August 14, 1990

22. YUGOSLAVIA - TECHNICAL ASSISTANCE

In response to a request from the Yugoslav authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/228 (8/6/90).

Adopted August 10, 1990

23. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/161 through 89/166 are approved.

24. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/163, Supplement 1 (8/9/90), EBAP/90/219 (8/10/90), EBAP/90/223 (8/13/90), EBAP/90/226 (8/16/90), and EBAP/90/229 (8/22/90), by Advisors to Executive Directors as set forth in EBAP/90/219 (8/10/90) and EBAP/90/223 (8/13/90), and by Assistants to Executive Directors as set forth in EBAP/90/224 (8/14/90) and EBAP/90/228 (8/17/90) is approved.

25. TRAVEL BY ACTING MANAGING DIRECTOR

Travel by the Acting Managing Director as set forth in EBAP/90/227 (8/15/90) is approved.

APPROVED: August 6, 1991

JOSEPH W. LANG, JR.
Acting Secretary