BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

August 13, 1975

STRICTLY CONFIDENTIAL (FR)
CLASS I FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

SUBJECT: Possible increase in swap line with Bank of Mexico

Attached is a paper prepared in the Board's Division of International Finance relating to a possible increase in the System's $180 million swap line with the Bank of Mexico. It is contemplated that this subject will be discussed at the meeting of the Committee to be held on August 19.

By way of background, when Mr. Hayes visited with Mr. Fernandez Hurtado, Director General of the Bank of Mexico, in Mexico City last January, Mr. Hurtado reviewed with him Mexico's economic situation and credit needs. Although no concrete proposals were made, Mr. Hayes received the impression that the Mexican authorities would be interested in further standby credit facilities, supplementing their $180 million swap line with the Federal Reserve, their $200 million swap arrangement with the U.S. Treasury, and their drawing rights in the Fund.

More recently, in a private conversation with Governor Wallich at a meeting of the IMF/IBRD Development Committee in June, Mr. Hurtado inquired specifically about the possibility of a doubling of the Bank of Mexico's swap arrangement with the System and a modification of the terms of the arrangement to provide for 6-month rather than 3-month drawings. He suggested also that the Bank might immediately draw the full $360 million that would then be available.

Subsequently, Governor Wallich suggested that the Manager develop recommendations, and that the Board's staff prepare a background paper, to assist the Committee in considering the subject. A memorandum from the Manager is expected to be available shortly.

Attachment

August 13, 1975

Mexican Request for an Increase in
its Swap Arrangement with the Federal Reserve System
and for a Drawing on the Swap

Strictly Confidential (F.R.)

The Mexican authorities have requested a doubling in their swap arrangement with the Federal Reserve System -- to $360 million from $180 million -- and have asked that they be allowed to draw the enlarged amount for a period of six months. If the System agreed to the request, both the increase in the size of the arrangement and the drawing would take place prior to September 1. The Mexican authorities indicate that they expect an outflow of capital to take place in the next few months as the time approaches for the nomination of the Presidential candidate of the Government party, and uncertainty about the policies of the next Administration becomes a factor in private decisions.

This paper reviews a number of considerations which might be given weight in deciding whether or not the size of the swap arrangement between the Bank of Mexico and the Federal Reserve System should be increased, discusses Mexico's need for a drawing now and the prospects for repayment within six months, and concludes with an analysis in some detail of Mexico's current economic and financial situation and prospects -- an analysis which serves as the basis for some of the comments made in the earlier sections of the paper.

The Issue of Increasing the Size of the Mexican Swap Line

As is more fully explained in the third part of this paper, the Mexican balance of payments has come under increasing strains in the last two years, and the prospects are that comparatively little improvement can be expected for the next 18 months. Mexico took steps to correct the disequilibrium at the end of last year, just as recessionary tendencies were beginning to develop, but shifted to a more stimulative policy last month when the slackening pace of economic growth and rising unemployment began to cause concern. Indeed, there may be some further loosening of restraints on public spending in 1976, as the outgoing Administration, whose term will end less than 16 months from now, attempts to complete many of the projects begun earlier in its tenure of office.

In these circumstances, Mexican reliance on foreign capital, which has long been heavy, is not likely to diminish much until 1977. This prospect worries the Mexican authorities because of the uncertainties prevailing in world capital markets and because some lenders may have begun to approach a level of exposure in Mexico beyond which they may feel a need to exercise caution. In addition, capital flight, which has been a factor intermittently in the last two years, may at times be on a larger scale during the balance of 1975 and perhaps in the early part of 1976 because of election year uncertainties. For these reasons, the Mexican authorities are looking for enlarged external credit facilities available promptly.

Mexico maintains a fixed exchange rate between the peso and the dollar -- a rate which has remained unchanged for 21 years -- and applies no foreign exchange control of any kind, and the authorities necessarily attach great importance to being able to maintain confidence in the future of the currency. The increase in reserves over the last 15 years has helped greatly in this respect. So has the fact that the authorities have been able to announce from time to time that, in addition to the reserves, the country had a secondary line of defense consisting of its credit tranches under its quota in the International Monetary Fund, a swap arrangement with the U.S. Treasury, and a swap arrangement with the Federal Reserve System.

But a drawing on the IMF, or even a standby arrangement, is regarded by the Mexicans as possibly counterproductive since it might attract attention to the weakness of the balance of payments position. The Treasury swap facility, for its part, cannot be drawn upon until substantial drawings on the Federal Reserve swap have taken place. In contrast, the swap arrangement with the Federal Reserve System has the advantage that it may be drawn upon without precondition or immediate publicity. Last summer, the Bank of Mexico drew the full $180 million available under the swap arrangement with the Federal Reserve, and repaid it in November, prior to maturity. This was the first use of the Federal Reserve swap arrangement by Mexico.

The growth of Mexican production, trade and reserves since 1967, when the swap arrangement was first put into place, could conceivably serve as a justification for approving the requested doubling of the swap line. Since 1967, Mexican exports have more than tripled, imports have nearly quadrupled, international reserves have more than doubled, and real gross domestic product and industrial production have each increased by about 60 per cent. The swap line, on the other hand, which was originally established at $130 million, has been raised (on July 10, 1973) by only about 40 per cent. In this span of time, the swap lines with the Central Banks of Austria, Denmark and Norway were

Table 1
Selected Data on
Mexico, Austria, Denmark and Norway

	1967	1974	Percentage Change
Gross International Reserves			
(at end of year, in million dollars)			
Mexico	586	1,395	+138.0
Austria	1,478	3,430	+132.1
Denmark	534	935	+ 75.1
Norway	677	1,929	+184.9
Merchandise Exports			
(in million dollars)			
Mexico	1,136	3,540	+211.6
Austria	1,809	7,160	+295.8
Denmark	2,539	7,718	+204.0
Norway	1,738	6,242	+259.1
Merchandise Imports			
(in million dollars)			
Mexico	1,746	6,504	+272.5
Austria	2,309	9,021	+290.7
Denmark	3,154	9,901	+213.9
Norway	2,748	8,423	+206.5
Real Gross Domestic Product			
(in billion dollars at 1970 prices and exchange rates)			
Mexico	24.4	38.0	+ 55.7
Austria	12.0	17.8	+ 48.3
Denmark	13.6	18.1	+ 33.1
Norway	9.9	13.2	+ 33.3
Industrial Production			
(1967 = 100)			
Mexico	100.0	156.8	+ 56.8
Austria	100.0	164.4	+ 64.4
Denmark	100.0	135.7*	+ 35.7
Norway	100.0	136.5	+ 36.5

Sources: IMF, International Financial Statistics; UN, Monthly Bulletin of Statistics; OECD, Main Economic Indicators.

* = 1973

each increased from $100 million to $250 million. Production, trade, and reserve statistics for these three European countries show changes generally comparable with those of Mexico over the last seven years. The relevant data are shown in table 1. An increase in the swap line with the Bank of Mexico so as to restore the relationship of that line to those with the Central Banks of Austria, Denmark and Norway as it stood when these lines were first established would bring the Mexican swap line to $325 million, almost the amount requested by Mexico.

The Bank of Mexico drew on the swap line in 1974, wishes to draw on the swap line this year, and it is possible that it will want to draw again in the future after repaying the 1975 drawing. It seems unlikely at the present time, however, that the Federal Reserve itself would consider drawing on the swap arrangement with the Bank of Mexico. The very low degree of "reciprocity" in actual use which this implies might be used as a justification for not increasing the amount of the swap. On the other hand, the same argument about "reciprocity" could also be applied to the swap lines with other countries which were increased proportionately much more than the Mexican swap in July 1973. Indeed, the probability of a low degree of "reciprocity" existed in 1967 and this did not prevent the establishment of the Mexican swap line at that time.

Mexico's relationship to OPEC is another element which might conceivably have a bearing on the decision whether to increase the size of the swap line. Mexico has been under pressure, especially from

Venezuela and Iran, to join OPEC. This has led to public statements by President Echeverría at the end of meetings with the Shah of Iran, indicating his interest in joining and expressing approval of OPEC decisions as "fair and expedient," and a statement, at a joint press conference with the Shah in Teheran, last month, supporting higher oil prices.

As regards OPEC membership, there is evidence that President Echeverría may have said more than he really means, and that his statements should probably not be interpreted literally. According to American Embassy reports, he told a visiting State Department official in June that he desired good relations with OPEC and hoped to have observer status within OPEC, but that he did not intend to join as a full member at this time or anytime soon. And he told Senator Mansfield, who visited him early in July, on the eve of a 42-day trip to 14 countries in the Middle East, Africa, and South Asia, that he expected to be under great pressure to join OPEC and the non-aligned group during his trip, but that he would not join either group.

President Echeverría's expression of support for Iran's oil price policies also would seem to go beyond the practical role which Mexico is currently playing in the world oil market. As far as can be ascertained, Mexico is not deliberately holding down the production of crude oil from its recently discovered fields. Mexico has only recently--within the last twelve months--emerged as an exporter of petroleum. Its exports have been rising slowly and were reported in May to be nearing 100,000 barrels per day (bpd). They are estimated to go up to 140,000 bpd by the fourth quarter. The size of the reserves in Southeast Mexico which have made exports possible remains a matter for some speculation, with estimates ranging rather widely. While some estimates have rated the new fields as "another Persian Gulf," this may be an exaggeration. But even if, as seems likely, there is a potential for substantial exports on a sustained basis, it will take time for this potential to be realized. The American Embassy in Mexico reports that Mexican crude oil exports are not likely to become substantial for some time.

In the meantime, as already mentioned, Mexico needs large amounts of foreign capital to balance its external accounts and is trying to raise loans and attract foreign funds in a variety of other ways. It was one of the objectives of President Echeverría, on his recent trip, to interest some of the wealthier members of OPEC to invest in Mexico. In this connection, it was announced, at the end of his visit to Teheran, that a joint fund to finance development in both countries would be set up, with each country putting up $400 million. In practice, since Mexico has no funds to spare for investment in Iran, this represents a commitment by Iran to invest $400 million in joint ventures in Mexico.

Mexican support of OPEC may take on more significance in the long run, given the possiblity that Mexico will become a substantial oil exporter in the future. But, even then, Mexico may have a strong incentive not to restrict its petroleum output, as OPEC members may wish it to, as pressures build up to use the country's petroleum to finance more rapid economic and social progress.

In any event, it does not appear that approval or denial of the Mexican request for an increase in the swap line and for a drawing under it would have a significant bearing on Mexico's attitude with respect to OPEC. If anything, approval of the request might make it less important for Mexico to attract OPEC funds and therefore increase its ability to maintain some independence from OPEC, while denial of the request might have the opposite result.

Mexico's Need for a Drawing Now and the Prospects for Repayment

On September 1, the President of Mexico will deliver the annual state of the nation's address. This is one of the few occasions when the level of the country's international reserves as of a recent date is announced publicly, and the authorities undoubtedly want to be able to show that the reserves are ample to face any eventuality.

Beyond this, the Mexican authorities are concerned about a capital outflow expected in connection with election year uncertainties. The timing of the various steps in the election process makes it likely that such an outflow already is underway and may intensify in the next few weeks.

The election will be held next July and the new President will take over from President Echeverría, who cannot succeed himself, on December 1, 1976. But the uncertainty should be over before election day. This is because the Government party has experienced little opposition in more than 50 years, and its candidate is virtually assured of election. What matters then is the identity of the candidate of the Government party and his views on public policies.

The identity of the candidate will become known in October or November as the culmination of a process involving lengthy unpublicized consultations among the various organs of the party in which the incumbent President plays an important role. Traditionally, there is no public campaigning for the nomination and there is no easy way to assess the relative chances of those under consideration. While the general political orientation of the nominee will be a matter of public knowledge once his selection is announced at a public rally, his specific views on various areas of policy will not begin to emerge until he starts campaigning in the ensuing months.

Press speculation on the candidate's identity is sure to mount in coming weeks, and the effect of uncertainty on capital movements is likely to increase at least until the selection is announced. If the candidate is not known to favor a greatly expanded Government role and new stiff curbs on the private sector, the announcement of his name should lead to a reversal of the capital outflow, if not immediately, at least when his subsequent speeches confirm the orientation of his views. This would tend to ease the strains on the Mexican payments position in a period probably beginning late in the fourth quarter.

The possibility that a candidate with "activist" economic views will be nominated cannot be completely excluded. If this happens, the outflow may intensify, as uncertainty gives way to certainty of adverse developments in the offing. There is no good basis to form a judgment as to the likelihood of this happening. But, as far as can be ascertained, there does not seem to be a widespread belief that such a nomination will in fact be made.

The Department of State reports that none of the persons now under consideration is known for holding extreme political views and that there should not be any great change in emphasis in Mexico's general orientation under the next Administration. The Department looks for a continuation of many of the present policies and for new initiatives which would generally have a tolerable impact on relations with the United States. The Department has no advance information regarding the extent to which "activist" economic policies might be pushed by the next President and comments that it is difficult to predict, merely from the public reputation of those under consideration, what specific policies they may espouse once in office.

In assessing the prospects for repayment of a swap drawing obtained this month, it should be borne in mind that the fourth quarter of the year is normally a period of seasonal strength for Mexican exports, while the third quarter is one of seasonal weakness. It is likely that receipts from exports occur with some lag, extending into the next quarter, so that this seasonal pattern would tend to contribute to an easing of the strains on the external position probably beginning late in the fourth quarter. This should be roughly in the same period as the capital reflow, should one be triggered by the selection of a moderate Presidential candidate by the Government party.

Under these conditions, Mexico would probably be in a better position to repay a swap drawing otbained this month in 180 days than in 90 days. On the other hand, a pickup in world economic activity in the third quarter should stimulate Mexican exports and, if this is reflected in third quarter shipments, it could result in a somewhat better performance of export receipts in the fourth quarter than would be the case in the absence of such a cyclical development. Moreover, the growth of crude oil exports is proceeding slowly but steadily, and this too may help to ease the external strains somewhat sooner than otherwise.

On the whole, these facts justify the 180-day repayment period requested by the Mexican authorities. Conceivably, a 90-day repayment period with assurances of a 90-day renewal if circumstances warrant it would serve the Mexican authorities equally well, at the same time leaving open the possibility of a repayment in a shorter time if the balance of payments should improve rapidly.

Apart from this, the risk that a Mexican drawing of as much as $360 million obtained this month could not be liquidated on schedule appears to be small. The present Administration will be in office for another 15 months and is unlikely to alter its economic policies to such an extent as to cause a deterioration in outlook sufficient to threaten the repayment of such a drawing. The loosening of restraints on public spending which is expected in 1976 will clearly increase pressures on the balance of payments. But, if it is viewed as a temporary phenomenon to be reversed by the next Administration, as has tended to happen every six years, there should be a good possibility of finding sufficient financing in world markets to cover the additional external deficit.

To put it another way, difficult though the Mexican situation may be, it does not seem to be so weak (or to be likely to become so weak) as to lead to the exhaustion of the country's lines of credit in the market and its reserves. Mexico has a long record of borrowing large amounts in world markets. In 1974, for example, net long term borrowings of the Mexican Government and its entities exceeded $2 billion. Compared to this, the repayment of a swap drawing of $360 million would seem to be manageable.

Even if it should prove impractical for Mexico to raise in the market all of the funds needed to repay a $360 million swap drawing, the country's reserves would seem to be more than ample for the purpose. The Bank of Mexico's net reserves were close to $1.4 billion in mid-May 1975 and the second line of defense (in addition to the Federal Reserve swap line) included an IMF quota of SDR 370 million and a swap arrangement with the U.S. Treasury in the amount of $200 million. While the Treasury swap line probably could not be used to repay drawings on the Federal Reserve swap, the reserves and the IMF quota together represent a comfortable cushion.

Mexico last drew on the Fund in 1961 and fully repaid this drawing in 1962. If it wished to draw on the Fund to repay the proposed swap drawing, it would have automatic access to its gold tranche (25 per cent of quota) of SDR 92.5 million (equivalent to $114.25 million at the end of June) and its super-gold tranche consisting of a claim arising from Fund sales of Mexican pesos to other countries in the amount of SDR 5.3 million (equivalent to $6.4 million at the end of June). It could also draw the first credit tranche (also 25 per cent of quota) in return for making general policy commitments satisfactory to the Fund, and the second and third credit tranches in return for progressively stiffer and more specific commitments.1/ A drawing of the full amount of the quota and the super-gold tranche would

1/ A drawing in excess of quota is allowed under the Fund's Articles of Agreement, but is a rarity. The Fund also has special facilities for compensatory financing of export shortfalls, for buffer stock financing, and for assistance to countries affected by the increased cost of petroleum (the oil facility). But Mexico does not meet the criteria of eligibility to draw on these facilities.

provide Mexico with about $463 million (calculated at the SDR/dollar rate prevailing at the end of June). As already noted the Mexican authorities may be reluctant to use the Fund's resources. But should they be willing to undertake commitments required by the Fund, this could be expected to inspire confidence in private markets and to open access to increased amounts of private credit for Mexico.

The Mexican Minister of Finance and Public Credit spoke publicly in January of revaluing the country's gold holdings. These amount to about $155 million at the official price of $42.22 per ounce and would have a value of nearly $600 million at current market prices. But nothing has been heard about this since then, and private conversations with Mexican officials have indicated that such a move was not imminent. For its part, the Bank of Mexico is known to prefer not to subject the level of its reported reserves to the vagaries of the gold market.

Recent Economic and Financial Developments in Mexico

For nearly 15 years, through 1972, Mexico had an enviable record of sustained real growth at rapid rates, with a remarkable degree of price stability and external balance. Real growth averaged more than 6 per cent annually, prices rose by less than 4 per cent per year, and external reserves of the country increased from $394 million at the end of 1958 to $1,164 million at the end of 1972.

But, in the last two and a half years, the situation has deteriorated. Inflation has set in at rates in excess of 20 per cent per year, the chronic balance of payments deficit on current account has widened considerably, and in recent months, the rate of real economic growth has slowed somewhat. External financing, on which Mexico has relied for so long, has had to be stepped up at a time when it was becoming more costly and when maturities offered in the market tended to become shorter. Capital flight has occurred sporadically and this has underlined the importance of maintaining a level of reserves which inspires confidence.

The balance of payments deficit on current account rose from about $900 million in 1972 to about $1.5 billion in 1973 and to $2.9 billion last year. This reflected a sharp deterioration in the merchandise trade balance, but there was also a small increase in net payments for services. Balance of payments information appears in Table 2.

Merchandise imports soared from $2.7 billion in 1972 to $3.8 billion in 1973 and to $5.9 billion in 1974. This occurred in spite of the appearance of an important addition to domestic petroleum supplies from newly opened wells, as a result of which Mexico ceased importing crude oil around mid-1974 and began exporting it in small amounts. Merchandise exports also rose rapidly, but at a slower rate than imports, and the trade deficit increased from $800 million in 1972 to $1.4 billion in 1973 and to $2.6 billion in 1974.

The surge in imports, which was particularly rapid in the first half of 1974, slackened in the third quarter, but picked up again in the fourth quarter and in the early part of 1975. Meanshile, exports fared less well in the second half of last year than in the first half, and continued to show sluggishness in the early part of this year. This reflected mainly the recession in the industrialized world, particularly in the United States which is Mexico's principal customer. It reflected

Table 2

Mexico - Balance of Payments
1972-74
(in million dollars)

	1972	1973	1974
Merchandise Exports	1,881	2,432	3,355
Merchandise Imports	2,694	3,814	5,947
Trade Balance	-813	-1,382	-2,592
Services (net)	-163	- 177	- 418
Travel (net)	(+623)	(+ 808)	(+1,073)
Investment Income (net)	(-858)	(-1,135)	(-1,620)
Other (net)	(+ 72)	(+ 150)	(+ 129)
Unrequited Transfers (net)	+ 64	+ 71	+ 115
Balance on Current Account	-912	-1,488	-2,895
Long Term Capital (net)	+827	+1,852	+2,808
Direct Investment in Mexico (net)	(+301)	(+ 374)	(+ 557)
Other Long Term Private Capital (net)	(+176)	(+ 342)	(+ 339)
Public Sector Borrowings (net)	(+397)	(+1,184)	(+1,912)
Subscriptions to IBRD and IDB	(- 47)	(- 48)	(--)
Short Term Capital (net)	+104	- 251	+ 223
Private Non-Bank Capital (net)	(+116)	(- 226)	(- 330)
Bank Assets (net)	(- 12)	(- 25)	(+ 553)
Central Bank Reserves and Other Foreign Assets (net)--(increase:-)	-179	- 99	- 36
Errors and Omissions (net)	+159	- 14	- 101

Source: IMF, Balance of Payments Yearbook, Vol. 26

also the impact of substantial wage increases, last September and October, on the profitability of Mexico's in-bond assembly plants serving the U.S. market. The combination of the U.S. recession and the rise in wages hit these plants hard and, beginning in the fourth quarter of 1974, many of them closed, others retrenched, and some shifted operations to other countries offering lower labor costs. As a result, the trade deficit widened further toward the end of last year and in the first few months of 1975.

In the face of this deterioration and the intermittent capital outflow, net public sector borrowings rose from less than $400 million in 1972 to $1.1 billion in 1973 and to about $2 billion in 1974. Although reserves rose nearly $200 million in 1973 (about as much as in 1972), there was relatively little net accumulation in 1974, as gains recorded in the first half were largely eroded in the second half, when the capital outflow was, for a time, particularly intense. But continued heavy external borrowings this year have made possible a modest further gain in reserves (at least up to mid-May) in spite of the growing deficit on current account. Reserve statistics are shown in table 3.

The onset of inflation and the widening of the balance of payments deficit on current account may be attributed mainly to an accelerated growth of domestic expenditure, chiefly by the public sector, to shortfalls in domestic agricultural supplies stemming from inclement weather, and to the impact of rising prices of many imported products.

Table 3

Mexico - Gross Official Reserves
Since 1958 at End of Selected Periods
(in million dollars)

December 1958	394
December 1962	427
December 1965	538
December 1968	657
December 1969	662
December 1970	744
December 1971	952
December 1972	1,164
December 1973	1,356
March 1974	1,540
June 1974	1,547
September 1974	1,354
December 1974	1,395
January 1975	1,393
February 1975	1,422
March 1975	1,479
May 1975 1/	1,509 2/

Source: IMF, International Financial Statistics

1/ Middle of the month.
2/ Preliminary, as reported by the American Embassy.

The accelerated growth of domestic expenditure reflects in part a lack of adequate controls over public spending, particularly that of the decentralized agencies and public enterprises. The current Mexican administration has been inclined to press ahead with projects at a more rapid pace than some of its predecessors.

Additionally, after the inflationary trend had gotten underway, the authorities felt that they must compensate workers for the rise in the cost of living. To this end, they abandoned the long standing policy of raising the minimum wage every two years, and instead raised it by 18 per cent in September 1973, by 14 per cent more in January 1974, and by a further 22 per cent in October 1974. Workers earning more than the minimum wage received a 20 per cent raise in October 1973 and a 22 per cent raise in September 1974. The impact of these wage increases on public sector spending was considerable, and of course there were consequences throughout the private sector as well.

The fiscal accounts also had to absorb the increase in food subsidies which developed when the public agency marketing foodstuffs at low fixed prices for popular consumption was forced by insufficient domestic crops to make large purchases abroad where grain prices were rising rapidly.

Public sector revenues also rose, but much more slowly, and the reliance on financing from the banking system grew. At the same time, the ability of the banking system to channel non-inflationary resources into public sector securities was weakened in 1973 and the first half of 1974 when the maximum interest rates which the commercial and investment banks are allowed to pay were not increased promptly enough or to a sufficient extent in response to rising rates in world financial markets. This slowed the inflow of private funds, both Mexican and foreign, into these institutions and provided an incentive for the intermittent movement of funds out of the country in this period.

Another factor was the uneasiness which developed in the business community in the face of the fiscal deterioration and of Government policies and statements affecting private investment. Monetary policy, which relies on reserve requirements to ensure that prescribed proportions of the assets of the financial institutions are invested in public sector securities, lost some of its effectiveness and, even though the requirements were tightened several times last year, the Bank of Mexico itself ended up holding an increasing portfolio of these securities.

The business uneasiness appears to have begun to retard the growth of domestic production in the second quarter of 1974. This condition was reinforced by the emergence of recessionary tendencies in other countries. Manufacturing output, which showed little further rise from the first to the second quarter, turned down in the third quarter, and while it recovered somewhat in the fourth quarter, it remained below the first quarter level, only about 1 per cent above the level of the fourth quarter of 1973. But output from mines and particularly petroleum production continued to rise, bolstering the overall index of industrial production. The services sector and Government activity also helped to cushion the slowdown in the rate of economic growth in the last half of 1974. Agricultural output showed a small increase after declining in 1973. Tables 4 and 5 summarize production trends.

Table 4

Mexico - Gross Domestic Product
and Industrial Production
Annually Since 1968

	Real Gross Domestic Product		Industrial Production					
			Total		Manufacturing		Petroleum	
	at 1960 prices (billions of dollars)	Growth Rate (per cent)	Index (1970 = 100)	Change (per cent)	Index (1970 = 100)	Change (per cent)	Index (1970 = 100)	Change (per cent)
1968	20.87	+ 8.1	86.1	+ 6.3	85.5	+ 8.1	84.6	- 5.1
1969	22.19	+ 6.3	94.1	+ 9.3	95.1	+11.2	86.2	+ 1.9
1970	23.73	+ 6.9	100.0	+ 6.3	100.0	+ 5.1	100.0	+16.0
1971	24.54	+ 3.4	102.0	+ 2.0	102.8	+ 2.8	102.4	+ 2.4
1972	26.33	+ 7.3	112.3	+10.1	112.4	+ 9.3	108.6	+ 6.1
1973	28.32	+ 7.6	122.7	+ 9.3	122.3	+ 8.8	110.1	+ 1.4
1974	30.02	+ 6.0	129.7	+ 5.7	128.1	+ 4.7	127.6	+15.9

Source: IMF, International Financial Statistics

Table 5

Mexico - Industrial Production
Quarterly Indices, 1973-1974
and Monthly Indices Since January 1974
(1970 = 100)

	Total	Manufacturing	Petroleum
1973 - I	117.8	119.6	100.5
II	120.9	120.8	108.4
III	123.9	121.7	113.1
IV	128.3	126.9	118.2
1974 - I	129.5	129.3	118.5
II	129.3	129.3	116.8
III	128.8	125.3	138.4
IV	131.3	128.4	136.8
1974 - January	129.1	129.6	121.5
February	124.9	124.0	109.0
March	134.6	134.4	125.0
April	128.1	128.6	115.4
May	134.2	135.4	115.6
June	125.5	124.0	119.4
July	130.2	126.5	135.4
August	131.7	129.2	138.5
September	124.4	120.1	141.4
October	138.1	137.1	137.2
November	129.4	126.1	138.7
December	126.3	122.1	134.5
1975 - January	134.9	135.3	133.8
February	127.5	126.9	125.4
March	n.a.	n.a.	138.4

Sources: IMF, International Financial Statistics, and Banco de Mexico, Indicadores Económicos.

For the year as a whole, real gross domestic product rose about 6 per cent, compared with more than 7.5 per cent in each of the previous two years. Moreover, the slowdown appears to have intensified in the first half of 1975 and reliable observers are generally forecasting a real growth rate of between 4 and 5 per cent for the year as a whole. Since Mexico's population is rising at the rate of 3.5 per cent per year, this implies very little per capita growth.

In the latter part of 1974, steps began to be taken to correct the internal financial disequilibrium. In September, reserve requirements of the banks were increased substantially. By the end of the year, an administrative mechanism was established to achieve greater discipline on current expenditure and more rigorous priorities on the execution of investment projects. In addition, a number of taxes were increased substantially and a new 50 per cent tax on gasoline sales was instituted. Rates for public services also were raised.

The fiscal measures together helped to reduce the fiscal deficit in the first half of 1975. Additionally, the decline in world interest rates in the latter part of 1974 and the first half of 1975 made Mexican interest rates attractive once again and this helped the financial institutions to attract a larger flow of funds than in the last two years, enabling them to absorb a greater volume of public sector securities. This process was helped by the severe limitations on credit to the private sector brought about by the tightening in reserve requirements.

The effect of these policies and the impact of the recession can be seen in the slackening of the upward trend in prices (see Table 6). Since last November, the consumer price index has risen more slowly -- at a rate averaging about 1 per cent a month through May -- and the twelve-month rate of increase has gradually declined from a high of nearly 26 per cent to about 17.5 per cent in May, the latest month for which figures are available. As inflation abated, it became possible to postpone the next wage increase until the end of the year.

At the same time, the slowdown in economic activity gave no sign of coming to an end. Concern over the effect that this was having on the level of employment began to grow. Eventually, last month, the Government changed course and announced a program to stimulate domestic production by stepping up public spending. Simultaneously, it took steps to curb the growth of imports, including a tightening of import licensing, an increase in the percentage of domestic component in total output required to be used by the auto industry, and restrictions on public sector imports.

In announcing the new program, the Minister of Finance and Public Credit made clear that, while emphasis was being shifted to the stimulation of economic recovery, the policy would be managed, as far as possible, in such a way as to avoid intensifying inflationary pressures. For his part, the Minister of Industry and Commerce said that the import licensing system would be used to promote import substitution of capital goods, that imports of machinery and equipment would receive priority, especially in cases in which these imports would enhance the country's exporting capacity, and that non-essential imports would be held at previous year levels or be cut back.

Table 6

Mexico - Index of Consumer Prices
in Mexico City
Monthly Since January 1973

	General Index (1968 = 100)	Change from Previous Month (per cent)	Change from Same Month Previous Year (per cent)
1973 - January	126.3	+1.8	+ 6.6
February	127.0	+ .6	+ 6.6
March	128.2	+ .9	+ 7.4
April	129.7	+1.2	+ 7.6
May	131.1	+1.1	+ 9.0
June	132.6	+1.1	+ 9.8
July	135.4	+2.1	+11.8
August	136.4	+ .7	+11.7
September	139.6	+2.3	+13.8
October	140.8	+ .9	+14.7
November	142.4	+1.1	+15.1
December	149.5	+5.0	+20.5
1974 - January	153.7	+2.8	+21.7
February	156.2	+1.6	+23.0
March	156.7	+ .3	+22.0
April	159.2	+1.6	+22.7
May	160.5	+ .8	+22.4
June	161.2	+ .4	+21.6
July	165.2	+2.5	+22.0
August	167.0	+1.1	+22.4
September	169.3	+1.4	+21.3
October	173.9	+2.7	+23.5
November	179.0	+2.9	+25.7
December	180.6	+ .9	+20.8
1975 - January	183.5	+1.6	+19.4
February	184.1	+ .3	+17.9
March	184.6	+ .3	+17.8
April	186.8	+1.2	+17.3
May	188.7	+1.1	+17.6

Source: Banco de Mexico, Indicadores Económicos.

The Outlook for the Next 18 Months

The stimulation of economic growth will inevitably require an increase in imports, and the authorities will have to administer the new import restrictions with skill to prevent them from retarding growth. This is especially so because non-essential imports are already being held down by previously imposed restrictions. The authorities may have to choose between stimulating recovery and preventing a further deterioration of the balance of payments on current account. If they strive for both objectives at the same time, they may well end up achieving neither of them very well. Private business investment is likely to remain relatively stagnant at least until the identity of the next President of Mexico is known and his economic and social policies have been outlined and assessed. While this will tend to reduce the inflationary consequences of the program, there is likely to be an intensification of upward pressures on prices.

The stepping up of public spending at this time should be viewed in the light of the fact that, traditionally, in the last year of a Presidential term in Mexico, the outgoing Administration tries to complete many of the projects which it started during its term of office. If, as seems likely, the current Administration intended to follow this tradition, and if, accordingly, the restraints on public spending were due to be loosened in 1976 in any event, the stepping up of public spending announced last month may merely anticipate by about six months what was already planned for next year. However, the situation could get worse if a substantial further loosening of fiscal restraints should be allowed beginning next January.

As regards the balance of payments, there was a modest decline in the deficit on current account from the fourth quarter of 1974 to the first quarter of this year, perhaps in part because of the receipt of lumpy payments for petroleum exports. But reliable observers believe that the deterioration resumed after that and generally project the deficit on current account for the full year at a higher level than in 1974, although they foresee a smaller rise in the deficit than occurred from 1973 to 1974.

The growth of petroleum exports is the principal favorable element in the picture. At the same time, exports of livestock and agricultural products, especially cotton, are facing difficulties in external markets and are expected to decline. The world recession is having adverse effects on other exports and on the important earnings from tourism, and an economic upturn in the industrialized countries in the second half is not likely to begin to reverse these effects until the fourth quarter. Merchandise imports are continuing to rise, albeit at a slower rate than last year, and are likely to continue to go up as the authorities strive to maintain a rate of economic activity which they deem appropriate. Payments of interest on the external public debt are also likely to rise, as the debt itself has risen considerably and is continuing to climb, and the additions to it in 1973 and 1974 were contracted at very high interest rates.

Under these conditions, reliance on foreign capital is likely to increase further this year. This is especially so since an outflow of domestic capital is likely to occur, and indeed may have already started, as a result of uncertainty surrounding the selection of the candidate of the Government party for next year's Presidential election. The need for increased foreign borrowing worries the Mexican authorities because of the uncertainties prevailing in the world capital markets. The possibility exists that borrowings on the scale anticipated may imply the use of a growing amount of credits with maturities shorter than Mexico has enjoyed in previous years. Such a development could have adverse consequences on the country's creditworthiness abroad, leading other lenders to harden the terms of their credits to Mexico. Moreover, the exposure of some lenders in Mexico may have begun to approach the limit beyond which they must exercise increasing caution.

Indications that these adverse trends may already have begun to develop are contained in a report by former President Hayes on his visit to Mexico last winter.[1/] He noted that "both Banco de Mexico and the commercial banks are disturbed by the growing difficulty in obtaining bank loans abroad, and particularly in the United States, on acceptable terms." He reported that "they cited examples of U.S. bank supervisors' adverse comments on the size of certain American banks' Mexican commitments."

At the same time, the Mexican borrowing difficulties may also stem from the borrowers' reluctance to agree to the lenders' terms and conditions. As Mr. Hayes reported, the bankers with whom he spoke "pointed out that the American banks have on occasion recently favored other borrowers, such as Brazil, which have been willing to pay higher interest rates or to accept other conditions more profitable to the banks."

Whether the Mexican balance of payments will begin to improve in 1976 will depend on whether a further loosening of restraints on public expenditures occurs in 1976. If it does not, a number of favorable factors should have helpful effects. First, as economic recovery in the United

1/ January 28 - February 5

States gathers momentum, Mexican exports and tourist earnings should be stimulated. There should also be beneficial results from the continuing expansion of domestic production of crude oil and the completion of oil refinery capacity and other productive facilities now under construction. Specifically, imports of oil derivatives, fertilizer, and other products should diminish and in some cases give way to exports. By 1977, Mexico should have sufficient refining capacity to export petroleum only in the form of refined products and oil derivatives. In addition, a new copper mine is expected to begin production in the next two years, and this should yield a substantial increase in exports. Finally, the efforts to develop the agricultural sector should begin to produce results next year, allowing imports of food grains to decline.

On the other hand, a further loosening of fiscal restraints in 1976 could prevent an improvement in the balance of payments on current account from occuring. In this event, it would have to be hoped that the next Mexican Administration, scheduled to take over in December 1976, would follow the precedents set by its predecessors and use its first year in office as a period of consolidation during which public spending increases little while plans for the future are developed and the Government gears up to implement them. This would markedly strengthen the balance of payments on current account in 1977.

As regards the capital which may be leaving the country now or in the next few weeks because of election year uncertainties, there may be a reflow beginning late this year, after the identity of the Government candidate for President is announced, or sometime next year, after his policies have been outlined and assessed. However, if the candidate turns out not to inspire confidence, the reflow of capital could fail to materialize, and indeed there could be an intensified outflow. The external situation could become difficult if this should happen to coincide with a further loosening of fiscal restraints in 1976.

The most likely prospect is that the balance of payments on current account will not materially improve until 1977 and that, in the interval, the authorities will have to be prepared to deal with possible adverse capital movements on a scale which might be larger than the capital movements experienced in the past. This would seem to require enlarged external credit facilities available promptly.

Prepared by Yves Maroni with comments and suggestions from Ralph C. Bryant and other members of the staff of the Division of International Finance.