EBS/85/188

CONFIDENTIAL

August 9, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Mexico - Modifications of Exchange and Trade System

There is attached for the information of the Executive Directors a paper on recent modifications to the exchange and trade system of Mexico.

Mr. Pujol (ext. 8480) is available to answer technical or factual questions relating to this paper.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

MEXICO

Modifications of Exchange and Trade System

Prepared by the Western Hemisphere Department and the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by E. Wiesner and Manuel Guitián

August 9, 1985

The Mexican authorities have informed the Fund about a number of measures that have been adopted recently, several of which involve modifications to the exchange and trade system. These measures are summarized below.

1. Exchange system

On July 11, 1985 the so-called "free" exchange market was abolished. Up to that date, three exchange rates 1/ had been in effect in Mexico: (1) a controlled rate, at which about 80 percent of Mexico's external transactions were conducted, 2/ (2) an officially set "free market" rate that was managed by the commercial banks and that covered transactions not authorized through the controlled market (access to this market has been subject to limitations from time to time), and (3) a parallel market rate. The parallel market rate gained official recognition on June 5, 1985, (Buff Statement 85/99); on that date, the authorities announced new rules for the operation of exchange houses and

---

1/ Several other special rates had been introduced in December 1982 involving forward cover contracts for the settlement of specified medium- and long-term obligations abroad but the transactions eligible to benefit from those rates have now been concluded (EBS/85/123, 5/13/85, p.39, footnote 1).

2/ Operations channeled through the controlled exchange market include: all merchandise export receipts in excess of Mex$200,000; payments for virtually all imports; payments by in-bond industries for wages, salaries, rent and the purchase of Mexican goods and services, other than real estate; royalties for the use of foreign technology; payments of principal and interest on registered debt by the public and private sectors; payments for the Mexican foreign service and contributions to international organizations; and other transactions specifically authorized by the Secretariat of Finance and the Bank of Mexico.

commercial banks were authorized to operate in the parallel market through exchange houses. Under the new regime announced on July 11, 1985, purchases and sales of foreign exchange for transactions other than those conducted at the controlled market rate are to take place at the parallel market rate.

From March 6, 1985 through July 11, 1985 the exchange rate of the Mexican peso in terms of the U.S. dollar in both the controlled and the "free market" had been depreciated in relation to the U.S. dollar by Mex$0.21 per day. The rate in the parallel market fluctuated freely in response to market forces. On July 10, 1985 the mid-point exchange rate of the Mexican peso vis-a-vis the U.S. dollar was Mex$230.1 per U.S. dollar in the controlled market, Mex$248.7 per U.S. dollar in the "free market," and Mex$317 per U.S. dollar in the parallel market.

The exchange rate in the controlled market continued to be depreciated in relation to the U.S. dollar by Mex$0.21 per day in the period from July 11, 1985 to July 24, 1985. On July 25, 1985 the authorities announced a 17 percent devaluation, moving the mid-point rate in the controlled market from Mex$232.8 to Mex$279.7 per U.S. dollar. On that date the average rate in the parallel market dropped from Mex$366 per U.S. dollar to Mex$356 per U.S. dollar. The value of the peso in the controlled market continued to be adjusted by Mex$0.21 per U.S. dollar a day until August 4, 1985.

On August 5, 1985 a new system of managed floating for the controlled market came into effect. Under this system, the exchange rate is to undergo daily unspecified adjustments, not necessarily equal in amount, which will be made on the basis of, inter alia, the following factors: (a) the demand and supply for foreign exchange in the controlled market; (b) the objective of obtaining adequate levels of international reserves; (c) the movements of domestic and foreign prices; and (d) movements in other exchange rate relationships. Parties eligible to utilize the controlled market can choose to complete the transaction at a retail rate, agreed between those parties and the financial institutions authorized to operate in this market, or at the "equilibrium exchange rate" of the day. The "equilibrium exchange rate" will be determined for the controlled market each day at a fixing session at the Bank of Mexico, where representatives of the various financial institutions operating in this market will exchange bids for purchases and sales of foreign exchange; the Bank of Mexico also may submit bids in these sessions. For transactions exceeding US$50,000, the parties concerned may make completion of the transaction contingent on the equilibrium exchange rate achieving a particular minimum or maximum value. Offices and agencies of the public administration must carry out foreign exchange transactions directly with the Bank of Mexico at average exchange rates, corresponding to specific periods, calculated on the basis of the "controlled market equilibrium exchange rate." On

August 5, the "controlled market equilibrium exchange rate" was Mex$282.30 per U.S. dollar, the average retail rate was Mex$282 per U.S. dollar, and the spread between the exchange rates in the controlled market and the parallel rate was about 22 percent.

The changes in the exchange system referred to above involve modifications of the multiple currency practices described in EBS/85/123, and discussed by the Executive Board on June 7, 1985 at the time of the last Article IV consultations and the approval of the program for the third year of the extended arrangement for Mexico. The modifications to Mexico's multiple currency practices fall within the purview of paragraph 4(e)(ii) of the extended arrangement for Mexico approved by the Fund on December 23, 1982, as amended, and are thus subject to approval by the Executive Board under Article VIII.

2. Trade system

On July 25, 1985 the Mexican authorities announced that the process of eliminating import permits, and their replacement by protection through tariffs, was being accelerated. The requirement for import permits is being abolished for 3,604 items (representing some 37 percent of the value of 1984 imports), thereby raising the total number of items free from import permit to 7,159 (61 percent of total 1984 imports). Thus, the proportion of total imports free from import permit will now exceed the 35 to 45 percent that had been envisaged for end-1985 in the letter of intent describing the economic program for the third year of the extended arrangement (EBS/85/70, p.8, paragraph 19). With this change, 909 items will remain subject to import permit, involving mainly: agricultural food products; industrial products subject to special manufacturing agreements; raw materials for the pharmaceutical industry; final products in the computer, telecommunications and tool industries; and some 333 items considered nonessential.

A new import tariff structure is being introduced with nine rates ranging from zero to 50 percent, with most imports subject to duties in the range of 25 to 40 percent. The rates applicable to 1,980 tariff items are being revised, with the zero rate being reserved mostly for agricultural inputs such as seeds and fertilizers; a 5 percent rate applies to machinery and equipment imported in component form; a 10 percent rate applies to raw materials and capital goods for which there is no local manufacture; a 15 percent rate applies to intermediate products for which there are many stages of processing; a 20 percent rate applies to goods that have close substitutes produced in the domestic market; a 25 percent rate applies to intermediate goods which are locally produced and have a high local value added, such as steel; a 30 percent rate applies to spare parts and unassembled machinery that are locally produced as well; a 40 percent rate applies to final goods and intermediate agricultural products; and a 50 percent rate applies to nonpriority final consumer goods.

Steps are being taken to liberalize the operation of the DIMEX, a scheme that provides exporters automatic access to import permits for a value equivalent to 30 percent of their exports. The number of items excluded from access to the scheme is being reduced, from 943 (representing some 28 percent of 1984 imports) to 537 items (representing about 21 percent of 1984 imports), and the minimum import tariff rate applicable to imports under DIMEX is being lowered from 25 percent to 10 percent.

3. Other policy actions

On July 25, the authorities took measures to reduce current expenditures of the Central Government, including the elimination of 15 units at the level of undersecretariat of state and at least 50 at the level of directorates-general, a freeze in salaries for high government officials and reductions in various other expenditure categories. Instructions have been given to public sector enterprises to reduce their operating expenditures to an extent at least comparable to that undertaken by the central administration. The authorities estimate that these spending cuts will yield some Mex$150 million (equivalent to 0.3 percent of GDP) in savings to the budget during the remainder of this fiscal year.

4. Staff appraisal

At the conclusion of the 1985 Article IV consultations with Mexico, the Executive Board urged the authorities to exercise greater flexibility in the management of the exchange rate policy and to unify the exchange system as quickly as possible (SUR/85/69). In the view of the staff, the recent modifications of the multiple exchange rate system by Mexico represent a step in the right direction and constitute a simplification of that system. They involve an effective depreciation of the peso and provide an indication of the authorities' intention to manage the controlled rate flexibly, and thus should facilitate the process of exchange rate unification. The staff also welcomes the measures taken to accelerate the process of phasing out import licenses and liberalizing imports.

The effect of the policy measures described above will be discussed with the Mexican authorities during the forthcoming staff visit to Mexico that is scheduled to review progress under the extended arrangement. In the meantime, no action by the Executive Board is being recommended.