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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/126

10:00 a.m., September 14, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
F. Cassell	C. Enoch
	Di W., Temporary
	C. S. Warner
	J. Prader
E. T. El Kogali	
E. A. Evans	
	R. J. Lombardo
L. Filardo	
R. Filosa	
	A. M. Othman
	S. K. Fayyad, Temporary
M. Fogelholm	
M. R. Ghasimi	
G. Grosche	
	S. P. Shrestha, Temporary
B. Jalan	L. E. N. Fernando
	L. M. Piantini
M. Massé	D. McCormack
Mawakani Samba	C. V. Santos
	B. A. Sarr, Temporary
Y. A. Nimatallah	
	J.-L. Menda, Temporary
G. A. Posthumus	G. P. J. Hogeweg
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

IBRD: J. Johnson, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: T. Leddy, Deputy Director; E. Brau, M. El-Erian, G. R. Kincaid. Fiscal Affairs Department: A. Ize, M. Katz. Legal Department: F. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; H. Elizalde, A. O. Liuksila. Research Department: G. Calvo, D. A. DeRosa, Y. Harada, E. L. Rojas-Suárez. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. L. Coats, Jr. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. O. Bonvicini, E. de la Piedra, E. R. J. Kalter, C. M. Loser. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, F. E. R. Alfiler, G. García, Z. Iqbal, P. O. Montórfano, D. Powell, F. A. Quirós. Assistants to Executive Directors: H. Brohs, B. A. Christiansen, H. E. Codrington, E. C. Demaestri, J. Gold, J. Heywood, K.-H. Kleine, R. Marino, W. K. Parmena, J.-P. Schoder, C. C. A. van den Berg.

1. MEXICO - REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report on the first review under the extended arrangement for Mexico approved on May 26, 1989 (EBS/89/178, 9/1/89; and Cor. 1, 9/8/89). They also had before them a note on Mexico's financing package from commercial bank creditors (EBS/89/171, 8/23/89).

The staff representative from the Western Hemisphere Department remarked that a press communiqué describing the main elements of the term sheet that had been negotiated between Mexico and the commercial bank advisory committee had been released the previous evening. The information in the communiqué was consistent with that provided in the staff papers.

Mrs. Filardo made the following statement:

> The Mexican authorities wish to express their appreciation to the staff for the high quality of the review paper, the lively and constructive discussions held in Mexico City during the first review of the program, and its support during the difficult negotiations with commercial banks. Since the authorities are in full agreement with the staff appraisal and all performance criteria for end-June have been observed, I will only highlight some aspects of recent developments in the Mexican economy.
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> The first review of Mexico's program comes less than four months after the Board's approval of an extended Fund facility and a compensatory and contingency financing facility for Mexico. At that time, Executive Directors supported Mexico's growth-oriented adjustment program based on its strong record of adjustment as well as the recent actions taken to further strengthen the fiscal accounts; the successful reduction of inflation; the major trade liberalization; and other structural reforms such as the liberalization of the financial system, the opening up to foreign investment, and the privatization of several important public sector enterprises. It was widely acknowledged that the success of the program hinged on reducing the heavy debt-service burden, which had adversely affected investment and the prospects for private sector capital reflows, as well as on consolidating the gains from the reduction in inflation and, in general, from the stabilization and structural adjustment efforts.
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> The uncertainties then prevailing on the external front related to the amounts of debt and debt-service reduction that would result from the negotiations with commercial banks, the availability of commercial bank financing, and the evolution of oil prices and international interest rates. On the domestic front, there was uncertainty about whether interest rates would

fall sufficiently as well as about the wage settlements following the end of the Pacto para la Estabilidad y el Crecimiento Económico (PECE) in July and, consequently, on the anti-inflation objectives of the program.

During the last four months, some of these uncertainties have been dispelled by the debt agreement reached with commercial banks, the renewal of the PECE, the favorable evolution of petroleum prices and international interest rates, and the strict adherence to a tight fiscal policy and a prudent monetary policy. All these events have helped improve market participants' expectations about the viability of the program and the sustainability of the current policy stance. The consequences of these improved expectations have been the important inflows of private capital during the last three months of 1988, the sharp decline in domestic interest rates, and the strength of private investment.

Developments with respect to credit policy and interest rates during the first half of 1989 have reflected the absence of external financing from private sources as well as the uncertainty surrounding the ongoing external debt negotiations. Even though financial savings rose by 9 percent in real terms in the first half of 1989--a considerable increase by historical standards--the response is meager when assessed against the high real interest rates that have prevailed on peso-denominated financial assets since the beginning of the year. This outcome reflects the unfavorable expectations in the private sector regarding the sustainability of the stabilization effort in the face of the uncertainty surrounding exchange rate policy prior to the renewal of the PECE and the debt agreement with external creditors. Once these fears were dissipated, interest rates on one-month treasury bills, which reached a peak of 57 percent in June 1989 fell by more than 20 percentage points. The simultaneous reduction of inflationary and devaluation expectations and nominal interest rates has presumably left the expected yield on peso-denominated assets unaltered at its previous equilibrium level. Therefore, financial savings should continue to grow at a healthy rate reflecting the coalescence of expectations toward the program's targets and the recent liberalization of the financial system.

If domestic interest rates remain around their current level, and given that domestic debt represents approximately 20 percent of GDP, the public sector would save nearly 4 percentage points of GDP on interest outlays on an annual basis. This savings, along with that on external debt-service payments emanating from the accord with commercial banks, would certainly contribute to reach the substantial increase in public sector savings that is contemplated in the medium term under the current economic program.

With respect to balance of payments and exchange rate policy, interest rates have been the instrument used to equilibrate the demand and supply of loanable funds and have contributed to promote a considerable inflow of private capital. In view of the lack of external financing, private capital inflows have contributed to finance expenditures on imports of capital goods, debt buy-backs by the private sector and public sector debt amortization; they have also allowed for an increase in international reserves during June and July.

The current nominal depreciation of the peso of around 1.2 percent a month under the guidelines of the renewed PECE, together with the decline in the monthly rate of inflation from 2.4 percent in January 1989 to 1 percent in July, has helped to maintain the competitiveness of Mexico's exports. Thus, manufactured exports continue to grow at a strong pace. The higher than projected imports reflect mainly the strength of private investment and, to some extent, the once-and-for-all increase in imports owing to trade liberalization.

With respect to external debt negotiations, Mexico reached preliminary agreement on July 23 with the steering committee of its commercial bank creditors on a debt restructuring package. The term sheet for the agreement is expected to be finalized shortly, with the financing package becoming effective around the end of 1989 or early 1990. Some specific features of the package are still being discussed. Therefore, the precise impact on Mexico's debt and cash-flow positions will be known only when these discussions are concluded and the distribution of the banks' choices among the three options is determined. The illustrative calculations in EBS/89/171 show the orders of magnitude and the sensitivity of cash-flow assistance to the different parameters involved in the calculations.

Mexico considers that the debt agreement has been an important step forward in reducing the debt overhang. The agreement will allow Mexico to reduce its net resource transfer to the rest of the world from an average of 6.2 percent of GDP during the past five years to 2.7 percent of GDP in 1989 and to around 2 percent of GDP in 1992. The reduction in the net resource transfer will free resources needed to effect the required investment in plant and equipment and infrastructure, items that have been highly neglected over the past seven years.

The benefits of the debt agreement go beyond its direct financial effects. An aspect that is often overlooked is the automatic stabilizers built into the accord and their effects--some of which are already apparent--on restoring confidence. Insofar as banks choose the par exchange involving 30-year bonds at a reduced fixed interest rate of 6.25 percent, Mexico's vulnerability to increases in international interest rates will be greatly reduced. Similarly, if oil prices fall below US$10 a barrel, additional financing would become available. Thus, even though the balance of payments might appear more vulnerable compared with the original baseline scenario, many elements of the agreement will act as automatic stabilizers.

Another important effect of the debt agreement will be its impact on public finances. The improved public finances will reduce public sector pressure on financial markets, thereby contributing to further reductions in real interest rates and promoting private investment. This virtuous circle will undoubtedly generate an atmosphere of confidence that will induce private capital repatriation and direct foreign investment. These autonomous capital inflows will contribute to finance private sector investment and related expenditures.

The developments during the last four months attest to the versatility incorporated into the design of Mexico's growth-oriented program and to the authorities' commitment to take the necessary policy actions in the light of changing circumstances. A close monitoring of the financial and foreign exchange markets has permitted the authorities to react rapidly to changing market conditions. The Government has had to pay a high price to regain credibility. The authorities' response to persistent adverse expectations has been to tighten further the fiscal stance, continue with thorough structural reforms, and maintain monetary discipline. The fruits of maintaining domestic policies on a steady course for several years are finally being reaped, as manifested by improved business confidence, greater private investment, lower interest rates, and a rebound of economic activity.

The unexpected vigor that economic activity has shown recently, which is the product of robust private investment, has exerted some pressure on the balance of payments. Private investment has, however, been financed mainly by private capital inflows that, according to some estimates, exceeded US$2 billion during the first seven months of 1989. These developments are being closely monitored by the authorities in order to promptly adjust monetary and fiscal policy should the external or internal balance be threatened.

The forthcoming review of the program, which is to take place before the end of the year, will permit a re-evaluation of the staff's medium-term scenarios in the light of the final outcome of the debt agreement.

Extending her remarks, Mrs. Filardo said that she was pleased to announce that her Mexican authorities had finished the second stage of a complex negotiating process with the commercial banks. She had nothing to add to the communiqué that had been released the previous evening, which had been distributed to Directors at the request of her authorities.

Her authorities had also requested her to inform the Board of their conversations with the commercial banks regarding the possibility of including an oil facility contingency equivalent to US$500 million over a three-year period in the financing agreement, Mrs. Filardo commented. The trigger price for such a mechanism had not yet been decided, but it was expected to be in the range of US$10-12 a barrel. The banks had requested her authorities to seek the Fund's views on the inclusion of such a contingency as well as on a contribution by the Fund of a similar amount pari passu with the commercial banks as part of the Fund-supported program. In addition, her authorities intended to request the front-loading of Fund disbursements once the negotiations with the commercial banks had been completed.

The Chairman observed that while the issues raised by the Mexican authorities did not have to be addressed at the present meeting, his own response to the proposed oil facility contingency was one of surprise, especially as the banks had in the past criticized the Fund's balance of payments scenarios, including its oil price projections, as too conservative. While he would be open to a discussion of the matter, it should be noted that a contribution by the Fund to a contingency mechanism would raise difficulties in view of the present guidelines on Fund support for debt reduction operations and access limits. A trigger price in the range of US$10-12 a barrel was also difficult to accept at a time when the median price of oil was US$15 a barrel.

Mr. Fogelholm said that he shared the Chairman's concerns and supported his views on a contribution by the Fund to a contingency mechanism. On another matter, he wondered when the authorities expected to present a request for front-loading of disbursements and of the set-aside amounts.

Mrs. Filardo remarked that the timing of the request would depend on the evolution of negotiations with the commercial banks. In the meantime, her authorities wanted to keep the Fund informed of their ongoing discussions with the banks and of possible future requests, particularly in view of the fact that enhancements totaling US$7 billion would have to be assembled when the agreement was concluded.

The staff representative from the Exchange and Trade Relations Department commented that a review of the Mexican program was expected to take place toward the end of the year. By that time it was expected that sufficient information on the banks' choices among options would be available to allow the Board to decide on the disbursement of resources, including the acceleration of the set-asides.

Mr. Piantini made the following statement:

> The performance of the Mexican economy demonstrates the success of bold management. All quantitative performance

criteria for end-June were observed, and the thrust of macroeconomic goals for the first year of the program is being achieved at a faster pace than originally envisaged.

The medium-term adjustment program supported by the extended arrangement approved last May has consolidated the gains already achieved during previous years. The implementation of structural reforms, mainly in the fiscal and financial sectors, and strict macroeconomic policies, together with the agreement negotiated with creditor banks, have strengthened confidence. This confidence has encouraged the private sector to maintain its commitments to comply with the economic plan agreed upon last December. Thus, during the first half of this year private savings and investment are running higher than projected, and economic activity is recovering faster, with industrial output growing at a robust rate of 6 percent a year. A better fiscal performance, along with a more stable incomes policy as a consequence of the social pact, has helped to lower the rate of inflation by two thirds--to less than 17 percent at the end of July, measured on an annual basis. Nevertheless, the weak response of the international financial community to support this program remains a matter of concern.

As I am in general agreement with the staff appraisal, I strongly endorse the proposed decision. My authorities welcome the progress made toward structural reform in the fiscal area, notably, the income tax reform and the privatization of 100 additional public enterprises during the first half of 1989. This reform, together with higher oil prices, contributed to increase fiscal revenue, which, combined with continued tight expenditure control, strengthened public finances. Therefore, during the first half of 1989 the primary surplus of the nonfinancial public sector rose sharply to 11.8 percent of GDP, or one third higher than programmed. The public sector borrowing requirement declined, helping to bring down nominal interest rates. Nevertheless, the performance of the public enterprises weakened. I encourage the authorities to adopt a market-oriented approach toward public prices and tariffs as a means of reducing distortions and further strengthening the primary surplus. The latter would help keep real interest rates low and release resources for social and investment expenditures.

With the rate of inflation falling faster than the nominal interest rate, real interest rates are still high. High yields on short-term financial instruments, combined with reforms to liberalize the financial system and foreign investment as well as the firm decision of the authorities to keep the program on track, have accelerated private capital reflows and inflows. This outcome is reflected in the sharp rise of financial private savings in real terms--to a level ten times greater than envisaged at the end of June. This increase and the reduction in the financial requirements of the public sector have allowed a sharp expansion of credit to the private sector by 23 percent in real terms. I agree with the staff that the authorities should stand ready to prevent any overheating of the economy, as this may stir up inflationary expectations in view of the historically high level of inflation in Mexico in the 1980s. In this regard, account must be taken of the fact that the weight of interest payments on fiscal expenditures may restrain the management of interest rates to deal with inflationary pressures.

The daily depreciation of the exchange rate has kept Mexico's exports competitive, as reflected in a larger, more diversified export sector. During 1989, stronger exports of manufactured goods, higher petroleum prices, and larger private capital inflows have contributed to offset the adverse impact on net international reserves owing to trade liberalization, the faster growth of economic activity, as well as higher external interest rates and a sharp decline in the projected inflow of official capital by about 2 percentage points of GDP during 1989.

Mexico needs to achieve steady economic growth over the medium term in order to reduce unemployment and reverse the harsh decline in living standards. The reduction of internal imbalances achieved so far and the revised medium-term outlook are testimony to the strong domestic efforts made to achieve those goals. The authorities have been tenacious in increasing economic efficiency through the implementation of structural reforms and the strict management of macroeconomic policies. The revised medium-term outlook foresees a large increase in gross national savings and a substantial decline in public sector borrowing requirements and in the external current account deficit.

The revised medium-term outlook is more realistic than the previous one. The most dramatic difference is the expected sharp decline in net official capital, which offsets the effects of increased export earnings and neutralizes the reduction in interest payments until 1994. The data reflect the outcome of the proposed commercial bank financing package. Compared with the outcome originally envisaged, Mexico's reserve position during the program period has been weakened. It may make the success of the program more vulnerable to external shocks or may delay Mexico's much needed economic growth. I do not question the incremental debt relief embodied in the new debt strategy and its positive effects in restoring confidence and in reducing the net resource transfer as Mrs. Filardo pointed out, but the results obtained so far do not call for complacency. Under the new scheme of debt rescheduling, the external outstanding debt in relation to GDP would be larger in 1994 than when the debt crisis erupted in 1982, with total debt remaining unchanged between 1989 and 1994. Debt service would absorb one fourth of total exports of goods, services, and transfers. I would again emphasize the position of this chair that only a major participation by the multilateral and bilateral official financial institutions can break through the barrier that the debt overhang poses for highly indebted middle-income countries so as to allow them to pursue healthy economic growth.

Mr. Warner made the following statement:

I commend the Mexican authorities on the progress made during the initial months of the extended arrangement with the Fund. I agree with the technical waiver requested for the end-June performance criteria, and the modifications to the September and December criteria. I also support the proposed decision, which will make the second tranche available.

By and large, my authorities support the staff's appraisal of the progress to date and the dangers that lie ahead. In particular, they agree that the authorities should avoid any slippages that would reverse the trend of growing confidence in Mexico's economic prospects. The extension of the price-wage agreement in July is encouraging, but considerable efforts will still be needed to maintain a strong primary fiscal balance. My authorities are also concerned about lags in the adjustment of some public sector prices and hope that it will be possible to step up the pace of reform in the public enterprise sector. They also agree that the authorities should be prepared to tighten credit policy if excess demand pressures emerge.

With respect to the commercial bank financing package, I am extremely pleased to note the announcement last night that a term sheet has been agreed upon. This is a critical milestone, which should help to increase confidence not only in Mexico, but in other countries that are making a comparable adjustment effort. I would like to commend Fund management for its considerable efforts to facilitate this agreement, the first practical application of the strengthened debt strategy.

The Mexican financing package conforms to the guidelines adopted by the Executive Board last May. Mexico is vigorously implementing a growth-oriented, medium-term adjustment program that incorporates strong measures to promote investment and the repatriation of flight capital. The financing agreement with commercial banks establishes the basis for voluntary, market-based debt and debt-service reduction, which will help Mexico to regain access to credit markets and attain external viability with growth. My authorities believe that the use of Fund resources in support of these transactions will be cost effective, although they continue to question the staff's emphasis on the "equivalency approach."

Considerable benefits are already accruing from this financing arrangement as a result of increased market confidence in Mexico's economic future. Domestic interest rates have fallen by more than 20 percentage points since June, and large private capital inflows have taken place in recent months.

My authorities do not believe that the financing package results in a substitution of official credit for private credit. The increase in Fund exposure to Mexico from end-1988 will be less than SDR 700 million. Mexico will be contributing a substantial amount of its own resources to support debt and debt-service reduction. Coverage for interest support is limited to 18-24 months, on a rolling basis.

In conclusion, my authorities would like to extend to the Mexican authorities, through Mrs. Filardo, their congratulations for the success in concluding a financing package prior to the second drawing under the extended arrangement. My authorities would also like to extend their appreciation to the banking community for respecting the deadline that was implicit in the Board's guidelines. At the same time, they believe that the Board is justified in taking pride in the role it has played in fostering this agreement. This case should help to reinforce the assessment contained in the Board's report to the Interim Committee on the debt situation that the guidelines for supporting debt and debt-service reduction are sound.

Mr. Cassell made the following statement:

It is encouraging that Mexico is performing well under the program. The cuts in government expenditure that the authorities made earlier this year, combined with higher than expected oil prices, have produced a substantial primary fiscal surplus. The fall in domestic interest rates over the last two months should, in time, help to reduce the operational deficit.

In monetary policy, the first priority remains the control of inflation. The program appears to be going well in this respect as well. On the external side, exports remain high, helped by increased revenues from oil exports. Shortfalls in official capital have been more than compensated for by substantial inflows of private capital. This is particularly welcome and has allowed an increase in imports and a pickup in investment.

The major development on the external front has been the agreement in principle that has been reached between Mexico and its commercial bank creditors. We have yet to see the details of this agreement, and the reaction of many of Mexico's commercial bank creditors is not yet known. However, it is clear that substantial progress has been made in securing external finance for Mexico's financing needs in the short term, which should produce a significant improvement in the medium-term outlook for Mexico. Although the agreement will not come into effect until early 1990, it has already led to a marked rise in private sector confidence as seen both in capital inflows and in a sharp fall in domestic interest rates.

Even so, Mexico's economy remains extremely vulnerable to exogenous shocks. It is disturbing that international reserves are projected to remain at a relatively low level throughout the program period. This means that the program could be derailed if there were significant adverse developments such as slippages in economic policies, increased inflation, lower world oil prices, or higher international interest rates.

The authorities may not be able to do much about many of these contingencies, but it is absolutely essential that they continue to pursue sound fiscal and monetary policies. They should also press ahead with structural adjustment, particularly with policies to encourage further inflows of private capital. The authorities have done a great deal in this respect and are planning to do more. It is, however, regrettable that so far they have not shown more interest in joining the Multilateral Investment Guarantee Agency (MIGA).

Mexico's vulnerability to changes in international interest rates will be somewhat reduced if a large number of banks take the debt-service reduction option included in the debt agreement. However, the agreement will do nothing to lessen Mexico's vulnerability to changes in oil prices. I note that it is now assumed that the price of Mexican oil will be US$15 a barrel, compared with US$12 a barrel when the program was originally drawn up: any margin of safety which was included in the original program is now gone.

There are a number of issues that will need to be addressed. The agreement with the commercial banks provides for a substantial enhancement for reduced debt on the part of both the Fund and the World Bank. Both institutions have still to consider whether the additional resources expected for this enhancement should be provided. While the agreement appears to be one we can support, a final decision will have to wait until the commercial banks' preferences between the options are known, which in turn will affect the call on the Fund's resources. The Board also needs to consider the details of how Fund and World

Bank enhancements should be provided, including where any escrow accounts should be held. Such issues will have to be resolved before the package can finally be put to bed.

In conclusion, I can support the proposed decision. While Mexico's economy remains vulnerable, the agreement with the commercial banks is a major step forward, and the commitment of the Mexican authorities to the adjustment progress remains impressive.

Mr. Yamazaki made the following statement:

The last three months have witnessed the Mexican authorities' achievement of significant progress both in economic adjustment and in external debt negotiations. They are to be commended for their perseverance with the program and for the favorable recent economic developments. I therefore have no difficulty in supporting the proposed decision.

Indeed, policy developments in the first half of 1989 attest to the exceptional efforts made by the authorities. The fiscal position strengthened much more than had been expected. The operations of the Central Bank have remained on track. As a result, all the performance criteria for end-June were observed, some with considerable margins. I find the thrust of the staff's appraisal of policy measures to be appropriate and do not have much to add.

Looking at certain aspects of the economy, however, some signs point to uncertainty in the future. Buoyant private investment has brought about unexpected improvements that have offset favorable exogenous factors, including higher oil prices and lower interest rates. Real interest rates have declined rapidly. However, prolonged external debt negotiations have kept domestic interest rates higher than expected. Furthermore, the delayed conclusion of external debt negotiations has affected reserve accumulation, while private capital inflows have largely filled the financing gap.

These developments clearly illustrate the difficult tasks that lie ahead for the authorities. The continued buoyancy of private investment might lead to an unexpected increase in imports or inflationary pressures. In that event, unexpected capital outflows might recur, since the rapid increase in capital inflows recorded in the first half of 1989 seems to reflect the high mobility and sensitivity of capital flows. I therefore urge the authorities to remain vigilant and to be prepared to take supplementary adjustment measures as necessary. Unforeseeable adverse exogenous developments such as a decline in oil prices or an increase in world interest rates would also necessitate supplementary adjustment measures. Such contingency measures could lead to further strengthening of the fiscal position and an acceleration of the planned depreciation of the peso.

These remarks should not be taken as a sign of any doubt about the authorities' credibility and capability. The downward risks, however, point to the need for careful economic management. The revised medium-term balance of payments projections, which indicate a lack of margin in the program, demonstrate the importance of such caveats. At the same time, I recognize the indicative nature of the staff's balance of payments projections.

These downward risks also underscore the importance of measures to promote capital reflows as well as direct investment, and I would welcome the staff's comments on the authorities' plans in this regard. In particular, what is the staff's assessment of the recently introduced tax measures to promote private capital inflows?

I would also be interested to hear the staff's assessment of the effectiveness of debt-equity swaps, since the declining inflation rate seems to have broadened the scope for such swaps. I note from the press communiqué that the agreed financial package includes a provision for debt-equity swaps.

Looking back at the long, winding path of external debt negotiations, I commend the authorities for their strenuous efforts to conclude the agreement with the commercial banks and strongly welcome the completion of the term sheet last night. At the same time, I would again underscore that the authorities' intensified adjustment efforts are the key to the eventual successful completion of external debt negotiations. I look forward to reviewing the agreed financing package and the authorities' policy intention for 1990.

Mr. Lombardo remarked that in supporting the Mexican program, the Fund should recognize the major reorientation of policy that Mexico had initiated after the emergence of the 1982 debt crisis, the comprehensive adjustment effort that had begun in 1986, and the strong short- to medium-term adjustment strategy on which Mexico had recently embarked.

Performance under the program supported by the extended arrangement had clearly been more than satisfactory, and program results had been encouraging, Mr. Lombardo continued. All of the performance criteria for end-June, adjusted for developments in oil prices, international interest rates, and factors related to the availability of foreign financing, had been fulfilled. Inflation had declined to its lowest level in recent years, and there appeared to have been the upturn in economic activity.

The primary fiscal surplus was considerably larger than programmed. Monetary policy had produced results that were within the program targets, and owing to the lower public sector requirement and an increase in private financial savings, a considerable expansion of credit to the private sector had been possible without negatively affecting the domestic asset target.

Future prospects were also optimistic, Mr. Lombardo observed. Economic growth was expected to accelerate, inflation is expected to decrease, and the current account imbalances were expected to be reduced. The only aspect that clouded the economic outlook arose from the agreement in principle recently negotiated with the commercial creditors. Although the agreed financial package incorporating debt and debt-service reduction was expected to improve the structure of indebtedness and bolster private confidence, the net cash-flow relief to be provided by commercial banks was smaller than initially envisaged. Consequently, some gains obtained from recent external developments would have to be used to finance the program in the short run, and no cushion of reserves would be available to meet eventual adverse developments in the international environment.

Appropriate external financial support was central to the success of Mexico's economic program, Mr. Lombardo considered. Reduced margins associated with lower than projected levels of financing would leave the authorities with less room for maneuver. More care would need to be taken in implementing policies, and they would need to be ready to adjust to unfavorable external developments. To assure adequate external financing, Fund support was essential.

As the conditions to be met by the time of the review under the extended arrangement had been fulfilled, he could support the proposed decision, Mr. Lombardo concluded.

Mr. Massé made the following statement:

> I agree with the staff that the performance of the Mexican economy in the last few months has been very good. Moreover, I would like to take this opportunity to commend the authorities for their able management of the economy.
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> The monthly rate of inflation has decelerated to 1.0 percent in July, compared with 2.4 percent in January; the primary fiscal surplus has increased to 11.8 percent of GDP in the first half of the year, compared with a target of 8.6 percent; and economic activity has begun to revive, with economic growth now forecast to be 2 percent, notwithstanding the unfavorable climatic conditions in the earlier part of the year. Nonetheless, I would caution the authorities to remain vigilant against too rapid an expansion, which could bring about a renewal of inflationary pressures. Accelerating inflation is still too recent a phenomenon in Mexico and, for that reason, the authorities

cannot risk a loss of credibility. The continuation of the rapid pace of import expansion could also become a cause for concern.

The key issue, however, is developments regarding the debt reduction negotiations with the commercial banks. In this area progress was slow, and it is only now that a term sheet has been finalized, although it has been close to two months since the preliminary debt agreement was concluded with the steering committee. At this point, the amount of new financing that will be made available is still somewhat indeterminate. Moreover, the proportion of banks that will choose to participate, and whether or not a free-rider problem will develop, are still unknown.

Despite the uncertainty that has characterized the financing arrangements over the last two months, one impact has become evident over that period--namely, the extent to which reaching an agreement with the steering committee has raised confidence in the Mexican economy. Particularly noteworthy has been the magnitude of private capital inflows. In May the staff estimated that these inflows would amount to US$0.5 billion for the year as a whole. However, private capital inflows have already risen to US$3.4 billion and are estimated to rise a further US$0.9 billion during the remainder of the year. In light of the substantial flows over the first half of the year, staff estimates for the second half may be conservative.

Further evidence of the increase in confidence is the decline in domestic short-term interest rates. Despite a fairly extended period of a relatively moderate rate of inflation, monthly interest rates remained stubbornly high. However, the expectation of reaching an agreement on a debt reduction package led to a sharp decline in interest rates and a strong revival in private sector investment.

The comparison of the medium-term balance of payments scenario in May, which assumes new money, with the most recent scenario, which takes into account the debt reduction package, is of some interest. The difference in the net capital flows from the banks between the two scenarios averages US$3.3 billion a year, while the decline in interest payments to the banks as a result of the debt reduction package averages only about US$1.5 billion a year. Private capital inflows have been revised upward by about US$1 billion a year. Altogether, the net impact on Mexico's balance of payments that could be attributed to the debt reduction package is actually a net increase in the deficit averaging about US$0.8 billion a year. Thus, the major near-term benefit from the debt reduction comes from the return of capital flight, and not from debt-service reduction itself. Nevertheless, over the long term, the benefits of the debt reduction package will accumulate, as the overall debt/GNP ratio improves considerably.

I would also stress that the debt reduction strategy is not without risk in the short term. Despite significantly higher oil prices and lower international interest rates, reserves over the next two years remain weak. By 1991 Mexico's reserves are to decline by an additional US$700 million rather than increase by US$1.6 billion, as initially envisaged in May. As noted by both staff and Mrs. Filardo, this leaves Mexico much more vulnerable to adverse developments, both domestic and external. I note the various contingency measures incorporated in the program. Nevertheless, I would urge the authorities to have in reserve some policy measures to strengthen their position in the event of an unfavorable outcome.

When the agreement in principle between Mexico and the banks was reached, there was some discontent with the terms of the arrangement in that it did not adequately reflect the secondary market price. Indeed, in some circles this sentiment persists, and this is also of some concern in other debt reduction negotiations. A closely related issue is that debt reduction packages will not significantly ease cash-flow problems in the near to medium term as seems to be in the case of Mexico. Moreover, there continues to be considerable skepticism about how effective the limited contributions of the Fund and the World Bank will be in catalyzing debt reduction. However, at the risk of sounding too optimistic, I think that some preliminary conclusions can be drawn regarding the strengthened strategy. From Mexico's experience, it would appear that just reaching an agreement in principle with the steering committee has had substantial impact on raising the perceptions of the medium- to long-term prospects of the economy. In this regard alone, the debt reduction strategy has already paid off handsomely. Consequently, judgments about the value of debt reduction packages and the contribution of the Fund, the World Bank, and other official sources, which make the strategy possible, must go beyond the direct dollar values. However, without the sustained adjustment effort of the authorities over the past years--namely, their exemplary track record--this immediate response from investors would almost certainly not have been forthcoming. I agree with the proposed decision.

Mr. Menda made the following statement:

The positive achievements of Mexico under the extended arrangement are encouraging, and I am pleased to note that all the performance criteria for end-June have been observed. Indeed, the far-reaching structural measures implemented by the authorities and their sound macroeconomic policies have produced positive results. Among these, I would especially note that economic activity has recovered at a faster pace than anticipated and that private investment has played a leading role in this process. It is also most encouraging that private sector savings have increased significantly in response to the liberalization of the banking sector and to positive real interest rates. Another source of satisfaction is that an agreement has been reached between Mexico and commercial banks, which should lead to a significant debt reduction.

However, the staff report makes it clear that the period ahead will not be an easy one. The external position is still fragile, and there will be no room for complacency in the months ahead. As I fully agree with the staff's report, I will briefly comment on macroeconomic policies and on the agreement reached by Mexico with commercial banks.

The strengthening of economic activity during the first half of the year has clearly put some pressure on the external position, inducing in particular a strong increase in imports. This strong performance, although a welcome development, stresses the necessity to pursue a strict demand management policy.

As regards fiscal policy, I fully agree with the staff on the maintenance of a strong primary fiscal balance. In this area, the good results achieved since the beginning of the year are encouraging. The tax reform has started to pay dividends, as nonpetroleum revenues have increased significantly, as envisaged initially in the program. Outlays seem well under control, and the authorities are encouraged to maintain a tight control on current expenditures. I also share the staff's view that the authorities should continue to adjust prices and tariffs in the public sector and to pursue the structural reforms envisaged in this sector.

In the area of monetary policy, the process of reintermediation is certainly a positive outcome. It is also clear that positive real interest rates, although excessively high, have been of paramount importance in the process of increasing private savings and have not hindered a strong recovery of private investment, accommodated by a strong expansion of credit to the private sector. It is worth noting that the reduction in the financial requirements of the public sector has played a significant role in this regard. However, the authorities should be ready to react quickly to tighten credit conditions if domestic demand expands too fast. The broadening of financial markets is also welcome, but I fully share the staff's view that the issuance of indexed bonds should be carefully handled.

Turning to the external sector, the staff makes it particularly clear that the situation will remain fragile in the years ahead, as the net cash-flow relief to be provided by commercial banks is smaller than originally envisaged. This smaller relief is offset by the positive impact of more favorable oil prices and interest rates. It clearly leaves little room for maneuver and reinforces the need for a strict implementation of policies.

As for this year's external developments, the large inflows of private capital, including the repatriation of capital and higher foreign direct investment inflows, are particularly encouraging. This outcome should encourage the authorities to pursue their policy of liberalization, particularly in the area of foreign direct investment.

I wonder whether the staff can cast some light upon two subjects of concern. First, how does it view the behavior of non-oil exports since the beginning of the year? The second concern relates to the recent strong increase in imports: I wonder whether, in the medium-term scenario, the staff has not underestimated the growth of imports in the next two years, and therefore the fragility of the external position.

On exchange rate policy, I share the staff's view that the exchange rate will need to be closely monitored by the authorities. It is of the utmost importance that the exchange rate be flexibly adapted to ensure the competitiveness of non-oil exports.

As to the recent agreement reached by Mexico with commercial banks, my authorities share the staff's view that it will lead to a net decline in contractual obligations broadly in line with prevailing market rate discounts for Mexico's medium- and long-term obligations. However, all the elements of the agreement are not yet in hand, and the Board will have to decide whether the package is fully consistent with its guidelines in order to provide the necessary enhancements.

But my authorities believe that the recent agreement provides sufficient financial assurances for the release of the second tranche. Therefore, I support the proposed decisions.

Mr. Grosche said that his authorities were pleased to note Mexico's good beginning under the Fund-supported program. The persistent manner in which they were implementing the program deserved commendation. He was particularly encouraged by the large increase in private capital inflows. The authorities' firm policy stance appeared to impress on the markets faster than could have been anticipated. As he fully endorsed the staff's recommendations with regard to the immediate tasks ahead, he would offer only a few comments on external financing.

The specific features of the financing package agreed with the commercial banks were subject to finalization of the agreement, Mr. Grosche observed. The term sheet was only one, although an important, step in that direction. Until the reaction of the nearly 500 banks to the term sheet was known, the precise impact of the agreement on Mexico's debt and cash-flow position remained unclear. But the staff's estimate of a shortfall of somewhat over US$2 billion a year from the program's assumption of US$4.3 billion, which was not to be covered by higher oil prices and lower interest rates, made it clear that the program had become extremely vulnerable to unforeseen adverse developments, particularly to lower oil prices and rising interest rates.

He was concerned about the implications of a smaller than expected cash flow, Mr. Grosche continued. In his view, the banks had to accept responsibility for emergency financing, and in that regard, he was grateful for the Chairman's comments at the outset of the meeting. He fully associated himself with those remarks.

The extent of the reduction in the program's net international reserve target was worrisome, Mr. Grosche commented. Although he assumed that the original target had foreseen some margin of maneuver, the remaining safety margin seemed almost too small and did not leave much room for maneuver. Clearly, one would like to see the banks provide more financing. Also, private capital inflows may help to close the gap, but one had to be realistic about those possibilities. In particular, private flows were extremely sensitive to changes in the overall environment. The authorities needed to be prepared, therefore, for a further tightening of financial policies if that proved to be necessary. He endorsed the staff appraisal and supported the proposed decision.

Mr. Sarr made the following statement:

> It is encouraging to note the exceptional response of the Mexican economy to the policies pursued by the authorities. Since the beginning of this year, the monthly inflation rate has been halved, and economic activity has recovered at a much faster rate than was envisaged at the outset of the program. In addition, impressive achievements were made in the reform of the public enterprise sector, with the divestiture or the reduction in public sector control of over 100 companies. In the fiscal sector, even excluding the positive effect of oil revenues, the primary surplus turned out better than expected, owing in part to the positive yield from the income tax reform undertaken at the beginning of the year, and resulted in lower than programmed public sector borrowing requirements. Moreover, the outcome in the external sector reflected better than expected terms of trade, the positive impact of the trade liberalization measures,

and increased private sector confidence, which resulted in a high inflow of private capital thus offsetting the shortfall in net official capital. Mexico has remained current in its payment obligations, and its net international reserves were within target. With this remarkable outturn, all performance criteria for end-June--adjusted for special factors--were met with a substantial margin.

The outlook for the remainder of the year, as well as for the medium term, remains clouded by uncertainties with respect to developments in oil prices and interest rates, as well as the size, timing, and nature of the financing to be secured from creditors. In this regard, the authorities' extension of the new pact for economic growth and stability to end-March 1990 and their intention to strengthen their policy stance as needed is most welcome. I can also endorse the staff's policy recommendations, and I found most appropriate the emphasis in the staff appraisal on the need for the Mexican authorities to exercise prudence in the implementation of their program for the remainder of this year.

In the fiscal sector, the envisaged adjustment in public service tariffs and the better revenue prospects are expected to offset the higher than initially estimated expenditure and thus allow the authorities to maintain their fiscal stance broadly unchanged. A worrisome development, however, is the rapidly rising domestic debt and the heavy reliance on nonbank financing above the programmed level during the first half of the year. I encourage the authorities to maintain strict control over expenditure and to pursue vigorously the fiscal reforms initiated early in 1989. This should help to reduce public debt and restore some flexibility in the fiscal area so as to allow for much-needed investment outlays and priority current expenditure over the medium term.

In the external sector, although the firming up of oil export prices and the lower than projected interest payments will offset partly the higher imports and the lower noninterest service receipts, the external current account is projected to deteriorate moderately. However, the availability of contingency financing in the form of a bridge loan and the continuation of net private capital inflows should help Mexico accumulate a modest level of reserves by year-end. As the external sector remains extremely dependent on net inflows of private capital and higher direct investment, the authorities should keep the policies and incentives needed for the continuation of these inflows under close review. It is reassuring to note from Mrs. Filardo's statement that the authorities are monitoring these developments closely.

With regard to the medium-term scenario, the sharp reduction in the interest burden over the next two years and the sustained net inflow of official and private capital should help Mexico to contain its inflation rate to single digits by 1991 and to raise the real GDP growth rate to over 5 percent a year by 1992. This medium-term scenario underscores the importance of pursuing appropriate policies and also the urgency of concluding the financing package with commercial banks at the earliest possible opportunity. In this context, I welcome the progress made on the term sheet. However, I would appreciate some comments from the staff on the degree of confidence it has that by the next review, sufficient progress will have been achieved in the finalization of the financing package so as to permit the staff to evaluate it and to recommend the acceleration of the set-aside and the augmentation of resources.

This chair would also like to endorse Mr. Warner's comments on the important role played by the staff, the management, and the Board throughout the debt-negotiating process for Mexico. My authorities are convinced that this attitude will be extended to other forthcoming debt negotiations. I support the proposed decision.

Mr. Ghasimi remarked that the case of Mexico was important for many reasons. First, Mexico was one of the largest middle-income developing countries. Second, in view of the size of its population and its advanced stage of development, Mexico had become over the years a trend setter for many other developing countries. In that regard, it was not surprising that Mexico had become the first beneficiary of many international debt initiatives, including the latest one, and of interesting innovations in the areas of program design and restructuring agreements. Third, despite some setbacks generally brought about by overwhelming exogenous factors, especially in the international oil market and international interest rates, Mexico had consistently and courageously implemented strong adjustment and structural reforms.

It was therefore without reservation that he commended the authorities for their success in the implementation of the program and the good economic performance during the first months of the extended arrangement, Mr. Ghasimi continued. The best indicator of such good performance was the sharp reduction in inflation. Real GDP growth was also picking up at a rate that was better than programmed but, unfortunately, still low compared with Mexico's potential capacity. Except for some unexpected developments, Mexico seemed well on its way to a strong economic recovery. That process would be helped by the restoration of private sector confidence, which was already apparent, and which would undoubtedly be reinforced by the good performance under the program as well as by the conclusion of negotiations with commercial banks.

He also commended the authorities for having reached agreement with the commercial bank advisory committee, Mr. Ghasimi commented. After long and hard negotiations, that agreement could definitely constitute a precedent for other developing countries. Nevertheless, the financial flows gained were lower than had been envisaged in the program.

It was in Mexico's interest to adhere to its adjustment program and in that regard, he supported most of the staff's suggestions in the fiscal, monetary, and external areas, Mr. Ghasimi remarked. More generally, the Mexican case showed clearly the success of adjustable performance criteria. Many programs would not have become inoperative if such performance criteria had been used more widely. The staff should study the possibility of generalizing such flexibility in the design of Fund programs.

The protracted time required to negotiate the agreement between Mexico and its commercial banks was unfortunately not unique to Mexico and showed that the time period set for the Board's review of such arrangements--namely, before the second drawing--was really very short, Mr. Ghasimi observed. He wondered whether it would not be appropriate for the Board to return to the original staff proposal, namely, to review the financing of the program six months after its approval by the Board. Finally, he could go along with the proposed decision.

Mr. Prader made the following statement:

> Yesterday's discussion on the review under the extended arrangement for Venezuela (EBM/89/125, 9/13/89) and today's discussion on Mexico display a number of similarities. As Venezuela, Mexico deserves the Fund's fullest support. The program is on track. The domestic adjustment measures and the remarkable results achieved so far are good signs for the continued successful implementation of Mexico's extended adjustment program.
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> On the domestic adjustment front, the substantial reduction in the inflation rate is most encouraging, and I would like to refer here to this chair's statement yesterday concerning the beneficial effects of disinflation on the future course of adjustment.
>
> Concerning external financing developments and preliminary assessments of the effect of the recent agreement with the banks on Mexico's payments outlook, it is unclear whether a sufficient number of banks will actually resume new lending in the medium term. This is especially worrisome because Mexico's liquidity needs will remain large for the foreseeable future and will have to be met by a smaller number of banks. The financing arrangement will thus probably be insufficient to stabilize Mexico's relations with her foreign creditors, whether official or commercial. A large gap will remain between the payments

burden and the payments assistance obtainable from the markets, and the likelihood of a permanent transfer of risk from the private to the public sector is still as great as it was earlier.

The financing arrangement confirms this chair's earlier concern that debt reduction operations absorb large amounts of financial sources for the repurchase or collateralization of debt obligations and yield in exchange only a small amount of annual cash relief. The disproportion between the large up-front resources provided by official sources on the one hand, and the limited liquidity relief granted by the private sector on the other, raises questions about the optimal use to which those official resources might otherwise have been put. The staff's correct observation that the net cash-flow relief to be provided by commercial banks is smaller than initially envisaged, together with the compelling conclusion that the Mexican program has henceforth become more vulnerable, also raises questions about the appropriate burden sharing of financing flows between private and official sectors.

At this stage, the Fund can probably do nothing more than draw the banks' attention to the need for sufficient contingency financing to be provided by them in order to cushion the program's increased vulnerability, which derives from the smaller cash relief to be provided by commercial banks. Such contingency financing is needed so that the program will have the necessary financial resources it deserves. As for the Fund's possible contribution to such contingency financing, I can fully associate myself with the Chairman's comments at the outset of this meeting.

So far, the Mexican economy has entirely lived up to the high expectations that were placed in the extended Fund arrangement and, consequently, I support the proposed decision.

Mr. Shrestha said that the authorities were to be commended for their successful implementation of the policy reform measures under the extended arrangement. He was pleased to note that all performance criteria for end-June had been observed.

When the Article IV consultation with Mexico had been discussed in May (EBM/89/64 and EBM/89/65, 5/26/89), Directors had agreed that the policy stance that was being pursued, with its emphasis on growth-oriented adjustment, was the only way for Mexico to pull itself out of its economic problems, Mr. Shrestha recalled. In addition, they had expressed the view that the success of the program hinged on effective control of inflation, a major increase in domestic savings, and effective debt reduction.

The significant improvement achieved in the inflation rate, which had been reduced from around 52 percent in 1988 to 20 percent in 1989, was impressive, Mr. Shrestha continued. He was also pleased to note that domestic savings had exceeded 24 percent in 1989, and that domestic interest rates had started to fall without adversely affecting the savings rate. Moreover, economic activity had recovered at a faster pace than envisaged in the program, mainly owing to increased private sector investment and strengthened public finances in 1989.

Exchange rate reform was another area where considerable success had been achieved in the first half of the year, Mr. Shrestha commented. That was an important area where close monitoring was needed to maintain external competitiveness. He was also pleased to note that the authorities had continued to pursue their policy of divestiture of public enterprises.

As a result of those reforms, business confidence had been restored, and, subsequently, private capital inflows had been substantially larger than had been envisaged, Mr. Shrestha observed. Those higher than projected net inflows of private capital were in large part due to higher foreign direct investment. However, the increased current account deficit, unadjusted public sector prices, and the expansion of credit to the private sector were areas where careful attention was needed for the present.

In view of those developments, the medium-term program as presented in the staff report was well in line with the problems faced by Mexico at present, Mr. Shrestha considered. Acceleration of the growth rate should be the main emphasis of the medium-term program. He was optimistic that Mexico's economic outlook would improve with the acceleration of domestic savings and investment, and the successful implementation of the proposed debt and debt-service reduction operations. With those observations, he could support the proposed decision.

Mr. Jalan said that he was pleased to note the positive developments in the Mexican economy. The economy had done as well as could be expected. All performance criteria had been met, and an agreement had been reached with commercial bank creditors. He congratulated the authorities on their achievements and was pleased to support the proposed decision.

He had little to add to previous speakers' comments, Mr. Jalan continued. There were two questions however, on which he would like some further elaboration from the staff. The first related to the observation in the staff appraisal regarding the greater vulnerability of the Mexican balance of payments. What were the implications of that greater vulnerability for Mexico's future debt-servicing capacity? Also, in view of the substitution of some commercial debt by public debt, what risks were involved in Mexico's capacity to service that new debt if oil prices fell?

The second question related to the staff's observation that the reduction in Mexico's contractual obligations was equivalent to that which would result from a buy-back carried out at a discount of about 60 percent of face value, Mr. Jalan commented. That was an interesting and reassuring observation, but some further elaboration would be welcome. In particular, according to the staff paper, a 35 percent discount equivalent to a buy-back at a discount of 55 percent to 60 percent reflected the greater risk attached by the banks to Mexican paper. He understood from the details of the agreement with commercial banks that the principal would be collateralized by the issue of U.S. Treasury bonds and that the interest payment would be mostly collateralized by an escrow account. Why then was the perceived risk assumed to raise the equivalent discount to 60 percent? A related question was: if the perceived risk was as high as assumed in the staff's calculation, what were the expectations regarding flows of new money?

Mr. Fogelholm said that the Nordic countries agreed with the staff's positive evaluation of economic developments under the program supported by the extended arrangement, and with its recommendations for future policy action. He very much welcomed the agreement on a term sheet reached between the authorities and the banks, even though he concurred with other Directors that many uncertainties remained relating to the final outcome of the package.

When the arrangement for Mexico was approved in May, he had expressed concern about the medium-term viability of the economic program, Mr. Fogelholm recalled. He was therefore pleased to note from the revised scenario that the external accounts appeared to improve somewhat in the medium term compared with the original program, even if the reasons for that improvement might be of a temporary nature. It was, however, most worrying that the financing agreement between the authorities and the banks had fallen somewhat short of the financing assumptions in the program and that, consequently, the program was left with very small margins, if any.

Although the shortfall in external financing from the banks had been compensated for by the increase in the price of oil and the decline in international interest rates, there was a clear risk that those favorable developments would not continue, Mr. Fogelholm commented. If a financing gap were to emerge, the authorities would have no other option than to reopen discussions with the banks or to undertake the necessary adjustments. Under no circumstances should the Fund step in and compensate for a shortfall in financing caused by the banks.

In concluding, he wished to reiterate his authorities' general concern about the risk involved for the Fund if it became financially committed to programs with inadequate margins, Mr. Fogelholm remarked. The basis for the Fund's participation in the debt strategy was strong programs, and adequate financing was included in that fundamental requirement. A general tendency toward underfinancing of Fund-supported programs under the revised debt strategy would, no doubt, lead to consideration of amendments to the Fund's guidelines. With those comments, he could support the proposed decision.

Mr. Evans said that the Mexican authorities were to be complimented on their continued policy achievements since the approval of the extended arrangement. The dramatic improvement in confidence, not least the confidence of international financial markets, in the Mexican economy in recent times should not go unremarked. Before that experience was too far in the past, it would be beneficial if the staff fully documented and analyzed those particular developments. There had been a great deal of commentary recently regarding the alleged failure of Fund policies, and Mexico's experience offered a fine example of the significant benefits that could come, and come quickly, from a truly collaborative approach between national authorities and the Fund. It warranted recording for future use.

He had no hesitation in supporting the staff appraisal, Mr. Evans continued. If a word of caution were needed, he would direct it primarily to the conduct of monetary policy. In view of the increased vulnerability of the external account under the revised financing assumptions, the authorities would need to be particularly vigilant regarding the pace of domestic demand growth and, hence, of inflation. In that regard, the acceleration of contractual wage settlements--to around 15-17 percent--and the projected increase in commercial bank credit--at a real rate of 25 percent--should both represent cause for concern, particularly as the propo sed nominal depreciation of the currency was likely to validate the continuation of inflation at around its recent rate.

The recent and projected substantial increase in business investment, which was a welcome development, appeared to be driven primarily by renewed confidence and therefore was unlikely to be particularly sensitive to interest rates, Mr. Evans observed. The balance of risks would therefore seem to lie in having monetary policy lean against further interest rate declines until more fundamental policy adjustments had had a chance to be effective. The resort to indexed bonds gave rise to particular concerns. With those comments, he supported the proposed decisions.

Mr. Filosa made the following statement:

> The staff presents an overall satisfactory picture of the Mexican economy. As of end-June, Mexico has observed all quantitative performance criteria under the extended program. I therefore can support the proposed decision.
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> As for the agreement between Mexico and the commercial banks, I agree that the term sheet is in line with the Fund's guidelines. I also agree that it allows for substantial cash relief. It is regrettable, however, that the agreement has eroded all contingency margins included in the program's financial plan. Nonetheless, I share fully the Chairman's doubts

about the banks' request that the Fund should provide further contingency financing on account of the erosion of the margins, which is largely attributable to the banks' provision of less new money than had been expected.

The question is: how can Mexico consolidate the results achieved so far? The issue is complicated by the fact that the package agreed with the commercial banks does not allow for any margin on the external financing side. Furthermore, despite the improved trade balance that is projected over the next few years, the reserve position is expected to remain vulnerable to adverse external developments such as increases in the interest rates and declining oil prices. In the circumstances, the higher than projected rate of growth should be regarded as a mixed blessing. The fact that the present rate of growth is mainly due to higher than expected levels of investment is cause for satisfaction, but the higher rate of investment has contributed to the current deficit, which is now slightly higher than originally envisaged despite the more favorable oil price developments. Until now, the financing of the current account deficit has been made possible by increases in private capital flows, which have largely compensated for a shortfall in official borrowing in 1989. The problem, as rightly emphasized by the staff, is that the high level of private capital inflows should be regarded mainly as stock adjustment, the effect of which will naturally tend to decline over time. Since commercial bank financing is not expected to compensate for the decline of private capital inflows and in view of the low level of reserves, careful control of total domestic demand is necessary if the authorities are to avoid future balance of payments difficulties that may arise as a consequence of unfavorable external developments. In particular, "the authorities, as noted by the staff on page 25 of its report, should stand ready to tighten credit policy if strong demand pressures should emerge as a result of developments in the private sector."

A delicate balance will need to be preserved. On the one hand, it is necessary to maintain the present level of investment expenditure to assure the achievement of an adequate rate of growth. On the other hand, the stringency of the balance of payments constraint suggests that the present rate of growth perhaps exceeds the level that can be maintained in the long term.

Whether the present rate of investment can be maintained also depends on the course of fiscal policy and on the pace of structural reform. With respect to fiscal policy, I am pleased to note the overperformance in the primary surplus. I also welcome the sharp reduction of interest rates and its positive effect on internal debt-service payments.

Concerning structural reform, it is encouraging to note that the authorities are trying to fine-tune their approach to privatization so as to improve the return from those operations. However, another important goal of privatization is to achieve a proper balance between public and private initiative within the strategic industrial sectors. I therefore encourage the authorities to proceed prudently but steadily on this road.

Mr. Posthumus remarked that Mexico's economic performance had been extremely satisfactory in the first stage of the Fund-supported program. The first review should therefore be completed so that the next purchase under the extended arrangement could be made.

On the economic program itself, he had only two remarks to offer at the present time, Mr. Posthumus continued. The introduction of indexed bonds by a government aiming at, and so far admirably succeeding in, decreasing inflation was somewhat surprising. It not only compromised the flexibility of financial management, but it might not be considered a sign of strength by the markets. The second observation was that the increase in bank credit was strong, and the authorities might have to be cautious, particularly as inflationary expectations may still exist.

The staff had rightly adjusted the performance criteria for higher actual oil prices and lower interest rates than originally estimated, Mr. Posthumus considered. However, no conclusions were drawn for the further financing of the program or for the further adjustment effort itself. The results of the negotiations with the banks meant that Mexico had had to change the assumptions which had served as the basis for the agreement with the Fund, apparently assuming that that would not affect the size of Fund and World Bank financing. The estimated reserve position was now substantially weaker than had been intended. He wondered whether that outcome had consequences for the Fund-supported program. If a contingency arose, further financing from banks might be required, as well as further adjustment. In that event, Mexico's debts and debt-service payments would again increase.

The package that had been negotiated may itself show sufficient debt reduction, as the staff contended, but the additional financing needed and the resulting increase in indebtedness should also be taken into account in making a final judgment on the debt and debt-service reduction package, Mr. Posthumus said. He wished to stress once again that the Fund's financing role in debt reduction operations had a specific purpose, namely, to help attain external viability with growth--to clear away the debt overhang. That criterion was not mentioned specifically in the staff appraisal.

He had two questions for the staff on the press communiqué, Mr. Posthumus commented. First, mention was made of debt-service reduction bonds denominated in other currencies. Did that mean that there were new risks for the Mexican financing package? Second, trade financing was one of the new money options: was it customary to include trade finance under new money?

Mr. Nimatallah remarked that he agreed with the staff's assessment that the Mexican authorities' performance had been exemplary. High marks and most of the credit for that successful performance should be given to President Salinas, who had been able to convince his people and the world community of his commitment to adjustment and reform. He had not only succeeded in extending the Pact of Economic Growth and Stability but had also succeeded in reaching an agreement with creditor commercial banks. Those achievements were indeed commendable and seemed to be encouraging capital repatriation. Major industrial countries, and particularly the United States and Canada, could improve the external environment for Mexico further by improving their fiscal policy and making it more flexible in responding to inflation threats so as to avoid raising international interest rates. Saudi Arabia was doing its best to make oil markets orderly.

The President of Mexico should turn his attention to three matters: domestic debt, which was heavy; domestic demand, which was threatening to disrupt progress on inflation; and the important task of encouraging foreign investment, Mr. Nimatallah considered. The Mexican authorities should reconsider their negative attitude toward MIGA and join as soon as possible in order to help encourage nondebt-creating inflows of capital. He endorsed the proposed decision.

Mr. El Kogali observed that Mexico had been the first country to use the Fund's debt and debt-service reduction facility, and it was therefore encouraging to see from the staff report and from Mrs. Filardo's statement how well the new facility had served Mexico's medium-term, growth-oriented program during the first four months. Mexico had observed all the performance criteria, and the preliminary agreement reached by Mexico with commercial banks on a financing package, together with the other favorable developments noted by Mrs. Filardo, as well as the compensatory and contingency financing facility that had also been approved by the Fund in May, had tremendously improved the economic environment. Those factors had worked effectively to eliminate inflationary expectations and encourage private capital inflows, which were estimated at more than US$2 billion during the first seven months of 1989. The authorities' adherence to sound fiscal and monetary policies, along the lines of the extended arrangement, were at the core of the economic upturn, so that the prospects for Mexico's growth had continued to improve as indicated in the staff's medium-term scenario.

The actual impact of the debt relief resulting from the financing package was not yet known, Mr. El Kogali noted. However, the estimated net cash-flow estimate during the program period was over US$8 billion. In addition, Mrs. Filardo had estimated a gradual reduction in resource transfers to the rest of the world from an average of 6.2 percent of GDP in 1989 to about 2 percent of GDP by 1992. It was clear that the catalytic impact of the Fund's debt facility in arresting the resource transfer from debt-saddled countries and restoring net investment and growth-oriented adjustment was considerable. Accordingly, he fully agreed with the staff's recommendation that upon the satisfactory completion of the program review by year-end to ensure that the financing package had come into effect and to ascertain the policies for 1990, the Fund should approve Mexico's request for an acceleration of the set-asides and a request for augmentation.

He urged the Fund to consider extending the debt facility to the debt-distressed low-income countries, such as those in his constituency, in view of its proven effectiveness, Mr. El Kogali remarked. Clearly, such relief in outward resource transfers, coupled with sound domestic economic policies, stood a much better chance of restoring growth once again to those countries. He supported the proposed decision.

Mr. Fayyad considered that Mexico's performance under the program to date had been impressive, both in terms of outcomes as well as policies. The progress that had been achieved so far in reducing inflation and the stronger than anticipated revival in economic activity were most encouraging signs, although the latter had led to a widening in the external current account deficit beyond what had been originally envisaged, notwithstanding the favorable impact of higher oil prices and lower international interest rates. However, he was assured by Mrs. Filardo's statement that developments in that area were being monitored closely and that the authorities stood ready to adjust financial policies as may be warranted.

He agreed with the staff appraisal, Mr. Fayyad remarked. He particularly noted the staff's observation that the good performance registered by Mexico could be expected to continue on the basis of the policies planned in the second half of 1989, but that in view of the reduced margins associated with lower than projected levels of financing, and thus the increased vulnerability of the program to adverse developments, particularly in oil prices, it would be important to take particular care in the implementation of those policies so as to preserve the gains already achieved in reducing inflation while consolidating the basis for sustained economic growth in the context of a viable balance of payments position. He supported the proposed decision.

The staff representative from the Western Hemisphere Department remarked that agricultural exports had grown slowly in the first part of the year compared with previous periods largely owing to two consecutive years of drought. As for manufactured exports, information for June indicated an increase at an annual rate of 20 percent in U.S. dollar terms, which suggested that the pace of growth in those exports remained high.

It had been suggested that the staff's import projections for the coming years were too low, the staff representative recalled. Those projections were based on macroeconomic relations that had been observed in the recent past. Moreover, there was a direct link between import growth and financing, particularly financing provided by private capital flows. To the extent that such flows were higher than had been projected, imports could be expected to increase above their present level. Thus, import growth accompanied increases in investment, as financed both by increased domestic savings and by capital reflows.

A question had also been raised about the medium-term economic prospects, particularly with respect to the benefits of debt reduction in the short term and thereafter, the staff representative continued. The benefits related to debt-service reduction itself could not be fully captured in the projections for the coming 4-5 years because its impact would be felt over the 30-year life of the bonds, although the impact would be smaller in later years. The impact of the debt-service reduction package had been felt more in terms of capital reflows, which had been significant. The fact that interest rates had declined without action by the monetary authorities--in fact, there had been a continued increase in financial savings--indicated that the decline was directly linked to the pursuit of strong domestic policies as well as increased confidence owing to the package. It should also be noted that in August, inflation had been below one percent a month, and interest rates had declined by half a point per month in the context of strong financial savings.

It was true that the vulnerability of the program had increased in the sense that the margins that had been built in the initial program, based on a projected oil price of US$12 per barrel would be eroded on the basis of a price of US$15 per barrel, the staff representative observed. The projections for the medium term, however, showed that the program was financeable. A decline in the price of oil from current levels to, say, US$12-13 per barrel would, of course, have an adverse impact and there would be less protection in terms of reserves. The fact that the package contained a greater component of debt reduction implied that there would be fewer uncertainties with regard to the debt-service burden and therefore that there was less need for reserves compared with initial projections. While that did not make the program less vulnerable, it did provide a partial justification for a lower level of reserves.

The design of debt-equity swaps in 1986 and 1987 had had a tremendous impact on monetary management, the staff representative commented. At present, the authorities had been extremely careful in selecting the elements to be financed through such swaps. Their objective was to place more emphasis on privatization and also on more transparency in the exchange process.

Another issue related to foreign investment was tax measures affecting capital reflows, the staff representative noted. The authorities had introduced a flat tax to replace previous taxes. They had, in a sense, declared a tax holiday insofar as the tax obligations of nationals who had brought money from abroad had been eliminated.

The staff's comments on the package with commercial banks were preliminary at the present stage, especially in view of the fact that the term sheet had just become available, the staff representative remarked. In that regard, one important question that had been raised was why the exchange ratio was not in line with the price of Mexican debt in the secondary market. According to the staff's calculations, the two were compatible in the sense that the new instruments carried only a certain percentage of non-Mexican risk. By contrast, if a cash transaction were effected, the Mexican risk would be eliminated and would be replaced by non-Mexican risk. Thus, when only part of a bond's value was collateralized, only part of the secondary market price would be adjusted. Moreover, it was important to note that the value of the principal collateralization was relatively small in a 30-year bond. At current interest rates, about 7-8 percent of the present value of the bond was determined by the collateralized principal. In addition, only 18-24 months of interest were collateralized. Therefore, a significant element of Mexican risk would remain, which would be valued at the market price.

A related issue was the inclusion in the package of provisions for collateralization for other currencies, the staff representative continued. The staff understood that the Mexican authorities were not increasing their risk because they would be covering a present value of collateral that was equivalent to that which would be paid for a U.S. dollar-denominated instrument, so that the banks would be absorbing the foreign exchange risk.

The element of trade financing in the new money package was customary, the staff representative observed. It constituted a rollover of previous facilities and had been incorporated in previous financing packages.

As to whether it would be possible for the staff to report on the progress of financing by the time of the next review, the staff representative from the Western Hemisphere Department explained that a clause in the agreement provided some incentive to banks to take a decision on financing options by the end of October. The small difference in spreads in fees was expected to encourage banks to move quickly. The staff expected that the banks' choices would be known by the time of the next review and that any requests relating to front-loading of disbursements and set-asides could be considered by the Board at that time.

Mr. Jalan observed that the market price of the new collateralized Mexican bonds would be about 80 percent of their face value. He wondered whether it was realistic to expect new money, which was not collateralized, to flow to Mexico at the same time as collateralized bonds were selling at a discount of 20 percent.

The staff representative from the Western Hemisphere Department remarked that the price of the bonds was expected to reflect an element of Mexican risk and an element of collateralization that would make them equivalent in the end with the new money package. Moreover, certain banks were expected to continue to opt for new money owing to their assessment of the prospects of the Mexican economy or their involvement in the economy, while other banks might opt for collateralized bonds or instruments that gave them more certainty or allowed them to phase out their operations in Mexico.

Mr. Nimatallah observed that the banks attributed the discount on their claims partly to their own miscalculation and partly to countries' lack of resolve to adopt strong economic and financial policies. The 20 percent discount on new bonds--the remaining Mexican risk--was associated with the continuity of adjustment. That risk could be expected eventually to disappear--and the provision of new money to reappear--as markets became convinced that Mexico was on the right course.

The staff representative from the Exchange and Trade Relations Department remarked that the increase in oil prices had benefited the economy, and clearly did not result in the program's increased vulnerability. Rather the greater part of the increased foreign exchange accruing to the economy as a result of the better oil price and lower interest rates would be utilized to compensate for the reduced cash relief expected to result from the commercial bank package. That development had given rise to a tighter liquidity situation, at least in the more immediate future, until the benefits from the package in terms of confidence and capital reflows materialized. In that sense, the staff viewed the program's vulnerability as having increased.

Adjustable performance criteria such as those in the Mexican program, had been used for a number of countries, the staff representative commented. For example, Venezuela's program supported by the extended arrangement incorporated an adjustment mechanism to capture some of the windfall on account of improved oil prices to increase its gross reserves. Adjustable criteria were also included in the program for Ecuador and others.

One Director had suggested that the timing of the review of Mexico's arrangement might have been more appropriate six months after the Board's approval of the arrangement in May so as to give the member more time to complete its negotiations with creditors and perhaps allow the Board to have more complete information regarding the financing package, the staff representative from the Exchange and Trade Relations Department recalled. On concluding its discussion on financing assurances in May, the Board had indicated that it would review the financing situation, if financing was not fully secured at the inception of the arrangement, at quarterly periods and would make a judgment at that time in the light of both the performance under the economic program and the progress made in concluding the financing arrangements.

Mrs. Filardo said that she was grateful for Directors' expressions of support for her authorities and for Directors' insightful comments regarding the risks that Mexico faced in the future. With respect to the program's increased vulnerability and the lack of margins, there was no doubt that Mexico faced a trade-off between rapidly reaching agreement with the commercial banks that left the program with a high degree of vulnerability and reaping the benefits of an early announcement of an agreement, such as capital repatriation and the return of confidence. Nevertheless, if portfolio managers perceived that the program was a tight one and that the debt overhang still remained, the authorities would face a great risk. The alternative would be yet another, perhaps protracted, negotiation with the banks to produce a better financial package for the program, and in that event, the Board might have to provide the country with more leverage for negotiations with the banks. In that regard, she agreed with Mr. Nimatallah's remarks on a previous occasion that the Fund should not close the door to a country which was implementing its program adequately, but should instead allow for the disbursement of the second or third tranche if the program was on track and negotiations with the banks were progressing.

Many Directors had expressed concern about the transfer of risk from the private sector to the public sector and had urged her authorities to be ready to implement further demand management policies if the commercial banks were not ready to provide adequate finance to Mexico, Mrs. Filardo observed. Her authorities had been seriously demonstrating their willingness to implement a good program and had taken courageous steps to transform their economy, including the privatization program. For example, they had declared the bankruptcy of a mine having one of the most important trade unions in Mexico. She therefore urged caution when advising on the need for further measures to ensure that such actions did not sacrifice the economic growth that had recently been achieved. The Fund should, of course, stand ready to support Mexico if it became necessary to enter again into negotiations with the commercial banks, including with financial assistance.

Some Directors had suggested that the authorities should reconsider their position regarding Mexico's membership in the Multilateral Investment Guarantee Agreement, Mrs. Filardo recalled. In her authorities' view, foreign investment was adequately safeguarded both by existing laws and the present level of economic activity. Mexico's economic potential and renewed confidence in its economic management were expected to lead to an increase in foreign investment. In any event, her authorities remained open to reconsider the possibility of joining MIGA.

The Executive Board took the following decision:

1. Mexico has consulted with the Fund in accordance with paragraph 4 of the extended arrangement for Mexico (EBS/89/91, Sup. 2) and paragraph 28 of the letter dated April 11, 1989 from the Secretary of Finance and Public Credit of Mexico and the Director General of the Banco de Mexico, in order to review the implementation of the economic program described in that letter and attached Technical Memorandum of Understanding 1989 ("the Memorandum"), and to reach understandings regarding the circumstances in which purchases by Mexico may be resumed.

2. Tables 7 and 8 in EBS/89/178, which incorporate understandings of the Fund with the Mexican authorities, shall be annexed to the extended arrangement for Mexico, and the letter and attached Memorandum dated April 11, 1989 shall be read as modified and supplemented by Tables 7 and 8 in EBS/89/178.

3. Mexico will not make purchases under the extended arrangement that would increase the Fund's holdings of Mexico's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that any of the limits described in paragraphs 2, 3, 8, 9, or 10 of the Memorandum attached to the letter of April 11, 1989 and adjusted as shown in Tables 7 and 8 in EBS/89/178 are not observed.

4. The Fund finds that the review contemplated in paragraph 4(b) of the extended arrangement has been completed, and that Mexico may proceed to make purchases under the extended arrangement.

Decision No. 9255-(89/126), adopted
September 14, 1989

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Massé upon the conclusion of his service as Executive Director.

APPROVED: May 11, 1990

LEO VAN HOUTVEN
Secretary