

L. 5. 2

RFD 557

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 26, 1965

Mexico's Economic and Financial Record

26 pages

Yves Maroni

This paper reflects the personal opinion of the author and must not be interpreted as representing the opinion of the Board of Governors. It was prepared primarily for internal circulation within the Federal Reserve System, and must not be cited, quoted, or reprinted without permission.

Mexico's Economic and Financial RecordSummary

In the post war years, Mexico has experienced rapid growth with increasing financial stability. The growth has been well distributed throughout the economy and has involved the development of a solid infrastructure and of varied industrial activities, including basic industries, without neglecting agriculture and the exploitation of natural resources. Industrialization has relied on protectionist policies, and enterprises often have high costs. But many of the new firms have proved willing and able to compete abroad. The result has been a marked diversification of Mexico's exports, the rapid rise of new exports and the relative decline of the traditional ones.

This very satisfactory growth record has been accompanied by increasingly stable price conditions, especially after 1958, and the peso has remained stable for the last eleven years. This performance owes much to the careful management of the country's finances. The budget deficits have not been excessive and within the capability of the Bank of Mexico to cushion or limit their monetary effects. The Bank has also had a respectable degree of success in keeping the expansion of credit to the private sector within limits consistent with the country's savings, augmented by funds made available by foreigners. Credit to the private sector has tended increasingly to be based on additions to bank liabilities not payable on demand, including funds borrowed abroad. However, the growing reliance on foreign funds carries with it an element of potential instability.

These policies have been instrumental in holding the growth of imports generally within the limits set by available foreign resources.

The trade deficit has grown over the years, but so has the net inflow of long term funds from abroad, much of it associated with capital goods imports. In particular, U. S. banking claims on Mexico have risen sharply in the last two years and now exceed \$1 billion. International reserves have fluctuated around an upward trend. At the end of 1964, they were at an all time high, even though, in recent years, Mexico has purchased all of the electric power companies from their foreign owners and redeemed in advance a substantial foreign debt dating back many years.

This internal and external performance, augmented by a long record of political stability, has made it possible for Mexico to begin floating securities in the private financial market in New York. However, the rise in foreign borrowings, involving a tripling of the external public debt since 1957, brought the debt service payments in 1964 to more than 20 per cent of gross current foreign exchange earnings.

In 1964, Mexico's economic expansion reached boom proportions, and upward price pressures emerged. There was an upsurge of imports (mainly of capital goods) and of net long term borrowings abroad (mainly to finance these imports). Reserves rose substantially less than in 1963. The banking system was highly liquid during the year, in spite of heavy demands for public and private financing, and interest rates eased. The Bank of Mexico intensified its operations to mop up excess liquidity.

Economic expansion is continuing in 1965 but at a somewhat slower rate than last year. Public spending on new projects was held down in the first half to avoid inflationary injections of liquidity in the economy and upward price pressures diminished. The external position weakened somewhat due mainly to a widening of the trade deficit, higher debt service payments, and a reduced rate of new public borrowings abroad.

Mexico's growth record

In the post war years, Mexico has experienced rapid growth with few interruptions and with increasing financial stability. Since 1950, gross national product in real terms has risen at an average rate of about 6 per cent a year, and total gross fixed investment (excluding additions to inventories) has risen from less than 12 per cent of gross national product to about 16.4 per cent last year. A recession took place in 1953, another in 1959, and a third in 1961. But, in six of the last fourteen years, the annual rate of growth of real GNP has exceeded 7 per cent (see table 1). With population growing at about 3.3 per cent a year, per capita GNP has increased at an average annual rate of about 2.7 per cent, exceeding the 2.5 per cent target fixed in the Alliance for Progress Charter.

Table 1

Mexico - Output Indicators  
Annual Rates of Change

	<u>GNP</u> <u>(1950 prices)</u>	<u>Index of</u> <u>Industrial</u> <u>Production</u>	<u>Index of</u> <u>Agricultural</u> <u>Production</u>
1951	+ 7.5	+ 9.0	+ 5.0
1952	+ 4.0	+ 6.1	- 3.7
1953	+ .6	- 1.4	+11.2
1954	+10.5	+ 7.9	+19.5
1955	+ 8.7	+10.3	+ 9.2
1956	+ 6.3	+10.5	- 2.4
1957	+ 7.7	+ 7.3	+13.7
1958	+ 5.5	+ 4.5	+ 9.8
1959	+ 2.9	+ 8.1	- 6.3
1960	+ 7.9	+ 8.5	+ 2.5
1961	+ 3.5	+ 3.7	+ 2.9
1962	+ 4.8	+ 5.1	+10.0
1963	+ 6.3	+ 9.2	+ 2.1
1964	+10.0	+12.9	+ 7.5

Source: Bank of Mexico, Annual Reports; Nacional Financiera, Annual Reports.

In 1963, about 24 per cent of the gross domestic product originated in manufacturing (up from 20 per cent in 1950), another 10 per cent in extractive industries, construction, and electricity production (unchanged from 1950), about 18 per cent in agriculture and related activities (down from 23 per cent in 1950), about 30 per cent in commerce, transportation and communications (down from 31 per cent in 1950), and about 18 per cent in other activities (up from 16 per cent in 1950), including about 3 per cent in government activities in both years.

At the end of 1963, total employment was estimated at about 12.6 million persons, from a population of about 39 million. About 53 per cent of this employment was in agriculture, and about 20 per cent in manufacturing, construction and the extractive industries. Since the 53 per cent employed in agriculture produced only 18 per cent of the gross domestic product in 1963, it is clear that overall productivity in agriculture is very low compared with the other sectors of the economy.

Industrial production was two and a third times as high in 1963 as in 1950, and agricultural production was nearly twice as high. About 7.4 million acres (20 per cent of the cultivated area) were under irrigation in 1963, up from 372,000 acres in 1934. The road network was 13 times longer and the number of vehicles in use 9 times larger. Petroleum production, at 126 million barrels in 1963, was entirely consumed in Mexico, in contrast with 1934 production of only 38 million barrels, only 20 per cent of which was consumed in Mexico. Installed electric capacity was about 5.5 million kilowatts at the end of last year, four and a half times as much as in 1950.

Installed steel capacity last year was about 2.5 million tons, and steel output was about 2.3 million tons, enough to supply the country's requirements for principal steel products other than rails and certain speciality steels. Cement production was more than two and a half times as large in 1963 as in 1950. Production of basic chemicals and fertilizers and of paper and paper products was rising very rapidly. The automotive industry produced about 75,000 vehicles in 1963, mainly through assembly operations.

Among the mineral products, output of iron ore, manganese, and sulphur showed the most rapid growth from 1950 to 1963, and coal production was up very substantially. But production of the more traditional Mexican minerals was down substantially (lead, copper, gold and silver) or at best little changed (zinc). In agriculture, wheat production tripled from 1950 to 1963, and output of beans did nearly as well. Production of corn, cotton, coffee and sugar cane doubled, while rice output rose 75 per cent from 1950 to 1960 only to fall back about 20 per cent in the next three years. Meat and livestock production also rose substantially.

Mexico's industrialization has been stimulated by tax and other incentives and access to credit from Government banks. It has also relied to an important extent on protective policies, administered mainly through restricted import licensing and outright import prohibitions. Protection is counted on to foster further industrialization, including the growth of a domestic automotive industry. In 1963, about three fourths (by value) of the components of the vehicles assembled in Mexico were imported, but the Government's objective is that domestic components,

including complete engines, should amount to 60 per cent of the value of each vehicle. The administrative curtailment of imports to achieve this goal has already begun.

While this policy has led to the development of enterprises whose costs of production are often higher than those of competing imports, many lines of industrial activity have proved to be competitive, and have been able to develop export markets. In 1963, manufactured goods accounted for about 20 per cent of Mexico's exports, twice as large a share as in 1957. These consisted mainly of chemicals, refined sugar and other edible products, henequen yarn and other textiles, and a variety of other manufactures. The diversification of Mexico's exports shows up also in the growth of such exports as tomatoes, meat and livestock, fish, and sulphur. These products and the manufactured goods already mentioned jointly accounted for 39 per cent of total exports in 1963, up from 21 per cent ten years before. The traditional exports (cotton, coffee, and non-ferrous metals) have correspondingly lost ground, and together accounted for less than 35 per cent of total exports in 1963, compared to 60 per cent ten years before.

Nevertheless, Mexico's exports remain predominantly agricultural, mineral and maritime. In 1964, cotton alone still accounted for a sixth of the total, and eight other primary products accounted for a further 35 per cent.

In 1964, Mexico ranked fifth as a market for U.S. exports, with purchases slightly in excess of \$1 billion. Mexican purchases from the U.S. accounted for more than two thirds of its total imports. Mexico also shipped more than two thirds of its exports to the U.S.

Mexico's domestic financial record

This very satisfactory growth record has been accompanied by increasingly stable price conditions (see table 2). Both the wholesale price index and the cost of living index, which rose at an average annual rate of around 10 per cent between December 1950 and December 1958, levelled off to an average increase of less than 2 per cent a year in following years. Wages, which normally undergo large readjustments every two years when the minimum wage is raised, showed smaller increases in each succeeding two-year period until 1962, but a larger one in 1963-64. The inflation of the forties and early fifties forced devaluations of the peso in 1948, 1949, and 1954. The 1954 devaluation appears to have more than offset any currency overvaluation which may have existed at that time. Ensuing price increases have probably compensated for the modest undervaluation then resulting, but have not yet gone far enough to endanger the stability of the peso exchange rate. At no time has Mexico employed exchange controls, and the peso has remained fully convertible. Mexico is an original adherent to Article VIII status under the Articles of Agreement of the International Monetary Fund, having accepted the obligations of Article VIII on October 12, 1946.

The successful performance of the Mexican economy in the last ten years owes much to the careful management of the country's finances. The Government's budget deficit and the expansion of credit to the private sector have generally been held within limits consistent with the growth of the country's savings and of the resources available from abroad. Except in one year (1961), the deficit has consistently been less than 1 per cent of GNP (see table 3). At the same time, the Bank of Mexico

Table 2

Mexico--Price Indices

Annual Rates of Change

	<u>Index of Wholesale Prices <u>1/</u></u>	<u>Index of the Cost of Living <u>1/</u></u>	<u>Index of Wages <u>2/</u></u>
1951	+17.9	+19.2	<u>3/</u>
1952	- 1.5	+ 8.1	<u>3/</u>
1953	+ 1.5	- 6.0	<u>3/</u>
1954	+15.2	+12.7	<u>3/</u>
1955	+17.1	+16.9	+16.2
1956	+ 2.2	- 2.4	+ 4.6
1957	+ 5.5	+13.6	+11.1
1958	+ 4.2	+ 8.6	+ 4.0
1959	0	0	+13.5
1960	+ 6.0	+ 8.0	+ 8.5
1961	0	- 2.8	+ 6.3
1962	+ 1.9	+ 2.9	+ 7.4
1963	+ 0.9	0	+18.5
1964	+ 5.5	+ 3.6	+ 9.8
1965	+ 0.9 <u>4/</u>	+ 3.5 <u>4/</u>	+ 1.1 <u>5/</u>

- 
- 1/ December data.  
2/ Fourth quarter data.  
3/ Not available.  
4/ First half year only.  
5/ First four months only.

Sources: Bank of Mexico, Annual Reports. IMF, International  
Financial Statistics.

has judiciously conducted its monetary policy so as to cushion or limit its monetary impact, while encouraging the commercial banks, by means of a rather elaborate selective credit regulation, to channel their lending into productive activities and other desirable investments. When an undue proportion of the country's financial resources began to be channelled through specialized private financing institutions known as "financieras," the authorities moved promptly to regulate them.

Table 3

Mexico - Federal Government Operations  
(in millions of pesos)

	<u>Receipts</u>	<u>Expenditures</u>	<u>Deficit</u>	<u>Deficit as % of GNP</u>
1958	8,802	9,677	- 875	.69
1959	9,204	10,127	- 923	.68
1960	10,967	12,144	- 1,177	.76
1961	11,236	12,929	- 1,693	1.03
1962	12,830	14,413	- 1,583	.89
1963	14,556	16,218	- 1,662	.86
1964	17,056	18,777	- 1,721	.77

---

Source: Bank of Mexico, Annual Reports.

The Government's deficit has been due in part to the need to cover the deficits of certain state enterprises. But, since the late fifties, progress has been made toward placing some of these enterprises on a paying basis. This is particularly true of PEMEX (the State Petroleum Agency) and the Federal Electricity Commission. Deficits remain in the railroads and in the foodgrain support agency (CONASUPO). The railroads have relatively low freight rates but cannot easily correct the situation because of the low costs and convenience of competing motor carriers. CONASUPO is buying wheat and corn at fixed prices and reselling

these commodities at lower prices in the domestic market. In addition to the deficits of the state enterprises, the Federal Government has faced growing expenditures of its own, mainly in the areas of education, social security benefits, electric power development, irrigation, and general administration.

Revenues, on the whole, have kept pace with expenditures over the last seven years. The 1961 recession slowed their growth and the deficit that year reached 13 per cent of total expenditures. But the ensuing recovery and expansion brought them back gradually to virtually the same position relative to expenditures as in the late fifties. The heavy dependence on customs duties, especially export taxes which were imposed at the time of the 1954 devaluation, has greatly diminished. Export taxes have been substantially reduced, and import duties have not changed much following substantial increases in the late fifties. At the same time, income taxes have been raised. Since 1959, the share of income taxes in total Government revenues has increased from 30 to 43 per cent, while that of import and export taxes has fallen from 29 to 17 per cent.

The budget deficits have been financed in the first instance by the Bank of Mexico. However, in recent years, the Bank of Mexico has been able to place growing amounts of official securities in the hands of private banks and other institutions. It has done so by means of the legal reserves requirements under which the banks must hold specified percentages of their deposits in the form of official securities.<sup>1/</sup> But it has also been able, in recent years, to transfer moderate amounts of these securities to non-bank institutions. At the end of 1963, the private credit

<sup>1/</sup> Including bonds issued by the Government banks, autonomous agencies and public enterprises.

institutions held about 44 per cent of the total central government internal debt, compared to only about 10 per cent in 1954. In 1963, for the first time, the private banks absorbed a larger amount of official securities than was needed to finance the deficit. In that year, and again in 1964, the need for domestic financing was lessened when the Government resorted to foreign borrowing, floating three bond issues for a total of \$100 million in the New York market. These were the first such issues in over 50 years. The proceeds of these bonds were to be used to cover foreign exchange costs of development projects and to refund foreign debts incurred for similar purposes.

Total credit to the private sector grew rapidly in the last fifteen years and with little let up (see table 4). However, it tended increasingly to be based on additions to bank liabilities not payable on demand. Lending by the deposit and savings banks rose at an average annual rate of about 16 per cent in the first six years of the fifties, but at only about half that rate in the period 1957-63. This slow down was accompanied by a marked stepping up of the expansion of the private "financieras." These institutions, which originated in the thirties as development banks set up by groups of industrialists to finance their investment needs, tended increasingly to become associated with the private banks, to attract shorter term funds through the sale of three, six and nine month notes, and to make not only medium and long term loans but also short term loans. Their lending grew quite rapidly until 1960, when the Bank of Mexico imposed a limit on the rate at which they might increase their short term obligations. While this sharply cut the rate of growth of their lending, it left ample room for further expansion, mainly with resources attracted on a longer term

Table 4

Mexico - Selected Money and Banking Data  
(year end data)

	Credit to the private Sector <u>1/</u>		Liabilities not payable on demand <u>1/</u>		Col. 3 as per cent of Col. 1	Money Supply (seasonally adjusted)	
	billion pesos ( 1 )	Per cent Increase ( 2 )	billion pesos ( 3 )	Per cent Increase ( 4 )	( 5 )	billion pesos ( 6 )	Per cen Increas ( 7 )
1950	6.62	18.2	4.55	20.7	68.7	6.01	35.7
1951	8.27	24.9	5.94	30.5	71.8	6.73	12.0
1952	8.99	8.7	6.75	13.6	75.1	6.98	3.7
1953	10.09	12.2	7.53	11.6	74.6	7.72	10.6
1954	13.68	35.6	10.21	35.6	74.6	8.62	11.7
1955	14.27	4.3	11.09	8.6	77.7	10.29	19.4
1956	16.39	14.9	11.96	7.8	73.0	11.37	10.5
1957	18.52	13.0	14.14	18.2	76.3	12.15	6.9
1958	21.20	14.5	16.68	18.0	78.7	13.03	7.2
1959	26.39	24.5	19.05	14.2	72.2	15.04	15.4
1960	33.60	27.3	25.12	31.9	74.8	16.40	9.0
1961	39.44	17.4	30.49	21.4	77.3	17.43	6.3
1962	46.75	18.5	35.20	15.4	75.3	19.65	12.7
1963	51.52	10.2	41.59	18.2	80.7	22.78	15.9
1964	60.50	17.4	50.49	21.4	83.4	26.77	17.5
1965 <u>2/</u>	64.01	19.2 <u>3/</u>	55.90	25.1 <u>3/</u>	87.3	27.42	11.0 <u>3/</u>

1/ Deposit and savings banks, private financieras and Government banks.

2/ May.

3/ Increase from 12 months earlier.

Source: IMF, International Financial Statistics.

basis. In addition, in the last five years, there was a substantial acceleration in lending to the private sector by specialized Government banks which were able to attract an increasingly large supply of funds from abroad.

The growing reliance on foreign funds carries with it an element of potential instability. Should the flow of such funds to Mexico decline or be reversed, the banking system would have to adjust its lending activities correspondingly or face the consequences of increased inflationary pressures.

#### Mexico's external financial performance

Mexico's financial policies of the last ten years have been instrumental in holding the growth of imports within the limits set by the rise in foreign exchange earnings from exports, tourist receipts and other factors and by the inflow of capital from abroad. Mexican imports were about 85 per cent higher in 1964 than in 1953, while exports were 79 per cent higher. The trade deficit which was negligible in 1950, reached a peak of \$216 million in 1953, followed by a low of about \$100 million in 1955, in the aftermath of the 1954 devaluation (see table 5). Since then its fluctuations have been in a higher range. It reached peaks in excess of \$420 million on three occasions (1957, 1960 and 1964), and intervening troughs at about the level of the 1953 peak (in 1959 and in 1962).

The larger trade deficits (on the average) of the post-devaluation era have been accompanied by a marked rise in net receipts from tourism and border trade, from less than \$150 million in 1950 to about \$325 million in 1964. But there has also been an almost equivalent

Table 5

Mexico--Trade and Long-term Capital  
(in millions of U. S. dollars)

	<u>Exports</u>	<u>Imports</u>	<u>Trade Balance</u>	<u>Net long- term capital</u>
1950	532	556	- 24	+ 83.7
1951	644	822	-178	+117.5
1952	653	807	-154	+ 77.1
1953	591	807	-216	+ 37.3
1954	664	800	-136	+126.7
1955	785	885	-100	+135.7
1956	834	1,072	-238	+153.1
1957	734	1,155	-421	+191.8
1958	736	1,129	-393	+191.5
1959	753	1,007	-254	+141.7
1960	764	1,186	-422	+120.1
1961	826	1,139	-313	+285.5
1962	930	1,143	-213	+260.9
1963	985	1,240	-255	+301.4
1964	1,055	1,493	-438	+503.6
1965 <u>1/</u>	1,050	1,560	-510	n. a.

1/ Annual rate for first five months.

Sources: Bank of Mexico, Annual Reports. IMF, International Financial Statistics, and Balance of Payments Yearbook.

increase in interest payments and profits remittances abroad, reflecting a growing inflow of long term funds, both as direct investment and in the form of loans to the Government and its official banks. This inflow, which was around \$100 million a year (net) in the early fifties, exceeded \$300 million for the first time in 1963 and reached \$500 million last year. Much of it is associated with imports of capital goods which have consistently accounted for 45-48 per cent of total imports in the last ten years. The net inflow of long term funds has gradually increased as a percentage of total imports, from about 12 per cent in the early fifties to about 25 per cent in 1963, and about 33 per cent last year.

The memories of past devaluations have left their mark and, the Mexican public has occasionally had less than full confidence in the continued stability of the peso. Such was the case in 1958, and again in 1961-62, when short term capital outflows were triggered, in the first case by the uncertainties connected with a presidential election and fears of excessive Government spending, and in the second case by doubts as to the Government's attitude toward private enterprise and toward the Castro regime in Cuba. In both cases, the movement was reversed by Government actions which proved these fears to be unfounded.

Mexico's gold and foreign exchange reserves, which stood at less than \$80 million at the end of 1948, rose to nearly \$300 million during the Korean boom, but fell back near \$200 million at the time of the 1954 devaluation (see table 6). In the aftermath of devaluation, they rose to almost \$500 million at the end of 1956, but fell back below \$400 million two years later when a recession in exports, an upsurge in

Table 6

Mexico - International Reserves  
(in millions of dollars)

	<u>Gold</u> <u>Holdings</u>	<u>Foreign</u> <u>Exchange</u> <u>Reserves</u>	<u>Total</u>	<u>Change</u> <u>during</u> <u>Year</u>
	<u>at end of year</u>			
1950	208	89	297	+171
1951	208	66	274	- 23
1952	144	115	259	- 15
1953	158	69	227	- 32
1954	62	147	209	- 18
1955	142	276	418	+209
1956	167	322	489	+ 71
1957	180	273	453	- 36
1958	143	229	372	- 81
1959	142	271	413	+ 41
1960	136	256	393	- 20
1961	112	299	411	+ 18
1962	95	280	375	- 36
1963	139	358	497	+122
1964	169	369	538	+ 41
1965 <u>1/</u>	167	297	464	- 74

Source: International Monetary Fund, International Financial Statistics.

1/ May.

imports and the 1958 outflow of short term capital combined to create an adverse situation. Early in 1959, Mexico drew on the IMF, and took steps to restrain total effective demand so as to bring down imports. The situation improved rapidly as imports fell 11 per cent and the capital outflow ceased, and Mexico repaid the IMF drawing in six months.

In 1960, the trade deficit widened again, but net invisible earnings and capital movements held the decline in reserves to a very small amount even though, in that year, Mexico redeemed in advance a substantial foreign debt dating back many years and purchased all of the electric power companies from their foreign owners. The power company purchase required cash payments of \$57 million. However, in the same year, Mexico received a \$100 million loan from the Prudential Insurance Company of America.

Reserves declined slightly further in 1961 and 1962, even though the trade deficit narrowed substantially. This appears to have been due primarily to an outflow of short term capital. In the summer of 1961, Mexico again drew on the IMF, repaying about a year later. However, in the last two years, with confidence returning and the acceleration of the capital inflow more than offsetting the worsening of the trade deficit, reserves rose sharply, approaching \$540 million (an all time high) at the end of last year. At this level, reserves were equivalent to slightly more than four months' imports (at the 1964 rate). Reserves may be levelling off in 1965, or perhaps turning down, judging from the decline experienced in the first five months, which is partly of a seasonal nature.

Mexico has taken part of its reserve gains of the last two years in the form of gold (see table 6). In 1963, it added \$44 million

to its gold reserves and \$78 million to its foreign exchange holdings. In 1964, it added another \$30 million to its gold reserves, but only about \$11 million to its foreign exchange holdings. The proportion of Mexico's reserves held in gold at the end of last year was less than 32 per cent, well below the two previous peaks of 75 per cent at the end of 1951 and about 40 per cent at the end of 1957. At the end of May 1965, with total reserves off from their peak, the ratio was 36 per cent.

The growing strength of the Mexican position has enabled the Mexican Government to float three 15-year bond issues in the New York market, at gradually declining yields. The first issue, in July 1963, for \$25 million of 6-3/4 per cent sinking fund bonds, was priced to yield 7 per cent. The second issue, in April 1964, for a similar amount of 6-1/2 per cent bonds, was priced to yield 6.75 per cent. The third issue, in November 1964, for \$35 million of 6-1/4 per cent bonds, was priced to yield 6.43 per cent. In addition to these issues, in July 1963, the Mexican Government floated in New York \$15 million of 6 per cent serial bonds due, \$5 million each, in 1966, 1967 and 1968.

At the same time, there has also been a substantial growth of U. S. banking claims on Mexico (see table 7). In the last two years, these claims rose by \$460 million, (or by 80 per cent), about six times as much as in the two preceding years. The rise was about evenly divided between long term and short term claims. At the end of 1964, the total of these claims was \$1,083 million, about 60 per cent of which was in short term claims. On that date, our short term banking claims on Mexico were exceeded only by those on Japan and Canada, while our long term banking claims on Mexico were higher than those on any other country. In 1965,

the increase slowed somewhat from last year's exceptional rate, partly because the Mexican authorities undertook to slow down the pace of public borrowings abroad. It is possible also that some U. S. banks sold some of their claims on Mexico to their European branches or to Canadian banks as part of their efforts to comply with the voluntary foreign credit restraint program.

Table 7

Claims on Mexico Reported by Banks  
in the U.S. at End of Selected Years  
(in millions of dollars)

	<u>Short-term Claims</u>	<u>Long-term Claims</u>	<u>Total</u>
December 1958	293	107	400
December 1959	291	175	466
December 1960	343	182	525
December 1961	425	171	596
December 1962	408	195	603
December 1963	465	322	787
December 1964	630	453	1,083
June 1965	692	480	1,172

Sources: Federal Reserve Bulletin, U. S. Treasury Bulletin.

The total external public debt of Mexico outstanding at the end of last year may be estimated at in excess of \$1.7 billion, more than three times as much as at the end of 1957. In 1964, service on this debt (interest and amortization) amounted to about \$370 million, more than 20 per cent of the country's gross earnings from exports, tourism and border transactions. In recent years, while the total external debt has risen substantially, its average maturity has been lengthened markedly, helping to keep the debt service ratio from rising to even higher levels. However, in 1964, there was a substantial rise

in debts of one to five years, and this trend was interrupted. Mexico may be expected to continue borrowing large amounts abroad, in part through public security issues. The rate of new borrowings may be somewhat less than in 1964, but in any event, the annual debt service payments are likely to continue to increase. This growing dependence on foreign borrowings is not without its dangers, especially if exports and other current earnings fail to grow at a sufficiently rapid rate.

The importance of expanding exports is well recognized by the new Secretary of Industry and Commerce, who, in a speech in January, coupled an endorsement of the policy of import substitution with a strong appeal to industrialists to become competitive and seek foreign sales "or to be obliged to make way for more dynamic producers." He warned that protective policies could not be continued indefinitely and urged industrialists to "turn their eyes to the limitless opportunities which the competitive exportation of articles of good quality and price affords." He offered to help businessmen identify and attack the factors leading to high cost low quality production.

#### Recent developments

In 1964, Mexico's economic expansion reached boom proportions. Real GNP reportedly was about 10 per cent higher than in 1963, the highest annual increase since the devaluation year of 1954, and well above the 6.3 per cent increase from 1962 to 1963. This acceleration of the rate of growth, occurring as it did in an election year, was due mainly to two factors. First, the rate of public investment spending was stepped up as the outgoing administration

undertook to complete as many as possible of the projects which it had started. Second, the private sector showed an unusual amount of confidence in response to statements by the new President of Mexico during the campaign indicating his support of private enterprise and a businesslike approach to government. Whereas private investment spending customarily declines in the last year of a presidential term because of uncertainties over what the successor may do, in this instance it rose further. In addition, Mexico enjoyed very good crops, foreign demand for its exports and its tourist facilities kept on rising, and domestic consumption spurted, partly in response to substantial increases in wages, including a large increase in minimum wages as of January 1, 1964.

The boom was accompanied by the emergence of upward price pressures. Last December, wholesale prices were up more than 5 per cent above a year earlier, while the cost of living was up nearly 4 per cent. Both indexes showed virtually no change in the previous twelve months. Part of the rise was concentrated in January-February 1964, and reflected to some extent the above mentioned wage increases. While the trend subsequently levelled off, it turned up again in the second half of last year.

The high level of investment was accompanied by an upsurge of imports which rose 20 per cent above the 1963 level. The bulk of this increase was accounted for by capital goods (up 31 per cent) and raw materials (up 17 per cent). Imports of consumer goods rose less than 3 per cent. Since exports rose only 7 per cent, the trade

deficit widened to \$440 million, up from \$255 million in 1963. Remittances of income from direct foreign investments rose nearly one third, more than offsetting the moderate increase in net receipts from other services. The payments deficit on current account exceeded \$400 million, double that of 1963.

The worsening of the current account deficit was more than offset by an improvement on capital account. Net long term borrowings abroad, mainly to finance capital goods imports, yielded about \$170 million more in 1964 than in 1963, while direct private foreign investment was \$34 million larger. There was also a moderate inflow of short term capital, in contrast with a modest outflow in 1963. However, errors and omissions, a positive item in 1963, turned negative last year. There was an increase in official reserves of about \$40 million, but this was down from the \$123 million increase recorded in 1963. The ratio of debt service payments to current foreign exchange earnings was markedly higher last year than in 1963 as a result of a large increase in debt amortization.

The public sector deficit last year was roughly of the same order of magnitude as in 1963, and amounted to about 3/4 of 1 per cent of GNP. The Bank of Mexico increased its financing of the public sector, but was able to increase its sales of official securities to the banks and other institutions. The latter found their liquidity bolstered not only by the primary effects of Bank of Mexico financing of the government deficit, but also by the inflow of foreign funds and by the growing confidence of the public in the banking system. The commercial banks, private financieras, and

Government banks, were able to increase credit to the private sector by more than 17 per cent (up from 10 per cent in 1963), partly on the basis of resources borrowed from abroad. Their quasi-monetary liabilities rose more than 21 per cent, while money supply, seasonally adjusted, rose 17.5 per cent. In spite of the heavy demands for financing by both the public and the private sectors, the supply of funds to the banking system was such as to place some downward pressure on interest rates for the second year in succession.

With the signs pointing to an overheating of the economy, the new Mexican administration took steps, early this year, to hold down spending on new projects to avoid excessive injections of liquidity in the economy while obligations left by the previous administration were settled. In these circumstances, over-all output continued to expand this year, but at a slower rate than last year. In his annual report to the Mexican Congress, on September 1, 1965, the new President said that the country's GNP in real terms appeared to have increased at an annual rate of nearly 6 per cent in the first half of the year.

The rate of growth achieved in the first half owes much to private investment which remained buoyant. In part, this buoyancy reflected the prevailing opinion that the new President of Mexico was more sympathetically inclined toward the private sector than any of his predecessors. But in addition, businessmen had confidence that the prudent financial policies of recent years would be continued. They knew that the new President had warned before his inauguration of the dangers of inflation if expansion continued very long at the rapid rate

of 1964; they were encouraged by his decision, upon taking office, to reappoint most of the top financial officeholders of the last administration; and they saw the evidence when he began moving to preserve financial stability and external balance.

With total investment rising more slowly, and in the absence of large wage increases at the beginning of the year, the upward price pressures abated somewhat. Wholesale prices rose only about 1 per cent in the first half, compared to 5.5 per cent in all of last year. However, the cost of living index rose nearly 4 per cent, almost as much as in all of 1964.

The already large trade deficit increased further in 1965. In the first five months of the year, imports were 4.5 per cent higher and exports .5 per cent lower than in the same months last year. Receipts from tourism and border transactions probably increased, as tourist arrivals in the first half were reported about 15 per cent higher than in the same months last year. On the other hand, payments abroad on account of interest, dividends and profits are probably exceeding last year's levels. Mexico is also having to do without the earnings of the seasonal farm workers (braceros) formerly employed in the United States in the summer and fall months, as the bracero program was virtually terminated at the end of last year.

The capital account also appears to have worsened somewhat this year. In part, this reflects a Mexican decision to reduce public borrowings abroad below the high levels reached last year. At the same time, external obligations falling due were probably larger than in the comparable months of 1964.

The deterioration of the balance of payments is reflected in the fact that, at the end of May, reserves were virtually at the same level as twelve months earlier, whereas at the end of last year they were showing a \$40 million increase over December 1963. Seasonal factors normally cause a decline in reserves in the first part of the year, and the decline for the first five months of this year was steeper than in the corresponding months of last year. However, it was not alarming when compared to similar months of earlier years. On September 1, the President of Mexico, in his annual report to the Mexican Congress, said that reserves were \$553 million. This is about \$4 million more than the President reported to Congress at the same time last year.

In the first five months of 1965, the efforts of the Government to hold down public spending and the decline in foreign exchange reserves put some pressure on the liquidity of the banking system. At the end of May, money supply seasonally adjusted was only about 2.5 per cent higher than at the end of last year and 11 per cent higher than at the end of May 1964, compared to a 17.5 per cent increase in all of last year. However, the banks and the financieras had ample liquidity at year end, and this did not markedly restrict their ability to expand credit. They were able to continue attracting funds not payable on demand at a more rapid rate than they expanded credit.

The prospects for further growth at sustainable rates with a reasonable degree of price stability and external balance appear good. The readjustment from the 1964 boom has yet to be completed, but

measures to bring it about have already had significant favorable effects. Prospects for exports and tourist receipts appear favorable, subject to continued economic expansion in the United States and Europe. However, as incomes rise in Mexico, domestic demand for some of the country's exports may begin to cut into exportable supplies. A special problem arises with respect to wheat exports, which began on a large scale only last year. The domestic price support for wheat is well above world market levels and continued exports depend on the willingness of the authorities to absorb the losses involved. Last year's exports of wheat were, for the most part, ultimately purchased by mainland China.

Mexico enjoys a favorable investment climate, which foreign investors have increasingly recognized. Barring some unforeseen development, foreign investment in Mexico should continue to increase. The rate at which it increases may well be crucial. Unless exports and invisible receipts show exceptional strength, foreign investment could play a dominant role in determining whether the rising levels of imports needed for development will be obtained without excessive dependence on borrowings abroad and without undue strains on the balance of payments.