Strictly Confidential (FR)
Class I - FOMC

August 13, 1986

TO: Federal Open Market Committee

SUBJECT: Proposed Bridge Financing Arrangements for Mexico

FROM: Paul A. Volcker

At the meeting of the FOMC in May, we discussed with you the then difficult situation concerning Mexico's development of an economic program that could gain the approval of the International Monetary Fund. After additional considerable discussion that goal was achieved on July 22, 1986, when the new Mexican Finance Minister, Gustavo Petricioli, announced that agreement had been reached with the Managing Director of the Fund on a Letter of Intent based upon a "program of growth-oriented adjustment and structural reform." (The attached Annex summarizes recent economic and financial developments affecting Mexico.)

The program forms the basis for a request by Mexico for a SDR 1.4 billion Stand-by Arrangement with the Fund. In addition, the World Bank and Mexico have developed a program for Bank support of Mexico's structural reform. Finally, substantial commercial bank participation in the financing of the Mexican program will also be necessary -- about $6 billion in net new financial in 1986-87.

At the same time, the Managing Director of the Fund requested support by the international financial community for a contingency facility to support Mexico's international reserves, pending the putting in place of the longer-term financing described above. In a statement to governmental authorities, the Managing Director said:

> While the financing package is being developed, arrangements need to be made to enable Mexico to cover its liquidity requirements in the interim period. Our examination of the country's external financing prospects in the next several months indicates that a bridging credit of at least US $1.5 billion is necessary to maintain the country's working balances at a sufficient level. It would be desirable to have the broadest participation possible in such a loan, including commercial banks and the official community. In view of the importance of initiating this effort in a climate of confidence and with orderly payment procedures, I hope you will consider positively your participation in the bridging credit. I have consulted with World Bank President Conable regarding this proposal, and he agrees fully on the importance of bridge financing to support Mexico's economic program.

The Managing Director's request was directed to governmental authorities in Europe, Japan, Canada and Latin America, as well as to ourselves. The response to this request was favorable and negotiations were undertaken to establish such a facility with eleven central banks in Europe, Canada and Japan (acting through the BIS), the central banks of Argentina, Brazil, Colombia and Uruguay, as well with as the Federal Reserve and the Treasury for the United States. The official participation would amount to $1,100 billion with the following shares: BIS ($400 million), Latin America central banks ($155 million) and the United States ($545 million). The U.S. participation would be divided roughly equally between the Treasury and the Federal Reserve, with our portion being drawn on the existing $700 million Federal Reserve swap arrangement with the Bank of Mexico.

In addition, the commercial banks are negotiating the final terms of their participation in the amount of $500 million. This commercial bank participation would be drawn upon after agreement had been reached on the "critical mass" of commercial bank participation in a new money facility for Mexico which would allow the Managing Director to present the Mexican program and standby request to the IMF Executive Directors for approval.

As now envisaged, the official portion of the facility would provide for up to $850 million to be available initially to the Bank of Mexico. The remaining $250 million could be drawn upon beginning September 16, 1986 provided the commercial bank portion of the facility is also available by that time. All drawings on the official facility could be pari passu on each participant in proportion to its contribution. The official portion of the facility would be repaid from Mexican drawings from the International Monetary Fund and from disbursements from World Bank. In addition, as a contingency repayment arrangement, payments of foreign exchange to Pemex by purchasers of oil would be paid to the Bank of Mexico, as they are now, at its commercial bank account, and these sums would be used to repay any amounts that might be unpaid after January 30, 1987.

Additional work must still be done to complete the arrangements for the facility. I expect to discuss this matter further at our upcoming meeting.

August 13, 1986

ANNEX

Recent Economic and Financial Developments in Mexico

Introduction

In 1985, Mexico's stabilization effort that began after the 1982 financial crisis suffered a setback. Fiscal policy became more expansionary and, while monetary policy was tightened, the ensuing increase in interest rates raised the cost of servicing the domestic public debt, aggravating the public sector deficit. The fiscal deterioration brought Mexico out of compliance with the performance tests of its IMF program. This year, Mexico has been hurt badly by the decline in world oil prices and a reduced volume of oil exports that is attributable in large part to a non-competitive pricing policy in the first four months of the year. These developments are cutting sharply into export earnings and public sector revenues. While the external impact is being mitigated by a shift to a more competitive exchange rate policy since July 1985, the domestic impact has been compounded by the effect of the continuing rise in domestic interest rates on interest payments on the domestic public debt. As a result, the public sector deficit is widening and is projected at about 16.9 percent of GDP in 1986, compared with about 10 percent in 1985. The economy is in recession this year while inflation is accelerating.

Mexico is attempting to restore external and internal balance and to promote a recovery of GDP through a combination of demand management measures and supply oriented structural adjustments. It has embarked on a new program to be supported by an 18-month IMF stand-by arrangement and seeks to obtain substantial additional external financing.

External Accounts

Mexico's current account is projected to be in deficit by $3.5 billion in 1986 and by $2.9 billion in 1987. This compares with large surpluses in 1983 and 1984 and near balance in 1985. The trade surplus in the first half of 1986 was only about $2 billion, down from $4.7 billion in the first half of 1985. Non-oil exports were 27 percent larger, but petroleum exports were about $4 billion lower. Crude oil exports averaged about 1.2 million barrels per day (mb/d), down from nearly 1.5 mb/d in the first half of 1985. The average price fell from about $19.70 per barrel in January to less than $10.00 in June. The average price for the six-month period was about $12.80 per barrel, less than half the average price of the first half of 1985. For the balance of 1986, the trade surplus is likely to shrink somewhat further. The IMF program assumes that the volume of crude oil exported in the second half of this year will average 1.2 mb/d, about as much as in the first half, but the average export price is projected to be $10 per barrel. While manufactured exports should remain strong, thanks to an aggressive exchange rate policy, agricultural exports will be seasonally low, and imports should begin to recover.

Reserves

According to confidential figures, Mexico's liquid international reserves declined by about $1.5 billion in the first half and by another $600 millin in July. At the end of July, they stood at about $2.8 billion. A further decline of $200 million occurred in the first 8 days of August. For the full month of August, assuming no new capital inflow, the decline in reserves may approach $800 million, reflecting net payments on current account of $410 million and principal repayments of $370 million.

Domestic Economic Performance

Monthly increases in the CPI have equalled or exceeded 5 percent in the past four months and, in July, the CPI was about 86 percent higher than a year earlier. This compares with a rise of 64 percent in the December 1984-December 1985 period. A slowdown in output, mainly in oil extraction and in construction, brought industrial production in the first half to about 2 percent below the level of the corresponding period of 1985. The public sector fiscal deficit has been swollen by (a) the shortfall in public revenues resulting from the decline in the price and volume of oil exported, and (b) the sharp rise in domestic interest payments attributable in large part to the increase in domestic interest rates.

Recent Policy Actions

Since June, the daily rate of crawl of the peso price of the dollar in the controlled market has been accelerated and the monthly rate of increase has jumped from an average of less than 7 percent in the second quarter to about 10 percent in July and about 9.3 percent in the first 11 days of August. In June and July, interest rates on short-term time deposits at banks were sharply increased. The authorities resumed selling Treasury bills to the highest bidder in late July, reversing the policy introduced last October of announcing the rate in advance of the auctions. In early July, the Bank of Mexico relaxed slightly its restrictions against increases in bank loans to the private sector.

The new IMF program, outlined in the letter of intent signed last month by Secretary Petricioli, calls for a reduction of the "operational" public sector deficit (excluding the inflation component of interest payments on peso-denominated debt) by 3 percent of GDP, through (a) a tax reform designed primarily to correct the effects of high inflation on the tax base (b) increases in public sector prices, and (c) a reduction in expenditures with a redirection toward investment. The program also involves an increase in privatization efforts with respect to public enterprises, significant further trade liberalization, encouraging foreign direct investment, and a recovery of GDP, which is expected to decline by 4 percent in 1986 and rise by 3-4 percent in 1987-88. The program envisages net new external financing over 18 months totalling about $12 billion, of which the commercial banks are being asked to provide about $6 billion in new money ($3.5 billion in 1986 and $2.5 billion in 1987). It includes two contingency mechanisms for additional financing, one in case the economic recovery fails to materialize, the other in case oil export prices average less than $9 per barrel for a calendar quarter within the first 9 months of the program. External financing would be reduced should oil export prices average more than $14 per barrel for a calendar quarter within the first 9 months of the program.

In line with its commitments to the IMF, the Mexican government, in early August, raised sharply Mexico City public transport fares and fuel prices. Increases in public sector prices are to continue with the aim of increasing public sector income by the equivalent of 1.2 percent of GDP.