

## INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 86/149

3:00 p.m., September 8, 1986

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

Executive Directors

C. H. Dallara  
J. de Groote

H. Fujino

J. E. Ismael  
A. Kafka

M. Massé

F. L. Nebbia  
Y. A. Nimatallah

H. Ploix  
J. J. Polak  
C. R. Rye

A. K. Sengupta  
S. Zecchini

Alternate Executive Directors

K. Yao, Temporary

T. Alhaimus  
M. Sugita  
B. Goos  
Jiang H.

M. Foot  
H. Fugmann

W. K. Parmena, Temporary

J. E. Suraisry  
G. Ortiz

B. Tamami, Temporary

N. Kyriazidis

L. Van Houtven, Secretary  
A. Akanda, Assistant

1. Mexico - 1986 Article IV Consultation; Stand-By  
Arrangement; and Exchange System. . . . . Page 3

Also Present

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

1. MEXICO - 1986 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors continued from the previous meeting (EBM/86/148, 9/8/86) their consideration of the staff report for the 1986 Article IV consultation with Mexico, together with a request for an 18-month stand-by arrangement in an amount equivalent to SDR 1.4 billion, with the possibility of augmentation to SDR 2.2 billion (EBS/86/161, 7/23/86; Cor. 1, 9/5/86; Sup. 1, 8/15/86; Sup. 1, Cor. 1, 9/5/86; Sup. 2, 9/4/86; and Sup. 3, 9/8/86). They also had before them a background paper on recent economic developments in Mexico (SM/86/220, 8/26/86; and Sup. 1, 8/27/86).

Mr. Jiang made the following statement:

The Mexican economy has experienced major imbalances in the past few years, and the external arrears issue has become one of the major concerns for the Mexican authorities. A series of adjustment measures were taken by the authorities under a Fund-supported adjustment program as a means of dealing with those economic difficulties; indeed, improvement was made in the adjustment process with the result that, for a time, external arrears became less prominent and severe. Unfortunately, Mexico was hit severely and unexpectedly when two earthquakes occurred in September 1985, and these events once again threw the country into a difficult situation where adjustment became much more difficult. Although emergency assistance was provided by the Fund, the drawing of resources under the Fund adjustment program was suspended during that period because of Mexico's failure to meet a few of the performance criteria. Regrettably, recent economic developments indicate a worsening of the economic situation in Mexico, where external arrears are once more becoming acute. The new economic program for 1986-87 shows the clear determination of the authorities to commit themselves to continuous adjustment and, therefore, I support the authorities' request for a new stand-by arrangement.

In addition, there are still countries, large and small, which have serious problems of external debt, and the Fund should also focus its attention on the difficulties facing these countries.

Mr. Nimatallah made the following statement:

I welcome this first case under the Baker initiative, and I support the proposed decision in principle. However, I do have some reservations.

The first reservation concerns the growth contingency. If growth is not stimulated in the short run, then I am not sure

that additional financial resources will be sufficient to stimulate growth. I think that growth will depend a great deal on the continuation of structural adjustment, which will not be a short-term matter. When oil revenues declined sharply in Saudi Arabia, real incomes declined and the whole economy had to adjust to a level where it could resume growth, which took some time. I will not be surprised if Mexico goes through almost the same process. In his opening statement, Mr. Ortiz notes that Mexico has lost approximately 6.5 percent equivalent of its GDP owing to the sharp decline in oil prices. Therefore, I emphasize again that the authorities need to intensify their structural adjustment efforts, particularly on the supply side. I commend the authorities for the measures they have taken thus far, but I encourage them to accelerate their efforts.

The next reservation that I have is on fiscal policy. I note that the overall public sector borrowing requirement (PSBR) is expected to be 17 percent of GDP in 1986, which is very high. I commend the authorities for the steps they are taking to redress this situation. However, more steps need to be taken.

To understand this, we need to examine the issue of how best to measure fiscal deficits. It is true that the fiscal effort, when measured as a percent of GDP, is not likely to depend greatly on the choice of deficit measure. However, the manner in which that fiscal effort is evaluated is very dependent on such a measure. Specifically, should the Executive Board assess the fiscal effort in the light of the financing requirements facing the authorities or should it concentrate on the performance of fiscal policy in a world without debt? I believe that it is very important to keep the financing requirement in mind. Therefore, in my opinion, it would be more appropriate to use the conventional measure of the deficit, because this allows the Board to evaluate the sustainability of a fiscal program. The authorities, however, emphasize the importance of the primary balance concept, which excludes all interest payments.

Like several other speakers, I feel that the primary balance concept is not particularly helpful, because by itself it makes the evaluation of the sustainability of a fiscal position difficult. As this chair has pointed out on other occasions, the fact that the fiscal balance, net of interest payments, is not in deficit may be of little comfort if debt has become so large that interest payments are beginning to feed on themselves. In Mexico's case, domestic and foreign interest payments, though anticipated to decline somewhat, nonetheless amounted to some 19 percent of GDP in 1986. Further, while the primary balance is anticipated to have a surplus equivalent to 5.6 percent of GDP in 1987, I note from the staff's medium-term scenario that the overall public sector deficit for 1987 is expected to be about 14 percent of GDP, a 2 percentage point decline over 1986. It is in the

light of this situation and the high debt service burden that I believe more may need to be done on both the revenue and expenditure fronts.

As to the use of inflation-adjusted measures, I agree with the views expressed by other Executive Directors during the recent Board seminar on inflation-adjusted fiscal measures that such measures are best viewed as supplementary tools. It is misleading to isolate the impact of inflation on nominal interest payments, since inflation typically has a number of other effects on the fiscal balance. For example, although the authorities are committed to further indexation of the tax system, the rate of inflation does affect tax revenues. In fact, the proposed tax measure to charge interest on overdue tax payments is sensitive to inflation, since it is based on market-related interest rates. Furthermore, as evidenced by the fact that the authorities have had to increase public sector prices, expenditures are also sensitive to the inflation rate. Finally, we must never lose sight of the fact that the inflationary process itself is generally affected by the fiscal deficit.

I would have liked to see specific inflation targets for 1987 in the program. I know that it is difficult to estimate accurately what such targets should be. However, it is important that the program should specify inflation rates that are tolerable.

I urge the authorities to be very careful in handling their wage policies. In my judgment, they need to widen the export base and to enhance Mexico's competitive position in world markets. This can only be achieved by controlling costs, particularly wage costs, and by adopting a flexible exchange rate policy. On the latter, I commend the authorities for their recent measures and encourage them to eventually unify their exchange rate.

In conclusion, I urge the authorities not only to accelerate their adjustment efforts, but also to be persistent and to try, in particular, not to interrupt those efforts. Structural adjustment needs continuity to convince the world that Mexico is keen on reforming its economy. I commend the authorities on keeping good relations with the banks and on the measures they have taken to reform the economy. It is fortunate that interest rates are low and that there are neighboring markets that are open for Mexico's exports. Above all, Mexico has the support of not only the Fund and the World Bank, but of the world community.

Mrs. Ploix made the following statement:

I would like to recall my authorities' satisfaction when the agreement on an economic program for Mexico was finally reached on July 20, which was a first step toward a stand-by

agreement. Thus, it is a great pleasure for me today to commend the Fund's staff and management, as well as the authorities, for the patience, tenacity, and goodwill that they have displayed in reaching this agreement: the history of the discussions during the past month illustrates perfectly the difficulty of the task that had to be undertaken and the importance of the final outcome.

Since I am in broad agreement with the thrust of the staff appraisal and support Mexico's request, I will stress only a few points on the major policy aspects of the program itself before addressing briefly the two distinctive aspects of the agreement--the oil and the growth contingency mechanisms.

It is not necessary to emphasize the reasons that have led to the unfavorable developments in the Mexican economy since our review of the previous program 15 months ago. It should be sufficient to recall that slippages, mostly of domestic origin, had destabilized the program to a large extent. Thereafter, shocks--the earthquake and the drop in oil prices--gave it the coup de grace, which necessitated reconsideration of the entire economic policy stance to be implemented by the authorities.

This difficult exercise has now been completed, and the economic program presented by the Government and developed with the support of the Fund is both comprehensive and reasonably rigorous, given the economic and social constraints. Its main objective, the resumption of a sound growth rate in the economy, is a necessary one. It is framed in a medium-term perspective, which is appropriately longer than the 18-month span of the Fund's program itself. We find appropriate, too, that the measures will aim at overcoming the imbalances and at implementing structural reforms.

It appears clear that the core of the program is control of public finance. The efforts envisaged are important but necessary, given the present imbalances and the clear need to dramatically reduce the PSBR. As noted by Mr. Goos, it is stated on page 15 of the staff report that it remains, of course, that it is the PSBR that must be financed. Even if we agree with the authorities that the planned reduction of the PSBR has to take into account its composition and the effects of inflation, we think that this reduction is a priority, given the impact of the PSBR on the external position, on tax and price policies, and on the operational balance. In our opinion, any relaxation would directly and immediately endanger the success of the whole program.

On the monetary side, we agree that the present situation does not permit the determination of precise objectives for the time being. As recognized by the authorities, developments will have to be closely monitored to reduce the inflation rate and

to meet the target set for the balance of payments. Control of public finances will here again play an essential role, since the PSBR will have to be reduced to a level compatible with monetary stability. The policy of positive interest rates in real terms that, fortunately, was implemented last year must be pursued, and the reliance on market mechanisms that has been introduced must be continued.

The commitment of the authorities to flexible management of the exchange rate is indeed the strongest guarantee that the external competitive position will be maintained and that the necessary liberalization of trade policy will be sought. Like the staff, I consider these aspects to be mutually dependent.

All these adjustment efforts are essential. On growth-oriented policy, I have no particular comments to add to the staff report; adjustment and improvement in public sector efficiency are already major components of the program.

I would like to emphasize that the continuation of both adjustment and development policies and the commitment of the authorities to the full and sustained implementation of those policies have or should have three positive consequences: substantial financial support from the international community; the restoration of confidence, which is essential for encouraging the investment or reinvestment of savings in the national economy; and the resumption of spontaneous external financing in the future.

The staff clearly justifies the inclusion of the two innovative aspects of the agreement, the oil and growth mechanisms. The justification is the influence on the financial package of important variations in oil prices and the weaker than expected recovery of industrial production. We will have the opportunity to discuss these innovations in the near future on the occasion of our discussion on the theoretical aspects of the design of Fund-supported programs. At this stage, we can approve the two mechanisms presented in the Mexican program.

As to the so-called "oil facility," the inclusion of such an emergency plan in the program will permit better identification of the responsibility of the Government and the influence of oil prices in the implementation of the program. As Mexico is highly dependent on the price of a single commodity and because its program entails efforts of diversification, such a mechanism will avoid the delicate renegotiation of the program if it were to be suspended owing to this obviously exogenous cause. Legally speaking, we would have preferred to have seen the sharp drop in oil export receipts taken into account by an extended use of the Fund's upper credit tranches in conjunction with other external financing. We note that the inflation rate, the second most

uncertain aspect of Mexico's economic outlook, is being taken care of by the program itself. Thus, it follows that the country will have to absorb the other fluctuations.

Given the external indebtedness of the country, the symmetrical mechanism of earlier amortization of external borrowings in the event of more favorable terms of trade is both logical and pertinent.

With respect to the growth mechanism, we welcome the direct involvement of the World Bank in this interesting component of the program, which seems to us perfectly justified because the revival of growth is necessary for mobilizing all forces. However, I would like to hear more from the staff about the way in which the mechanism might operate, for example, the initiation of the request should the conditions necessary for its operations materialize, the role of the Fund, and the origin of the financing.

One of the fundamental results of this program is the convergence of external financing provided by different external entities--the Fund, which has also displayed extensive intellectual ability and imagination; the World Bank, whose cooperation with the Fund has been of major importance; and public creditors.

The main difficulty that still remains is the attitude of the commercial banks, which reinforces the concern we expressed last week during the discussion on international capital markets (EBM/86/143 and EBM/86/144, 9/3/86) that commercial banks seem somewhat reluctant to act, or at least seem to ask for very long delays. We urge the commercial banks to come to an agreement with the authorities so that the whole program may be implemented. At the same time, we urge the authorities to make their best efforts to be flexible and to set the discussion on realistic and sound grounds, especially in light of the multiyear rescheduling agreement.

Therefore, we support the proposed decision in principle. We hope that this decision will be formally approved as soon as possible--in any event, before the Annual Meetings. Such approval will require the critical mass of new money to be reached. However, we would insist that Mexico's situation be treated as an exceptional case, and that approving the decision in principle not set a precedent for similar situations in other countries.

Let me conclude by reiterating my authorities' commendation to the main actors of this very welcome agreement--the Fund staff and management, the World Bank, and the Mexican authorities. This agreement is in line with the agreed approach under the debt strategy.



Mr. Ismael made the following statement:

Mexico made a promising start when it undertook a comprehensive adjustment program in late 1982. Substantial gains were made in 1983 and 1984. However, by late 1984 and early 1985, policies began to unravel, resulting in pressures on prices and the balance of payments. This difficult situation was made worse by the traumatic effects of last year's earthquakes and adverse developments in the international oil market. In such a critical situation, Mexico cannot make an orderly adjustment without external financial assistance.

It is, therefore, essential that under the new program Mexico receives adequate external financing in support of its adjustment efforts. I can support the two flexible features built into the program: the linking of more financing for adjustment should the price of Mexico's oil drop below \$9 per barrel, thereby substantially reducing the risk that Mexico would fail in its adjustment efforts; and the contingency plan that would permit an increase in selected public sector capital outlays if the economy did not appear to be overcoming the recession by the first quarter of 1987, which would provide another cushion against failure for Mexico. At the same time, the scrutiny of capital outlays by the World Bank will give the program the added importance that it needs to ensure that Mexico achieves a moderate rate of growth.

It is essential that the strengthening of public finances be made a major element of the program so as to moderate inflation, reduce interest rates, and strengthen domestic investment. To this end, it is critical that public sector expenditure, price, and tax policies are strictly implemented. I cannot stress more strongly the urgent need for the authorities to monitor developments closely and to be prepared to undertake further corrective policy measures if necessary.

It is clear that there is a need to use the concept of an operational deficit in the case of Mexico, which has a high inflation rate. By separating the inflationary component of the servicing of the internal public debt, the Board would be better able to evaluate the progress in the implementation of fiscal measures. As such, it is encouraging to note that the fiscal effort envisaged under the program measured at the level of the primary balance would be in the order of 3 percent of GDP. Coming as it does in addition to the improvement of some 3.5 percentage points of GDP that is expected to take place, existing budgetary policies relative to 1985 indicate a significant effort on the part of the authorities to rationalize the budget of public enterprises.

Although major adjustments in the prices and tariffs charged by public enterprises were made in 1983 and 1984, follow-up adjustments and price realignments have not become necessary because of higher inflation. These are positive efforts by the authorities, who should be commended, particularly on their decisive stance in following through on price adjustments in politically sensitive areas such as basic staples and urban transportation.

I would also like to commend the authorities for the substantial cuts in public expenditures over the past four years. The authorities' emphasis on intensifying their efforts to implement their current policy of structural change in public expenditure is most welcome. As a result, the authorities have managed to sell, merge, or close many of the nonstrategic and nonpriority firms even though some of those actions were politically unpopular. I urge the authorities to continue these efforts so that the remaining firms can be utilized efficiently and productively.

The authorities' intention to proceed with a structural reform of the tax system is welcome. I urge the authorities to take this opportunity to correct distortions and recoup the revenue losses of the past few years. As the staff points out, structural tax reforms, if fully implemented, should serve to bolster fiscal revenues in the years beyond the program period.

There is no doubt that the excessive credit expansion to the public sector has contributed to pressures on the country's international reserves. Therefore, measures taken by the authorities to tighten controls on credit, including that to the private sector in mid-1985, are appropriate. For the period of the program, therefore, I endorse the authorities' commitment to conducting monetary and credit policy in conformity with the objectives of slowing the rate of inflation, achieving the balance of payments target, and supporting output recovery.

It cannot be overemphasized that the maintenance of positive real rates of interest will be indispensable for strengthening domestic savings. In this connection, I am pleased to note that the adoption of a more flexible interest rate policy in late 1985 and early 1986 has prevented further deterioration in the willingness of the public to raise its holdings of financial assets in real terms. Therefore, I urge the authorities to continue such a flexible policy, which would not only mobilize domestic savings but also contribute to the efficient utilization of financial resources.

It is unfortunate that the gains in competitiveness resulting from the sharp exchange rate adjustment in 1982 were eroded by the real effective appreciation of the currency from 1983 to mid-1985.

As a result, the strengthening trends in the balance of payments in 1983 were reversed. The authorities appear to have been fully aware of the situation and to have strongly emphasized the importance of avoiding the recurrence of currency overvaluation. With that in mind, they undertook major changes in the exchange rate system in mid-1985; consequently, it is encouraging to note that the 40 percent depreciation of the currency since mid-1985 has had a positive effect on non-oil transactions and on the capital account. With regard to the eventual unification of the currency rates, I agree with the staff that in view of the current uncertainties and the narrow rate differential, temporary approval of the dual market should be allowed until further review.

I commend the authorities for maintaining orderly financial relations with foreign creditors. As a result, agreements with commercial banks during 1984 and 1985 on the restructuring of debt permitted a significant improvement in Mexico's debt service profile. The modification of the debt management strategy, which now calls for substantial recourse to new external financing, is understandable on account of the adverse development in the oil markets.

Significant progress has been achieved by the authorities in their efforts to liberalize the trade system. At present only 39 percent of import value is subject to prior licensing, which is well below the level envisaged under the extended arrangement. However, more needs to be done, and the authorities' commitment to further progress in this area, despite the adverse external trade conditions faced by Mexico, is positive indeed. I am confident that with the aid of the World Bank, particularly through the trade policy loan of \$500 million that was approved recently, the authorities' goal of opening the economy to the rest of the world will help strengthen the export capacity of its domestic industries and make utilization of resources more efficient. Furthermore, it is hoped that Mexico's admission into the GATT will allow it to play an important role in trade liberalization. I fully agree with the authorities that further progress in trade liberalization depends on assurances of Mexico's access to foreign markets, particularly the removal of barriers to key markets abroad.

I support Mexico's request for a stand-by arrangement and have no difficulty with approval in principle, pending achievement of the critical mass of financing. I also support the proposed decision relating to the multiple currency practices.

Mr. Dallara made the following statement:

In January 1986, when the Executive Board considered Mexico's request for emergency assistance (EBM/86/5, 1/10/86), and the oil decline had just begun, the full extent of the erosion of Mexico's adjustment efforts in 1985 had not been apparent. Nevertheless, there had been clear indications at the time that, following two years of rather impressive economic performance, serious slippages in economic performance had occurred in 1985--indications which have now been confirmed to us, as a number of Executive Directors have already noted. The extent of the shortcomings in last year's performance is clearly reflected in exchange rate and international reserve developments and the fact that the PSBR, at 10 percent of GDP, is more than double the 4.9 percent target, although oil revenues were higher in 1985 than had been expected.

During the Board discussion in January 1986, it had been obvious that although a number of measures had been taken during the second half of 1985 to contain the emerging problems, a considerable strengthening of the economic policies would nevertheless be required. At that time, we and other Directors had stressed the need for a comprehensive growth-oriented approach, with sound macroeconomic policies, including exchange rate policies to be complemented by a range of more aggressive structural reforms.

Since that time, oil price developments have had a substantial adverse effect on the Mexican economy, involving the loss of approximately \$9 billion in oil exports and more than 20 percent of public sector revenues. In spite of this, or perhaps because of these new circumstances, the authorities themselves have developed and come forward with a comprehensive growth-oriented program reflecting their recognition that such an approach is necessary to restore financial stability, external viability, and sustained economic growth in Mexico.

We commend the authorities for their actions in the face of adversity and support their broad approach as reflected in the measures and commitments incorporated in the proposed stand-by arrangement as well as in the many elements which are supported by World Bank loans. Viewed as a whole, the elements contained in the various programs constitute an important start in dealing with the serious fiscal imbalances, in allowing relative prices to have greater effect on resource allocation, and in moving ahead aggressively on a number of structural reforms.

Much, of course, remains to be done. It is clear that the approach of the authorities will need to be fleshed out further in 1987, which they have recognized by adopting a medium-term framework. In this connection, I would stress that the first review of the program should provide an opportunity not only to

develop the detailed fiscal and related policies and targets for 1987--which we do not have before us--but also to set forth, perhaps with more information and more precision, the exact nature and timing of certain structural adjustments.

We welcome the support of the Fund and the World Bank for Mexico's programs, including the innovative contingency features incorporated into the stand-by arrangement. Regarding those features, it seems to me that the key question to ask is whether in the context of the specific circumstances and implications of this case--a number of which have already been referred to by other Directors--the two mechanisms are constructive and whether they serve the interests of Mexico, the Fund, and international financial stability.

I am convinced that the mechanisms are appropriate and would like to emphasize five aspects. First, the symmetrical aspect of the oil contingency mechanism by which external financing needs will be reduced as the price of oil increases to over US\$14 a barrel is particularly welcome. Second, the World Bank support for and involvement in the mechanisms is critical. Third, the oil contingency mechanism raises the interesting question whether we should consider future use of tranches of drawings under the compensatory financing facility, since tranches are implied in the structure of the oil contingency mechanism. Fourth, the contingency mechanism does not imply--and it is important to stress this--that should growth fall short of the target, additional public sector investment may be the only appropriate response. Depending on the circumstances prevailing at the time, lower than expected growth could send a number of different signals, including perhaps a signal for policy changes such as an intensification in the effort to reduce inflation and inflationary expectations; this would be particularly true if it appeared at the time that the level of inflation might deter private sector investment, which in the medium term will be more critical to the realization of the Government's objectives than public sector investment. Fifth, Mexico's acceptance of these features of the stand-by arrangement implies not only the uniqueness of the situation but also a special responsibility by the authorities to see that the features in particular, and the program in general, work.

It is clear that restoration of a better balance in the fiscal accounts is critical. A smaller and more efficient public sector can have important effects on financial stability, business confidence, private savings and investment decisions, and the flow of capital in and out of Mexico. Most of the problems in the fiscal accounts are on the expenditure side. Between 1980 and the forecast for 1986, the ratio of public sector expenditures to GDP will rise from about 35 percent to about 45 percent. Perhaps this level was realistic, or somewhat

less unrealistic, in the context of the world environment that Mexico faced in the early 1980s. The ratio for interest payments alone will rise from less than 4 percent to 19 percent, and interest payments will amount to 42 percent of total public sector outlays. This leaves little room for maneuver, given the falling ratio for all other public sector expenditures.

The various fiscal measures that have been embodied in this program, which total 3 percent of GDP, constitute an important step in the right direction. We should not underestimate the difficulty that the authorities have had in developing, or that they will face in implementing, those measures, given the very difficult circumstances now facing the economy. At the same time, we should not try to convince ourselves that this is necessarily an optimum approach to the problem.

Every effort needs to be made to reduce specific low priority expenditures and to strengthen the revenue base so that it will not increase disincentives in the economy. For example, we notice several line items in the fiscal accounts that were apparently important contributors in 1985 and that will evidently play an important role in the expected adjustment in 1986. These are labeled "financial requirements of the rest of the public sector," "other current expenditures," and the cost of "floating debt." We would be interested in any additional information from the staff or Mr. Ortiz about expenditures in these areas and the scope for further curtailment in the period ahead.

As other Directors have commented at length, a number of fiscal deficit concepts have been incorporated into the program. Each of these can shed some light on different aspects of the fiscal deficit problem. We can accept the inclusion of a performance criterion based on the operational balance in addition to the more traditional limit on the PSBR, given the effect on the PSBR of the current high rate of inflation. But we have some reservations--if I understand from Mr. Ortiz's opening statement that emphasis will be placed by the authorities on the primary balance rather than the overall PSBR--because we believe that the primary balance will provide only one perspective of the problem, and that in reality it is complete awareness of the entirety of the fiscal problem that must be the basis for the authorities' medium-term fiscal policy. Indeed, the justification for paying attention to the operational deficit is based on the assumption that holders of government bonds will want to maintain the real value of these holdings. That assumption requires that the terms of government securities be kept attractive and capital flight be minimized. Given the need to avoid crowding out the public sector in credit markets, the history of capital flight difficulties in Mexico, and the very limited availability of credit to the private sector that is envisaged

in the months ahead, it would be risky to place too much focus on operational or primary balances. Therefore, we urge the authorities to take a comprehensive view of this problem, keeping in mind the utility of these particular balances and also urge the staff to give full attention to the PSBR when evaluating performance in the future.

We recognize that not much more can be said about fiscal prospects until the 1987 budget is formulated. However, based on preliminary information presented to us, it is possible to identify some imbalances. The target for fiscal adjustment under the program implies a PSBR that could be in the range of 15 percent of GDP and interest payments still in the range of 19 percent. We look forward to further elaboration of the fiscal accounts for 1987 in the review of the program to be completed before the end of the year.

Some elements of tax reform are included in the proposed stand-by arrangement. We welcome these as particularly important in the prevailing environment of high inflation. However, I am sure that the authorities would not disagree when I say that this does not constitute comprehensive tax reform. Of course, it is not clear that comprehensive tax reform is called for or what the nature of such tax reform could be. Nevertheless, in our view, the income tax rates in Mexico remain rather high. With a 48 percent tax bracket falling in the range of around \$14,000, we wonder whether in the context of restoring financial stability in the period ahead the authorities plan to look at the possibilities--or need--for broader tax reform. We would welcome further comment from the staff on this.

Some encouraging steps concerning the public enterprises have been taken, not only in the number of parastatal enterprises, but also in the various reorganizations that have taken place--eliminating, merging, and selling unprofitable or inefficient firms--and reducing subsidies that were an important and substantial element in the operation of enterprises and a significant drag on the public sector. We recognize the difficulty now faced by the authorities in preparing a list of "strategic" or "priority" enterprises, with the remaining enterprises to be available for change in ownership. We urge the authorities to move promptly in this area in the light of the importance of achieving their medium-term goals and hope that the World Bank will play a useful role in supporting this effort.

Clearly, the financing requirements of the public sector have been a constraint on the overall exercise of monetary policy and pose a real threat to the availability of sufficient credit to the private sector and, therefore, a potential threat to the achievement of the growth objectives of this program. In fact, the staff report indicates that real credit to the private

sector will be negative, although by the fourth quarter it should be positive. In 1987 full attention should be given to private sector credit needs within the overall inflationary constraint.

It must be recognized that the worsening in Mexico's terms of trade--as pointed out by Mr. Ortiz in his opening statement, it deteriorated by nearly 49 percent between 1981 and 1986--has imposed a severe burden on the external accounts. All the same, the fall in the volume of exports by nearly 9 percent in 1985 was a severe disappointment and underscores the need of the authorities to maintain a vigilant attitude toward exchange rate policy, to continue the flexible approach embodied in recent months, and to avoid a repetition of the unfortunate period in 1985 when exchange rate policy may not have been fully consistent with the objectives of maintaining competitiveness. Such a policy is also particularly important in the light of the strong need for the authorities to restore investor confidence both inside and outside Mexico. Like Mr. Polak, I wonder about the timing and ultimate objective of exchange rate unification, and whether Mr. Ortiz might be able to provide more precise information.

A relatively promising part of the program, and one where a considerable amount of progress has been achieved, is in the area of trade liberalization. The many steps that have been taken are well documented in the staff reports and are supported by the World Bank. We encourage the authorities to make further progress.

The authorities are clearly seeking substantial foreign financial support. At the Fund, there is a request for a stand-by arrangement of 80 percent of quota on an annual basis, with possible augmentation of a considerable amount. This is in addition to the current exposure to the Fund, which is already considerable. Mexico has requested financing in the range of US\$6 billion from the commercial banks and an approximately equal amount from official creditors. In addition, there will be substantial debt relief required from both private and official creditors.

The authorities are currently engaged in important negotiations with commercial banks. Let me make two points in that regard. First, we firmly believe that it is in the interest of the banking community to support Mexico's strengthened economic program and we certainly hope that they will cooperate with the authorities in developing the precise parameters and elements of a financing package in the near future. At the same time, we understand the desire of the authorities to face a realistic set of external accounts in the period ahead, but we are also of the view that the package that has been developed with the support of the Fund, containing US\$6 billion in new money from the banks, is realistic. As we understand it, the package is based on the



Fund's best estimates of the financing needs in support of this bold program over the period ahead. I am somewhat puzzled by the implication in Mr. Ortiz's opening statement that the financing package itself may not be realistic. We would also caution that, in seeking to reach agreement with the banks, excessively ambitious and unrealistic approaches should not reduce, either in the short or the medium term, Mexico's capacity to obtain needed financial support from the international community.

Before turning to the question of the approval in principle, let me add to the remarks of other Directors who have expressed their recognition and appreciation for the exceptional efforts of management and staff that have helped bring this program to the Board today.

Concerning the question of approval in principle, we have had some reservations about the application of this approach, which is a somewhat unusual approach in that it has not been previously applied in circumstances in which a major debtor was involved and there were discussions with commercial banks. Nevertheless, on the ground that approval in principle could facilitate the conclusion of these discussions, we are prepared to support this approach. But we would urge the authorities, as well as the banks, to work closely and cooperatively in the days ahead to reach a prompt and mutually satisfactory conclusion of the negotiations. We are also prepared to support the period indicated in the staff report, which we believe presents a rather ambitious task for the authorities and the banks, but one which they appear prepared to accept and we would urge them to fulfill. It is critical that time not be lost. The authorities have put forth a broad-based program. It will need financial support and, therefore, the conclusion of the financing arrangements are essential to ensure that a broad range of policies can be combined with external financing so that the program which the authorities have outlined to restore growth, financial stability, and external viability can get under way in full force.

Mr. de Groote made the following statement:

The quality of the information given by Mr. Ortiz and by the staff is well matched to the importance of the subject. It helps us convincingly cover all aspects of a program that for many reasons will remain a landmark in the Fund's history. Convincing the Board that it is legitimate and proper to increase the Fund's exposure substantially in a country that has failed so seriously to implement the previous program in which such strong hopes had been invested has surely been a far from easy task. Convincing the Mexican authorities that there was no alternative other than a Fund-supported solution, and showing them that they could count on several important innovations that

might protect them against slippages beyond their control has been a remarkable exercise in persuasion and creative imagination on your part, Mr. Chairman, and on the part of the staff. Mr. Ortiz has demonstrated, in this case, the dual nature of the function of the Board.

In my view, three main reasons justify our support for Mexico's request. First, it has been demonstrated, during the two first years of the program initiated on December 23, 1982, that the adoption of strong corrective measures can yield expected results. The dramatic turnaround in the current account and public sector deficits during those two years, accompanied by the simultaneous recovery of output and a sharp decline in inflation, show the resilience and responsiveness of the economy to adjustment policies. Although the present program includes many aspects of structural reform that were absent from the December 1982 program, the demand management measures now before us are of the same nature as those that had led to remarkable results in 1983 and 1984. We can thus expect them to be effective again. Among the measures, the reduction of the public sector deficit, at the level of the primary balance, by 3 percent of GDP is of a magnitude that should produce--based on experience under the previous program--an important correction in the current account. On this point, I find it particularly welcome that this reduction of the public sector deficit will result from fiscal revenue increases, an approach which permits a small but much needed recovery in public investment after the drastic cuts it had to undergo under the previous program. The recent adjustments in public sector prices, which are the main source of additional revenue, are indeed large but might have to be followed by additional increases since they represent in large part only a catching up with the ongoing inflation.

The possibility of implementing the public finance aspects of this program will be reinforced by the use--I believe for the first time in the design of a Fund program--of the concept of operational balance for the nonfinancial public sector, and the concept of primary balance. The use of these notions is particularly appropriate under inflationary conditions, as observed by Mr. Ortiz and demonstrated in the study on inflation and the measurement of fiscal deficits (SM/86/53, 3/3/86) that was discussed at the Board recently (Seminar/86/7, 6/4/86). However, as Mr. Tanzi noted in his study of the deficit experience in the industrial countries, published by the American Enterprise Institute in 1985--a study whose sample of countries does not include Mexico--we should not forget that the concepts used to adjust the deficit for the effect of inflation, as in the case of the primary balance, have shortcomings, just as the more conventional measures have theirs, so that both need to be used jointly. Indeed, even if it is true that a country with a high rate of inflation and a high domestic debt ratio does not need to

adjust to the magnitude of the deficit because the reduction in the inflation rate will also reduce interest payments, a definition subtracting the effects of inflation on interest payments is still not equivalent to a situation with low inflation because measures that were expected to be restrictive can themselves result in inflation. We should use these important conclusions of the Fund's Fiscal Affairs Department as we very closely monitor Mexico's achievements in the area of public finance under the alternative definitions available, especially with a view to determining the financing modalities of the public deficit.

The second reason for confidence in the program is that it is based on a major structural reform of trade practices and of the Government's involvement in the economy. Therefore, it does address the principal weaknesses of the previous program, which had focused exclusively on demand management measures, although this was an understandable shortcoming given the paramount importance at that time of rapidly correcting the external situation in order to restore the country's capacity to meet its rescheduled debt obligations. A broad basis for sustained recovery is embodied in the current program. The experience we have had with similar policies in Turkey and several other countries allows us to expect that trade liberalization measures will have a large effect on exports. However, the decline of the Government's economic role and the proposed measures to improve the efficiency of state enterprises are decisive contributions to more efficient resource allocation, and they are all the more significant in that they radically change what come to be regarded as a traditional and untouchable characteristic of the economy--the importance of the public sector in the production process. The World Bank should be congratulated for its successful role in the adoption and financing of these measures and for having organized its action quickly enough for it to have become an essential component of a Fund-Bank approach jointly based on demand management and structural reform in the true spirit of the Baker initiative.

Third, the program's chances for success are considerably enhanced by the relationships established between the behavior of the price of oil, the performance targets, and the size of the Fund's financial assistance on the one hand, and between the rate of recovery of the economy and access to additional financing on the other hand. These relationships were essential in order to ensure that the program would not break down again owing to price behavior outside Mexico's control and that there would be a resumption of growth without undue delay. I am particularly happy that Mexico's importance in international banking relations has made it possible to put into practice an approach that we have recommended for a long time. I hope that Mexico's creditors might also consider a similar approach in the coming

rescheduling exercise by accepting a deceleration of reimbursements should the price of oil should fall further, a provision complemented by an acceleration of reimbursements should the price increase above a certain level. I was especially interested in the staff's justification for the oil and growth contingency mechanisms because only the degree of Mexico's vulnerability to the unit price of its main export commodity and the need to ensure that adjustment would quickly lead to growth are given as reasons for introducing these useful new mechanisms. I presume we can conclude that the Board should also favorably consider the adoption of such mechanisms in other cases similarly vulnerable to export price fluctuations and to the risk that adjustment would not lead rapidly to growth. I would have great difficulty in supporting these new mechanisms if they are regarded as applicable only to the Mexican case, because the arguments given in favor of their introduction are not specific to that case.

The only question I have on the working of these new mechanisms relates to the fact that the adjustment in the ceilings on the public sector's net use of foreign credit, on the PSBR, and on the operational balance of the nonfinancial public sector, by an amount of US\$500 million is related to the 12-month rate of change in the index of manufacturing production ending in March 1987. Is a worse than expected performance of manufacturing production the only trigger we should retain for these mechanisms? Is it not possible to suppose that on the occasion of a program review, when we will have become more familiar with these mechanisms, that a worse than expected performance of investment could also trigger an adjustment of those ceilings? If we admit that possibility, then we can take better account of the forces on which the medium-term performance of the economy depends. I know that by taking this position, I differ with Mr. Polak on the validity of this aspect of the contingency mechanisms. Directing additional Fund financing--in the circumstances of income decline--toward public investment, a sector which cannot benefit from increased funding under the constraints of the program and which remains crucial for sustained growth, seems fully in line with the purpose of a program aiming at adjustment through growth, as was stressed by Mr. Dallara. I would simply like to see the behavior of total investment included for consideration as a possible trigger mechanism, although figures on this item may not be as readily available as figures on manufacturing production.

I was interested in a point raised by Mr. Nimatallah, who wondered whether we should not first have had a general discussion on the implications of the contingency mechanisms, given that this would be the first use of the mechanisms. I would certainly have welcomed this, having frequently asked that such an approach be examined by the Board. But I also know that new

techniques are seldom accepted except under the pressure of events, a fact that makes me extremely optimistic as to future allocations of SDRs and increases in Fund quotas. The Mexican case has made possible that which long discussions have not accomplished. Nonetheless, it might be useful to examine in the near future the general aspects of this new mechanism in the light of the experience the Mexican case will help us gather.

The program can be achieved only if the agreed policies are strictly adhered to and additional measures adopted without delay at the first sign of slippage. The medium-term projections to 1991 assume an annual growth rate of the U.S. economy of 3 percent, an assumption that, although accepted for the world economic outlook exercise, few observers of the U.S. scene would be ready to underwrite. The expected substantial increase in real terms of the demand for financial assets is predicated on a decline of the inflation rate to 10 percent rate in 1991. Not only will this be hard to achieve, but also after so many years of pronounced inflation, there is also no guarantee that households will perceive it as a sufficiently good motive for increasing financial savings to the desired level. Even if savings increased, an important financing gap would remain that would have to be covered by external resources, which would imply a continuing though declining recourse to financing by banks and multilateral official institutions, since neither any large increase in direct foreign investment nor any large reflow of private capital can be expected. The difficulty Mexico is experiencing in convincing the banks to fully assume their part in the financial package clearly shows that this continued dependence on bank financing will leave exceedingly small leeway for underperformance. Finally, given the nature of the oil market, an annual increase of 4 percent in the price of crude through 1991 is an assumption which could just as easily be too high as too low. It might, therefore, be prudent to admit already the possibility that the contingency mechanisms will have to be strengthened if the price of oil fails to increase as expected, and conversely, that the process of adjustment will have to accelerate if the oil price behavior is more robust. The successive reviews of the program should be based primarily on the examination of those possibilities, possibilities on which the whole concept of the program depends.

Generally speaking, Mexico's situation might lead us to reconsider the problem of access limits, including cumulative limits. Indeed, even without the oil contingency mechanisms, Mexico's total credit outstanding at the end of February 1988 will reach 335 percent of quota, and given the uncertainties of the situation after 1987, it seems probable that the Fund's involvement will have to be continued. Therefore, it does seem important to protect the flexibility of the access limits so that the Fund can remain in a position to play its catalytic role effectively.

Even if everything goes according to plan and on schedule, per capita income in Mexico can only be restored to 1980 levels by 1991 at the earliest. This fact, more than any other, shows how determined the authorities must be in implementing the program, how ready we must remain to reconsider the program in the light of circumstances, and how crucial the contribution of the banks to the maintenance of the value of the funds they have already invested, sometimes too eagerly, in the economic future of Mexico. Contrary to some highly counterproductive presentations in the press, an effort of extraordinary magnitude is not required of the banks, since their exposure would increase only by just over 2 percent for the period 1985-87 and by just over 3 percent for the whole period through 1991. Confirming the Fund's confidence in the Mexican program should comfort the banks and lead them rapidly to make a positive contribution of a magnitude commensurate with the responsibility they bear for Mexico's situation. It should be well understood by the banks that if the Board can agree only in principle to Mexico's request, it is because its decision cannot materialize until the banks come up with their own share of the solution.

Mr. Yao made the following statement:

Like previous speakers, I would like to commend the staff and management for their realistic and constructive approach in the design and in the financing of the proposed stand-by arrangement with Mexico. Also noteworthy is the flexibility incorporated in the program that insulates the economy from the fluctuation of the price of oil, and the growth contingency mechanism that would trigger additional external resources if the anticipated economic recovery failed to materialize after all the recommended measures had been implemented. Such a flexible approach augurs well for the success of the program. This chair would strongly encourage management and staff to adopt a similar approach in formulating other Fund-supported programs.

After important improvements in 1983 and 1984 under an extended arrangement, the economy began to experience some difficulties in 1985 due to a change in the direction of economic policies, the continued fall in oil prices, and natural calamities. Growth of real GDP is estimated to have dropped below 3 percent, the overall government fiscal deficit to have increased, and the overall balance of payments to have turned negative. The progress made earlier in public sector pricing was eroded and inflation remained high. In the light of these unfavorable developments, the new program appropriately focuses on restrictive demand management, flexible exchange rate policy, and supply-oriented structural reform. The emphasis placed in the short run on the strengthening of the public finances is welcome because previous inappropriate fiscal policies have

largely contributed to Mexico's present problems. The comprehensive measures that are being taken to reform the tax system, to adjust prices and tariffs, and to reduce public expenditure in relation to GDP are steps in the right direction. However, the effectiveness of the tax reform will certainly be enhanced with a strengthening of control over revenue collection.

As to prices and tariffs, there have already been major adjustments. However, with inflation at such a high level, production costs have increased. The authorities need to keep these prices and tariffs under review if the objective of improving the efficiency in the use of resources in the economy is to be achieved and if pressure on the fiscal account is to be reduced. The need for a reduction in public expenditure that is envisaged under the program is clear, because the overall deficit of the public sector is about 16 percent of GDP. More important, the composition of public expenditure should be changed by allocating more resources to investment and containing the growth in current expenditure in order to lay the foundation for future growth.

In the external sector, the adoption of a flexible exchange rate strategy should help nontraditional exports. It is necessary for the exchange rate to remain competitive if the other objectives of diversification and increased domestic production are to be achieved. The measures being introduced to simplify export procedures and to encourage the shift of resources to the export sector are in the right direction and should help in reducing pressure to the current account balance. However, the success of this policy is contingent on Mexican goods obtaining access to foreign markets, as noted in the letter of intent. The intention of the authorities to accelerate the process of trade liberalization as well as Mexico's accession to the GATT are positive elements that should encourage others to open their market to Mexican goods.

Mexico's external debt will remain a cause for concern in the medium term, especially in view of the uncertainty in the petroleum market. Under the medium-term scenario presented in the staff report, the debt service ratio is projected to increase from 37 percent in 1987 to 44 percent in 1991. Such an outlook makes it necessary for Mexico to continue to adhere closely to the measures in the program, while rigorously implementing structural adjustment measures in order to expand and diversify the country's export capacity and remove the rigidities that have hampered foreign direct investment. Exceptional external financing and debt relief will continue to be needed. I support the proposed decision and wish the authorities the very best in their endeavors.

Mr. Zecchini made the following statement:

Knowing the economic, social, and financial difficulties of Mexico in the first part of 1986, it is appropriate to start our presentation by expressing appreciation for the decision taken by the authorities to embark on an important adjustment effort with the cooperation of the international community. This approach, which is based on the solidarity of all the other countries in support of significant efforts to redress the economy and which avoids a confrontation with the financial community, appears to be the most positive way of dealing with the external debt problem. It is beneficial for Mexico because it allows the country to gradually lessen the financial constraint on economic growth and to pursue a more viable development strategy. It is beneficial to the international community because it prevents new financial disturbances that could have negative repercussions on the market attitude to lend to the many other developing countries in similar conditions.

Appreciation should also be expressed to the staff and the Chairman for having facilitated the process of reaching an agreement on the required adjustment, and for having shown great imagination and skill in making innovations in the Fund's traditional approach to adjustment. These innovations open a new chapter in our strategy toward balancing external adjustment with financing; consequently, it would be appropriate to have at least an informal discussion at the Board on the validity of the general approach. We hope that we will learn from this first experience in order to better define the guidelines of our approach before embarking on other programs with similar features.

It is regrettable that after the stabilization measures taken in 1982-83, Mexico's policy approach became looser in the second part of 1984, leading to the resurgence of imbalances in both the price and the external account fronts. It was evident at that time that the looming weakening of oil prices and the expected reversal in the terms of trade would have aggravated the negative impact of the inappropriate easing of policy; therefore, more caution in economic management would have been required.

The authorities intend to pursue a strategy of growth and gradual reduction of inflation and of the external current account deficit in a situation in which structural measures would play a more fundamental role than the stabilization of domestic demand.

From Table 15 of the staff report, we infer that for the period 1986-91 a real annual GDP growth higher than 3 percent is to be combined with a reduction of the external current account deficit by 1.5 percent of GDP. These results will not be achieved



by a rise in the excess of domestic savings over investment because gross investment will expand by 4 percent as a ratio to GDP and will remain higher than gross savings despite the latter's sharp increase. As to savings, the public sector will carry the entire burden of the accelerated expansion of savings, thereby more than offsetting the rising propensity to consume of the private sector. The determinants of this combination of growth and adjustment are the increases in the surpluses of trade and other services surpluses, together with the rise in fixed investment, which is also supported by significant net official capital inflows and a reduction in the outflow of private capital. In the light of the great uncertainties surrounding the possibility of achieving trade surpluses and of stemming capital outflows, the authorities should stand ready to strengthen the contribution of private savings, especially household savings, to the country's accumulation of fixed capital.

We strongly endorse the structural measures to be taken in the various fields. However, the focus on structural adjustment in this program raises the problem of how to monitor progress in structural reform effectively. In this respect, we note that there is neither a timetable nor performance criteria which would allow us to monitor progress in the rationalization of the parastatal enterprises, the price system, and the exchange rate policy. Furthermore, there is no criterion to monitor the targeted pace of trade liberalization. With respect to the latter, a quantified trade liberalization program has been approved by the World Bank. Nevertheless, the question of how developments in the structural area would affect disbursements under the stand-by arrangement remains open, and a rethinking on these aspects seems necessary for the later stage of program implementation.

For the purpose of stabilizing domestic demand in the short term, fiscal correction seems to be the most important element of the planned strategy. It is also evident that the curtailment of the total PSBR is limited and not adequate to bring public finances to a sustainable position in the next 18 months. The introduction of the two notions of primary and operational balances is a useful complement to the PSBR in better assessing the corrective effort.

However, the remaining part of the budget, which is not covered by these two concepts, is significant and its evolution extremely uncertain, since it depends mostly on the reduction of inflation and on the impact this will have on inflationary expectations, nominal and real interest rates, and the savings ratio. Therefore, there is a real possibility that the performance criterion on the operational balance may be met while that on the PSBR may be missed.

In this respect, we recall the recent Board discussion on the two concepts (Seminar 86/7). In line with the considerations expressed in the third paragraph of the précis of the discussion at the Seminar, we do not consider it appropriate to assign a greater weight to the operational balance than to the PSBR. The operational balance is more in the nature of an indicator of the fiscal stance and should not necessarily be used as a performance criterion. Moreover, it is not clear which data will be used to calculate the inflation component of interest payments; we would like further clarification on this from the staff. In our view, for successful implementation of the program it is necessary that the authorities and the Fund attach higher priority to compliance with the overall PSBR criterion.

Efforts to curtail expenditures in the current account need to be strengthened. The program envisages a reduction in public expenditure on goods and nonfinancial services equivalent to only 0.5 percent of GDP in 1987. From the last sentence in paragraph 9 of the letter of intent, it seems that current expenditures will still increase in real terms in 1987, albeit at a slower pace than the expected growth in real GDP. Moreover, the first paragraph on page 18 of the staff report states that current spending in 1987 is to be reduced by some 1 percent of GDP. What would happen if real economic growth were not to materialize? Would current expenditures be allowed to rise in real terms in such a situation? Further clarification by the staff on this issue would be appreciated. In our opinion, performance criterion of the relative shares of current and capital expenditures would be more effective in monitoring the structural part of the adjustment effort in the public budget.

In the light of recent experience, it seems advisable to have a clearly defined commitment on the part of the authorities to avoid any real exchange rate appreciation and to unify the exchange markets in a predetermined period or to limit the exchange rate differential to a specified narrow margin. It is unclear why precise commitments in this direction are not stated in the letter of intent. At the same time, we note from Chart 11 of the staff report that the exchange rate differential has been rising sharply in 1986.

The contingency clauses represent an innovative element of flexibility in the program that will ensure the continuation of the adjustment on the part of the country even in the face of unexpected developments that in normal programs would have led to noncompliance with the performance criteria and most likely to a relaxation of the adjustment efforts. If seen in this context, the contingency clauses are an important improvement in the effectiveness of Fund conditionality in the sense that they leave less justification for policy slippages.

The oil contingency mechanism also adds symmetry and progressiveness to the adjustment. Symmetry will allow for possible improvements in the terms of trade due to oil price increases that will be used to strengthen the adjustment effort. Progressivity sets the pace of the adjustment effort inasmuch as in the second phase of the program an intensification of adjustment will take place even under the worst scenario.

The contingency mechanism for supplementary capital expenditure is an interesting device which fits well with structural reforms. However, it is also crucial to avoid achieving compliance with the public budget performance criteria through the compression of capital expenditure in order to leave more room for current expenditures. Theoretically, this result is possible under this program. Moreover, under certain circumstances, the country could resort to the contingency clause to receive additional financing that would boost public capital expenditure to the level that should have been reached without a contingency mechanism. Some sort of subceiling on expenditure composition, therefore, would have been advisable.

We would like to make some observations on the systemic implications of these clauses. First, these mechanisms have been necessitated by special circumstances related both to the crucial importance of a single commodity--oil--in Mexico's exports and growth and to the considerable uncertainties surrounding oil prices in this particular period. We believe that similar arrangements with other countries are useful only in very limited cases, for example, when a country's exports are concentrated in one or two commodities, or when the price of these commodities is temporarily affected by wide and sudden swings and the country concerned has almost no power to influence price behavior. However, when there is only an export shortfall of this type, the use of compensatory financing would seem to be more appropriate.

Second, since growth-oriented programs rely heavily on structural reforms, it is more appropriate to bring them under an extended arrangement rather than under an 18-month stand-by arrangement. Indeed, the Fund's acceptance of an external imbalance for longer periods should go together with a closer monitoring of the policy stance over longer periods.

Third, the contingency mechanism should be financed in the marketplace in the same proportions as those applied to the main part of the financial plan. This implies that the banks should provide larger financial support to these clauses than in the Mexican program.

We support the proposed stand-by arrangement and the proposed approval in principle because this program is a valuable contribution

to the development and the stability of the world economic system. We also hope that account will be taken of our remarks in the review of this program and in considering the same approach for other countries. In our opinion, an extensive application of this approach to many other cases would not be advisable before clear guidelines have been established.

Mr. Alhaimus made the following statement:

Since late 1985, the Mexican economy has been encountering renewed severe difficulties after enduring the upheavals of the debt crisis of the past few years. At the present time, it is the sharp fall in oil prices that is threatening to undo much of the gains that have been achieved with considerable domestic sacrifices and international assistance. The present package of adjustment policies and external financing that has been put together is far reaching and highly innovative. It should, therefore, contribute to achieving better balance and recovery of the economy in the coming years.

The authorities, for their part, have often shown persistence over the past few years in pursuing firm adjustment; consequently, substantial progress was made during the first two years of the extended arrangement with the Fund. The problems of implementation that ensued in 1984, although due to a considerable extent to policy slippages, were also compounded by the fall in oil receipts and the impact of the earthquakes. Also relevant to the deterioration of the fiscal performance, a key element in the slippages, were the higher than expected interest payments on the internal debt, which accounted for more than half of the fiscal deviation. New measures to put the program back on track were taken in mid-1985 in the fiscal, monetary, and exchange rate areas. In addition, the 1986 budget contemplated a sharp cut in the fiscal deficit.

It has become increasingly clear, however, that these measures have been inadequate in dealing with the sharp and sudden deterioration in both the fiscal and external balances resulting from the drastic fall in oil receipts. As estimated by the staff report, the oil price fall implies a direct loss in public sector revenue in 1986 equivalent to 6.5 percent of GDP and 20 percent to total public sector receipts. The loss for the external balance is equally drastic; in 1986, oil receipts are expected to fall by over \$9 billion, a loss of about 40 percent of last year's total exports. The magnitude of the oil price loss has been pointed out in Mr. Ortiz's opening statement, which notes that in the context of domestic production, "the oil shock is equivalent to the total agricultural production of the country."

The new program under consideration today is a major step in responding to the present situation and incorporates, in addition to the traditional adjustment policies, some new mechanisms to ensure additional financing that would protect the program in the event of serious disruptions of export proceeds and would maintain a reasonable rate of growth of the economy. The emphasis of the program's objectives on revitalizing economic activity in a context of financial stability is appropriate. The measures to be put in effect for these ends are sufficiently broad, encompassing fiscal, monetary, and structural elements. The fiscal effort of 3 percentage points of GDP, coming in addition to the 3.5 percent contemplated by the present budgetary policies, seems to be a fairly strong effort. The monetary and credit policies will be consistent with the objective of slowing down inflation. In view of the prevailing high rate of inflation and the uncertainties that lie ahead, additional measures, as the staff notes, should not be ruled out. Action on the exchange rate has already been taken to protect the external competitive position and the authorities seem to be firmly committed to maintaining flexibility in the management of the exchange rate. This will contribute to the expected significant increase in non-oil exports, both in relative and absolute terms, in the years ahead, which will be an important achievement in the efforts to diversify the economy. It may also be helpful in reversing capital flight.

The most significant aspects in the design of the program are the two financing mechanisms aimed at ensuring the achievement of its objectives and that, more generally, might constitute an important experiment in the design of Fund programs. The oil contingency mechanism is most suitable in the light of the dependence of the economy on oil exports, which are presently fraught with uncertainty. The mechanism provides for needed flexibility should oil prices deviate from the range of US\$9-14 a barrel by envisaging changes in the program targets, the size and structure of the financing package, as well as the possibility of incorporating further measures in the event of persistent fall in oil prices. It should also be noted that the provision of resources by the mechanism could take the form of compensatory financing. Obviously, compensatory financing, should it be utilized, is the form that is especially suited to addressing the type of shortfall now being experienced by Mexico.

From a broader perspective, the oil contingency mechanism is a highly significant innovation that can be used, as already stated by other Directors, in Fund programs where uncertainties surrounding future markets of primary products might have a decisive impact on the prospects of program implementation. One wonders how many programs could have been put back on track if such a mechanism had been in place over the past years. Of

course, it is not always possible to have the necessary incentives for the financial community to commit the crucial element of additional financing as in the Mexican case. But it would still be helpful if international institutions could contribute to some scale of contingency financing to ensure the success of programs threatened by uncertainties in the economies of many producers of primary products, both oil and non-oil.

Also welcome is the financing mechanism that provides for additional investment projects--approved by the World Bank and financed with external resources--should the economy not recover as planned, despite full adherence to the program. This, perhaps, is the most important specific mechanism that comes in response to the recent widespread concern about the need to achieve both adjustment and growth in the heavily indebted countries. This mechanism could be instrumental in enhancing the contribution of Fund programs to growth prospects, in many cases even beyond those of the heavily indebted countries.

The new program, with the new contingency mechanisms and the large financing package that is being mobilized on global scale, should enable Mexico to achieve the program's objectives. Nevertheless, as the staff points out, the program is subject to considerable risk and, even with full implementation, substantial use of external credits will continue to be required by Mexico in the medium term. Of course, the acute circumstances might ease should oil prices improve and stabilize in the coming period. But, on the basis of present uncertainties there seem to be no room for slippages in the program as already emphasized by other Directors. I endorse the proposed decisions for approval in principle.

Mr. Fugmann made the following statement:

Like others, we are pleased that agreement has been reached between the Fund and Mexico. The difficult economic situation facing Mexico, and the consequent threat to the international monetary system, have necessitated flexibility on both sides. The agreement includes certain innovations, which makes it of utmost importance to achieve the expected results--at least for the sake of the Fund's own credibility. In addition, this arrangement would serve as an incentive for other debtor countries to search for similar solutions to their balance of payments problems, for example, through negotiation.

I would like to emphasize that the Fund, according to its Articles of Agreement and guidelines, has to take into consideration the specific problems of each country. Each arrangement should be judged as a comprehensive package, and specific features in the Mexican arrangement should not be allowed to create a

precedent for future arrangements. In arrangements such as this, involving considerable financial resources as well as adjustment measures covering a wide spectrum of problems, close collaboration is of course of the greatest importance, particularly the need for close coordination between the Fund and the World Bank, both with respect to financial assistance or policy advice.

The importance and the need for financial contributions from commercial banks is indisputable. However, in our view a possible risk resulting from increased exposure on the part of the banks is that it may prolong the period before countries such as Mexico can again rely on spontaneous lending when its creditworthiness has been re-established.

As to new export credits and guarantees, my authorities are of the view that these have to be decided according to national procedures and guidelines.

We find that the emphasis on growth in the Mexican program is necessary because of the very difficult economic situation that has lasted for so long, due to three factors: inadequate economic policies; the earthquake in 1985; and the sharp decline in oil prices during the first half of 1986. The \$500 million facility that has been set up to underpin the growth rate as needed represents an innovation. The experience with this facility should be analyzed to see if its possible advantages exceed its risks.

Since mid-1985, the authorities have adopted several adjustment measures, including tightening monetary policies, selling private enterprises, and liberalizing trade. In the context of trade liberalization, we strongly welcome Mexico's membership in the GATT. Thus far, these measures have not produced adequate results, and the undertakings in the letter of intent with respect to future implementation are imprecise. In certain cases, the undertakings seem to have merely clarified prior intentions. However, developments indicate that Mexico is moving in the right direction.

In general, we can support the proposed program. For various reasons--including the emphasis on growth and flexibility--it seems unavoidable that the program is weaker as far as the detailed precision and quantification of policy measures is concerned, particularly in the long run. The 1987 targets for several important variables will be established only during the review that will take place after a few months. We believe that the program would have gained from a more specific description of the 1987 forecast and targets. After all, the oil contingency mechanism should have the effect of reducing uncertainty about future developments in that important area. Together with the

lack of experience with programs of this nature, it is difficult to compare Mexico's program with other Fund programs, and this makes the likelihood of its success difficult to assess.

We would have appreciated more clarification from the staff in three areas: First, it would have been desirable to have had the envisaged fiscal effort of 3 percentage points of GDP expressed in terms of an explicit target under one of the various concepts. As it stands, it is difficult for outsiders to evaluate the progress of budget consolidation. Second, the status of the so-called indicative target for inflation in 1987 is unclear. Without the expertise of the staff and the authorities, it is difficult not to regard the estimated halving of the inflation rate as somewhat optimistic, which also applies when an account is taken of the limited tightening of policies. Third, it is not clear how the reduction or increase in external financing requirements will take place and be shared among creditors in the lower and upper end scenarios involving the oil contingency mechanism. Very close monitoring and follow-up of the program will be crucial in reducing lack of clarity on these aspects.

Given the importance of not allowing temporary external factors to destroy the adjustment program of a major debtor program and Mexico's high degree of oil dependence, we can accept the oil price contingency mechanism, which we believe should be discussed in a more general context at a later stage. There is an obvious risk that other oil dependent and other commodity-producing countries will request similar arrangements. We wish to reiterate the specific character of this arrangement that takes into account the total financial position of Mexico. With these words of caution, we support the proposed decision in principle and express the hope that the authorities will fully use the opportunity provided to improve the program where necessary and they will sustain the adjustment effort well beyond the time horizon of the stand-by arrangement.

The Chairman said that financial support from the Fund and the international community for Mexico's adjustment program contained features tailored to Mexico's specific circumstances. The negotiations that had led to the program had taken place in a period when there had been an extremely sharp and rapid fall in oil prices. In 1985, at the time negotiations had begun, oil represented about 75 percent of Mexico's merchandise exports. At that time, the price of oil had been about US\$25 a barrel; within a few months, during the negotiations, the price had fallen by 60 percent to about US\$10 a barrel. That fall had had a tremendous impact on the balance of payments, with the country losing about US\$9 billion; the decline also had had a significant impact on the fiscal position of the country because oil receipts represented some 25 percent of budgetary revenues.



Oil prices could well have continued to decline, the Chairman remarked. The uncertainty of the oil market was such that it would have been almost impossible for any one to have predicted--in mid-July--that prices would have not gone down further. Thus, the authorities had told the Fund very clearly that they would not be able to meet any further decline--the price at that time was US\$9 a barrel--by an immediate and equivalent domestic adjustment, which would be in addition to the ongoing adjustment that was itself the object of a protracted and difficult discussion. A program could have been developed that would have disregarded the risk of a further decline in oil prices. However, he had judged it inappropriate to present such a program to the Executive Board under uncertain conditions relating to the effectiveness and continuity of the program and the relationship between Mexico and the Fund; the authorities would have also supported such a view. In the event that those circumstances had come about, both the program itself and the authorities' commitment to its adherence would have been much weaker.

Another alternative to the proposed arrangement would have been to provide compensatory financing based on developments in the oil market, the Chairman continued. However, that would have had a major drawback in that it would not have been as effective as the oil contingency mechanism in catalyzing additional external bank financing; it would have also not been adequate to cover possible shortfalls resulting from a further decline below US\$9 a barrel. It might be argued that bank financing could have been designed to take the shortfall into account; however, it was unlikely that the commercial banks would have agreed to that arrangement.

Thus, the only feasible solution--which the Board was being asked to approve--was to consider that the decline in the price of oil below a certain level would create a situation that would require further financing for a limited period, financing that would come from the Fund and the commercial bank community, the Chairman considered. During the discussion, the authorities had agreed that the financing would have three characteristics: first, it would be limited in amount; second, it would be available for only a limited time, during which the authorities would assess the depth and duration of the decline and undertake necessary corrective measures in order to begin addressing the problem after nine months; third, the mechanism would be symmetrical, as the rise in the price of oil above the US\$14 upper reference point would lead to a reduction in the country's dependence on external financing, which would mean an increase in reserves as far as the Fund was concerned.

Mexico's concern about the potential impact of a further loss of exports had long been recognized by the Fund in the establishment of the compensatory financing facility, the Chairman pointed out. The appropriateness of using international financing to cushion the impact of temporary declines in export earnings was reflected in Fund procedures. In Mexico's case, the issue had been the manner in which the principles of compensatory financing could be incorporated into the complex financial arrangements for the country; also, it had been essential to ensure that a persistent fall in oil prices would not have led to a breakdown of the

program, which would have been a major blow to cooperation between the Fund and Mexico and would have damaged the credibility of the Fund.

The use of the oil contingency mechanism had increased the credibility of the program and facilitated the mobilization of about SDR 800 million from the Fund and about twice as much from the banking community, the Chairman remarked. At current oil prices, a sizable export shortfall might have qualified Mexico for immediate compensatory financing of only about SDR 968 million.

In terms of total access to Fund's resources, the proposed arrangement was essentially more conservative than what could have been provided through a combination of maximum compensatory financing and financing through the stand-by arrangement, the Chairman continued. The program would be protected for only nine months if the oil price were to fall below US\$9 a barrel; beyond that, adjustment would have to be intensified progressively to make up for the additional shortfall. Although Mexico's access, including the maximum amount under the oil contingency, would certainly exceed both the annual access limits of 90 percent of quota and the high limit of 110 percent, the amount available--which was 126 percent on an annual basis--would remain significantly lower than that normally available under a combination of compensatory financing and enlarged access. Thus, the proposed Fund financing was consistent with the existing policies of access and involved an adaptation of Fund procedures to Mexico's special circumstances, including an arrangement to augment the financing accompanying the contribution of the Fund to the oil contingency. Thus, the Fund was not formalizing a generalized model, but was being guided by the need to tailor the arrangements to meet the special circumstances of Mexico.

The growth contingency was less of an innovation than the oil contingency mechanism, the Chairman observed. There had been growth contingency mechanisms in the past, but these had not been arranged in the same way because they had generally resorted to more domestic financing. In Mexico's case, the contingency mechanism would trigger more external financing. The authorities were extremely concerned not only about the uncertainties of the oil markets, but also about the growth prospects of Mexico. The authorities believed that the fiscal effort recommended by the Fund was excessive in terms of its impact on growth. They were not convinced that the fiscal effort would be consistent with a modest resumption of growth in 1987. The Fund believed strongly that the greater the adjustment on the fiscal side, the greater the resources that would be freed for the private sector. Although the authorities had agreed to what they had believed to be an excessively demanding fiscal component in the arrangement, they had wanted to ensure that a modest boost in public investment could take place even if there was a protracted recession in the first part of 1987. It was true that a limited boost would not ensure a steady growth rate, but it was important that there be a linkage between the fiscal aspect and the growth contingency.

The negotiations for the program had been long and difficult, the Chairman remarked. However, the agreement that had been reached ensured the continuation of open and active collaboration between Mexico, a major country in the world system, and the Fund and the banking community.

Mr. Ortiz said that his authorities deeply appreciated the efforts of the staff and the Chairman during the difficult negotiations. The negotiations had not been easy for the authorities because of the continued uncertainty about the oil market and the repercussions it had on the country. His authorities fully supported the way in which the Chairman had conducted the negotiations.

Mr. Fujino remarked that after the decision had been approved in principle, it would remain necessary for the commercial banks and the authorities to reach a successful and reasonable agreement. He reiterated his desire to see the Fund continue to provide adequate advice in support of the conclusion of the negotiations.

The Chairman said that he appreciated Mr. Fujino's remarks, but because the negotiations were being conducted between Mexico and its bankers, it was not certain that the Fund's advice would be followed.

The staff representative from the Western Hemisphere Department commented that the adjustment of public finances was one of the most important areas of the program. One of the problems that had been encountered in putting the program together was the significant deterioration of public finances within a very short time. The issue at the time had been what the public sector could do to offset the large decline in oil revenues. Although there were measures, such as pricing policies, that the Government could have implemented rather quickly to provide relief for other programs, those would have had some immediate adverse effects on the price level that would have introduced uncertainty about the impact of inflation under the program. That element had created difficulties in programming the behavior of some of the variables over time. The authorities had wanted to be able to evaluate the impact of the measures before finalizing some of the projections for the PSBR and other nominal variables in the fiscal accounts for 1987. At the same time, their commitment had been framed in terms of taxation and expenditure policy measures.

In response to the question why the staff report had merely indicated possible tax measures rather than identifying specific measures, the staff representative explained that the tax plan would have to be presented to the Mexican Congress, which would involve a process of discussion and negotiation. The authorities did not want to commit themselves to specific policy instruments before Congressional approval because some of the measures might be subject to modification during the discussions. The general understanding was in terms of the yield from the tax effort over the program period. Among the problems under the current tax system was the existence of an inflation component in interest payments that favored the taxpayer rather than the Government. In some

cases, the taxpayer was able to deduct as expenditure the full amount of interest payments, irrespective of whether they contained some amortization of the debt or could be considered as current expenditure. The tax reform would correct the distortions in the tax system and strengthen the tax base, which had deteriorated over the past three years. The Fund had provided technical assistance through two missions that had visited the country over the past year to review various aspects of the tax system. Some of their recommendations were currently being implemented, including a review of the level of corporate tax rates. It was essential that the implementation of the recommendations be carefully timed to achieve a balance between the need for receipts and the need for an equitable impact on various activities.

The impact of inflation on the debt and on interest payments had created a number of problems in interpreting the various concepts used to address the fiscal balances--the primary balance, the operational balance, or even the PSBR level, the staff representative observed. Although the staff report gave the Directors the opportunity to examine the behavior of the variables and the implications of the staff recommendations from various angles, the staff had felt that it was important to be pragmatic in its approach and to maintain during the discussions the traditional concepts that it had used in the past and with which it was most familiar. In the circumstances, the authorities had accepted that approach as appropriate, and the various monetary elements introduced into the program corresponded closely to those used in previous programs with Mexico. However, other concepts, including the operational balance, had been introduced because they were important monitoring devices and, from the point of view of the Fund, determined whether or not automatic drawings would occur.

The program that had been established utilized those concepts, and as in previous programs, the targets and ceilings had been set in nominal terms, the staff representative continued. Nominal values were essential for determining whether the objectives that were being sought had been attained. In the context of the operational balance, to the extent to which the authorities were able to levy an inflation tax in the system through the issuance of currency, a situation might arise in which interest rates could be negative in real terms in a given situation. However, to the extent that people were not willing to accept increases in money supply in general or the acceptance of such balances tended to reduce in situations of high inflation, then the implicit tax tended to disappear; that phenomenon had been seen in Mexico as well as other countries that had experienced high inflation.

The thrust of the program was to reduce the current expenditure of the public sector, and many of the reforms being carried out at various levels were part of the effort to make the public sector more efficient and to reduce expenditures in current terms, the staff representative remarked. At the same time, because the reform contributed both to efficiency and the adjustment process and made room for a higher level of investment expenditure, one of the authorities' concerns was that in

order to adjust to the situation that had developed over the past three years, investment expenditure had been reduced substantially and no new net investment was currently taking place. As a consequence, capacity had suffered in a number of cases. In addition, the authorities were seeking areas where capacity could be increased to accommodate potential productivity, while reducing capacity elsewhere.

Inflation had accelerated over the past few months, which was not a surprising development, the staff representative noted. Slippages in the public sector accounts had required greater financing even in early 1985. Such slippages were not surprising because, despite corrective measures taken during the second half of 1985, the large losses in revenue by the public sector had created such a large gap that closing it within a very short period had created significant pressures on the scarce financial resources available in the system, especially as external financing had not been available.

The significant depreciation of the exchange rate had had an impact on domestic prices, the staff representative continued. Certain developments had provided relief for the pressure on prices during the past few months, namely, the adjustment in public finances and the tighter monetary policy. Recent significant public sector price adjustments--which had had the opposite effect--had been such that the resulting improvement in the finances of the public sector would not necessitate further adjustments of that magnitude. There would be some increase in prices in the early part of the program, but inflationary pressures would abate as the beneficial effect of the various measures currently being undertaken took effect. However, the authorities believed that it would be difficult to make an early projection of the inflation target for 1987 until the effects of the current measures were apparent. With the introduction of the program, the expectations about the economic situation in Mexico--which had been quite negative, as reflected in the movements that had occurred in the free exchange rate recently--would take a turn for the better. Any resulting decline in inflation or real interest rates would bring about an adjustment in the primary balance that would probably have a greater impact on the PSBR than the 3 percent reduction foreseen under the program.

The monetary and credit policy envisaged under the program represented a significant change from the policy implemented in 1985, the staff representative commented. In 1985, there had been a large expansion in credit, in particular primary credit by the central bank. The credit expansion under the program for 1986 would be about 25 percent that of 1985.

At the time of the staff report, the authorities' new financial instrument, the PAGAFE, which would be adjusted by the exchange rate, had not yet been introduced because arrangements had not been made for placement in the market, the staff representative went on. Since that time, there had been an issue of the PAGAFE with an initial maturity of six months. It had been issued through an auction. The yield on those dollar-denominated notes would be 7.5 percent.

The projection for the medium term in the staff report reflected the authorities' own projections, the staff representative explained. The staff believed that if the tax reform were to be implemented together with the other measures, one could expect a stronger performance beyond 1987 than anticipated by the authorities. In that connection, the savings ratio--which, as noted by Directors, would not be as large as in the earlier period--should be interpreted cautiously. In a situation in which one began with a very high rate of inflation and ended with a low rate, the relationship between savings and GDP would be affected by inflation. Savings ratios would tend to be inflated in a period of high inflation.

The assumptions for the medium-term balance of payments projection were relatively cautious, the staff representative continued. Those assumptions included a growth rate of 7 percent in real terms of non-oil exports, which was certainly attainable given the large size of the economy and the fact that non-oil exports represented a small proportion of the total value of the economy. Such a growth rate could be achieved without much difficulty, particularly if the policy of keeping the economy open was maintained together with a flexible exchange rate policy. The growth would come largely from manufacturing and the in-bond industries, which were areas that had shown potential for significant growth.

In 1985, capital outflows had been fairly substantial--about US\$2.5 billion, the staff representative said. In the first half of 1986, there had been very little capital outflow. Although there had been some estimate of capital reflows, it should be noted that the private sector had a number of foreign obligations. The projections assumed that there would be some repayment of those obligations over time.

The staff had not undertaken a detailed projection that would trace developments of the external debt beyond 1991, the staff representative noted. On the basis of the debt existing at the end of 1985, 1991 would represent the peak period in terms of total debt repayments to be made; thereafter, repayments would become smaller.

The price of oil had recovered from the low level of US\$9 a barrel at the time of the negotiations with the authorities, the staff representative remarked. The prices of Mexican crudes tended to be somewhat below those of the major indicators used to follow the oil market, which reflected differences in the quality of the crudes. However, Mexican prices tended to follow the markets, given that the country was a price taker in the world market and was not large enough to be able to affect prices by its own actions.

The reason for assuming, under the oil contingency mechanism, a reference volume for petroleum while allowing prices to vary was that Mexico had relatively little influence on oil prices because it was a price taker, the staff representative said. The contingency was designed to protect the program against developments beyond the control of the

authorities that would affect the price of oil, although it was true that the Mexican oil industry could affect the volume of world oil exports to some extent.

The manner in which the conditionality of financing and sharing would take place was still under discussion because it was part of the negotiations with the commercial banks on the form of their participation in the scheme, the staff representative continued. Although the Fund had basically decided to take a one-third participation, the details of the scheme were still being worked out.

As to the growth contingency, the staff believed that the implementation of the current program would, among other things, improve confidence in the economy, increase availability of credit to the private sector, and reduce crowding out, the staff representative observed. Thus, there would be a situation in which normal production could be undertaken and normal investment activities could be carried out by the private sector, which would help to restore the level of economic activity. With some recuperation in activity, growth could be about 3.5-4 percent by the end of 1987. It was expected that economic activity would bottom out in the third or fourth quarter of 1986. The role of the growth contingency mechanism would be to provide a greater margin for dealing with deviations from the expected growth path. In the operation of the growth contingency mechanism, the rate of change in the index of manufacturing production had been chosen as an indicator because it had been a reliable indicator in the past. Data on manufacturing production were readily available, and developments in that sector were closely related to developments in GDP. However, all the performance criteria would have to be in compliance for the facility to be triggered; in a sense, the mechanism was for use at the margin.

There would be a review of the program in mid-1987 that would assess the general economic policies and their success in achieving the objectives of the program, the staff representative noted. The establishment of a clear indicator that would trigger the oil contingency mechanism was an issue that was still being negotiated between the authorities and the commercial banks.

The Deputy Director of the Exchange and Trade Relations Department said that the absence of performance criteria for the nominal PSBR in 1987, which was also the case with other ceilings denominated in Mexican pesos, related to the existence of serious uncertainties at the time the program had been negotiated. Given the high degree of uncertainty under which the program had been formulated--which Directors had noted, particularly with regard to developments in key variables, such as the inflation rate--policies for 1987 had been difficult to frame at that time. Consequently, the staff had followed the normal procedure of scheduling the formulation of the 1987 ceilings at the time of the review that would take place before the end of 1986.

Both the operational balance concept and the overall PSBR had been used in the case of Brazil for precisely the same reasons that applied to the Mexican case, the Deputy Director continued.

As to the general applicability of the operational balance concept to other cases, he hoped that countries would approach the Fund before inflation in their countries reached levels that required them to resort to both operational and nominal deficits. It was important to emphasize the fact that the operational balance could not substitute for the overall PSBR, as it remained necessary to bring inflation under control.

The growth contingency mechanism had also been applied to some other cases; the two-year stand-by arrangement with Chile had included a similar concept, the Deputy Director noted. The relationship between the contingency scheme and fiscal adjustment was particularly relevant. In that connection, he agreed with Mr. Polak that the observance of performance criteria would not guarantee growth. The linkage of the growth contingency mechanism to such observance of performance criteria was simply to provide the assurance that lack of growth would not result from lack of performance under the program. A shortfall in growth could come from many sources, but the staff believed that the policies of the program as measured by performance criteria would provide reasonable assurance of a resumption of growth.

As to the monitoring of structural measures and the extent to which they could condition drawings under the arrangement, the Deputy Director said that the forthcoming review of program design and performance criteria would be a good opportunity to look at actual performance in structural adjustment.

With respect to the split between current and capital spending under the growth contingency mechanism, it was clear that not only the level but also the composition of spending would become more important as greater attention was given to growth performance, the Deputy Director noted. In that regard, additional criteria to monitor developments in the composition of outlays might have to be considered. Generally speaking, in addition to certain technical reasons it had been decided that the country itself would determine the composition of spending to avoid excessive interference by the Fund in the country's decision-making process.

As to the status of the exchange rate policy under the arrangement, there was a balance of payments test that could be used to determine whether policies in general, and exchange rate policies in particular, were being pursued properly, the Deputy Director remarked. Exchange rate developments would be analyzed as part of the periodic review of the progress under the program.

As he had noted at the outset, uncertainties had made it difficult to formulate policies and objectives beyond the end of 1986, thereby making it difficult also to have the three-year horizon that an extended arrangement would require, the Deputy Director stated. Thus, the stand-by



arrangement appeared to be the appropriate instrument or facility to provide resources to Mexico at the current time.

Mr. Nimatallah, noting that the staff had assumed that the authorities had control over the volume but not the price of oil, asked whether the volume that the staff had assumed was full capacity, the most recent level of production, or average production. If that average production were below full capacity, he wondered whether the authorities could increase the output instead of requesting augmentation of the financing arrangement.

The staff representative from the Western Hemisphere Department said that Mexico's production volumes over the past few years had been examined and that the volume proposed by the authorities--1.2 and 1.3 million barrels a day--was considered reasonable in terms of what it could actually deliver. The volume taken was a reference figure; at any time, the actual volume exported might be above or below that figure. The reference volume would remain constant throughout the period.

Mr. Ortiz commented that the fiscal adjustment measures taken by the authorities in reducing expenditures by 10 percent of GDP, not including interest payments, were an indication of the adequacy of their fiscal adjustment efforts. Although the Government faced a huge resource gap, it should be noted that the gap was the result of very large external shocks. Previous deviations observed from fiscal targets were the product not of the modification of policy intentions, but of difficulties associated with the timely implementation of corrective measures. The speed of recovery had been somewhat misjudged in 1984. At the time that the private sector had begun to increase its activities and credit expansion had increased rapidly, the authorities did not have a complete understanding of the public finance situation; therefore, in a short period expenditures had increased much faster than had been expected. However, despite some delay, the authorities had eventually reversed the policies.

As to the recent inflationary pressures and the lack of an inflation target for 1987, Mr. Ortiz noted that inflation was inevitable in the present context, and the only viable recourse for the Government to extract real resources from the economy. If the external shock had been absorbed entirely by budgetary means without resorting to measures that would have inevitably resulted in additional inflation, such as additional depreciation of the currency or an increase in prices and tariffs by state enterprises, the investment program for the year would have been totally dismantled. The approach taken by the authorities was a combination of monetary, fiscal, and exchange rate policies, of which inflation was a by-product. He did not believe that it would have been feasible to have maintained the inflation levels existing at the end of 1985.

Although real wages had been falling at a dramatic rate and the exchange rate had been depreciating, the competitiveness of the economy was better measured by taking wages rather than prices as comparators, Mr. Ortiz remarked. The authorities intended to keep both wage and

exchange rate policies in line to maintain the competitiveness of exports, which had already produced tangible results. Non-oil exports were 30 percent higher than in 1986.

As to the unification of the exchange rate, his authorities were of the opinion that the dual exchange market had served them well because the spreads were currently very low and, since most of the transactions were still being carried through the controlled market, the distortions that the dual system would create had been reduced to a minimum, Mr. Ortiz continued. However, the free market represented a temporary outlet for exchange rate pressure and, in that respect, his authorities were of the view that formal unification of the rate would be unnecessary.

In addition to the financing being sought, the authorities would have to arrange a more medium-term arrangement to clear the debt problem; negotiations on that arrangement were under way, Mr. Ortiz concluded.

Mr. Nimatallah said that Saudi Arabia had successfully reduced the wage level, a policy in line with the general reduction of income in the country and as part of the process of making the economy more efficient. He suggested that the Mexican authorities look for ways in which to prevent increases in wages and even to reduce real wages for a period of time to enhance competition as well as to stimulate growth.

Mr. Ortiz replied that real wages in Mexico had fallen considerably--30-40 percent over the past four years.

The Chairman made the following summing up:

Executive Directors welcomed the authorities' decision to engage in a new program to redress the major economic imbalances faced by Mexico. They recalled that the adoption of a strong economic program in late 1982 had brought substantial benefits to the economy in the following two years, including a recovery of economic activity and a major strengthening of the balance of payments. Many Directors noted that even though the recent deterioration of economic conditions in Mexico was in large part the result of a very sharp worsening of the terms of trade, domestic prices and the balance of payments had come under pressure earlier because of a significant and unfortunate relaxation of fiscal, monetary, and exchange rate policies in late 1984 and early 1985. Commendable attempts to redress these policy slippages had been in progress from mid-1985, but the combination of the September 1985 earthquakes and the weakening of the international petroleum market has severely complicated this task.

Directors, therefore, welcomed the adoption of a combination of fiscal and monetary measures with structural reforms, aimed at restoring the viability of the balance of payments, strengthening the savings performance of the economy, and improving overall economic efficiency as a means for re-establishing

sustained growth. Directors drew attention to the importance of policies to improve supply conditions in order to foster growth.

Directors noted that Mexico's economic program called for a strengthening of the public finances through adjustment in public sector prices, increases in taxes, and rationalization of public sector activities. They underscored that a major and lasting reduction of the public sector deficit was essential to the restoration of external balance and price stability in Mexico. Many Directors believed that the pace of fiscal adjustment should have been more ambitious. They observed with concern that the 1986 public sector borrowing requirement would be nearly as large in terms of GDP as in 1982, and that it was likely to be reduced under the present program at a significantly slower pace than under the previous Fund program. Moreover, the financing of the 1986 public sector borrowing requirement would be a heavy burden on monetary policy and add to inflationary pressures. A number of Directors noted with reservations the introduction of the operational balance as a complement to the public sector borrowing requirement in monitoring fiscal performance. Most Directors warned that the use of various concepts of fiscal balance should not deter the authorities from continuing to focus primarily on the public sector borrowing requirement.

The program for adjusting public sector prices to realistic levels had been started under the previous extended arrangement, and Directors emphasized that it was important to complete the process of removing distortions in the existing price structure and of eliminating inefficiencies in the management of public sector enterprises. Directors stressed, however, that until inflation was overcome, it would be necessary to keep administered public prices under close scrutiny to avoid slippages such as those that had occurred in the recent past.

Directors noted that, in addition to the fall in oil export receipts, the yield of certain taxes had diminished in importance in recent years, in part because of the impact of inflation, and they agreed on the need to reinforce the tax base. A number of Directors urged the prompt and full implementation of the proposed tax reform, which was likely to have a favorable impact on revenue in the years beyond the period of the current arrangement. Such a development was important from the standpoint of strengthening capital formation while reducing the reliance on borrowing from abroad in the medium term. Several Directors believed that, in addition to tax increases, the Mexican program should have included a stronger emphasis on further cuts in current outlays.

Directors observed that the implementation of structural change in the public sector, including the cessation of public operations in nonpriority areas and industrial reconversion, was central to the improvement of economic efficiency and to the

strengthening of domestic savings. They welcomed the steps that had already been taken by the authorities but pointed out that much still remained to be done. Directors underlined the importance of cooperation between the authorities and the World Bank in this area.

Directors noted that over the recent past, monetary and credit policy, together with exchange rate policy, had carried the brunt of the adjustment effort. As a consequence, there had been a crowding out of the private sector in its access to credit, with adverse repercussions on capital formation and economic activity. Taking into account the magnitude of the public sector borrowing requirement and the strength of the inflationary pressures, Directors generally stressed that the monetary and credit policy that was planned would need to be forceful enough to ensure that it would lead to the much needed improvement in price performance and the achievement of the international reserve target, while at the same time making room for more credit to the private sector.

A number of Directors emphasized that to achieve a reduction of inflation without high costs in terms of unemployment it was necessary to act in the area of incomes policy to complement the tightening of financial policies. Directors regretted that the authorities were not in a position at this time to present their objectives for the reduction of inflation in 1987, and they urged them to develop a policy package for 1987 that would be consistent with a major and lasting improvement in price performance.

Directors emphasized the need to rely on market prices for the determination of interest rates and urged the authorities to maintain positive interest rates in real terms in order to strengthen the savings performance as well as the capital account of the balance of payments.

Directors commended the steps taken since mid-1985 to improve the international competitiveness of the Mexican economy and to make exchange rate policy more flexible. Directors noted that private capital flows had responded favorably to the tightening of credit policy and to the greater flexibility of the exchange rate, and that non-oil exports had reacted very positively to the more active exchange rate policy. Directors remarked that the large loss of export earnings that had resulted from the drop in oil prices meant that exchange rate policy, together with financial and structural policies, would have to play an important role in shifting resources to the export sector and to areas of efficient import substitution. Thus, a flexible approach would need to be taken toward exchange rate policy to ensure that external competitiveness would be not only restored but also maintained.

Directors observed that the differential between the controlled and the free market rates had narrowed significantly in recent months. They welcomed this development but stressed both the distortions and adverse effects on confidence associated with the maintenance of a dual exchange market. Thus, a number of Directors urged the authorities to adopt a timetable for the prompt unification of the exchange rate system.

Directors were encouraged by the steps that were being taken by the Mexican authorities to liberalize trade policy. They viewed with particular satisfaction the entrance of Mexico into the GATT and the support that the World Bank was giving to Mexico's initiatives for trade liberalization. They viewed the joining of the GATT as a sign of the Mexican authorities' commitment to an efficient economy, open to trade and capable of competing in international markets.

Directors noted that steps were being taken by the authorities to encourage export-oriented foreign investment and the new guidelines had just been issued for implementing debt/equity swap operations. Directors stressed the importance of direct foreign investment in the financing of Mexico's external capital requirements in the future. Thus, Directors urged Mexico to move boldly in removing administrative requirements that hamper the flow of direct investment to Mexico.

Directors noted that the authorities planned to deal with their external payments and debt problems through a combination of adjustment and further financial assistance from abroad. They remarked that Mexico's economic program involved a substantial amount of external financing, which was to be seen in the light of the extremely fast and large drop in export earnings that had been experienced. They also noted that the official financing that was contemplated was sizable in relation to outstanding credits to Mexico from these sources. It was important that the contribution of the private financial institutions to the financing package be completed without further delay, and Directors hoped that Mexico and its private external creditors would come to a realistic agreement very soon.

Directors noted that the program presented by the authorities incorporated two new contingency mechanisms to meet the special circumstances of Mexico. While a number of reservations have been expressed today regarding these mechanisms, it is fair to say that Directors generally felt that they had been tailored to the very special circumstances of Mexico and should facilitate the implementation of the program. It was observed that the oil contingency mechanism provided the economy with some temporary protection if the price of oil were to fall below US\$9 a barrel, and stipulated a reduction of the reliance on external financing if the price of oil were to rise above US\$14 a barrel. Directors

commented favorably on this symmetry. Directors also stressed that purchases under the oil contingency mechanism would be regarded as compensation for export shortfalls in the event Mexico were to request use of Fund resources under the compensatory financing facility. With regard to the second contingency mechanism, which would come into place in the event that economic recovery should fail to materialize, notwithstanding the pursuit of all the agreed policies, Directors emphasized the importance of using the additional financial resources to support projects that would yield satisfactory returns on capital investment.

In sum, Directors were of the view that the Mexican authorities--under exceptionally adverse circumstances--were showing their determination to strengthen their efforts in dealing with the problems that would need to be solved to provide the conditions for sustained growth and adjustment. However, today's discussion has clearly shown that most Directors believe that a stronger fiscal effort would be appropriate. Moreover, some doubts have been expressed whether the planned financial policies would be fully consistent with the targeted acceleration of growth and the braking of inflation. Even with the full implementation of the program, the balance of payments position will remain vulnerable for a number of years to come and there will be further additions to the already exceptionally heavy foreign debt burden. Directors therefore emphasized the need for total adherence to the program and continued strengthening of financial and structural policies to ensure that inflation will be brought down, capital formation raised, resource use improved, and external debt management put on a solid footing.

It is expected that the next Article IV consultation with Mexico will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Mexico has requested a stand-by arrangement for a period of 18 months in an amount equivalent to SDR 1.4 billion, with the possibility of augmentation to SDR 2.2 billion.
2. Subject to paragraph 5 below, the Fund approves the stand-by arrangement set forth in EBS/86/161, Supplement 4.
3. The Fund waives the limitation in Article V, Section 3(b)(iii).

4. Purchases of amounts by which the amount of the arrangement is augmented will be regarded as compensation for export shortfalls of equivalent amounts in respect of the period of the arrangement under the Fund's policy on the compensatory financing of export fluctuations.

5. The stand-by arrangement set forth in EBS/86/161, Supplement 4 shall become effective on the date on which the Fund finds that satisfactory arrangements have been made with respect to the financing of the estimated balance of payments deficits for the period of the stand-by arrangement, but provided that such finding shall be made not later than September 29, 1986.

Decision No. 8385-(86/149), adopted  
September 8, 1986

Exchange System

Mexico retains a restrictive multiple currency practice as described in EBS/86/161, Supplement 1. The Fund encourages Mexico to remove this practice. In the meantime, and in light of the adoption by Mexico of comprehensive policies for balance of payments adjustment, the Fund approves the retention of this practice until December 31, 1986.

Decision No. 8386-(86/149), adopted  
September 8, 1986

APPROVED: May 18, 1987

LEO VAN HOUTVEN  
Secretary