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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 8, 1976

To Board of Governors

Subject: _____

From John E. Reynolds *JER*

RESTRICTED

Attached for your information are two notes on the Mexican economic program prepared by Mr. Maroni.



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Comments on the Mexican Program
in the Light of Recent Developments

The Mexican program negotiated with the IMF staff^{1/} is a very comprehensive one covering all facets of economic and financial policy. It will require a considerable amount of austerity for the three-year period over which it will be phased. This period begins January 1, 1977, and there are no policy understandings between Mexico and the IMF for the remainder of 1976. This hiatus for the next three months reflects the fact that the present Mexican administration will be leaving office on December 1 when President-elect Lopez Portillo is scheduled to be inaugurated. Apparently, outgoing President Echeverria was willing to take the blame for the devaluation, but not for the austerity measures which the situation requires. The result may well be an erosion of the advantages expected from the September 1 devaluation before the austerity program begins to take effect. Recent developments in Mexico described below would seem to be in line with this assessment. If this trend continues, the peso, which is currently held within narrow margins by the Bank of Mexico, may well have to be allowed to float to a lower value in coming months.

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MR 95-1 #3
CBH 4/12/96



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Recent Developments

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Late last month, the Mexican government announced that the wage increase promised by President Echeverria on September 1 would range from 16 to 23 per cent. Organized labor, which had threatened a general strike unless the raise amounted to 65 per cent, agreed to this outcome when the authorities made it clear that prices of many consumer goods would not be allowed to rise by more than 10 per cent and that a freeze would be placed on others. These price measures were put into effect on September 27.

However, this wage increase is in addition to the wage bargains currently being negotiated by individual employers and unions. These range up to 10 or 15 per cent, so that the total wage increase this year will turn out to be close to 35 per cent for most workers.

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On September 29, the Mexican government tightened controls on public expenditures and placed new restraints on investment spending and on hiring of workers by the public sector. But the public sector must now pay the higher wages just announced, and the peso burden of its external debt service payments has jumped with the devaluation. It will also have to cover the increased losses which public enterprises must incur as a result of the price freeze on essential goods and services sold by them in the face of higher costs. In this situation, the September 29 measures appear likely to provide only a partial offset to the continuing fiscal deterioration.

The full extent of the program and the magnitude of the required adjustments have not yet been spelled out for the general public. As a result, the public remains confused and skeptical of the Government's ability to prevent a further deterioration of the economy. The Government's credibility has been damaged by the fact that the currency was devalued after repeated assurances that it would not be, and now its confident statements about the future are widely disbelieved.

More significant measures than the newly announced restraints on public spending will be needed before confidence begins to return. For this, most observers believe that we will have to await the inauguration of President-elect Lopez Portillo on December 1.

The Long-Run Prospects

The magnitude of the Mexican disequilibrium is such that a major shock would have to be administered to the economy if it were to



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be corrected quickly. The decision to phase the adjustment over a three-year period will make the annual adjustments smaller and therefore easier to accomplish. But there is a danger that the will to practice austerity may gradually weaken before the objectives of the program have been fully achieved. If this should happen, there could well be some slippage in the country's economic and financial performance under the program.

Indeed, the magnitude of the adjustment required, particularly in the budgetary area, is so large that some slippage may be inevitable. But even if the precise targets of the program are not fully achieved, the result should still be beneficial--unless the slippage is so large that the country ends up in effect with no program at all.

Mexico's prospective drawings on the IMF under the Extended Fund Facility arrangement will be phased over the three years to which the program is to apply, and Mexico's eligibility to draw will be subject to suspension if specified targets under the program are not met. This will give the Mexican authorities an added incentive to persevere in their efforts. The Fund staff will closely monitor Mexico's performance under the program and will conduct frequent reviews to determine its continued eligibility. Should slippage occur and should eligibility be suspended, new targets must be negotiated with the Fund to restore the country's right to draw. This will provide flexibility in case of slippage and ensure that Mexico is not faced with an

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all-or-nothing situation. In other words, if the improvement expected under the program does not fully materialize, the door will be open to promote a more moderate measure of progress--one which, hopefully, will be attainable.

This flexibility on the part of the IMF, though understandable carries the risk that the authorities, encouraged by knowledge that a more modest degree of progress may be forgiven by the Fund, will not exert their best efforts to carry out the original program, or will tend too easily to give in to domestic political pressures to relax their austerity policies. But this risk is probably the price that must be paid to avoid a complete break between the member country and the Fund in case of unavoidable slippage.

The Mexican program is very specific in most areas of economic and financial policy, but it does leave a few things unsaid. One of these has to do with interest rate policy. In this area, there is a need for a rise in interest rates to make them positive in real terms and thereby enhance the attractiveness of peso assets to domestic and foreign investors. No such commitment or target is explicitly mentioned in the Mexican memorandum to the Fund. However, the Mexican authorities have accepted a commitment to pursue interest rate, credit, and reserve requirement policies that will permit the currency issue to increase by no more than the amount of any increase in the country's net international reserves, and within that constraint they have made a vague commitment to pursue

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an interest rate policy aimed at retaining the largest possible portion of domestic savings within the country and inducing compensatory capital movements. Some more specific interest rate action might be particularly helpful in cushioning the capital outflows that have resumed at a steady rate over the past three weeks. In fact, Mexican interest rates, which are administered by the Bank of Mexico and remain fixed for substantial periods of time, have not been increased since the devaluation. The last increase occurred only about three weeks before September 1.

The most crucial task of the program must be to permit a shift of resources into the external sector. The program requires that strong steps be taken in this direction, especially on the fiscal side. But even over a three-year period, the proposed reduction in the size of the public sector deficit is huge and must be thought of as quite ambitious. A large part of the public sector deficit may be found in the state enterprises, the social security system, the state and local governments and the Federal District. There may be great difficulties in bringing about the needed reduction in these sectors.

If the reduction which is envisaged were achieved, it would allow the tightening of monetary policy that would support the aggregate demand objectives of the program and encourage a net inflow of capital. However, the measures needed to achieve the 1977 target for the public sector deficit may have to be so severe as to produce a recessionary shock.



This will severely test the will of the authorities to persevere on this course and may bring about social unrest.

On the external side, the restoration of confidence so as to end capital flight is another problem area. This may require the adoption of political and social policies which partially reverse the course followed in recent years--a difficult move to carry out. It may also require steps to overcome the credibility gap that seems to have been created by the decision to devalue after repeated assurances that there would be no devaluation. Should the flight of capital continue, this would jeopardize the achievement of the targets for external official financing and for the rebuilding of international reserves.

The performance of real wages is likely to be the most critical element in determining the success or failure of the program. Holding down increases in real wages will help directly in reducing pressures on the balance of trade by restraining real consumption. It will also help improve the public sector finances since wages are such a large fraction of total public expenditures. But organized labor in Mexico is powerful and holding down wage increases will not be easy. Indeed, the shift of resources into the external sector could create significant difficulties with the incomes policy.

Prepared by Yves Maroni
Division of International Finance
October 8, 1976



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Summary of the Mexican program and IMF Staff Assessment

The Mexican program developed in agreement with the IMF staff in support of the Mexican request for an Extended Fund Facility arrangement involves a three-year effort to correct the economic and financial disequilibrium affecting Mexico. The program calls for the following:

(1) a reduction in the fiscal deficit from over 8 per cent of GDP in 1976 to about 2.5 per cent in 1979, with about 40 per cent of the distance (to 6 per cent of GDP) to be covered in 1977.

(2) a rise in public sector revenues from 26.4 per cent of GDP in 1976 to 30 per cent of GDP in 1979, and restraints on the rise in public sector current expenditures so that they will decline as a percentage of GDP, from 25.9 to 24.5 per cent. This would result in a rise in public sector savings from 0.5 per cent of GDP in 1976 to 5.5 per cent in 1979.

(3) restraints on the rise in public sector capital formation to lower moderately the proportion of GDP which it represents (from 8.7 to 8.0 per cent), but a rise in private fixed capital formation from 14.3 per cent of GDP in 1976 to 18 per cent in 1979. With these investment targets, the rate of growth of real GDP would rise from 4 per cent in 1976 to 7 per cent in 1979.

(4) a drastic cut in external financing by the public sector--the annual increase in net external public debt would fall from an amount equal to 5.7 per cent of GDP in 1976 to an amount equal to 1 per cent of GDP in 1979.

(5) a shift in the balance of payments on goods and services account from a deficit equal to 2.3 per cent of GDP in 1976 to a surplus

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MR 95-1, # 4

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equal to 0.6 per cent of GDP in 1979, with about two-thirds of the improvement to occur in 1977.

(6) a rebuilding of the Bank of Mexico's net international reserves in an amount equal to 1.5 per cent of GDP, two-thirds of this (or close to \$1 billion) to occur in 1977. In this connection, the program specifies that gold holdings are not to be revalued during 1977.

(7) a flexible exchange rate policy consistent with balance of payments equilibrium and permitting a lowering of import duties and the progressive reduction of non-tariff restrictions on imports imposed for balance of payments reasons and of artificial incentives for exports.

(8) a monetary policy designed to hold the increase in the currency issue at or below that of the net international reserves of the Bank of Mexico, to observe the explicit limits which are being placed on the increase in the Bank of Mexico's net domestic assets, and in general to promote the achievement of the objectives of the program. In this connection, there is a specific understanding that interest rate policy will be aimed at retaining the largest possible portion of domestic savings within the country and inducing compensatory capital movements.

(9) a progressive convergence of the rate of nominal wage increase in Mexico with those prevailing in its major trading partner countries, adjusted for differences in productivity gains.

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- 3 -

(10) the setting of prices and rate structures of goods and services sold by state enterprises at remunerative levels, coupled with periodic adjustments in the face of cost increases.

(11) efforts to avoid subsidizing consumers save in exceptional cases of articles of popular consumption.

Specific targets for all of the relevant macroeconomic flows have been set in agreement with the IMF staff not only for 1979 but also for 1977 and 1978. Mexico's performance under the program will be reviewed periodically and will be measured against these targets.

To promote adherence to the program, Mexico's eligibility to draw against the Extended Fund Facility will be conditioned on several key targets being observed. For 1977 specifically, suspension of eligibility will be triggered by (i) failure to achieve the quarterly international reserve target, (ii) non-observance of the quarterly ceilings on net external borrowing of the public sector, (iii) failure to stay under the quarterly ceilings on the overall deficit of the public sector, and (iv) violation of the October and December ceilings on the increase in the net domestic assets of the Bank of Mexico. In addition, suspension will be triggered by the introduction or intensification of any non-tariff import restriction for balance-of-payments reasons or by the imposition of any restriction on international payments and transfers for current international transactions. Suitable performance clauses will be established before the beginning of the second and third years of the arrangement.

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II. IMF Staff Assessment of the Program.

The IMF staff believes that the program contains both reassuring and worrisome elements. They find comfort in the areas of balance of payments and external public debt management, as well as in those for commercial and monetary policy. They are also encouraged by the guidelines for price and wage policies, but they express concern over the political difficulties standing in the way of terminating the rather general subsidization of consumers of basic commodities and of securing the broad support needed for a policy of readjusting real wages.

They characterize fiscal policy as another critical problem area. They point out that the needed budgetary adjustment is enormous, even if it is phased over three years. They comment that the adjustment will require both revenue and expenditure measures and that the needed compression of public expenditures will not be attained without restraint on wage increases, given the importance of wage costs in public spending. It has to be assumed that appropriate tax measures will be announced with the next budget.

The IMF staff also stresses that success of the program will be contingent on an early restoration of confidence at home and abroad. The program calls for a strengthening of the net international reserve position of the Bank of Mexico and a strong pick-up of private investment activity. The IMF staff point out that neither of these objectives are attainable if massive capital flight from Mexico continues or if Mexico's foreign creditors seek to reduce their exposure in the country. Implied

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- 5 -

in this statement is a concern that political and social policies as well as economic policies may inhibit private investment or frighten creditors into retrenching. In this connection, the political and social trends of the last few years are not very encouraging. Moreover, the fact that President-elect Lopez Portillo is a technocrat with a relatively limited political base is enabling outgoing President Echeverria to place many of his own followers in key positions around his successor, and this may make it difficult to remove some of the irritants which worry the private sector.

Finally, the IMF staff pointedly states that "the success of the program also hinges critically on developments in the remainder of 1976, a period for which there are no policy understandings with the Mexican authorities." The IMF staff ends its analysis with the statement that, "notwithstanding the formidable tasks ahead, they have no reservation in concluding that the program is deserving of Fund support with an Extended Fund Facility arrangement."

Prepared by Yves Maroni
Division of International Finance
October 8, 1976

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CHAIRMAN BUENOS

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[10-8-76]

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INFORMATION SECURITY PROCEDURES FOR RESTRICTED INFORMATION



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Two pages missing from earlier distribution of this memo.

Please replace with the attached copy.



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Prepared by Yves Maroni
Division of International Finance
October 8, 1976



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Prepared by Yves Maroni
Division of International Finance
October 8, 1976

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CHAIRMAN BURNS

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[10-20-76]

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

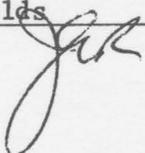
Office Correspondence

Date October 20, 1976

To Board of Governors

Subject: _____

From John E. Reynolds



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The attached note by Mr. Mills reports his investigation into the large syndicated bank loan for Mexico now in preparation.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 19, 1976

To Mr. Gemmill

Subject: \$800 million loan to

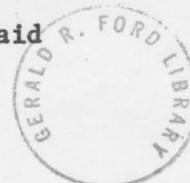
From R. H. Mills, Jr.

Mexico

RHM

I spoke on October 15 with persons at Chemical Bank (Robert Engelhardt), Chase Manhattan (Anthony Gerard), and Citibank (Jerry Finneran) about certain aspects of the \$800 million loan that these three banks and 15 other banks are syndicating for the Mexican Government. The 15 other banks acting as lead managers include five U.S. banks, viz., Bankers Trust, Continental Illinois, Manufacturers Hanover, First National of Chicago, and Bank of America. The principal comments I received were as follows:

1. The Mexicans did not have to do any "arm-twisting" to get those 18 banks to act as lead managers.
2. Chase, Citibank, and Morgan Guaranty -- which latter subsequently dropped out of the negotiations -- pressed for the imposition of some conditions regarding Mexico's economic performance, but none of the other banks sided with them, and Chase and Citibank eventually went along with the majority. Most of the banks still think of Mexico as "the best game in town" because of its economic growth potential and close relationship with the United States. The Mexicans were adamant against any conditions -- they think of themselves as being more like Venezuela than like Peru.
3. Chemical and Chase wanted more information about the Mexican economic situation and the Mexican Government's stabilization plan, and asked to see the IMF report, but were refused. They said



that most other banks were satisfied with the information they had. Both Chemical and Chase felt that, because of what they saw as an inadequacy of information, the negotiations were not conducted in a sufficiently professional way.

4. All three of the banks I talked with said their Mexican exposure would rise as a result of the new loan, because no big repayments would be made soon on earlier loans to Mexico, and these banks thought that all or most of the other banks involved would also experience an increase in claims on Mexico. Big repayments by Mexico will be coming up in 1978-79.

5. The probable interest rates of 1-1/2 per cent over LIBOR for the 5-year tranche and 1-3/4 per cent over on the 7-year tranche are the same as what Mexican public sector borrowers were paying earlier this year. But the likely front-end fees -- 1 per cent on the 5-year and 1-1/8 per cent on the 7-year -- are higher than Mexico was paying before.



C.9b

FINANCIAL INDICATORS -- MEXICO

(dollar amounts in millions)	1975				1976									
	YEAR	QI	QII	QIII	JULY	AUG	SEPT	OCT1-28	Week ended					
									SEPT 22	SEPT 29	OCT 6	OCT 13	OCT 20	OCT 27
EXCHANGE RATE (CENTS PER PESO, END OF PERIOD)	8.00	8.00	8.00	8.00	8.00	8.00	5.03	4.96	5.04	5.03	5.03	5.04	5.03	3.77
SDP VALUE OF PESO	.06842	.06924	.06985	.04364	.06980	.06957	.04364	.04363	.04362	.04364	.04351	.04367	.04363	n.a.
SHORT TERM INTEREST RATE (E.O.P.)	12.94	13.11	13.11	13.11	13.11	14.36	14.36	14.36	14.36	14.36	14.36	14.36	n.a.	n.a.
LONG TERM INTEREST RATE (E.O.P.)	No appropriate long-term rate available													
RESERVES (IFS, E.O.P.)	1,533	1,501		897 ^P		1,159	897 ^P	57 ^e						
AVAILABLE IMF CREDIT TRANCHES (E.O.P.)	433	620	615	621 ^P	615	618	621 ^P	621 ^{P*}						
INTERVENTION, PURCHASES (+) OR SALES (-)**														
OF DOLLARS							-262	-840	-228	-131	-189	-156	-241	-288
(OF OTHER CURRENCIES; EQUIVALENT)														
SWAP ACTIVITY														
ININGS (+), REPAYMENTS (-)	360	--	360	--	--	--	--	--	--	--	--	--	--	--
SWAP LINE --	360							-360						
SWAP LINE --	360													

* With additional credits negotiated from the Compensatory and Extended Fund facilities, Mexico's overall access to IMF credit could rise over time to \$960 million.

** The figures reported in this row are those for Mexican intervention that is reported to us, we understand that these data are incomplete and the net intervention and change in reserves since September 1 may be one half or one third as large.



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October 28, 1976

MEXICO: ECONOMIC INDICATORS
(NOT SEASONALLY ADJUSTED)

C.9a

October 28, 1976

	1973	1974	1975	1975 Q1	1975 Q2	1975 Q3	1975 Q4	1976 Q1	1976 Q2	1976 FEB	1976 MAR	1976 APR	1976 MAY	1976 JUNE	1976 JULY	1976 AUG
REAL GDP(\$BIL.P)	354.1	375.0	390.9	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.						
IP (1973=100)	100.0	107.3	112.3	106.9	115.7	112.8	113.8	116.3	116.6	112.8	123.3	113.6	118.8	117.4	N.A.	N.A.
UNEMPLOYMENT	NOT AVAILABLE															
WPI (73=100)	100.0	122.5	135.4	128.5	133.6	138.0	141.2	149.1	153.9	149.0	151.2	151.9	154.2	155.6	159.5	159.0
CPI (73=100)	100.0	123.8	142.3	136.3	140.3	144.9	147.8	154.2	158.2	154.6	156.2	157.2	158.4	159.0	160.4	161.9
M1* (Seas.adj.)	24.8	20.9	22.2	5.6	6.5	3.3	5.2	4.3	5.1	1.5	0.6	1.8	3.1	0.7	N.A.	N.A.
EXPORTS (\$BIL)	2.1	2.8	2.9	0.7	0.8	0.7	0.8	0.8	0.9	0.2	0.3	0.3	0.3	0.3	N.A.	N.A.
IMPORTS (\$BIL)	3.8	6.1	6.6	1.4	1.7	1.6	1.9	1.4	1.7	0.4	0.5	0.5	0.5	0.6	N.A.	N.A.
TRADE BAL (\$BIL)	-1.8	-3.2	-3.7	-0.8	-0.9	-0.9	-1.1	-0.7	-0.8	-0.2	-0.2	-0.2	-0.2	-0.3	N.A.	N.A.
BALANCE OF GOODS & SERVICES(\$BIL)	-1.3	-2.6	-3.6	-0.8	-0.9	-0.9	-1.1	-0.6	-0.9	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

*Percentage change from previous period.



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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October 29, 1976

To: Chairman Burns

From: Ted Truman

EMT

At Governor Wallich's request I prepared the attached notes on the meeting on the Mexican economic situation that was held at Treasury yesterday. I have also enclosed a copy of Mr. Maroni's notes on the Mexican economic situation that were circulated to the Board earlier in the month. Finally, you will find copies of the latest summary economic and financial data on Mexico that we have.

If you would like to discuss with me any aspect of these materials this afternoon, I will be available. I will also be available either at home or in my office over the weekend.

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E.M. Truman
October 29, 1976

NOTES ON MEETING ON THE MEXICAN ECONOMIC SITUATION
(October 28, 1976)

Participants: Governor Wallich, Under Secretary Yeo, Messrs. Robichek (IMF), Cross (Treasury), Widman (Treasury), and Truman

Note: These notes are not intended as a comprehensive treatment of the Mexican economic situation. They are based on a meeting that was held at the U.S. Treasury at which information on the major features on Mexican economic performance was exchanged. (The discussion covered wage policy, exchange-rate policy, fiscal policy external debt, and short-term prospects.) However, along with the notes prepared by Yves Maroni on October 8, (copy attached) these notes serve to bring the evaluation of Mexican economic situation up to date to the extent that available data permit. A set of the most recent Mexican economic and financial indicators is attached.

I. Wage Policy

Mr. Robichek led off the discussion by commenting that the Fund staff has passed through several phases in its understanding of Mexican wage policy following the initial floating of the peso on September 1. First, there was fear that wage increases would eat away all of the competitive advantage to be derived from the depreciation. Second, when the Government announced agreement on a package of wage increases ranging from 16 to 23 per cent, this was regarded as favorable. Third, it was learned to everyone's disappointment that these adjustments were to be on top of regular wage bargains. On Wednesday, the statement was made in the IMF Executive Board that the government would encourage the re-opening of wage bargains that appeared to be excessive; no matter how desirable such a policy might be, it hardly sounds realistic.

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Mr. Robichek explained his understanding of the situation. The roughly 16 million Mexican labor force consists of three, approximately equal groups: (1) workers who earn the minimum wage, (2) workers covered under normal collective bargaining arrangements, and (3) workers who are "self employed" who are concentrated at both ends of the income distribution.

In Robichek's opinion, the wage increase of 23 per cent granted to the first group were not excessive given that the last adjustment was on January 1, 1976 and assuming that a further substantial adjustment would not occur in January 1977.

In his opinion, the major problem involves the second group of roughly 5 million workers covered under collective bargaining agreements. The one million government workers in this group had not received a wage increase since August 1975; therefore, Mr. Robichek did not think that the 21-23 per cent increase that they had now received was too worrisome. The big question mark concerns the other four million workers covered by collective bargaining agreements, who will receive a 16-23 per cent increase automatically. Here, case-by-case negotiations are now under way and no one can tell how they will come out.

Mr. Robichek offered the following general observations. (1) His hope was now that the average wage in 1976 would be no more than 30-35 per cent above the average wage in 1975. (2) Over the first eight months of 1976 the increase in wages had been about 10 per cent. (3) Prior to the depreciation, changes in the cost of living were running at about a 15

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per cent annual rate. (4) He had thought that the maximum tolerable 1976 wage adjustment given the depreciation was an overall increase of 20-25 per cent which he felt would have been consistent with an "equilibrium" exchange rate of 20 pesos per dollar -- a roughly 40 per cent depreciation from the previous parity of 12.5 pesos per dollar. (5) While he did not think that present wage situation was a disaster, he found it disturbing and still very uncertain.

Mr. Yeo echoed Mr. Robichek's sentiments; he had gone from elation to gloom and was now in the middle.

A question was raised about union reaction to the second depreciation of the peso. Mr. Widman reported that he had heard that the (or some) unions had indicated that they would not seek to reopen the overall wage bargain.

II. Exchange-Rate Policy

Mr. Robichek remarked that Mexico's exchange-rate policy since September 1 had been badly handled. First, they had managed the rate too heavily. Second, they had adjusted it after the initial depreciation in the wrong direction, i.e., forcing a small appreciation of the peso. Third, they had held the peg at 19.80 pesos too long. All of the official intervention that occurred was at pegged rates, which was contrary to the advice the Fund had given to Mexico. (The Fund paper on the Mexican drawings of their expanded first credit tranche and under the Extended Fund Facility states as an assumption that "the Mexican peso



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will be allowed to float in the next few months with only limited net intervention by the Bank of Mexico, the latter's net international reserves should not change much over the remainder of this year.")

Mr. Robichek said that he was, therefore, relieved that the Mexican authorities had apparently now decided to allow the peso to float more freely. (The average quotation on Thursday was 25.90 pesos per dollar or a depreciation of over 50 per cent since August 31.) The question was what would be the market's reaction. It was a second and riskier gamble.

Mr. Robichek commented that the figures the Federal Reserve and Treasury had been receiving on Mexican intervention were an inaccurate indication of the change in Mexican reserves. These figures cover only net sales to banks by the Bank of Mexico. On the one hand, they do not include purchases of dollars from government enterprises in connection with their financial and other operations. On the other hand, they do not include payments to finance withdrawals from dollar-denominated accounts with Mexican banks.

Mr. Cross offered the estimate that the actual change in Mexican reserves since September 1 was on the order of minus \$350 million, in contrast with the over \$1 billion in reported "net intervention." Mr. Robichek reminded the group that no one had been able to obtain hard figures -- the Mexicans are very hard to pin down. It was agreed, however, that hard figures were necessary in order to assess the damage inflicted by Mexican intervention policy.

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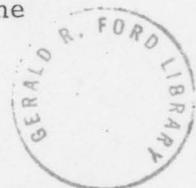


Mr. Robichek commented that the analysis of the intervention and reserve statistics was complicated by the fact that the Mexican situation was one of a large current account deficit, capital flight, and the need for large amortization payments all of which led to extensive external borrowing. (See Section IV below.) He also commented that withdrawals from dollar-denominated accounts were associated with persistent worries that these accounts would be blocked or taxed.

Mr. Yeo commented that Lopez Portillo wanted to hold the rate so that he could take adjustment action later. (It was unclear to me whether he was talking about exchange-rate adjustment or macro-economic adjustment or both.) He said that Fernandez Hurtado had been caught in a crossfire involving the present government, Lopez Portillo, and the unions. He, too late, persuaded the authorities to let the rate move; now he has not only lost a large amount of dollars but a psychological advantage vis-à-vis the market. His problem now was that he had to intervene to some extent to prove that he had not "run out of gas" or "exhausted his ammunition," but he could not afford to get trapped again (in the near future?) into pegging the rate. Mr. Yeo said he expects runs on the peso because observers realize that there is a high probability that at some point the Bank of Mexico will be forced to block the dollar liabilities of banks.

III. Fiscal Policy

As a prelude to the achievement of the objective under the Mexican drawing from the IMF Extended Fund Facility of reducing the



global public sector deficit from 9 per cent of GDP in 1975 and an estimated 8.2 per cent of GDP in 1976 to 6.0 per cent of GDP in 1977 and 2.5 per cent of GDP in 1979, the Mexican Government on September 29 announced the tightening of controls on public expenditures, new restraints on investment spending, and restrictions on hiring new workers by the public sector.

At the meeting, it was generally agreed that everyone had received glowing reports on what was happening on the fiscal policy front, but no one had any specifics. It was agreed that such specifics were urgently needed.

IV. External Debt

Governor Wallich asked what information we had about Mexican debts that were coming due.

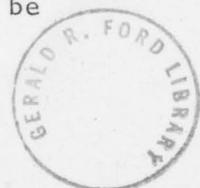
Mr. Robichek replied that in his analysis he viewed the problem as having three components. The first component is borrowing necessary to cover the current account deficit estimated, by the IMF, at \$4.3 billion for 1976 less long-term capital inflows estimated at \$1.2 billion for 1976 -- a net figure of \$3.1 billion. (Note part of the long-term capital inflow is in kind, directly offsetting the current account deficit.) The second component is the amount that is necessary to cover amortization payments on external public debt. For 1976, he estimated these needs at \$1.7 billion, including the assumption that all debt with an original maturity of under one year must be rolled over or refinanced once during the year. Adding these two components together



one gets a combined total of \$4.8 billion (\$3.1 billion in net current account financing plus \$1.7 in amortization) or an average \$400 million a month, which was the figure he worked with.

Governor Wallich commented that Fernandez Hurtado had told him that they needed only \$250 million per month. Mr. Robichek replied that this was an example of the problem of pinning the Mexican's down; what assumptions was Fernandez Hurtado making? He cited the example of Mexican statements that short-term credit lines of about \$3.2 billion in mid-1976 were "renewable lines of credit." But this was certainly not the way banks saw them. (In other words, if Fernandez Hurtado were including only the borrowing needed to cover the current account deficit net of long-term capital inflows, then the average monthly figure would be just over \$250 million per month, using the IMF's estimate of the 1976 current account deficit, which is higher than the official Mexican estimate.)

The third component in Mr. Robichek's analysis of the Mexican debt situation is the potential gross outflows from the dollar liabilities of banks. As of mid-1976, such demand liabilities were about \$1 billion, and they rose somewhat thereafter according to reports, but we do not have up-to-date figures on these liabilities. Total dollar liabilities of banks were about \$3 billion in mid-1976. Mr. Robichek made no attempt to include these amounts in his calculations of Mexican needs for external financing. However, everyone agreed that they were a critical element of the story on which current information would be obtained.



Mr. Yeo said that the situation was not entirely one of measuring Mexico's needs. Mexico needed to establish the proper "adjustment atmosphere." If they were faced with policy paralysis, or had a poor financial environment, or did not take needed adjustment actions, then they were headed for trouble no matter how comfortable the formal debt situation was.

Governor Wallich asked Mr. Robichek what he knew about the \$800 million syndicated loan for Mexico; what was its role in all of this? Mr. Robichek said that this was designed to cover part of the residual financing of the 1976 public sector deficit. No new expenditures would be financed from it either in 1976 or in 1977. In principle, it would cover the \$400 million per month in external financing needed during the last two months of 1976.

Mr. Yeo said that we would be obtaining specific information on Mexican debts coming due. He also volunteered the observation that it was a very confused situation, citing the experience he had the day before when first he was told Mexico was receiving \$150 million from Deutsche Bank and later was told that the deal had been cancelled.

V. Effects of the Mexican Program

It was asked what evidence, if any, we had regarding the effects to date of the Mexican depreciation of the peso and the associated program on the balance of payments. It was agreed that we had none but would try to obtain some.



Mr. Robichek merely repeated the figures in the IMF paper which indicate a gross external borrowing requirement of about \$5 billion for 1977 composed of \$2 billion for the current account net of long-term capital inflows, \$1 billion to add to reserves, plus about \$2 billion for "amortization." (In other words, the rate of Mexican external borrowing in 1977 will on average be higher than in 1976. But the purposes will be different.)

VI. Items not Mentioned

The following items were not discussed at the meeting.

A. There was no mention of the fact that Mexico has removed its export taxes imposed after the first depreciation of the peso and has reinstated export subsidies. The second action would appear to violate the spirit, if not the letter, of the Mexican commitment to the IMF on commercial policy.

B. There was no discussion of monetary policy.

Attachment

