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MEMORANDUM

NATIONAL SECURITY COUNCIL

INFORMATION

September 14, 1976.

MEMORANDUM FOR: BRENT SCOWCROFT
FROM: ROBERT HORMATS
SUBJECT: The Mexican Float--
Many Unanswered Questions

Keep this in mind for the Portillo talks.

Two weeks after Mexico's decision to float the peso -- effectively a 40% devaluation at this point -- there are signs that the experiment may be turning sour. The measure can only improve Mexico's international economic position if followed by appropriate corrective domestic policies. But such policies do not appear to have been devised as yet. The burden will fall on President-elect Lopez Portillo.

Background

The devaluation surprised Mexicans as well as foreigners. The symptoms of over-valuation were many and visible, but it was generally thought that the Mexicans would continue their costly foreign borrowing (roughly \$5 billion per year) until earnings from oil exports corrected the imbalances in the trade account. (Trade deficits have been running above \$3 billion.) In the meantime, however, the costs were high in terms of both debt service and of economic growth, as capital flight (\$200 million per month) reduced investment and job creation. Budget deficits financed partly from abroad fueled inflation, which has averaged 17% in recent years.

The Announcement

The announcement was made on the eve of President Echeverria's final State of the Union address. Echeverria emphasized the long-term benefits of a more competitive international position, noting that exchange rates must reflect fluctuating economic conditions. It was justifiable to borrow money to invest, Echeverria said, but not to increase consumption, and certainly not to finance capital flight.

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Echeverria also outlined measures to insure that the domestic impact of devaluation was cushioned. Selective salary increases would protect wage earners, price controls would be applied to basic consumer items, and interest rates would rise for savers and remain stable for small borrowers. Inflation would be controlled by cutting back non-essential budget expenditures and limiting the growth of credit. Taxes would be imposed to reduce the windfall profits of exporters.

Reaction

The initial reaction in Mexico was mild. The government moved ostentaciously against retailers who took advantage of the confusion to jack up prices. Informed business circles were reassured by the availability of \$1 billion of IMF money to bolster exchange reserves, and more through U.S. swap arrangements if necessary. But now pressures are building. Labor organizations, at first seemingly unaware of the implications for the standard of living of wage earners, are now expressing their concern stridently, and there is considerable uneasiness about implementation of the announced stabilization measures. Prices of basic items are now rising sharply, and confusion is increasing in the absence of firm and visible government action.

Internationally, the peso seems likely to stabilize at the new rate of roughly 20 per dollar, which the Bank of Mexico is supporting. On the first day of free trading in Chicago, futures settled at this spot rate, and the Finance Minister has now indicated it may become relatively fixed.

Potential Problems.

The most immediate issue is whether the devaluation will correct Mexico's distorted payments position. The success of the devaluation depends primarily on the extent to which the government reduces liquidity and consumption in a politically tolerable way. A devaluation cannot be successful without some degree of austerity, since the inflation which made it necessary must be treated simultaneously through monetary and fiscal measures. Moreover, the capital reflow resulting from the devaluation must be neutralized to prevent an increase in the money supply. In addition, import prices will obviously be higher immediately, intensifying the need for domestic restraint. To correct this requires a lower level of deficit spending and a reduction of the money supply, which together will lead to lower real incomes. Echeverria's rhetoric emphasized working together rather than sacrifice, and protection from

negative effects rather than tightening up to fight inflation, and Embassy Mexico City reports that the realization that things are going to be tighter seems not to have taken hold. The austere budget being planned by Lopez Portillo may thus come as a shock. How firmly he will be able to hold to the wage and price guidelines which will be necessary to make the devaluation work is a key question. Insufficient control will simply re-create the conditions which lead to the crisis. Firm control, on the other hand, could create problems with the less affluent ~~■~~ on the other side of our southern border.

A second question is the response of the international sector. Mexico's import requirements of capital goods and raw materials would appear to be relatively inelastic -- i. e., they are essential to economic growth and production and will be imported no matter what the price. In this case imports may not fall in volume, and they will certainly rise in price terms even at constant volume. Further, the country's exports cannot expand rapidly if they are now being produced at capacity, as is the case with at least some products. Thus it will take adroitly designed and administered incentives to insure that the devaluation has the desired effects on earnings and production in the medium to long term.

Another question, one which has immediate implications for U.S. investors, is whether the devaluation portends a shift on the part of the Mexican Government from financing development through foreign borrowing -- which they clearly realize had reached unhealthy levels -- to a new strategy of encouraging equity participation of the foreign capital which will be attracted by the more favorable exchange rate.

We will also have to be aware that the increased competitiveness of Mexican exports to this country may result in complaints from U. S. manufacturers of affected products, with corresponding demands for increased protection. This may test our established policy of objective review of these cases on their economic merits. The removal of export subsidies, made possible by the devaluation, and the imposition of higher export taxes to reduce windfall profits, should if anything increase the "fairness" of Mexican competition.

Finally, we can expect that as things get tougher at home for poorer Mexicans and the dollar earned abroad buys more for the family back home, the U.S. labor market will become even more attractive to "illegals." This will result in additional calls to end the displacement of U.S. workers by cracking down on immigration laws, already a delicate element in U.S. - Mexican relations.