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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.

1/ A summary of the Mexican program will be found in a separate paper also being circulated.

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Recent Developments

The Mexican stabilization effort has gotten off to a shaky start. On the basis of rumors (officially denied) that (a) bank accounts would soon be frozen and (b) exchange controls were about to be imposed, a run on banks developed around mid-September, and the capital inflow of early September was reversed. While the panic has abated, withdrawals from banks continue. Our Embassy in Mexico and the banks themselves are receiving an enlarged volume of inquiries about investment opportunities in the United States. The demand for U.S. currency has also increased.

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.

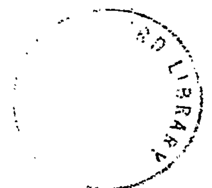
The Long-Run Prospects

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

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



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.

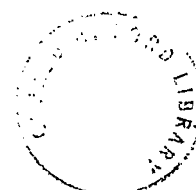
This flexibility on the part of the IMF, though understandable carries the risk that the authorities, encouraged by knowledge that a more modest degree of progress may be forgiven by the Fund, will not exert their best efforts to carry out the original program, or will tend too easily to give in to domestic 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

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.

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