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Recent Economic and Financial Developments  
in Mexico  
and Prospects for 1976-77

Mexico's balance of payments deficit on current account increased substantially in 1975, mainly as a result of the world recession and a rise in interest payments on external obligations. As shown in table 1, according to preliminary data, the current account deficit exceeded \$4 billion, up from about \$2.9 billion in 1974. The world recession was the principal reason why most traditional exports declined, and it was only because of the steady rise in exports of petroleum from wells opened in 1974 that the year ended with the value of total exports virtually unchanged from 1974. In contrast, the value of imports rose more than 8 per cent. The rise in imports in 1975 was modest when compared with increases of more than 50 per cent in each of the previous two years, and it was associated with a marked slowdown in the country's rate of economic activity. The world recession also brought about a 5 per cent drop in tourist earnings. The rise in interest payments reflects the rapid increase in the country's external debt and a rise in the average interest rate on outstanding obligations.

The current account deficit was financed by a net inflow of medium- and long-term capital, as has been the case for many years. Last year, this net inflow totalled about \$4.3 billion, over \$1.3 billion more than in 1974. This was enough to allow an increase in net official foreign assets of \$151 million.



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Table 1

Mexico - Balance of Payments

1973-75

(in million dollars)

	1973	1974	1975 <sup>P/</sup>
Merchandise Exports	+2,419	+3,443	+3,445
Merchandise Imports	-3,656	-5,754	-6,283
Trade Balance	-1,237	-2,311	-2,838
Services (net)	- 252	- 678	-1,344
Travel (net)	(+ 808)	(+ 902)	(+ 810)
Investment Income (net)	(-1,135)	(-1,599)	(-1,974)
Other (net)	(+ 150)	(+ 19)	(- 180)
Private Unrequited Transfers (net)	+ 66	+ 100	+ 114
Balance on Current Account	-1,423	-2,889	-4,068
Govt. Unrequited Transfers (net)	+ 8	+ 13	+ 12
Long-Term Capital (net)	+1,820	+3,048	+4,303
Direct Investment in Mexico (net)	(+ 457)	(+ 678)	(+ 749)
Other Long Term Private Capital (net)	(+ 119)	(+ 590)	(+ 854)
Public Sector Borrowings (net)	(+1,293)	(+1,780)	(+2,700)
Subscriptions to IBRD and IDB	(- 48)	( -- )	( -- )
Short-Term Capital (net)	- 308	+ 242	+ 486
Private Non-Bank Capital (net)	(- 178)	(- 441)	(+ 250)
Bank Capital (net)	(- 130)	(+ 683)	(+ 236)
Official Foreign Assets (net)-- (increase:-)	- 144	- 32	- 151
Errors and Omissions (net)	+ 46	- 381	- 582

<sup>P/</sup> Preliminary

Source: International Monetary Fund, International Financial Statistics, and IMF staff.

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The country's real gross domestic product last year is estimated at about 4 per cent more than in 1974. With population rising at about 3.5 per cent per year, this represents little real growth per capita. The 1975 growth rate was also well below the average rate achieved in the past 20 years and below the 1974 rate--both about 6 per cent. With slower growth came a slower rate of increase in prices, but the consumer price index late last year and early this year was still showing a rise of more than 13 per cent over the year-carrier levels, and the monthly percentage increase appeared to have begun to turn up in January and February, after diminishing rather steadily during 1975. Recent price movements are summarized in table 2.

Until early 1973, the rate of inflation in Mexico was comparable to that in the United States. Its subsequent acceleration is only partly attributable to the impact of rising prices of many imported products. More important, perhaps, were an accelerated growth of domestic expenditures, chiefly by the public sector, an expansionary incomes policy, and shortfalls in agricultural production owing to inclement weather.

Public spending began to increase faster late in 1972 as the Government stepped up its rate of investment and the growth of its welfare programs. As public sector revenues rose more slowly, reliance on financing from the banking system grew. However, the ability of the banks to channel non-inflationary resources into the purchase of public sector securities was rising more slowly, and the Bank of Mexico itself

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ended up holding an increasing amount of these securities.

At the same time, the authorities undertook to compensate workers for the rise in the cost of living and began to grant more generous and more frequent increases in the minimum wage, setting the pattern for significantly larger raises in other wage categories. The latest increase in minimum wages, effective early this year, averages about 21 per cent (with a range of 17 to 34 per cent). This was the first increase in 15 months and, like earlier ones, it is fairly close to the rate of inflation in this 15-month period. It is bound to make it more difficult to reduce the inflation rate further in 1976.

Steps began to be taken to correct the internal financial disequilibrium in the latter part of 1974. In September of that year, the reserve requirements of the banks were raised substantially. Subsequently, some administrative improvements were introduced to achieve greater discipline on current government expenditures. In addition, a number of taxes were substantially increased and a new 50 per cent tax on gasoline sales was instituted. Rates for public services also were raised. At the same time, the decline in world interest rates beginning in the latter part of 1974 made Mexican interest rates relatively more attractive, and this helped the financial institutions in the country to attract a larger flow of funds than in the previous two years, enabling them to absorb a greater volume of public sector securities in 1975. Absorption of public securities by the financial.

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Table 2

Mexico - Index of Consumer Prices

in Mexico City

in Selected Months Since December 1972

	General Index (1968 = 100)	Average Monthly Change Since Last Month Shown (Per cent)	Change from Same Month Previous Year (Per cent)
1972 - December	124.1		
1973 - March	128.2	+1.1	+ 7.4
June	132.6	+1.1	+ 9.8
September	139.6	+1.8	+13.8
December	149.5	+2.4	+20.5
1974 - March	156.7	+1.6	+22.0
June	161.2	+1.0	+21.6
September	169.3	+1.7	+21.3
December	180.6	+2.2	+20.8
1975 - March	184.6	+ .7	+17.8
June	192.5	+1.4	+19.5
September	198.7	+1.1	+17.4
October	200.3	+ .8	+15.2
November	202.8	+1.2	+13.3
December	204.6	+ .9	+13.3
1976 - January	207.9	+1.6	+13.3
February	211.9	+1.9	+15.1

Source: Banco de México, Indicadores Económicos

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institutions was helped by the severe limitations on credit to the private sector brought about by the tightening in reserve requirements.

However, the slowdown in economic activity as the year progressed began to cause concern and, after mid-year, the Government again stepped up the rate of public spending. For the year as a whole, about 5 per cent of total public expenditures were financed directly by the Central Bank, and this financing accounted for about 75 per cent of the increase in the money supply (narrowly defined). The increase in  $M_1$  in 1975 was 23 per cent, somewhat more than in the two previous years, and about twice the pre-1973 rates.

For 1976, public spending is projected by the authorities to increase by only 10 per cent over the 1975 level. This compares with a 30 per cent increase in public spending from 1974 to 1975. If the recent rates of inflation continue unchanged during the year, this would represent a cut in public sector spending in real terms. Even so, the fiscal deficit would amount to about 27 per cent of total public expenditures. The authorities hope that three-fourths of this can be financed internally and without direct recourse to the Central Bank, and the rest externally. To avoid recourse to the Central Bank, credit to the private sector will have to remain tightly restricted. Under such a projection, the rate of growth of real GDP for the year would probably not exceed the 1975 rate, and there should be some improvement in the balance of payments on current account.

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There are reasons to question whether this projection will be realized. The recent wage increases appear to exceed what would have been consistent with a 10 per cent increase in public spending. Moreover, it is likely that public spending will exceed the projection if only because this is the last year of the term of office of the President of Mexico, and the outgoing Administration, like its predecessors, will want to complete as many of the projects which it started as it possibly can. The American Embassy reports that private sector economists generally tend to doubt that public spending will be held down as much as is officially projected. Private forecasters believe that there will be some recovery in real GDP growth, an intensification of inflation, and a further deterioration of the balance of payments on current account.

As regards the balance of payments, the worldwide economic recovery should be reflected in an upturn in Mexican exports and tourist earnings. However, Mexican industry may find itself increasingly at a competitive disadvantage, after three years of inflation at rates in excess of those in the United States, especially if this differential widens in 1976. Also, some tourists may stay away because of Mexico's stand on Israel in the United Nations. The principal hope for increased current account earnings lies in the petroleum sector and this could make a substantial contribution. Production from the rich wells of southern Mexico began in 1974 and has not yet reached its full potential. It has already turned the country's position from that of a net importer of

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petroleum to one of a net exporter, as shown in table 3. Official policy is "to increase the rate of production [there] to the highest sustainable rate consistent with current conventional practices, in order to make the maximum contribution to the current account of Mexico's balance of payments."<sup>1/</sup>

At the same time, it will be difficult to hold down imports, especially if it proves impossible to hold down public spending. Equally important, interest payments on the external debt are bound to rise as the debt increases. All told, any improvement this year in the balance of payments on current account is likely, at best, to be rather moderate, and there is a possibility that some further deterioration may occur.

For the longer run, there are reasons for somewhat more optimism. A new Administration will take office in December, following the expected election of former Finance Minister José López Portillo as President in July. The change in Administration may be the occasion for the adoption of stronger anti-inflationary measures if, as seems likely, the new President's Finance Ministry experience leads him to attach more importance than his predecessor to the financial consequences of his political decisions. In addition, in 1977, it is expected that a large new copper mine now under development will begin to contribute substantially to the export picture.

<sup>1/</sup> Prospectus for \$50 million Issue of Mexican Government Bonds, dated February 19, 1976, p.14.

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Table 3  
-Mexico - Petroleum  
Exports and Imports  
(in million dollars)

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	Exports	Imports	Balance	Exports	Imports	Balance
Crude Oil	61.9	76.4	- 14.5	393.3	--	+393.3
Natural Gas	1.1	--	+ .1	--	--	--
Refined Products	62.0	240.5	-178.5	23.7	225.7	-202.0
Petrochemicals	9.5	74.4	- 64.9	4.3	57.5	- 53.2
Total	133.5	391.3	-257.8	421.3	283.2	+138.1

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Source: Prospectus for \$50 million Issue of Mexican Government Bonds, dated February 19, 1976, p. 15.

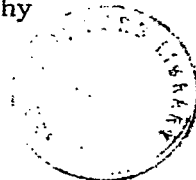


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But until these developments occur, uncertainty will continue to produce periods of nervousness in the Mexican foreign exchange market, heightened by questions as to whether Mexico can raise enough financial resources in external markets to cover its needs. The question whether the peso should be devalued is receiving increasing attention in private circles. The principal argument in favor of devaluation is that, over the last three years, the rate of inflation in Mexico has exceeded the rate prevailing in the United States by an average of about 9 percentage points per year (as measured by the respective consumer price indices) and a large differential is likely to continue for at least another year, and that this is interfering with the competitiveness of Mexican exports. On the other side, it is argued that the dollar-peso rate has remained unchanged for 22 years, that its alteration would be a shock to foreigners who have invested large amounts in peso-denominated accounts in Mexican financial institutions and would close this source of external financing for many years (for fear of new devaluations), that the internal burden of servicing the country's huge foreign debt would be greatly increased, that exports of raw materials (still the bulk of the country's exports) are traded at world prices which would not be affected by a devaluation, that there is little or no excess industrial capacity with which to increase manufactured exports, and that a devaluation would set off an upsurge of inflation as prices of imported goods (in pesos) would increase and prices of domestically produced articles would go up in sympathy

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(presumably more for psychological reasons than in response to cost increases)--in effect leading to what is called the "argentization" of the Mexican economy.

The authorities are determined to defend the current dollar-peso exchange rate. Their principal line of defense is the country's reserves which amounted to more than \$1.6 billion on March 29. The country's credit tranches in the International Monetary Fund total about \$626 million (including the 45 per cent addition approved at the recent Jamaica meeting of the IMF's Interim Committee), but not all of it would be available without the adoption of corrective policy measures acceptable to the Fund. The Bank of Mexico's swap arrangement with the Federal Reserve System is for \$360 million, having been doubled in August 1975. Mexican drawings under the swap have occurred twice before, in August 1974 and in September 1975. Both drawings, for \$180 million in 1974 and for \$360 million in 1975, were repaid before they came due at the end of three months. The Bank of Mexico also has a swap arrangement with the US Treasury, the amount of which was increased from \$200 to \$300 million at the end of 1975. But this cannot be drawn upon until after the swap line with the System has been fully drawn. The country appears to be able to continue to borrow in international markets, and this may be important in helping to repay short term obligations.

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Whether the defense of the peso will ultimately succeed

is likely to depend importantly on the ability of the authorities to prevent the fiscal position from getting out of hand, and eventually to restore a sound fiscal and monetary policy.

Prepared by Yves Maroni

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