

Federal Open Market Committee

Conference Call

October 17, 1988

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Heller
Mr. Hoskins
Mr. Johnson
Mr. Kelley
Mr. LaWare
Mr. Parry
Ms. Seger

Messrs. Keehn, Melzer, and Morris, Alternate
Members of the Federal Open Market Committee

Messrs. Boykin, and Stern, Presidents of the
Federal Reserve Banks of Dallas and
Minneapolis, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
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Mr. Coyne, Assistant to the Board, Board of
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Ms. Low, Open Market Secretariat Assistant,
Division of Monetary Affairs, Board of
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Transcript of Federal Open Market Committee Conference Call
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CHAIRMAN GREENSPAN. Good morning, everyone. We've been having a series of conversations with Mexican officials in recent days. And I thought it would be useful and appropriate to discuss it with the Committee. I'd like to call on Ted Truman to fill us in on the details of the conversations of recent days.

MR. TRUMAN. Well, I plan, Mr. Chairman, not to go into all the details. [See Appendix for an outline of Mr. Truman's remarks, which were not transcribed.]

CHAIRMAN GREENSPAN. I want to add that Mexico is critical to the whole debt strategy; and fundamental to that strategy is the underlying economic policies of the debtor nations. If Mexico can continue to improve and ultimately become a success story--meaning restoration of normal access to the international financial markets--it's very likely to have an anti-contamination effect, so to speak, and have important implications for the resolution to the debt problem in the most beneficial way. As a result, we think it's important that Mexico be supported through this period to whatever extent is reasonable. And we hope that (1) if the oil price stabilizes and (2) their policies are effective, that Mexico--which led us into the debt crisis--may very well be the country which will lead us out. The timing of the oil price decline in sort of the "lame duck" status of the current [Mexican] administration is an awkward period and one which makes it rather difficult to implement significant policies. As a consequence the agreement, which I believe was struck yesterday, has within it I think a surprisingly reasonable number of provisions and fallbacks which I must say I think are better than one ordinarily would have expected during a period such as this. Are there any questions for Mr. Truman?

MR. PARRY. This is Bob Parry.

CHAIRMAN GREENSPAN. Yes, Bob.

MR. PARRY. In light of the tight policy and also the large budget cuts, what is the anticipated growth for Mexico?

MR. TRUMAN. Next year?

MR. PARRY. Yes.

MR. TRUMAN. The new Mexican administration is not looking for very much growth next year; maybe things will pick up in the second half of the year--something on the order of 1 to 2 percent at most.

MR. PARRY. Thank you.

MR. FORRESTAL. Mr. Chairman, this is Bob Forrestal in Atlanta.

CHAIRMAN GREENSPAN. Yes, Bob.

MR. FORRESTAL. In view of the political situation in Mexico, the emergence of opposition parties and so on, with a new president coming in on December 1st, what degree of optimism do the Mexican officials have for a tighter monetary policy and the other measures that they outlined, including budget cuts? It seems to me that they might have some difficulty in following through on these.

MR. TRUMAN. Maybe the Vice Chairman of the Board would like to comment on the monetary policy, but the measures that were announced on Saturday are ones that are to be implemented by this current administration--on both the fiscal side and the privatization side and with respect to monetary policy.

MR. JOHNSON. On the monetary policy side, they're not excited, of course, about the prospect of having to take these substantially tighter actions, but that was one of the conditions for this bridge loan. And so I think the feeling was that even though they had a wage-price pact that was trying to freeze prices, they weren't getting at the condition of [aggregate] demand in the country, which is still quite strong. Good evidence of that, even though they have a measured lower inflation rate, is the seepage on reserves that has picked up substantially. And I think the anticipation of a substantial devaluation, if conditions continued, is a pretty good indication of the underlying inflation problem in Mexico. So, I think it's a perfectly consistent policy to have a substantial tightening to deal with demand and at the same time restrain the outflow of reserves. I think they finally realized that they can't even hold the pact--their wage-price system that they've agreed to--together without additional restraint on domestic demand. I think the central bank has been reluctant to take this action, but I think now they realize that it is necessary and, of course, they realize too that in order to receive this bridge financing that's a necessary action. And they certainly have acknowledged that those pressures are there and something other than just a wage-price freeze needs to be done.

CHAIRMAN GREENSPAN. You know, there is a difficult problem that they've got, and which one would expect in this type of environment. They have nominal peso-denominated interest rates well in excess of 40 percent, annual rate, with a notational inflation rate of less than 1 percent a month. Now, what is very obvious from that is an implicit real rate of interest that makes no sense whatever in a free market. What we're looking at, in effect, is not only an inflation element in the nominal interest rate but also an expectation of devaluation. And that essentially is what is driving these markets--that is, the markets presume that Mexico is on the edge of a devaluation and clearly that's putting pressure on their reserves. You can address that issue in one of two ways: either through the fiscal side--that is, to bring down inflationary expectations which clearly are in excess of the current inflation rate which in turn would remove the expectation of a devaluation and bring nominal interest rates down--or, alternatively, you devalue to a point where expectations of further devaluation are frustrated. The Mexicans' concern about the latter is they assert, with some limited evidence I must say, that should they do that the internal inflation that would occur would offset the devaluation effects and leave real exchange rates essentially unchanged without any alteration of expectations involved. We think they are wrong on that issue, but that's been a basic question which has created some differences of opinion about how

to proceed on this particular type of policy. As a consequence, one cannot argue that an increase in interest rates is the wrong policy, even though from a domestic Mexican point of view peso-denominated real interest rates are rising, and as Vice Chairman Johnson has indicated that's at the moment the only effective way in the short run to try to suppress excessive internal demands.

MR. ANGELL. Mr. Chairman, I certainly support the policy and would support the Open Market Committee agreeing to a release in this language. I am reluctant to have us make as strong a statement as we do on devaluation. It seems to me that it would be far better for them to pay the interest rates necessary in order to avoid the devaluation, which ultimately then can lead them to a position of falling interest rates because those interest rates coming down have to be in their long-run interest. And I hesitate for us to get involved in the recommendation of a devaluation which once again simply rewards those who have held their money-capital outside the country and I think will reinforce that behavior. So, it seems to me that interest rates in Mexico will have to be as high with devaluation as they will without.

MR. JOHNSON. Governor Angell, that isn't quite what the agreement is. We're not suggesting a devaluation. As a matter of fact, the whole purpose of these conditions was not to force them to a devaluation; it was to force them to take domestic fiscal and monetary actions to avoid a devaluation. Those are, in fact, the conditions.

MR. TRUMAN. I should emphasize that in the second part of this agreement

And I would hope that members of the Committee would please keep it to themselves, so to speak. But that part of it, as the Board's Vice Chairman said, is only if they fail in holding the exchange rate; only then would the second part come in.

MR. ANGELL. Well, I feel better, but I'd feel better yet if you said that the second part would be a further rise in interest rates.

MR. TRUMAN. I think you can be confident that if it fails there will have to be a rise in interest rates, too, at least in the short run.

CHAIRMAN GREENSPAN. The basic problem is that there are conditions under which interest rate increases don't create the type of environment which brings stabilization; you need more than that. And, hopefully, that won't be necessary and presumably it won't be. But there's a fallback position, that in the event that all else fails, you have really no choice. What happens is that if you get into a situation in which you get a big run on your reserves, ultimately you get to zero and you have no choice; I mean, you've got to devalue [unintelligible] de facto moratorium.

MR. TRUMAN. Well, in addition they face, potentially, a very large further shift in their terms of trade.

CHAIRMAN GREENSPAN. Yes.

MR. TRUMAN. A normal way to deal with that--

MR. ANGELL. Well, if it gets to the place where the terms of trade problem becomes acute, then I would grant that that's a step that has to be taken. I do not agree that devaluation as a technique of stopping capital outflows is a desired solution--

CHAIRMAN GREENSPAN. I don't think anybody disagrees with that statement.

MR. JOHNSON. That's what we're trying to stop.

MR. HELLER. But, Mr. Chairman, as the discussion right now shows, I think it's very difficult to make a judgment on the appropriateness of the program in the absence of a briefing on what's going on in Mexico. I for one would have very much appreciated either to have a briefing like that or to have a background paper so we can form some considered judgment as to whether these are appropriate measures in the current Mexican situation. As it is now, I'm happy to go along with it, but it's blind faith.

The second point I would like to make is in the press release. I'm [not] exactly sure what it means at the end--that the Treasury and the Federal Reserve are prepared to develop a short-term bridge loan depending on the development of loan programs by Mexico with the World Bank and IMF. I mean, they've got to do those programs first, then we do the bridge loan, or is it--?

MR. TRUMAN. The disbursement of the bridge loan would depend upon having in place the appropriate loan arrangements--the appropriate loan of the World Bank and the IMF to bridge to. There would be no disbursements on the bridge, at a minimum, until there was agreement on that. That stage of agreement is, I think, a little open at this time, and that would be subsequently negotiated. But essentially it [would be an] agreement that, yes, Mexico would qualify for compensatory financing. That might be done serially--in sequence. Or they might qualify for one of three structural loans, one a structural adjustment loan, and two large sectoral adjustment loans from the World Bank.

MR. HELLER. Wasn't there a whole series of them? One is in place already and does the second one roll in?

MR. TRUMAN. No, that's different; you may be remembering Argentina. These are three new loans; they've had a program over the last two years of so-called structural adjustment loans. But these would be three new loans that they are in process now of negotiating. One is a structural adjustment loan addressed broadly at macroeconomic policy and deregulation; the others are an industrial restructuring loan and a public enterprise loan, both dealing with reforms in the public enterprise sector.

MR. BRADFIELD. It should be clear that these are very secure loans from the point of view of the Treasury and the Federal Reserve. There's almost no risk. The loans would be disbursed only when there are appropriate assurances from the World Bank and the International Monetary Fund that their disbursements, to which we are bridging, would be forthcoming within the period of maturity of the bridge. As

to the part of the loan which is a bridge to Mexican reserves, there would be in effect a tying up of those reserves at the Federal Reserve Bank of New York as security for the bridge loan. So there would be absolutely no risk with respect to that part, which is bridging to Mexican reserves. So this is a very strong bridge and very little in the way of true financing for Mexico. The major effect of it is our expression of support that's contained in the statement.

VICE CHAIRMAN CORRIGAN. Mr. Chairman, I'd like to pick up on that point that Mike Bradfield just made, because there are always questions in these things, and there are always uncertainties. But it seems to me that the case for the United States--the Treasury and the Federal Reserve--is that this is a powerful way to support Mexico at this point. That's just beyond question. I certainly would enthusiastically support the thrust of your comment recommending the terms of this program. It's very, very important at this juncture. There are always questions or uncertainties on these things, but most things get worked out.

MS. SEGER. I just have two questions. I guess they would be political but they're probably tied into the economics also. You mentioned that the new president will take office December 1. In the context of this country, anyway, to what extent can an outgoing government commit a new government?

MR. TRUMAN. A representative of the new president--I should have mentioned this earlier--the senior economic advisor to the new president was a participant at the meeting. In that sense, you have a little more commitment to the process than you would if he wasn't participating at the meeting. And he was on the phone several times to New York.

CHAIRMAN GREENSPAN. Mr. Salinas has been briefed and is on board on this agreement.

MR. JOHNSON. The fact of the matter also is, though, if they were to fail to live up to the conditions, the bridge wouldn't be disbursed. We have complete control over the disbursement and if the conditions aren't met, then they wouldn't be able to draw the funds.

MS. SEGER. I guess I was thinking more of some of the fundamental changes that Ted alluded to in his briefing. I think it would be hard to get those all accomplished in the next 30-some days.

CHAIRMAN GREENSPAN. Well, actually they are being announced by Mr. Salinas, allegedly in last night's speech.

MR. TRUMAN. Well, the first-phase budget cuts and the privatization program are essentially under the control of the outgoing government. You'd probably have a document which details the privatization program--what stages some of them are in, or bids that have already been let, and some of them in process of development, and so forth and so on. And the monetary policy is under the control, so to speak, of the finance ministry and the central bank until the first of December.

MS. SEGER. Okay, that leads me to my second question. Some of these kinds of policies might not be terribly popular with the

populace. And as I understand it, the election was sort of a squeaker anyway, if that's a fair term. So, are we maybe going to have to face some real political instability if interest rates shoot up?

MR. JOHNSON. On that, let me just say that [unintelligible] I agree these policies won't be particularly popular. But at the same time, you have to consider whether the alternative would be popular. And what Governor Angell was getting at is that their alternative is a major devaluation that would substantially diminish the real incomes of those people who have submitted to a wage freeze. And so you have to take, as an alternative, a devaluation versus this. And I think that with them seeing what their alternatives are, it makes it more palatable for them to be willing to pursue a more restrained monetary policy and take stronger fiscal actions and sell off more of their nationalized firms. They're actually undertaking some fairly impressive privatizations--the two major airlines, two major copper companies, and I forget some of the other natural resource areas. There's a long list that they have already received bids for and they're prepared to accept bids on. So the numbers are fairly solid. If all of them go through as expected, it would be about \$2 billion worth of privatizations. And a large part of that would be the two major copper mining companies, which are very large. That is already pretty much sealed up because the bids are already in and it's a matter of accepting the bids.

MS. SEGER. I'm not opposed to a loan and I certainly would believe in supporting the government. I just wonder if in 45 days we're going to be sitting around discussing this again.

MR. JOHNSON. Well, there's no guarantee.

MS. SEGER. That is what I was driving at.

CHAIRMAN GREENSPAN. That is not an inconceivable event.

MS. SEGER. Thank you.

MR. HOSKINS. This is Lee Hoskins. I'd like to hear the language in reference to the Federal Reserve that's in the press release and also ask who's putting out the press release, as well as a comment or two on the extent of our involvement in these kinds of activities in the past--bridge loan activities. And I guess, last, what has been the experience of the Treasury and other governments on some of these kinds of measures before? I'm just wondering if we have any way to gauge the success of those things. It seems to me that they have not been all that successful long term.

MR. TRUMAN. Well, I'll let the Chairman comment on the last question. The two places where the Federal Reserve appears in this press release are in the first sentence and the last sentence. The first sentence is, "The U.S. Treasury Department and the Federal Reserve welcome the economic measures recently announced by the Government of Mexico"--that's the four points that I described about the fiscal policy action, privatization, the tighter monetary policy, and the applications to the Fund for compensatory drawings. I should emphasize on that last point that the importance of that is that it forces the Mexican authorities to enter into conversations about other policy actions extending into 1989 that the Fund feels are appropriate

to their circumstances. The last sentence, with explicit reference to the Federal Reserve, says "Accordingly, the U.S. Treasury and the Federal Reserve are prepared to develop a short-term bridge loan of up to \$3.5 billion, depending on the development of loan programs by Mexico with the World Bank and the International Monetary Fund." And that was the question that I guess Governor Heller asked about the staging of all this and the "depending on" clause.

As far as the precedents for the Federal Reserve's being involved in these kinds of operations, there are some--in large part because we do have, and have had for 20 years, a swap line with the Bank of Mexico. On previous occasions like this, the Federal Reserve has participated alongside the Treasury Department in providing this type of short-term financial support to Mexico. We did it in 1976; we did it in 1982-83; we did it in 1986; and it's proposed that we should do it now. It is my personal view that these things have normally been relatively successful, though that clearly depends on one's standards of success.

MR. BRADFIELD. In terms of repayment, I think the U.S. altogether has participated in approximately 15 bridge loans and every one of them has been repaid.

MR. HOSKINS. Well, my comment was not directed to non-repayments but was addressed--

MR. BRADFIELD. No, I was just addressing that specific aspect of it. I assumed that you were addressing the economic policy.

CHAIRMAN GREENSPAN. You can look at the economic policy responses in two ways. First, the fact that these Latin American countries are continuing in significant difficulty clearly suggests, of necessity, that [past] programs have not been fully successful. If they were [successful] for any of them, they wouldn't be in the particular situation they are in currently. However, it is also true that there have been very significant improvements in the structure of some of these economies, which were unbelievably arthritic previously. For example, the Mexican economy is a lot more flexible, a lot more market-oriented than it used to be. And this is true pretty much across Latin America where very substantial changes have occurred. That they have not been sufficient to make these wholly viable operating economies, I guess goes without saying. But all that is indicating is that they haven't come far enough yet; but the direction clearly has been positive. And I think it should be the policy of this country to be supportive of moves in that direction. But, Lee, I think what you're saying mainly is that they haven't come out of the extraordinarily poor state they've been in; and that's obviously the case. I don't think, however, it is generally the case that no progress has been made. On the contrary, I think significant progress has been made and in that context I would say that a number, not all, of these programs have been successful.

MR. BLACK. This is Bob Black. What is the timing on the release?

MR. TRUMAN. As soon as we finish this meeting, assuming [the Committee's view] is positive, it would be released by the Treasury Department. Are you planning on [releasing] it?

MR. COYNE. Yes.

MR. TRUMAN. And Joe Coyne will release it here as well.
[See Appendix for a copy of the press release issued.]

MR. BLACK. Could you send us a facsimile copy?

MR. TRUMAN. We will do that.

MR. BLACK. Thanks.

MR. KEEHN. Mr. Chairman, this is Si Keehn. Going beyond the bridge loan, is there any additional private sector participation contemplated or required to deal with this?

MR. TRUMAN. Not at this stage. If, and this depends a lot on the future course of oil prices and whether this works and so forth, if you get involved in a full blown IMF program, then there would have to be--or one would expect there to be--a bank financing package along side that. If things do stabilize both in terms of the Mexican economy and the oil price and they merely go forward, which they will in any case with these World Bank loans, it is contemplated that there would be some parallel lending of a modest size that would go along with that over the next two or three years, but not a big jumbo loan in the next several months.

CHAIRMAN GREENSPAN. Are there any further questions?

MR. MELZER. Tom Melzer, here. I just wanted to quickly ask what their remaining reserves are and how much \$3-1/2 billion would augment them. In other words, is there a prospect here of really catching the shorts and lending some support to the currency just through the announcement?

MR. TRUMAN. Their usable reserves are something between at the moment. And their total reserves are about larger than that. I think the chances of catching the shorts off guard is primarily through the announcement effect that's been mentioned earlier and the monetary policy actions that are expected to follow up on that this week. And to the extent that their government, both the outgoing government and--based on the speech last night--the incoming government, convey a notion of following through, then there's some chance that the situation will stabilize.

MR. JOHNSON. I think what they're counting on is not the actual amount of this bridge, because as Mr. Bradfield and Mr. Truman point out there's not a lot of up-front drawing associated with this. What they're counting on is the statement of support from the U.S. on top of the strong actions that they're announcing on monetary and fiscal policy. Really, in the short term between now and the time that we're really dealing with it, all the burden is going to be on monetary policy to stabilize their reserve situation through interest rates. It's not like it's just a pure currency crisis with no inflation problem; they've got enough of an underlying inflation problem to need a substantially more restrained monetary policy, as the Chairman has pointed out. Even though their measured rate is relatively low, it's purely because of the wage and price controls

situation. There's a lot of underlying inflationary pressure in that country.

CHAIRMAN GREENSPAN. You can't expect a short stampede, largely because I don't think the markets at this stage are aware of the size of the problem that Mexico currently is dealing with. In fact, one aspect of this issue is that we don't know to what extent the markets know what's happening. And this announcement in and of itself obviously will suggest that there's something going on. So you can actually, in the very short run before the monetary actions take place, conceivably have the market reacting in either direction.

MR. JOHNSON. We have some fairly significant assurances on the monetary side. We probably laid out as conditions of this substantially more detail [unintelligible]. As a matter of fact,

So, I think you would probably be pleased with the degree of scrutiny we gave the mechanism by which they would take tighter action.

MR. LAWARE. John LaWare. I have a question. Ted, you talked about the privatization program--is any part of that a debt-for-equity swap?

MR. TRUMAN. Some of these operations are financed through debt-for-equity swaps. Some of them are in the pipeline now. They have not approved any new ones in the last year or so, though there is talk of their reopening that program in a mild way. But I would expect that some of these do involve debt-for-equity swap operations in one form or another.

MR. LAWARE. Thank you.

CHAIRMAN GREENSPAN. Anything further on this? If not, thank you very much.

END OF SESSION