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By KJH NARA, Date 5/11/95

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE April 8, 1976

TO Files

SUBJECT: Request for \$360 million swap

FROM Scott E. Pardee

drawing by Bank of Mexico

CONFIDENTIAL

Mr. Miguel Mancera, Deputy Director General of the Bank of Mexico, called yesterday to request a drawing by the Bank of Mexico of the full \$360 million available under the swap arrangement with the Federal Reserve. He explained that Mexico had suffered a sudden heavy outflow of funds over the last few days, which had already cost \$160 million in reserves, including \$80 million on April 7 alone. More outflows could be expected through the Easter weekend.

For some time, the market had been nervous over policy possibilities in view of the forthcoming presidential election. The election will take place on July 4 and the inauguration of the new president will be on December 1. Although it is a foregone conclusion that Lic. López Portillo will win, there is genuine market concern over the policies of the Echeverría government as it moves into its final months. Devaluation rumors in particular are rife, in view of the higher rate of inflation in Mexico than in the U.S. In addition, each year prior to Easter weekend the peso is subject to speculative selling; in 1954 the peso was devalued over an

Easter weekend, and the market remembers that even today. Finally, Mancera noted a political squabble, which had developed in recent days, over a bill prepared by the government to deal with real estate interests. This has given rise to some rather personalized mud-slinging about profiteering in real estate. He naturally did not want to go into the specifics, but said that the squabble had been damaging to market sentiment at this time.

Last week, when I was in Mexico, Lic. Fernández Hurtado, Director General of the Bank of Mexico, had indicated that the trade position had improved somewhat in early 1976 and that Mexico had had a small reserve gain for the first quarter of the year. He expected some selling pressure on the peso during the Easter period but believed it manageable. He thought that the election time in July and inauguration in early December might also be difficult. Nevertheless, he expressed confidence that they could weather speculative pressure as long as the current account continued to improve. In that connection, they are banking on the economic recovery in the U.S. and elsewhere to expand exports, while Mexico will do its best to hold down imports.

In yesterday's call, Mancera said that the heavy reserve losses were a surprise. With a week and a half to go before Easter the outflows would surely continue, and for that reason the Bank of Mexico might well need to use the full

\$360 million available under the swap. Although some reflows normally develop after the Easter period, Mancera suggested that in view of the general atmosphere of uncertainty, it would be realistic to expect that they would ask for renewal after three months, with repayment within six months.

Turning to repayment prospects, he said that the Bank of Mexico believes that policies already adopted should suffice to stage an important improvement in Mexico's current account through next October. As of now, no new policy measures are planned. The process is more one of maintaining pressure within the government to avoid budgetary excesses by the outgoing administration, and the Bank is reasonably hopeful that this effort will succeed.

As backstop to the drawing, Mancera said that reserves stand at \$1,550 million, including \$118 million in gold and super gold tranche positions with the Fund and just under \$100 million of SDRs. Mexico also might have access to up to \$626 million of credit tranche drawings from the Fund (including the 45 per cent increase agreed at Jamaica) under certain conditions. In addition, although he did not specify the amount, the Bank of Mexico has not made unusual use of its credit lines with commercial banks. At this stage, however, since most of Mexico's currency reserves are held with commercial banks, heavy liquidation of CD's or drawdowns on credit lines would provide those banks with a signal that a significant outflow has occurred. On that basis the swap drawing directly on the Federal Reserve would help avoid additional repercussions in the marketplace.

When in Mexico last week, I raised with Lic. Fernández Hurtado the question of market concern over the possible devaluation of the peso. He reiterated the Mexican authorities' strong view that there is no reason for the peso to be devalued. He admitted that the rate of inflation in Mexico has been higher than in the United States over recent years. (Last year, prices there rose by some 13 percent, and the authorities hope to reduce this year's rise to no more than 10 percent.) Nevertheless, he argued that the experience with devaluations has been negative both in Mexico, citing the Mexican markets' long memory of the 1954 devaluation, and in other developing countries, citing the inability of devaluation-prone countries like Brazil to bring their inflations under control. The Finance Ministry and the Bank of Mexico concur that a fixed rate policy vis-à-vis the dollar is necessary to maintain internal discipline. In their view a devaluation would exacerbate inflationary pressures and open a Pandora's box of other problems.

On receipt of the request for the swap drawing, Mr. Holmes and I discussed the matter with Chairman Burns and Mr. Volcker, Vice Chairman Gardner and Governor Wallich, all of whom agreed that the drawing seemed appropriate. Several commented that the Mexicans had a good repayment record in the past. In discussing the matter with John Reynolds of the Board Staff, I suggested that a memorandum be prepared by Yves Maroni, who has a sound grasp of the Mexican economic situation. Subsequent

to our conversations within the Federal Reserve, Mr. Holmes and I consulted with Under Secretary Yeo, who also agreed that the drawing was appropriate. I also informed Under Secretary for Economic Affairs at the State Department, Charles W. Robinson, of the drawing.

Following these various conversations, I called Mancera back and told him that we agreed to the swap drawing for value April 9. I stressed that in the event market reflows did not occur, we would look to Mexico's drawing rights with the Fund as a take-out. Mancera thanked me for responding so quickly, but I answered that the Bank of Mexico's excellent repayment record on past drawings had paved the way. He was pleased to hear this and indicated that he would stress the point in discussions with the government.

SEP:msb