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FROM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 240800Z FCO
TELNO 232
OF 232300Z JULY 86
AND TO DESKBY 241500Z MEXICO CITY

MY TELNO 230
IMF: MEXICO

1. LAROSIERE BRIEFED EXECUTIVE DIRECTORS THIS MORNING. HE HANDED OVER THE LETTER OF INTENT (EBS/86/161) WHICH WE HAVE FAXED TO LONDON. HE DESCRIBED THE KEY ELEMENTS OF THE MEXICAN PROGRAM: TAX REFORM, PRICE INCREASES AND RESTRUCTURING IN THE PUBLIC SECTOR, REORIENTING OF PUBLIC EXPENDITURE IN FAVOUR OF CAPITAL SPENDING, TRADE LIBERALISATION, AND A FLEXIBLE EXCHANGE RATE POLICY. HE WENT OVER THE TWO INNOVATIVE FEATURES OF THE PROGRAM--THAT IS, THE OIL PRICE TRIGGER AND THE PROVISION FOR ADDITIONAL PUBLIC INVESTMENT IF RECOVERY FAILS TO MATERIALISE. THESE ARE SPELT OUT IN THE LETTER OF INTENT. IT SHOULD BE NOTED THAT FULL COMPENSATION IF THE OIL PRICE FALLS BELOW DOLLARS 9 PER BARREL RUNS FOR ONLY NINE MONTHS, IT IS PHASED OUT OVER THE SUCCEEDING THREE QUARTERS. LAROSIERE SAID THAT THE TOTAL COMPENSATION FOR WHICH MEXICO COULD BE ELIGIBLE IN THE EVENT OF THE PRICE FALLING AS LOW AS DOLLARS FIVE PER BARREL WAS DOLLARS 2.5 BILLION. HE WOULD EXPECT THE FUND TO CONTRIBUTE UP TO HALF OF THIS BY WAY OF ENLARGED ACCESS AND THE COMMERCIAL BANKS THE REMAINDER. AS MENTIONED IN TUR, LAROSIERE EXPECTS THE IBRD TO FINANCE THE EXTRA DOLLARS 500 MILLION OF ADDITIONAL PUBLIC INVESTMENT IF GROWTH DOES NOT MATERIALISE. THE LETTER OF INTENT SAYS THAT "THIS FUNDING WOULD NEED TO BE COMMITTED IN ADVANCE AND NOT AT THE MOMENT OF THE TRIGGERING OF THE MECHANISM". IT REMAINS TO BE SEEN WHETHER THE IBRD CAN AGREE TO THIS. I HAVE MY DOUBTS, PARTICULARLY SINCE THEY ARE ALREADY PLANNING ON LARGE NEW COMMITMENTS AND NET DISBURSEMENTS OF ABOUT DOLLARS 1 BILLION IN BOTH 1986 AND 1987. NONETHELESS, IT IS CLEAR (FROM WHAT PETRICIOLI SAID HERE YESTERDAY, AND FROM ORTIZ (IMF MEXICAN ALTERNATE DIRECTOR) WHO ALSO SPOKE AT THIS MORNING'S BRIEFING) THAT THE MEXICANS REGARD THIS AS AN IMPORTANT ELEMENT IN THE PROGRAM.

2. LAROSIERE SAID THAT HE HAD NO ILLUSION ABOUT THE DIFFICULTIES IN PERSUADING THE BANKS TO COME UP WITH THEIR SHARE OF THE FINANCING (DOLLARS 6 BILLION PLUS), BUT IT WAS CRITICAL THAT THEY SHOULD. IF THEY WANTED THE BAKER INITIATIVE TO TAKE OFF, NOW WAS THE TIME FOR THEM TO SHOW IT. HE POINTED OUT THAT COMMERCIAL BANK EXPOSURE TO MEXICO WAS ABOUT DOLLARS 70 BILLION, SO THE FINANCING ASSUMED FROM THEM WOULD ADD ABOUT 4 PER CENT PER ANNUM IN 1986 AND 1987 TO THEIR EXPOSURE. THIS WAS MORE THAN THE 2-3 PER CENT PER ANNUM ASSUMED IN THE BAKER-15 COUNTRIES TAKEN AS A WHOLE. BUT BANK LENDING TO COUNTRIES OTHER THAN MEXICO HAD BEEN MINIMAL AND THE BANKS WOULD BE RECEIVING SOME REPAYMENTS FROM THE MEXICAN PRIVATE SECTOR (ALMOST DOLLARS 1 BILLION IN 1986 AND 1987).

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3. THE LETTER OF INTENT DOES NOT GIVE A COMPLETE PICTURE AND IT WILL NOT BE POSSIBLE TO PROPERLY ASSESS THE PROGRAM UNTIL WE HAVE THE FULL STAFF REPORT. IN PARTICULAR, IT INCLUDES LITTLE ON THE BALANCE OF PAYMENTS. HOWEVER, LAROSIERE DID READ OUT THE BALANCE OF PAYMENTS PROJECTIONS UNDERLYING THE PROGRAM WHICH ARE AS FOLLOWS:

(DOLLARS BILLION

	1986	1987	TOTAL 1986-1987
OIL EXPORTS	5.6	6.0	
TOTAL IMPORTS	12.0	14.3	
CURRENT ACCOUNT DEFICIT	-3.5	-2.9	-6.4
PRIVATE CAPITAL ACCOUNT	-1.5	-1.3	-2.8
OF WHICH:			
DIRECT INVESTMENT	+0.6	+0.6	+1.2
EXTERNAL CREDIT	+1.8	+1.0	+2.8
DEBT AMORTISATION	-2.2	-1.3	-3.5
INTEREST RECEIPTS			
NOT REPATRIATED	-1.2	-1.2	-2.4
ERRORS AND OMISSIONS	-0.5	-0.4	-0.9
INCREASE IN NET RESERVES	-0.5	-0.9	-1.4
INCREASE IN GROSS RESERVES			-2.8
FINANCING GAP			12.0

FINANCED BY:

IBRD/IDB	+2.7
IMF	+1.4
PARIS CLUB	+1.5
COMMODITY CREDIT CORPORATION	+0.7
MYRA INTEREST REBATE	+0.5
OTHER AND SHORT-TERM ITEMS	-0.8
COMMERCIAL BANKS	+6.0

4. OIL EXPORT PROJECTIONS BASED ON PRICE OF DOLLARS 9 PER BARREL OF MEXICAN CRUDE OIL MIX IN Q3 1986 AND DOLLARS 11 IN Q4 1986 AND 1987, AND EXPORT VOLUME OF 1.2 MBD IN H2 1986 AND 1.3 MBD IN 1987. IMPORT PROJECTION FOR 1987 IS BASED ON MINIMUM REGARDED AS CONSISTENT WITH GDP GROWTH OF -3.5 PER CENT AND STAFF ARE ASSUMING GDP REDUCTION OF 4 PER CENT IN 1986). UNDER PRIVATE CAPITAL ACCOUNT, EXTERNAL CREDIT IS MAINLY TRADE CREDIT, DEBT AMORTISATION INCLUDES REPAYMENT OF BANK CREDIT BY THE MEXICAN PRIVATE SECTOR (ESTIMATED AT DOLLARS 0.9 BILLION OVER THE TWO YEARS) AND AMORTISATION OF BONDS BOTH OF WHICH IT IS ASSUMED CANNOT BE RESCHEDULED, INTEREST RECEIPTS NOT REPATRIATED REFERS TO INTEREST RECEIVED ON MEXICAN ASSETS HELD BY THE PRIVATE SECTOR ABROAD WHICH ARE, STRICTLY SPEAKING, CURRENT RECEIPTS BUT WHICH IN PRACTICE ARE NOT AVAILABLE TO FINANCE IMPORTS. FUND STAFF THINK IT RIGHT THAT MEXICO SHOULD REPLENISH ITS RESERVES. FIGURE OF DOLLARS 1.4 BILLION FOR INCREASE IN NET RESERVES CORRESPONDS

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TO PERFORMANCE CRITERION UNDER STAND-BY ARRANGEMENT (SEE TABLE 1 OF EBS/86/161). FIGURE OF DOLLARS 2.8 BILLION FOR INCREASE IN GROSS RESERVES INCLUDES DOLLARS 1.4 NET DRAWING FROM THE FUND (I.E. DOLLARS 1.7 BILLION PURCHASE UNDER STAND-BY ARRANGEMENT MINUS DOLLARS 0.3 BILLION OF REPURCHASES FALLING DUE). THE FIGURE OF DOLLARS 1.5 BILLION FOR PARIS CLUB IS, LAROSIERE FREELY ADMITTED, A COCKSHY. THE MYRA INTEREST REBATE IS THE REBATE UNDER LAST YEAR'S RESTRUCTURING AGREED WITH THE BANKS. "OTHER AND SHORT-TERM ITEMS" REFERS MAINLY TO CREDIT LINES AND OTHER SHORT-TERM DEBT WHICH THE MEXICANS SAY CANNOT BE RENEGOTIATED. IF YOU DEDUCT THE LATTER AND THE FUND NET DRAWING FROM THE DOLLARS 12 BILLION FINANCING GAP, THE RESULTANT FIGURE OF DOLLARS 10.1 BILLION CORRESPONDS TO THE PERFORMANCE CEILING FOR NET FOREIGN BORROWING IN THE LETTER OF INTENT.

5. ON THE FISCAL SIDE, IT SEEMS THAT THE MEXICANS ARE PROPOSING TO RAISE ADDITIONAL REVENUE AMOUNTING TO 1.3 PER CENT OF GDP (PARA. 7). THEY ARE PROPOSING TO CUT PUBLIC EXPENDITURE BY 0.5 PER CENT OF GDP, BUT WITHIN THIS TO RAISE CAPITAL OUTLAYS BY 0.5 PER CENT OF GDP (PARA. 9). IN ADDITION, THEY ARE PLANNING TO RAISE THE PRICES AND TARIFFS IN THE PUBLIC SECTOR TO YIELD 1.2 PER CENT OF GDP (PARA. 8). THIS SEEMS TO BE CONSISTENT WITH THE 3 PER CENT OF GDP EXTRA FISCAL EFFORT WHICH WE HAVE BEEN TOLD ABOUT PREVIOUSLY, BUT IT IS NOT CLEAR WHAT IT MEANS FOR THE PSBR IN 1987. THE CEILING ON THE LATTER IS TO BE AGREED SOMETIME BEFORE END-1986.

6. LAROSIERE SAID HE HOPED TO BRING ALL THIS TO THE BOARD IN EARLY SEPTEMBER, BUT HE WOULD NOT DO SO UNTIL THE CRITICAL MASS OF FINANCING WAS PRETTY MUCH TIED UP.

7. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, LAVELLE, MOUNTFIELD, AND MATTHEWS (TREASURY), PS/GOVERNOR, LOEHNIS, KENT AND CRAWFORD (BANK OF ENGLAND), AND FOWLER, BRAITHWAITE AND MAUD (FCO).

LANKESTER

(ADVANCED AS REQUESTED)

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FM UKDEL IMF/IBRD, WASHINGTON
TO DESKBY 220800Z FCO
TELNO 153
OF 212300Z MAY 86
AND TO ROUTINE MEXICO CITY

Please file

IMF: MEXICO

WHEN I SAW LAROSIERE YESTERDAY ON ANOTHER MATTER, WE BRIEFLY DISCUSSED MEXICO. HIS MOOD WAS SOMBRE. HE SAID HE HAD SEEN MANCERA IN PHOENIX OVER THE WEEKEND AND (NOTWITHSTANDING MANCERA'S OPTIMISM ON AGREEMENT WITH THE FUND AS REPORTED IN MONDAY'S FINANCIAL TIMES) THEIR DISCUSSION HAD BEEN UNCONCLUSIVE. LAROSIERE GAVE THE IMPRESSION OF BEING RATHER PESSIMISTIC ABOUT THE MEXICANS' WILLINGNESS TO DO MORE ON THE FISCAL SIDE. AT CURRENT OIL PRICES, IT WAS ESSENTIAL THAT THE PUBLIC DEFICIT BE REDUCED TO AT LEAST SOMETHING BELOW 10 PER CENT OF GDP TO JUSTIFY A FUND PROGRAMME. ANYTHING HIGHER THAN THIS WOULD BE TOO RISKY FOR THE FUND, DAMAGING TO THE MEXICAN ECONOMY AND WOULD LACK CREDIBILITY WITH THE COMMERCIAL BANKS.

2. LAROSIERE GAVE ME THE FUND STAFF'S LATEST FIGURING ON THE BUDGET. AS OF LAST NOVEMBER, THE MEXICANS WERE BUDGETING ON A PUBLIC DEFICIT AT 5.3 PER CENT OF GDP. THIS HAD INCREASED TO 9.3 PER CENT AS A DIRECT RESULT OF THE OIL PRICE COLLAPSE. IT HAD RISEN FURTHER TO 13.8 PER CENT LARGELY ON ACCOUNT OF HIGHER PUBLIC SECTOR INTEREST PAYMENTS DUE TO HIGHER INTEREST RATES IN MEXICO AND THE HIGHER PESO INTEREST COST OF FOREIGN LOANS. THE LATTER FIGURE HAD IN THEORY BEEN REDUCED TO ABOUT 12.3 PER CENT BY THE MEASURES ANNOUNCED BY SALINAS ON 23 APRIL (MEXICO TELNO 156). STAFF SIMULATIONS SHOWED THAT, EVEN IF ADDITIONAL EXTERNAL FINANCING WERE AVAILABLE TO COVER A 12.3 PER CENT DEFICIT, A DEFICIT OF THIS MAGNITUDE WOULD INCREASE THE RATE OF INFLATION TO AROUND 150 PER CENT. LAROSIERE POINTED OUT THAT THE LONGER THE MEXICANS DELAYED, THE RISING RATE OF INFLATION WOULD, BY INCREASING THE COST OF DEBT SERVICE, PUSH UP THE DEFICIT FURTHER.

3. FUND NEGOTIATING TEAM HAVE RETURNED FROM MEXICO WITH MEXICAN TEAM HEADED BY SUAREZ. ORTIZ (MY MEXICAN COLLEAGUE ON THE FUND BOARD) TELLS ME THAT THEY ARE TRYING TO PERSUADE THE FUND TO ACCEPT THE CONCEPT OF THE QUOTE OPERATIONAL DEFICIT UNQUOTE - I.E. THE DEFICIT MINUS THE INFLATION COMPONENT OF PUBLIC DEBT INTEREST PAYMENTS. THEY ESTIMATE THE INFLATION COMPONENT AT NEARLY 9 PER CENT OF GDP IN 1986, AND ACCORDINGLY ARGUE THAT THE INFLATION ADJUSTED DEFICIT IS VERY MODEST. NO DOUBT WHETHER THE STAFF WILL ACCEPT THIS LINE OF REASONING SINCE THE HIGH ACTUAL DEFICIT STILL HAS TO BE FINANCED, AND PARTICULARLY WITH HIGH AND RISING INFLATION, THIS SEEMS UNLIKELY TO BE ACHIEVED WITHOUT RECOURSE TO THE BANKING SYSTEM UNLESS REAL INTEREST RATES ARE TO REMAIN UNCOMFORTABLY HIGH.

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4. ORTIZ SAYS THAT THE MEXICAN TEAM WILL NOT GIVE ANYTHING FURTHER ON THE BUDGET. HOWEVER, HE HAS ALL ALONG BEEN IN THE PESSIMISTS' CAMP AND HAS NOT (NOT) ALWAYS BEEN PROVED RIGHT - SEE E.G. MY TELNO 67.

5. FCO PLEASE ADVANCE TO MOUNTFIELD (HMT), KENT (BOE), RICHARDSON (ERD) AND WOOLVERTON (ODA).

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