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OF THE
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TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached for your information is a memorandum dated today and entitled "Recent Economic and Financial Developments in Mexico," prepared by Mr. Maroni of the Board's Division of International Finance.

Attachment

ıves Maroni
June 30, 1982

Recent Economic and Financial Developments in Mexico

A. Summary

On February 18, declining reserves forced the Bank of Mexico to withdraw from the foreign exchange market temporarily and to allow the peso to depreciate by about 40 percent. The Mexican government did not quickly adopt a meaningful stabilization program after the devaluation and instead took steps to alleviate its impact. However, on April 21, a stabilization plan was announced, with features suggestive of the techniques used in IMF standby agreements. Mexico's presidential election on July 4 and the fact that the new administration will not take office until December are acting to constrain the capacity of the Mexican government to implement the plan forcefully.

Since the plan was announced, the Mexican authorities have instituted some increases in public sector prices, and some spending cuts, but total spending nevertheless appears likely to exceed the level originally budgeted. They have allowed interest rates to rise rapidly but, up to now, not enough to provide an incentive to hold pesos in the face of high current and prospective inflation, the slow rate of crawl of the peso/dollar spot exchange rate, and the high forward market discount on the peso.

Since late last year, the terms on Mexico's Eurocurrency borrowings have hardened. In spite of this, the most recent syndication achieved relatively poor results. Mexico's reserves have declined sharply this year. This fact is not fully reflected in the most recent published figure (May 31) which was influenced by special transactions. Mexico has not yet sought recourse to IMF financing, but is keeping the Fund informed. The Fund staff views the Mexican program as a minimum and believes that additional steps will be needed soon to lessen the risks of high inflation and severe balance of payments pressures.

B. Background

Mexico's external financial position deteriorated in 1980 and 1981. Expansionary policies implemented since 1978 to promote employment yielded a growth rate averaging over 8 percent in 1978-81, but led to large public sector deficits, accelerating inflation, and high import growth. In spite of a persistent and growing differential between Mexican and U.S. inflation, the peso/dollar exchange rate was held virtually stable in 1978-80 and was allowed to depreciate only slowly in 1981. The result was a decline in Mexico's international competitiveness which further stimulated imports and held down non-oil exports. In 1981, weakness in the world oil market, a recession in the industrial countries, and an accelerated rise in interest payments on the growing external debt as world interest rates reached new highs, worsened the situation still further and the current-account deficit rose to $12.5 billion, (more than 40 percent of current-account earnings), compared with $7.4 billion in 1980. Market fears of a large peso devaluation, which became evident last year, grew early this year, as the realization spread that expansionary domestic policies would continue in 1982 and that the short-run outlook for exports was not encouraging. In February, the Bank of Mexico concluded that it would be too costly to continue supporting the exchange rate, and allowed the peso to depreciate.

On March 22, the government announced an agreement with organized labor calling for large across-the-board wage increases to compensate workers for the loss of purchasing power caused by the devaluation. In combination with a 34 percent increase in the minimum wage, effective January 1, the new wage increase fully restored the purchasing power of the most favored groups to its December 1981 level. To enlist employer cooperation, the government announced on March 24 a number of business tax concessions and benefits. Following these announcements, the peso, which had appeared to stabilize in early March, came under renewed pressure as market participants reacted to the perceived inflationary consequences.

The stabilization program announced April 21 takes the form of a Presidential decree and has the backing of all cabinet members, including those who, in the past, have been strong advocates of stimulating economic growth in order to reduce unemployment as rapidly as possible. The program covers all areas of policy except wage policy which, apparently, could not be changed again so soon after the March agreement with organized labor.

Up to now, implementation of the program has been limited. But indications are that the atmosphere in Mexico seems to be improving. This owes much to the appointment, in late March, of a new economic team, with Messrs. Jesus Silva Herzog as Finance Secretary and Miguel Mancera as Director General of the Bank of Mexico. Both are perceived as representing presidential candidate de la Madrid who is virtually assured of being elected on July 4. The candor with which both have spoken about the crisis has been well received, as has the readiness of candidate de la Madrid to make statements in support of the adjustment effort ahead of the election, when by tradition he should be avoiding specific pronouncements.

The adjustment task is formidable: the public sector deficit reached 15 percent of GDP in 1981, inflation was running at the annual rate of about 75 percent during the first five months of this year, international reserves are barely above the minimum legal cover required against the currency issue, the gross external debt is estimated at more than $75 billion (45 percent of GDP) of which about $55 billion is owed to foreign banks, and access to new external credits is becoming difficult. However, as Mr. Mancera said recently, adjustment in Mexico is inevitable and the only question is whether the authorities will manage the adjustment or the adjustment will manage them.

C. Implementation of April 21 Stabilization Program

1. Public Spending

The program calls for an 8 percent cut. The reduction will not apply to spending for public employee pay, debt service, or transfers to the states, for which 1.5 trillion pesos was budgeted. This leaves spending of only 1.8 trillion pesos to which it will apply. The expected "savings" of about 150 billion pesos represent less than 5 percent of the 3.3 trillion peso budget approved in December.

On May 10, the Programming and Budget Secretary announced (i) suspension of construction on administrative offices of the government and of "work of an ornamental character," (ii) elimination of certain fringe benefits of public officials, (iii) restrictions on purchases of office furniture and equipment by public agencies, (iv) cuts in public sector imports, (v) a job freeze except for employment in schools and hospitals, and (vi) compliance procedures. The Secretary also said that 300 billion pesos in desirable outlays in excess of the approved budget would not take place. But he noted that the public employee pay raise granted in April and the increased cost of servicing the foreign debt at the new exchange rate and the domestic debt at higher interest rates would require spending in excess of budgeted amounts for these items. He did not indicate the level of total spending that would result from these revisions. We estimate that it will exceed the 3.3 trillion pesos originally budgeted.

On June 21, the Secretary said that no further budget cuts were presently contemplated.

2. Public Sector Prices

The program calls for increases in public sector prices so as to raise 150 billion pesos in additional revenues. Effective June 1, natural gas prices were raised by 55 percent and fuel oil prices by 5 percent. Beginning July 1, there will be monthly increases of 5 percent in both cases for the next twelve months. Prices of various petrochemicals have been raised by 30-455 percent. Air, rail, truck, and maritime transportation fares were raised by 30 percent on June 1. Electricity rates are to be increased by 2.5 percent a month and a 17-18 percent increase in telephone rates (with an unspecified effective date) has been announced. According to Finance Secretary Silva Herzog, these increases are estimated to yield 40 billion pesos (at an annual rate).

No increase has been announced so far for gasoline, diesel fuel and urban transport fares. The Mexico City subway fare is still 1 peso (about 2.1 cents) per ride anywhere on the system. No further increases are expected before the election. We understand that increases in gasoline, corn, sugar, and wheat prices are to be announced after the election and that the prospective gasoline price increase is estimated to yield 50 billion pesos at an annual rate.

3. Public Sector Deficit

The program calls for reducing the ratio of the deficit to GDP by three percentage points. The May deficit is reported to have been the smallest in 16 months, but we have no way to assess the significance of this report. Finance Secretary Silva Herzog recently indicated that the three percentage point reduction would not be achieved because the peso cost of servicing the external debt was likely to exceed expectations. He thought that a two percentage point reduction would be realized.

4. Interest Rates

The program calls for continued interest rate flexibility so as to encourage savings and favor the placement of funds in peso instruments. Since the end of March, rates on deposits at banks have been raised almost every week. On June 28, the rate on 3-month deposits of corporations was 49.15 percent, and that on 6-month deposits of individuals was 52.27 percent. This compares with end-of-March rates of 29.0 and 36.1 percent, respectively. The 3-month Treasury bill rate has also risen fairly steeply and stood at 52.35 percent on June 24, compared with 33.2 percent at the end of March. Somewhat more risky placements in 30-day commercial paper yielded 58.5 percent on June 24 (earlier quotations are not available to us).

5. Exchange Rate Policy

The program calls for the maintenance of the competitiveness of the Mexican economy and avoidance of peso overvaluation. Since early April, the peso price of the dollar for transactions with the public has increased each business day by 4 centavos. This corresponds to an annual rate of crawl of about 22 percent, less than half of the prospective inflation differential between Mexico and the United States this year. The Mexican authorities claim that, at the end of March, when the crawl started, the peso was undervalued. Even if this was so, unless the crawl accelerates or inflation abates relatively soon, peso overvaluation is likely to reappear well before the end of the year.

On June 28, the 3-month forward premium on the dollar was 59.55 percent per annum. This reflects market participants' skepticism regarding the viability of the present rate of crawl and suggests that administered domestic interst rates have not yet reached the level at which, after allowing for the cost of forward cover, the yield on a peso placement would equal the yield on a comparable dollar instrument.

Finance Secretary Silva Herzog recently indicated that he was prepared to increase the rate of crawl slightly following the election.

6. Monitoring the Program

The program contains two specific criteria subject to statistical verfication. One is that the net credit of the Bank of Mexico to the Federal Government will not exceed the increase in deposits of private banks in the Bank of Mexico. The other is that the Bank of Mexico's note circulation will increase only to the extent that net international reseves of the Bank of Mexico increase beyond the level of such reserves as of April 21, 1982. We do not have many of the statistics needed to monitor compliance with these criteria, and what we do have is several months old.

We understand that the Mexican authorities are planning to send an information package to the banks from which Mexico has borrowed. However, it does not appear that this will contain data on net international reserves.

D. Recent International Borrowings

The most recent Eurocurrency credit obtained by Mexico is a $2.5 billion loan consisting of a three-year tranche at 1 percent over LIBOR and a seven-year tranche, with a three-year grace period, at 1.5 percent over LIBOR, both with prime rate options. The $2.5 billion jumbo credit is due to be signed June 30. The 27 lead-managers succeeded in selling down only about $350 million in participations during the syndication that ended June 18 after two extensions. Potential "second-tier" banks held back because they had reached their internal lending limits for Mexico or in anticipation of higher spreads later on. At least half of the loan is to be used to refinance short-term credits falling due, so that only about $1.2 billion of new money is involved. A bridge loan of $1,088 million was drawn down by Mexico on May 28, leaving little new money still to be disbursed when the final credit is signed. The bridge loan was originally for thirty days. But its maturity has been extended to July 7 when the first $1 billion of the jumbo loan will become available.

In the first five months of 1982, Mexico has reportedly secured nearly $8 billion in external credits, of which about $5 billion represents net new borrowings. Syndicated Eurocurrency credits announced in this period totalled $6.5 billion (including the $2.5 billion jumbo loan). New international bond issues reported in this period accounted for the $1.4 billion balance. Gross borrowing requirements for 1982 are estimated at close to $20 billion—$11 billion in new external borrowings for the public sector alone and about $7 billion to cover medium-and long-term public and private debts maturing in 1982. Since late last year, the spreads on Mexico's Eurocurrency borrowings have increased and the maturities have shortened.

The poor reception of the jumbo loan does not augur well for subsequent financing. A $600 million Eurocurrency credit for the Federal Electricity Commission, which was reported to be under preparation, will now be held off the market for at least six weeks. We understand that Finance Secretary Silva Herzog believes the spreads for Mexico are likely to rise at least to 2 percent, slightly below the level for Brazil.

E. Reserves

At the annual meeting of the Mexican Bankers Association on June 1, Finance Secretary Silva Herzog announced that Mexican reserves on May 31 totalled \$3.9 billion. This was \$2.2 billion more than the unpublished level of May 24 provided to us on a confidential basis. By June 28, Mexican reserves had declined to \$2.0 billion. The improvement shown on May 31 reflects receipt of the bridge loan, plus an additional \$1 billion derived from a variety of sources about which we have little information. These may have included foreign currency balances of independent public agencies that were temporarily brought into the reserves, credit lines that Mexican banks may have been asked to draw down, inflows generated by the peso/dollar swap facility for the private sector, and advances against future sales of Mexican oil.[1/] In this connection, Mexico's oil exports in May were reported to have reached 1.5 mbd, some 350,000 bd more than the average of the previous four months. This alone would bring in nearly \$300 million more in export revenues than in earlier months. In addition, the reserve buildup was aided by a reduction in the capital outflow that was apparent in the last two weeks of May, and probably by delaying payments due on public sector imports. More generally, the current-account balance may have begun to improve as a consequence of the devaluation: In the first four months of 1982, Mexico had a trade surplus of \$120 million, compared with a deficit of \$350 million in the same period of 1981.

1/ We have heard of a \$400 million one-year credit of this nature with a spread of 1/2 of 1 percent over LIBOR, that PEMEX obtained just before the end of May.

Included in the reserve figure for May 31 is $800 million in Mexican claims under payments agreements, mainly with other Latin American countries. These claims are not counted in calculating the legal reserves against the currency issue. The required reserves may be estimated at about $1.6 billion.

F. Mexico and the IMF

The Fund staff has not, so far, been asked to monitor progress under the Mexican stabilization program. However, the program has been reviewed in the context of Mexico's Article IV consultations with the IMF. The consultations report is scheduled for consideration by the Fund Executive Board on July 16.

The Fund staff believes that Mexico must give priority to the improvement of the balance of payments and to a slowing of inflation, and that, accordingly, output and employment growth objectives will have to be given less emphasis for a time. The Fund staff stresses that the key to the adjustment is the strengthening of the public finances. They view the Mexican objective of reducing the ratio of the public sector deficit to GDP by three percentage points from 1981 to 1982 as a minimum and they emphasize that further large reductions in the public sector deficit will be needed in the near future to lessen the risks of high inflation and severe balance of payments pressures. They point out that the willingness of foreign lenders to extend credit to Mexico will depend on whether progress is being made toward a lower and more sustainable public sector financing requirement. They note the importance of adjusting domestic interest rates promptly so as to maintain an incentive for savers to hold peso instruments, and the danger of granting compensatory wage adjustments in response to equilibrating price and exchange rate adjustments. They express concern about the relatively slow rate of crawl of the exchange rate, and comment that this approach to exchange rate policy underscores the critical importance of pursuing demand policies geared to a quick slowing of inflation.

President Lopez Portillo has expressed his distaste for having recourse to financial assistance from the IMF. Finance Secretary Silva Herzog recently indicated that an agreement with the IMF was not possible during the remainder of President Lopez Portillo's term (i.e., until next December), but that the Fund would be kept informed. Mexico's IMF quota is SDR 802.5 million, about $900 million.

Table 1: Mexico--Domestic Economic Indicators

	1977	1978	1979	1980	1981	1982
			(percentage change)			
Real GDP	3.4	8.2	9.2	8.3	8.1	
Industrial Production	3.4	9.9	10.4	8.0	7.6	3.3 (Jan.)
Consumer Prices (Dec. to Dec.)	20.6	16.2	20.0	29.8	28.7	44.4 (May)
Wholesale Prices (Dec. to Dec.)	18.2	15.8	19.9	26.4	27.2	43.7 (May)
Minimum Wages 1/ (effective Jan. 1)	10.0	13.5	16.5	21.5	32.0	34.0
Money Supply (Dec. to Dec.)						
M1 2/	26.4	33.1	33.1	33.1	32.8	35.7 (Mar.)
M2 3/	26.2	31.6	33.7	33.3	33.3	38.5 (Mar.)
M3-A 4/	23.7	25.1	36.3	36.2	33.1	
M3-B 5/	22.5	24.3	36.7	37.1	34.5	37.4 (Mar.)
M4-A 6/	27.8	35.2	32.4	38.9	44.4	
M4-B 7/	31.8	34.3	35.5	38.3	49.8	63.0 (Mar.)
Domestic Credit (Dec. to Dec.)	25.6	31.4	34.8	38.8	52.3 8/	
			(percent)			
Public Sector Deficit/GDP	6.7	6.6	6.4	7.5	12.5-15.0e	
Interest Rates at end of year						
on 3-month Time Deposits	11.0	11.7	16.2	23.7	31.8	49.1 (6/28)
on Treasury Certificates	none	12.2	16.9	26.1	33.2	52.3 (6/24)

1/ Average of increases decreed for the various regions of the country.
2/ Narrowly defined, excluding demand deposits denominated in foreign currencies.
3/ M1 plus demand deposits denominated in foreign currencies.
4/ M2 plus liquid savings instruments denominated in pesos.
5/ M3-A plus liquid savings instruments denominated in foreign currencies.
6/ M3-B plus time deposits denominated in pesos.
7/ M4-A plus time deposits denominated in foreign currencies.
8/ November to November.

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Table 2: Mexico—External Debt Estimates
(in billion dollars)

	1976	1977	1978	1979	1980	1981	1982 Latest
Gross Debt 1/	24.8	30.8	34.6	41.6	55.3	76.0	
Long-Term	18.6	23.8	29.1	32.8	38.3	49.0	
Public	(15.9)	(20.8)	(25.6)	(28.8)	(32.8)	(42.0)	
Other	(2.7)	(3.0)	(3.5)	(4.0)	(5.5)	(7.0)	
Short-Term	6.2	7.0	5.5	8.8	17.0	27.0	
Public	(3.7)	(2.7)	(1.2)	(1.4)	(1.5)	(10.5)	
Other	(2.5)	(4.3)	(4.3)	(7.4)	(15.5)	(16.5)	
Total Public	(19.6)	(23.5)	(26.8)	(30.2)	(34.3)	(52.5)	
Total Private	(5.2)	(7.3)	(7.8)	(11.4)	(21.0)	(23.5)	
External Assets 1/	3.0	3.8	4.1	5.0	6.5	7.9	
Bank of Mexico	1.4	1.9	2.3	3.0	4.1	5.0	3.9(May)
(excl. gold)	(1.2)	(1.6)	(1.8)	(2.0)	(2.9)	(4.1)	
(Gold) 2/	(.2)	(.3)	(.5)	(1.0)	(1.2)	(.9)	
Commercial Banks	1.6	1.9	1.8	2.0	2.4	2.9	
Net Debt 1/ 3/	21.8	27.3	31.0	37.6	50.0	69.0	
Debt Service (gross)	3.4	4.7	7.5	11.7	10.1	14.6	
Amortization	1.7	2.7	4.9	8.1	4.7	6.4	
Interest	1.7	2.0	2.6	3.6	5.4	8.2	
Claims of Foreign Banks 1/							
BIS Area 4/	17.9	19.9	23.2	30.7	41.0	55.3	
BIS Area 5/	17.9	20.3	23.3	30.9	42.5	46.6 6/	
U.S. Banks 4/	11.7	11.9	10.8	12.0	15.9	21.5	21.8(Mar.)
U.S. Banks 5/	10.7	11.2	10.7	11.5	15.7	21.5	

1/ End of year.
2/ At market prices.
3/ Gross debt minus the external assets (excluding gold) of the Bank of Mexico and the commercial banks.
4/ Quarterly series.
5/ Semi-annual series.
6/ June.

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Table 3: Mexico—Balance of Payments
(in billion dollars)

	1975	1976	1977	1978	1979	1980	1981e/	1982p/
Current Account	-4.1	-3.4	-1.8	-3.2	-5.5	-7.4	-12.5	-9.0
Trade Balance	-3.3	-2.3	-1.0	-1.8	-2.8	-2.3	-2.2	2.5
Exports (f.o.b.)	3.0	3.5	4.6	6.2	9.3	16.3	20.9	20.0
(Oil)	(.5)	(.5)	(1.0)	(1.8)	(3.9)	(9.9)	(14.2)	(13.5)
(Other)	(2.5)	(3.0)	(3.6)	(4.4)	(5.4)	(6.2)	(6.7)	(6.5)
Imports (f.o.b.)	-6.3	-5.8	-5.6	-8.0	-12.1	-18.6	-23.1	-17.5
Services (net)	-0.9	-1.3	-1.0	-1.6	-2.9	-5.4	-10.6	-11.8
Receipts	3.3	3.7	3.6	5.2	6.7	8.5	9.3	10.0
(Tourism)	(.8)	(.8)	(.9)	(1.1)	(1.4)	(1.7)	(1.8)	(2.0)
Payments	-4.2	-5.0	-4.6	-6.8	-9.6	-13.9	-19.9	-21.8
(Interest)	(-1.1)	(-1.7)	(-2.0)	(-2.6)	(-3.6)	(-5.4)	(-8.2)	(-10.7)
(Tourism)	(-.4)	(-.4)	(-.4)	(-.5)	(-.7)	(-1.0)	(-1.5)	(-1.2)
Transfers (net)	.1	.2	.2	.2	.2	.3	.3	.3
Capital Account	5.4	5.5	2.5	3.7	5.0	11.0	19.0	
Long-Term (Net)	4.6	4.9	4.6	5.1	5.1	7.4	14.9	
Direct Investment	(.6)	(.6)	(.6)	(.8)	(1.3)	(1.9)	(1.9)	
Other	(4.0)	(4.3)	(4.0)	(4.3)	(3.8)	(5.5)	13.0	
Short-Term (Net)	.8	.6	-2.1	-1.4	-.1	3.6	4.1	
Errors and Omissions	-1.2	-3.0	.1	.1	.7	-2.4	-5.5	
Change in Net Reserves 1/	-.1	.9	-.8	-.4	-.2	-1.2	-1.0	

1/ Not including gold revaluation. Increase: -.

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