RFD 313

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

December 23, 1958

Mexican Monetary Policy Since the 1954 Devaluation

11 pages

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NOT FOR PUBLICATION

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Relatively little has been written on recent Mexican monetary policy, which is regrettable in view of Mexico's economic importance in the Western Hemisphere. For examining this subject, the period since the 1954 devaluation can be conveniently selected since it is short enough to permit fairly thorough investigation, yet long enough to provide some indication of economic trends. Pertinent questions involved are: How is monetary policy determined? What are the current policies? How effective have they been? What is Mexico's economic outlook?

The process of determining monetary policy

In general, Mexican monetary policy is determined by the Director General of the Bank of Mexico who in turn is aided by the advice and counsel of the Bank's Monetary Policy Commission. In addition, as with most central banks, there is close day-to-day co-operation with the Treasury. The Bank's most important body, the Administrative Council (Consejo de Administracion), does not play an important role in the determination of monetary policy.

While the supreme body of the Bank of Mexico is the General Assembly (a group representing all stockholders in the Bank), it approves practically all actions automatically at its annual meeting. To facilitate the Bank's current operations, the General Assembly has delegated all necessary powers to a nine-man Administrative Council. Though this Council reviews and approves important policy matters, the real and active control of the Bank rests with the Director General. Therefore, in the field of monetary policy, basic policy is actually formed by the Director General with the aid of the Bank's staff.

The eight-man Monetary Policy Commission is a permanent body composed of the Bank's second sub-director, five economists, the manager in charge of private bank relations, and one of the technical advisers to the Director General. The Commission is charged with analyzing all data relative to the national and international economic situation, and, upon the request of the Director General, studying prospective, as well as existing, monetary policy measures. After examining the work of the Commission, the Director General dictates appropriate measures and, if necessary, makes suggestions to the Treasury. Since the Bank of Mexico has no legally constituted body to issue rulings of interpretation for various monetary and credit regulations, the Bank occasionally asks the Federal Government, through the Treasury, for credit directives clarifying certain legislation and regulations in force. These credit directives are then used by the Bank to force precise and formal compliance on the part of the commercial banks.

The Bank of Mexico works in close co-operation with the Treasury in order to coordinate monetary policy with fiscal and debt management policy. Article 71 of the Organic Law of the Bank of Mexico gives the Treasury the power to veto the resolutions of the Bank of Mexico on important matters directly affecting the country, but since Bank of Mexico-Treasury co-operation has always been very close, this veto power has never been exercised.

Current monetary policy

The aims of Mexican monetary policy as set forth in the Bank of Mexico's annual reports are almost always stated in broad, general terms. These aims have not changed since the 1954 devaluation and, in general, may be stated as follows: (1) to maintain internal monetary stability, (2) to channel credit primarily to industrial, agricultural, and livestock activities and secondarily to commerce, (3) to guard the liquidity and solvency of the banking system, and lastly, (4) to promote a sound development of the securities market. In the international field, Mexico has followed a policy of maintaining unlimited convertibility for the peso, an action which has, of course, had its influence on domestic monetary policy.

In examining the influence of monetary policy, a distinction should be made between the extent to which the different types of financial institutions within the financial sector are subject to monetary control, and between the particular monetary instruments utilized. In Mexico, the structure of the financial sector is sufficiently complex to merit some attention, particularly in view of a recent expansion in control over one part of the sector.

Basically Mexico's financial sector can be divided into government credit institutions and private credit institutions. Within the former are included the Bank of Mexico, a large national finance agency (Nacional Financiera), and the sixteen national banks. The private sector can be conveniently divided into the deposit and savings banks, investment banking companies (sociedades financieras), and other private institutions. Included in the latter, in decreasing order of importance as based on total assets, are capitalization banks, mortgage banks, trust companies (sociedades fiduciarias), and saving and loan banks for residential housing (bancos ahorro y prestamos para la vivienda familiar). At the end of 1957, the private sector held approximately 53 per cent of the banking system's total assets. Within this sector, the deposit and savings banks held 72 per cent of the total assets and investment banking companies 22 per cent.

It is only within the last few years that investment banking companies, which are usually affiliated with commercial banks, have grown to this position of relative importance. In 1957 alone, their total assets increased from 2,704 to 3,749 million pesos, or by 39 per cent.

Concerned by this rapid expansion, the monetary authorities in February of 1958 acted to restrain the credit expansion of these institutions. Cash and security reserve requirements equivalent to 20 per cent of demand liabilities in domestic currency were established for the first time for these institutions and they were ordered to comply completely with the new regulations by the end of the year.

With regard to Mexico's instruments of monetary policy, it is clear, when the four general aims listed earlier are examined in the light of the particular monetary instruments utilized, that Mexico has relied almost exclusively on one instrument--namely, bank reserve requirements. This tool, however, has been used in both a quantitative and qualitative sense. While the volume of rediscounts allowed by the central bank has been conservative, other traditional instruments, such as open market operations and use of the central bank rediscount rate, have not been important.

The use of open market operations is not feasible, largely as a result of the system of security reserve requirements, rather than any lack of commercial bank holdings of government securities. Currently, deposit and savings banks in the Federal District are required to maintain 50 per cent of their demand deposit liabilities in national currency in various types of securities. Three-fifths of these must be approved government securities. Because of this large volume of required security holdings, the Bank of Mexico feels compelled to support these issues so that commercial banks do not face significant losses as a result of decreases in capital value.

Regarding central bank rediscounts as a weapon of monetary policy, the Bank of Mexico does restrict the availability of rediscounts, but does not utilize the rediscount rate as a restraining force. The Bank's policy is to provide rediscounts to only those banks where deposit liabilities are not growing at a "normal" rate. In practice, this "normal" rate has been arbitrarily set at 6 per cent per year, and since most banks' deposits have grown faster, the result has been that the volume of commercial bank rediscounts has not changed significantly since the devaluation. The only recent exception to this practice occurred in April of 1957 when the Bank of Mexico announced that it would accept for rediscount 50 per cent of each credit granted to CEIMSA (<u>Compania Exportadora y Importadora de Mexico, S.A.</u>), a public Export-Import agency, by a commercial bank and would allow the other half to count as part of the bank's legal deposit requirements. With regard to the government-owned national banks, the only significant rediscounts made since 1954 have been to the National Bank for Foreign Commerce (<u>Banco Nacional de Comercio Exterior</u>), these resources in turn being used to finance the importation of basic foodstuffs, such as wheat and corn, through CEIMSA. Taken together, central bank rediscounts to commercial and national banks since the devaluation have not resulted in any significant net credit expansion.

With regard to the rediscount rate, this has been maintained traditionally at a low level by the Bank of Mexico and since 1953 has been 4-1/2 per cent for agricultural, industrial, and commercial paper. The current rate is not a penalty rate since most government securities yield at least 5 per cent. Even if the monetary authorities were able to increase the rate to very high levels, it is likely that the banks would be able to find other financial sources so as to avoid the penalty rate. In sum, the rediscount weapon has been partly effective in Mexico in that the central bank has limited the availability of rediscounts. On the other hand, the psychological advantages in announcing changes in the rediscount rate have not been utilized, but these aspects are seldom important in countries where money markets are not highly developed.

Unlike open market operations, legal reserve requirements for commercial banks have been used extensively in Mexico as an instrument of monetary policy. They have been utilized to fulfill several of the monetary policy aims mentioned earlier: the over-all reserve requirements have been used to maintain internal monetary stability; the security requirements have been used to channel credit into favored fields; and the cash requirements have been used to guard the liquidity of the banking system.

While the legal reserve requirements for the associated deposit and savings banks in Mexico have been rather complicated in the past, the system has recently been somewhat simplified. In 1956 the number of separate sets of requirements was reduced, and in 1957 provision was made for the abolishment of the system of marginal reserve requirements against demand and time deposits denominated in local currency.1/ Separate reserve requirements still exist for banks outside of the Federal District, and for demand and time deposits, and savings deposits, in foreign currency. However, Table 1, which indicates the requirements for demand and time deposits in national money for banks in the Federal District, conveys a sufficiently valid concept of the 1953, 1955 and current requirements inasmuch as these banks maintain a large majority of Mexico's total demand and time deposit liabilities.

1/ Marginal requirements against demand and time deposits denominated in foreign currencies and against savings deposits were left in force.

Table 1

Legal Reserve Requirements for Demand and Time Deposit Liabilities in National Currency in Deposit and Savings Banks in the Federal District

Bank of Mexico circular Date of circular	1219A Feb. 16, 1953	1279* Jan. 10, 1955	1340A July 1, 1957
1. Cash requirements	30%	30%	25%
2. Portfolio requirements	40%	55%	50%
a. Approved government securities	(10%)	(20%)	(30%)
b. Approved mortgage and investment bonds	(10%)	(15%)	(5%)
c. Approved medium-term credits	(20%)	(20%)	(15%)
3. Unrestricted	30%	15%	25%
	100%	100%	100%

*Requirements for deposit liabilities in excess of those outstanding on January 9, 1955.

In addition to the percentage requirements stated above, the current law also specifies that at least 70 per cent of a bank's portfolio must be devoted to loans for production and no more than 30 per cent can be devoted to loans for commerce.

In addition to the deposit and savings banks, other types of private financial institutions have been subjected to various security requirements. In 1956 capitalization banks were ordered to invest 5 per cent of their demand liabilities in bonds issued by national credit institutions for the promotion of residential housing, and another 5 per cent in mortgage loans for residential housing or in the aforesaid bonds. Similarly, savings institutions and investment banking companies were ordered to invest amounts equivalent to 10 per cent of their capital account in credits for residential housing. Insurance companies have also been ordered in the past to place part of their assets in special types of farm credits.

Just as legal reserve requirements have served to protect banking liquidity, so capital-deposit ratios have served to maintain commercial bank solvency--one of the monetary policy aims cited earlier. However, though these ratios have been helpful in this long-run sense, it should be made clear that they cannot be regarded as a direct weapon of monetary policy similar to the use of the rediscount rate, open market operations, or changes in reserve requirements. In addition, there has been a trend toward higher ratios since 1953 when the ratio of contingent and demand liabilities to paid-in capital and reserves was set at 12.5:1. In September of 1955, the ratio was increased to 15:1, and in 1956 it was further increased to 20:1, chiefly in order to facilitate the financing of cotton. With the production of cotton increasing significantly, larger sums have been required to finance the holding of the crop before export, and the increase in the capital-deposits ratio merely relieved many banks from the task of augmenting their capital base.

A powerful tool at the time of foreign exchange devaluation is the Bank of Mexico's power to take over certain revaluation profits of the commercial banks. This was done at the time of the last devaluation in April of 1954, when approximately 800-900 million pesos were sterilized. Banks were compensated by the Bank of Mexico in pesos at the old exchange rate for net foreign assets held on April 14, 1954. Since this sum was equivalent to about 11 per cent of the total money supply at the time, a possible expansion of circulating medium by a considerable amount was averted.

While the monetary authorities have utilized other instruments in the past besides reserve requirements, limited rediscounts, capital-deposit ratios, and seizure of revaluation profits, they have been of only minor importance. For example, Article 32 of the Organic Law of the Bank of Mexico empowers the Bank to set maximum and minimum rates of interest for commercial banks, as well as permissible premiums and discounts. In practice, however, this power has seldom been exercised, and the only recent use occurred in 1956. At that time, a maximum limit of 3 per cent was established for time and savings deposits in foreign currency in order to discourage inter-bank rate competition, to encourage national savers to maintain and invest their capital in domestic money, and to increase the use of the Mexican peso in the frontier zones. Other relatively minor actions could be mentioned: a 1953 action, still in force, requires domestic banks to clear all rediscounts, loans, and credits from foreign banks, other than commercial credits up to 90 days, with the proper monetary authorities; in 1954 the Bank of Mexico took over the debts of two national banks totaling 741 million pesos, increasing their capital by the same amount, but suspending their rediscount privileges; and finally, the Bank of Mexico has been a prime factor in the silver market, buying and selling in large amounts so as to support and stabilize the price.

From the above it is apparent that the monetary authorities have had to rely almost entirely on one single weapon--namely, legal reserve requirements. While this weapon has been partly effective, it will be shown in the following section that the volume of fiscal operations and the balance of payments situation have far over-shadowed the economic influences of monetary policy.

Relative effectiveness of current policy

Before examining the relative effectiveness of the various monetary instruments employed since the devaluation, it might be helpful to survey briefly the economic trends since the 1954 devaluation. Many observers would probably agree that a convenient division could be made between the period of strong economic advance running from approximately mid-1954 to the spring of 1956, and the subsequent period up to the present characterized by a slower rate of economic growth.

Following the 30.8 per cent devaluation of the peso on April 18 to a rate of 12.5 pesos to the dollar, the current account in the balance of payments continued to remain negative for two months. In July the balance turned positive, and except for November, remained positive for the rest of the year; in 1955 the current account registered a surplus of $123.8 million compared to a deficit of $23.6 million in 1954. In 1956 and 1957, the current account balance again turned negative.

On the industrial side, the general index of the volume of industrial production, which had been relatively stable for several months prior to the devaluation, began to rise in the third quarter of 1954 and in the following months, with the result that the index for 1955 as a whole showed an 11 per cent increase over that for 1954. A second advance of 12 per cent occurred in the period from the fourth quarter of 1955 to the second quarter of 1956. Since then the index has advanced more slowly.

The Federal Government budget registered a surplus of 543 million pesos in 1955 compared with a deficit of 711 billion pesos in 1954. In 1956 the surplus was about half as large as in 1955, and in 1957 there was a slight deficit. A fair-sized deficit is expected for 1958.

The devaluation and monetary expansion stemming from high foreign exchange receipts influenced domestic prices, with the result that wholesale prices rose 26 per cent in the two years ending in April 1956. During 1955 the cost of living index registered its greatest increase. Both price indexes declined during 1956 but began a renewed, gradual rise in the spring of 1957 which has continued to date.

In the post-devaluation period, gross national product, money supply and over-all bank credit registered their biggest increases in 1955 and since then have been increasing at a slower rate. The effect of the above developments on the money supply during 1954-57 is illustrated in Table 2.

Table 2

Variation in the Circulating Medium by Origin
(In millions of pesos)

	1954	1955	1956	1957
A. Credit expansion	2,461.3	1,137.3	1,986.2	1,781.1
B. Increase in time and other long-term deposits	-1,613.1	-912.6	-846.3	-1,668.7
C. External origin	-482.0	2,539.5	746.9	-207.4
D. Purchase of securities	980.0	-106.1	152.6	1,027.8
1. Government	508.5	-4.4	-34.9	660.5
2. Private	471.5	-101.7	187.5	367.3
E. Other items	-293.5	-866.5	-862.5	-131.6
Net Increase in Money Supply	1,052.7	1,791.6	1,176.9	801.2

During the four-year period considered above, money supply continued to expand significantly each year, but the influence of the balance of payments situation and federal budget varied between being expansionary or contractionary. Bank credit remained expansionary each year but was counteracted partly by increases in time and other long-term deposits. Both the national and private banks contributed to this credit expansion. During 1953-54, the national banks expanded credit in much greater volume than private banks; however, in 1955-56, this situation was reversed, and in 1957 both expanded credit in approximately the same volume. During 1955 and 1956, factors of "External Origin" turned expansionary, reflecting a surplus in the balance of payments. On the other hand, the contractionary influences of the Federal Government's budget surpluses during the same period are reflected in a small net reduction in holdings of government securities. During 1957, the contractionary influence of the balance of payments was more than offset by the expansionary effect of a large increase in the holdings of government securities.

On the whole, the expansion in the circulating medium has been greater than warranted by the increase in real output. The result has been a substantial increase in domestic prices. Nevertheless, the post-devaluation inflation would have been even more serious had not the central bank taken various steps to restrain inflation. Probably one of the most significant anti-inflationary weapons employed by the monetary authorities just after the devaluation was the seizure of revaluation profits cited earlier. Another post-devaluation monetary action taken in January of 1955 was the imposition of marginal reserve requirements for associated banks as indicated in Table 1. These requirements undoubtedly restrained secondary expansion somewhat; however, they were far short of the contractionary influence exercised by the budget surplus of 543 million pesos, which incidentally was due not to higher tax rates but merely to increased domestic economic activity (leading to higher receipts) as a result of the devaluation and a high rate of activity in external markets. For the majority of the deposit liabilities, as indicated in Table 1, the cash requirement of 30 per cent was not altered and specified security requirements were increased only 15 percentage points, or from 40 to 55 per cent. The next set of changes in reserve requirements in mid-1957, as listed in Table 1, were really not intended to be anti-inflationary. If anything, there was probably an easing of credit conditions. The chief aims of the mid-1957 changes were to permit improved commercial bank earnings and to simplify the legal reserve requirements system. The Bank of Mexico also hoped that the step would stimulate the purchase of industrial securities. In short, the only active monetary measures of any anti-inflationary significance following the devaluation were the seizurè of revaluation profits and the imposition of marginal reserve requirements in January of 1955. On the passive side inflation was also restrained by the central bank's reluctance to extend commercial bank rediscounts.

Bank of Mexico intervention in the security market during the period under observation aggravated the inflationary pressures except in 1955-56 when the Bank reduced its holdings of both governmental and private securities. In 1954, for example, when the circulating medium increased 1,053 million pesos, the Bank increased its holdings of government securities by 558 million pesos. In 1957, when the money supply increased 801 million pesos, the Bank added 286 million pesos in government securities to its portfolio. Hence, the Bank's operations in the security market, except during periods of significant budget surplus, have been inflationary rather than anti-inflationary. This intervention in the market coincides with the fourth general aim of monetary policy stated earlier. The Bank of Mexico tends to justify its inflationary intervention as mandatory if there is to be any significant development of the Mexican securities market, and also, as indicated earlier, if commercial banks are to be freed from the danger of a decrease in the capital value of their security reserves. It therefore appears unlikely that open market operations could be utilized by the Bank of Mexico in the near future as an effective tool of monetary policy.

From the foregoing, one is led to the conclusion that Mexican monetary policy since 1954 has contributed somewhat to general monetary stability, but that the deficits or surpluses in the federal budget or balance of payments have exerted even stronger inflationary or anti-inflationary pressures. The main monetary weapons have been the limited availability of central bank rediscounts and changes in commercial bank reserve requirements with the latter weapon being more or less effective only with regard to restraining secondary expansion. The seizure of revaluation profits is merely a one-time weapon and hence is not available on a continuing basis. It therefore appears that a large share of the responsibility for maintaining internal monetary stability falls on the Federal Government, with budget surpluses being almost a necessity when significant surpluses occur in the balance of payments.

External and other factors in Mexico's economic outlook

The outlook for the Mexican economy is one of continued growth, but probably at a slower rate than in 1955-56. It is likely that inflationary pressures will continue to be prevalent, particularly in view of recent federal budget deficit operations. These inflationary pressures will mean a continuing responsibility for an intelligent monetary and especially fiscal policy if another devaluation in the near future is to be avoided.

The price indexes shown in Table 3 below indicate that from the viewpoint of relative prices between Mexico and the United States, not all of the price benefits from the 1954 devaluation have been eliminated. In April of 1954 as a result of the devaluation the value of the dollar in terms of Mexican prices rose by 44.5 per cent. In the four years since the devaluation, United States' prices increased approximately 8 per cent; for the same period, Mexican prices rose about 45 per cent. Thus the net increase in Mexican prices of 37 per cent is still 7.5 per cent below the rise in the value of the dollar. While this analysis suggests a more precise determination than is really possible, the general conclusions are nevertheless probably correct.

Table 3

Relation of Mexican and United States' Prices
(April, 1954=100)

Date	Index of workers' cost of living in Mexico Cty.	U.S. consumer price index	Index of cost of food in Mexico	Food component of U.S. Consumer price index	Index of whlsle prices in Mexico Cty.	U.S. whlsle price index
April 1954	100.0	100.0	100.0	100.0	100.0	100.0
April 1955	117.5	99.7	119.2	98.9	119.0	99.5
April 1956	129.0	100.3	125.9	97.5	131.6	102.3
April 1957	129.6	104.1	129.2	101.2	131.7	105.6
April 1958	148.5	107.8	142.8	108.2	144.1	107.5

While the general economy continues to advance, particularly in view of higher agricultural output in 1958, prices have been increasing at a rate of about 10-12 per cent a year. Largely because of these inflationary aspects, capital flight occurred early in the year and during the first five months of the year, international reserves dropped $83 million compared with $50 million for the same period in 1957. Lately there has been a trend for imports to rise more than exports and increasing tourist receipts have not offset this imbalance. On September 1, 1958, the Bank of Mexico's international reserves were $386 million compared to $430 million the year before.

A heavy drain in reserves, of course, could exert strong pressure for another devaluation. However, if reasonable internal price stability can be maintained, Mexico would have a stronger case for utilizing the foreign exchange facilities provided through the International Monetary Fund and the Stabilization Agreement with the United States in order to defend the current exchange rate.

Looking at the more favorable factors, Mexican exports are now sufficiently diversified so that occasional slumps in world market prices are not likely to affect seriously total export earnings. In addition, domestic and foreign investment has been continuing at a high rate, which augurs well for the continuation of a rapid rate of economic growth. Investment has been aided by an increasing rate of internal saving; thus in 1955, 1956, and 1957, private credit institutions had increases of 20, 24, and 28 per cent, respectively, in their time obligations which at the end of August 1958 composed 41 per cent of total liabilities.

From the above, it is evident that for economic stability, Mexico's basic need is a balanced budget and a tight money policy. Both would then aid in maintaining equilibrium in the balance of payments. If credit continues to expand at a significantly higher rate than real economic output, the inevitable consequence will probably be another devaluation.