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 it, 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

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

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 risker 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.

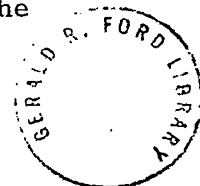
Mr. Cross offerred the estimate that the actual change in Mexican reserves since September 1 was on the order of minus $350 million, in contrast with the over $1 billion in reported "net intervention." Mr. Robichek reminded the group that no one had been able to obtain hard figures -- the Mexicans are 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.

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

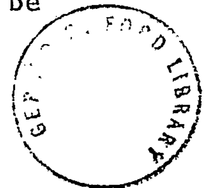
Governor Wallich asked what information we had about Mexican debts that were coming due.

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.

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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 reinstituted 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

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