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MEXICO: THE DEBT CRISIS AND OPTIONS FOR DEVELOPMENT STRATEGY

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Working Paper #82 - September 1986

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An earlier version of this paper was presented at the conference on External Debt in Mexico, UNAM, Mexico City, May 18-22, 1986.

ABSTRACT

This paper highlights elements of macroeconomic policy issues facing Mexico in coping with its debt crisis. The author begins with a brief introduction to the origins and evolution of the crisis, and goes on to provide an overview of its socioeconomic impacts in Mexico and an examination of its implications for Mexico's future development. The concluding section of the paper critically evaluates Mexico's options for development strategy. One aspect of the debt crisis which particularly concerns the author is the economic Interdependence between Mexico and its neighbor, the United States, and consequently the need for their mutual collaboratlon if the crisis is to be resolved.

RESUMEN

Este ensayo destaca elementos de la política macroeconómica que enfrenta México debido a su deuda externa. Empezando con un sumario de los orígenes y de la evolución de la crisis, nos provee con una vista general de los impactos económicos de la deuda externa en México y examina sus implicaciones para su futuro desarrollo. El trabajo evalua de forma crítica las opciones de México para una estrategia de desarrollo. Un aspecto de la deuda externa que se enfatiza es la interdependencia económica entre México y los Estados Unidos, y por lo tanto, la necesidad de una mutua colaboración en la resolución de esta crisis.

Introduction

Mexico's external debt has been climbing steadily and was over the $100 billion mark by the end of 1985. In August of 1982 when the current debt crisis surfaced openly, the debt had reached about $80 billion.[1] Faced with the prospects of default, which immediately sent tremors through the international financial community, the world's banking system decided to bail Mexico out. In return, Mexico carried out austerity measures that slashed government spending, shoving the economy into a painful recession. The commercial banks have continued to provide more money to Mexico, which has mainly been used to pay the interest due to foreign banks.

Mexico's international crisis has been aggravated by external developments since then. The price of oil has fallen: Oil provides 75% of Mexico's foreign exchange and the price decline is expected to slash export revenue by $6 billion in 1986 alone. On top of this, Mexico has suffered natural disasters like the earthquakes which directly caused several billion dollars of damage[2] and indirectly cost unknown millions more because of the depressing effect on the tourist industry.

The gravity of the Mexican crisis at present is that, given the current economic conditions and policies, prospects for its resolution in the foreseeable future are bleak. In this context, Mexican president Miguel de la Madrid Hurtado recently stated that Mexico could not at present meet obligations imposed by the international banking community: Budget cuts sufficient to offset the loss of oil revenue would "imply putting at risk basic food security and the supply of drinking water." Indeed, the conditions now in Mexico seem more dire than in 1982. As the financial crisis deepens, it is beginning to threaten

[1] See Table (appendix).

[2] According to an Inter-American Bank estimate, the investment outlay required for total rehabilitation would be $3.5 billion.

political stability; hundreds of thousands of Mexicans have demonstrated against the government policies of complying with the IMF program[3]; and Leftist opposition parties have been calling for an 18-month halt in repayment. The government seems unable to placate either left or right, capital or labor. So far, Mexico has not called for a default but for negotiations and compromise, threatening, on the other hand, to join forces with Venezuela in a cartel of debtor nations.

Mexico's success in avoiding a financial collapse is of crucial concern to the United States. It is important to understand the intricately interwoven nature of U.S. involvement in the Mexican crisis: U.S. commercial banks are among the largest lenders to Mexico.[4] In addition to U.S. banks' involvement, some 2900 U.S. companies have direct investments in Mexico, and Mexico provides an important market for U.S. products. For instance, in 1981, the year before the beginning of the current crisis, U.S. exports to Mexico amounted to more than $17 billion. More importantly, by virtue of Mexico's sharing a 2000 mile border with the U.S., socio-political unrest in Mexico--which is a likely result unless present trends are reversed--could turn into a nightmare with the specter of massive illegal migration to the north.

This paper starts with a brief review of the origins and evolution of the debt crisis, and then turns to an examination of its impacts on Mexicans. In the final sections, it explores some developmental implications of the crisis and future options for Mexico.

[3] At a recent demonstration in Monterrey 10,000 dismissed workers participated to protest against the shutdown in early 1986 of Fundidora Monterrey, one of the oldest and most heavily subsidized foundries in Mexico.

[4] Among the leading lenders are Citicorp, First Chicago Corp, and Continental Bank.

Origins and Scope of the Crisis

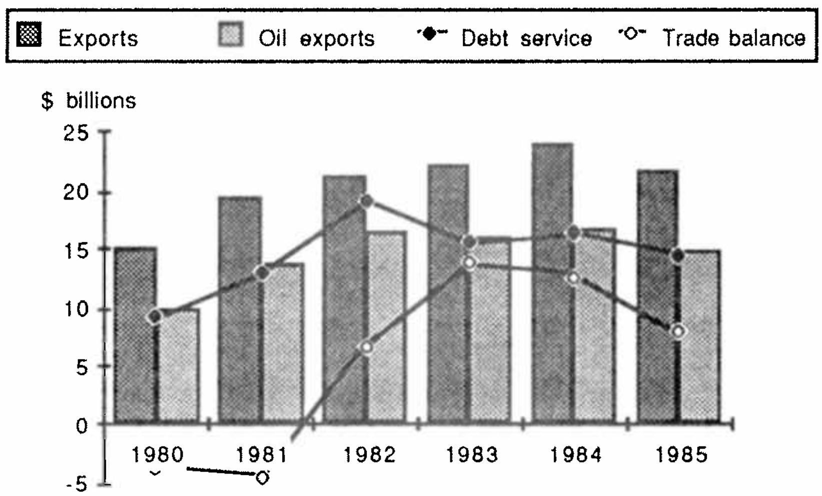
A careful analysis of the debt crisis in Mexico shows that the blame lies as squarely on misconceptions of international bank-lenders as on poor policy formulation of the Mexican government in the 1970s. On the supply side of loans, the beginning of the crisis can be traced back to the post-1973 period when U.S. private bank reserves started to swell with petro-dollars from OPEC countries, accumulated in the form of Euro-dollar deposits. Western banks were duly impressed by the pace of Mexico's progress in achieving stabilization in the wake of the 1976 IMF intervention. There was also a pervasive optimism among bankers about the outlook for Mexico's oil, about its political stability, and about the ability of its government to control external instability. Western bankers soon fell over one another to lend to Mexico, then considered to be one of the most promising developing countries. In the space of 12 years, Mexico's debt grew to the level of $80 billion by 1982 from less than $4 billion. Loans from Western banks, mostly of U.S. origin, accounted for nearly 70% of Mexico's total borrowing, about three quarters of which were borrowed by public-sector firms in Mexico.[5]

It is significant to note that bank credits were continuously extended despite some serious warnings about Mexico's ability to service the debt. Bankers continued to exhibit naive faith in government guarantees for (private and public) debt. For example, the debt service ratio--payments of amortization and interest as a percentage of export earnings--was about 65% in the 1980-81 period, rising quickly to close to 90% in early 1982 (Figure 1). For bankers, the range of 20 to 25% would normally be considered safe. The debt-service ratio, however, underestimates the true capacity of the economy to finance debt service. For a developing country such as Mexico it is essential to maintain positive net export earnings in order to secure imports required for

[5] Pemex's foreign debt alone was $16 billion in 1982, about as much as the debts of Ecuador and Peru together.

industrialization. During the period of 1978-1981, Mexico's interest payments persistently exceeded its current account surpluses. By the end of 1981, the gap between annual debt service and trade balance widened to as much as $20 billion (Figure 1), which indicated inter alia that Mexico would need increasingly larger loans to be able to continue to service the debt. There was a clear sign of deterioration in Mexico's credit-worthiness. Nevertheless, Mexico continued to receive new loans from Western banks.

Figure 1: Debt services and exports



Source: Appendix Table

Turning to the borrowing side, the roots of the crisis can also be found in the Mexican government's failure to implement a rational economic policy. With the conclusion of the government's stabilization efforts in the wake of the 1976 devaluation, the oil windfall of 1979 suddenly unleashed political pressures in favor of rapid economic growth. In short, on the basis of an over-optimism about the future of oil exports, the government indulged in a spree of spending that far exceeded surplus oil revenues. For instance, in 1979-80 real investment rose by 15 to 20% per year and real consumption increased by 5 to 7% annually. In particular, imports in real terms more than tripled over the 1978-1981 period, as the domestic productive capacity quickly ran into bottlenecks in an overheated economy. Scarcities developed everywhere: in skilled labor, technical and managerial skills, materials and components, and capital for infrastructural development.

With the fall in oil prices in 1981, the required imports had to be financed at increasing levels by short-term loans from foreign banks in order to avoid a devaluation of the peso. On the other hand, foreign banks seemed all too willing to provide the needed financing. Unabated government spending soon started to produce an enormous disequilibrium in the balance of payments, especially during 1981-1982 when the government accumulated $15.3 billion in short-term debt.[6] At the same time, the government's inexplicable policy permitting liberalization of international capital movements touched off a rapid capital flight, reversing the direction of movements from a positive net inflow to a net outflow as thousands of skeptical Mexicans took a hedged position against impending possibilities of the peso devaluation. As capital flight accelerated, Mexico's international reserves began quickly to deplete. By mid-1982, the external debt rose to close to $80 billion, of which some $20 billion accounted for the debt owed by private corporations. The public-sector deficit rose to almost 17% of GNP at the end of 1981 from 8% at the end of the previous year. Banks then reached a collective decision to withhold all new extensions of credit, thereby precipitating the government's declaration of a partial moratorium in August, 1982.

The latest crisis, when the world financial community was again threatened by another possibility of Mexico's default in the wake of the September earthquake and the falling oil prices, appears to have more to do with extrinsic causes than intrinsic ones. The earthquake damage that amounted to several billions of dollars has forced the Mexican

[6] For a detailed account of the 1982 crisis, see Roberto G. Newell & Luis F. Rubio, Mexico's Dilemma: The Political Origins of Economic Crisis (Boulder & London: Westview Press, 1984), pp. 220-226.

government to call for an additional demand for international loans in order to provide relief to its citizens. The financial loss inflicted by the earthquake, however, pales in comparison with that brought about by the drastic declines in world oil prices. Crude oil had sold for an average price of $29 per barrel in international markets through November of 1985 until the following month when the production ceilings were abandoned by the OPEC decision. As Saudi Arabia increased production of its oil from 2.6 million barrels per day to 4.4 million, the oil price quickly tumbled to below $20. Continuing to ride on the wave of a world oil glut, its price once threatened to fall below $11 per barrel.

For Mexico, using the estimate that for every $1 drop in the price of a barrel of oil its annual export revenue would decrease by one half of a billion dollars, a $20 reduction would imply a loss of nearly ten billion dollars in export revenue. The drop in oil revenues for 1986 is currently projected at $7 billion. Mexico's export earnings were $20 billion in 1981, and are currently projected at $15 billion for 1986. Mexico will need to borrow more or slash imports--or stop interest payments. Even before the earthquake disaster, Mexico had already requested about $4 billion in loans from the IMF to help service its debt, and has since then readjusted that request to $6.5 billion, of which about $2.5 billion would be provided by private banks if Mexico could agree to an IMF-imposed, government deficit target of 5% of GDP for 1986.[7]

Finally, it is worth noting that the recent oil price drop and the earthquakes that struck Mexico City were not really the only causes of the renewed crisis. The economy in late 1984 and early 1985 was already overheated, as the government increased spending in an attempt to return the economy mired in a deep recession to growth. The moderate budget overruns in 1984 ballooned into a hugh deficit in the following year, sending the peso tumbling in a free-fall from 200 to the dollar to 500 in a matter of a few

[7] Refusing the continuation of a severe austerity regime, Mexico has been holding on to the planned deficit target of 12.5%. If the impasse is not resolved, Mexico will have to embrace a García plan to link its debt payments to its capacity to pay.

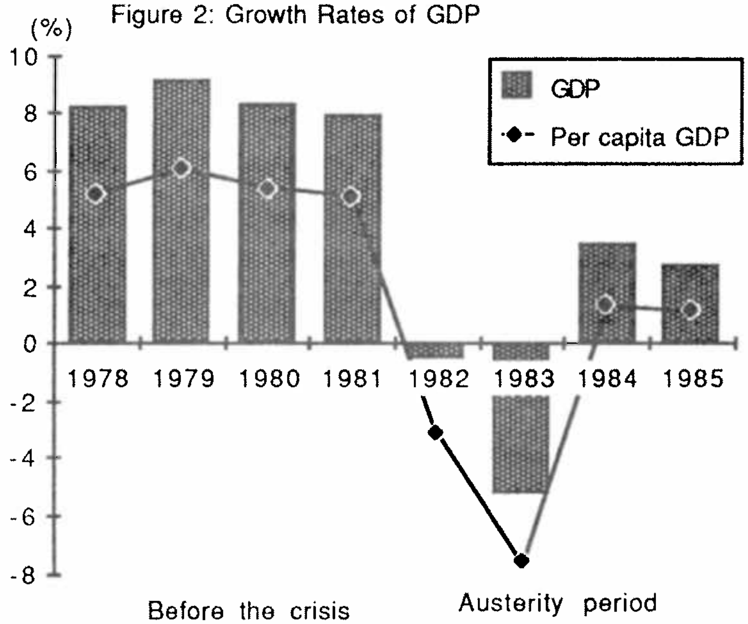
months in late 1985 and to 650 by mid-1986. As a result, inflation in 1986 is expected to continue at much higher rates than in the previous two years. Mexico seemed to have reached the political threshhold of tolerance by 1985, after three years of an austerity regime.

Reflections on the Adjustment Process

The approaches followed by Mexico in coping with the debt crisis have had strong recessionary effects on the economy. In an attempt to solve the debt problem, ways of carrying out the adjustment have been sought within the context of a retrenched economy: In order to pay the interest on the debt exports should be expanded; imports should be cut back with a concommitant reduction in fiscal deficits; and the exchange rate should continue to be readjusted to reflect international competitive conditions. These policies that have been enforced since 1982 have, however, failed to bring about any significant reversal of the recessionary trends, nor have they achieved any noticeable progress in the reduction of the amount of the debt.

The external indebtedness of Mexico increased from $87 billion in 1982 to about $100 billion by the end of 1985. Although the gross domestic product (GDP) recovered from a decline in 1983 to a positive 3.5% growth in both 1984 and 1985, there was virtually no real gain on average in the period between 1982 and 1985. This contrasts with the more than 8% average growth registered during the pre-crisis period from 1978 to 1981 (Figure 2). Per capita GDP, on the other hand, shows a slight decline since 1982, whereas it increased at an average growth rate of more than 5% during the preceding four years. Since GDP figures include payments to foreigners, per capita real income for Mexicans must be considered much lower than what the corresponding GDP figures indicate. As will be shown soon, evidence of this can be seen in the decline of real wages.

Figure 2: Growth Rates of GDP



Source: Appendix Table

On the other hand, Mexico made stunning improvements in the trade balance after 1982. By 1984 the trade surplus rose to US $12. 8 billion, although it fell to $8 billion in 1985 as a result of 20% increase in the value of imports and 10% decrease in that of exports (Figure 1). It is important to note that these surpluses were achieved largely through the drastic compression of imports, which led to a very serious contraction in economic activity. The worsening of the terms of trade, in particular, the weakness of the petroleum market, was the determining factor contributing to the decline in export earnings after 1984.

While the enormous compression of imports set in motion a process of de-industrialization in Mexico, the long duration of the government's austerity policy has also brought with it a worsening of structural problems in the distribution of income, which have long affected the Mexican economy.

Unlike such Latin American debtor nations as Chile, Argentina, Venezuela and Ecuador, in which reductions in imports set off a wave of factory closings, the Mexican economy has shown a capacity for substituting local production for the imported goods that it can no longer afford. [8] Nevertheless, many of its factories have been running at less than half capacity, as the economy has been limping along at meager rates of growth by virtue of policies aimed at retrenching the economy to deal with its financial problems. The economy would have to grow at a much faster rate in order to provide jobs for the 900,000 new entrants to the labor market every year. Contraction in economic activity has rapidly swelled the ranks of open unemployment, particularly affecting young people. Since 1982, the austerity measures have boosted open unemployment to about 15%, and 40% of Mexican workers hold only part-time jobs. High levels of open unemployment have compounded the long-standing problem of underemployment. There has been a surge of informal-sector--often "underground"-- economic activities in Mexico, as both private and public enterprises are experiencing severe difficulties affecting their productive capacity.

It is also worth noting that those policy measures aimed at financial stabilization actually resulted in accelerated inflation. As illustrated in Figure 3, the inflation rate in Mexico jumped from an average of 23% in the four years preceding 1982 to the range of 60 to 100% in the period after it. The acceleration in inflation was caused both by excess demand and cost-push: Excess demand resulted largely from the cutback in essential imports, and the consequent contraction in domestic output, whereas the cost-push was the result of continued devaluations of the peso that raised imports prices and the domestic cost of production. In addition, continued devaluations and inflation created an

[8] For instance, the Mexicans have begun to locally produce the imported chemicals that go into the manufacture of such products as soap, detergents, and plastics.

atmosphere of uncertainty about the Mexican economy and accelerated flight of capital from Mexico. The de-industrialization process is evident from Figure 3, which contrasts the levels of domestic investment before and after 1982.

Massive devaluations and accelerated inflation struck most viciously at the poor and middle-income groups, while the well-to-do were able to transfer their capital outside the country. First, increases in nominal wages for the working classes have been capped at levels below rates of inflation: As shown in Figure 4, the minimum real wage rate in 1985 was about 64% of the 1978 level, and average real wages are now estimated to have declined at least by 40% over the 1982-1985 period. Secondly, to comply with the austerity regime imposed by the IMF, the government had to pledge to slash its budget deficit.[9] The reduction of fiscal deficits has been effected in Mexico by making substantial cuts in social welfare expenditure and in subsidies on basic commodities, affecting mostly the poorest sectors. In particular, the reduction and eventual elimination of subsidles for production of basic staple food eroded the purchasing power of workers and campesinos,[10] as prices kept up with inflation. The price of such staple food as tortillas has risen by 40% since 1982, and the price of gasoline by half by the end of 1984. The poorest 10% of the Mexican population spends roughly two-thirds of its income on food alone.

In conclusion, the austerity program has imposed extreme costs on the Mexican people and caused a setback in the development of Mexican industry. The burden of adjustment has mostly fallen on the middle-income as well as more vulnerable groups.

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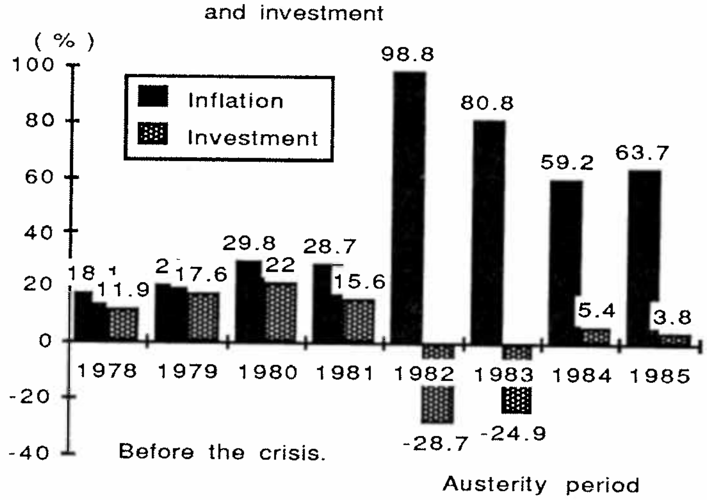
9 In effect, despite the government's efforts to cut spending, the deficit stood at a disastrous 10.5% of GDP in 1985, and the recent oil price drop is likely to reduce spending cuts by 5%, which could cause the deficit to climb to 12% of GDP in 1986.

10 Unionized workers appear to fare better compared to unorganized labor. National unions have been cooperating with the government on wages in exchange for nonwage gains. For instance, the Confederation of Mexican Workers (CTM) is expected to start a business producing low-cost basic goods for union members which will be subsidized by the government, while government subsidies towards goods for the general public continue to be removed.

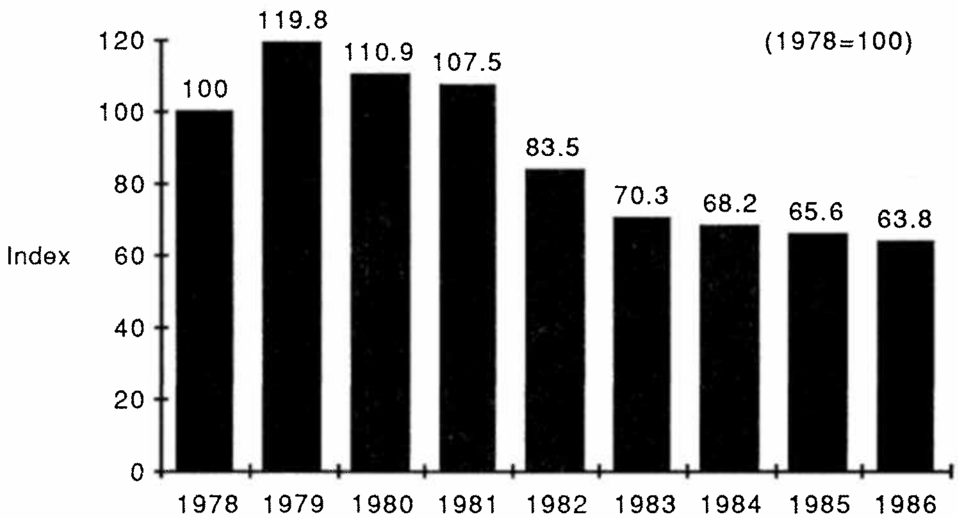
Many members of Mexico's middle class--considered as crucial supporters of the democratic government--have been forced to take second jobs to support themselves. The problems of the lowest income groups seem to have worsened, with poverty, marginality and malnutrition spreading widely: The poor are clearly eating less meat and drinking less milk. Inevitably, the effect of immiserization is spilling over to the United States. There has been an upsurge in illegal immigration from Mexico into the United States. According to the U.S. Border Patrol, in 1985 arrests of illegal Mexican immigrants rose to a record 1.3 million.

Figure 3: Rates of change in inflation and investment



Source: Banco de Mexico & NAFINSA

Figure 2. Real Minimum wages



Source: Recalculated from E. Ortiz, "The Debt Crisis: Limits of Stabilization Policies, and Alternatives for Development and Renegotiations," Paper presented at the Conference on the External Debt in Mexico, UNAM, Mexico City, May 1986, p.21; Also from Commercio Exterior and El Mercado de Valores, 1981-1986.

DILEMMAS AND CHALLENGES IN THE FINANCING FOR REVITALIZATION

It is clear from the foregoing discussions that Mexico's debt crisis cannot be resolved simply through reschedulings that will provide only a temporary relief. There is really no sense in continuing the current routine of lending more money to Mexico merely to pay the interest due to foreign banks, as Mexico may soon be compelled to limit payments to its capacity to repay. The solution to the crisis must, from now on, be sought more from the perspective of structural adjustment rather than from that of financial adjustment: The economy must grow rather than contract to repay.

The longer-term issue facing Mexico would of course be: What policy measures must be adopted to propel the economy to the higher growth rates that will be needed to meet debt obligations as well as the demands of 900,000 new job seekers a year? The more immediate issue is: What measures will be necessary to encourage investment in plants and equipment required for strengthening the productive structure of the economy? How can Mexico finance the production that any economic revitalization strategy presupposes?

Mexico faces a truly serious problem on the supply side of investment capital. Under the corrosive effects of inflation and economic stagnation, domestic savings in Mexico have declined drastically in recent years.[11] To this may be added the effects of high interest rates and massive devaluations, which raised the domestic cost of production, discouraging investment.[12] Prospects for obtaining funding from external sources have similarly diminished. Resources of multilateral donor agencies have been greatly strained because of large commitments of involuntary lending to the developing world,[13] and banks in general have been taking a much harder look at international operations, so Mexico will be in stiff competition not only with other Latin American countries but with other developing countries with a better risk prospective.

Compounding these problems is a loss of confidence by Mexican investors. In the case of Mexico, capital flight--legal or illegal--has been the major factor behind the foreign exchange shortages. Mexicans, according to an informed estimate, took more than $4 billion out of the country in 1985 alone, and capital flight by the end of 1985 was estimated to total more than $60 billion, a monumental jump from the estimated loss

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[11] The Mexican banking system has currently high liquidity due to increased peso deposits by the firms that owe dollars that they cannot obtain for settlement of their foreign accounts.

[12] According to a recent estimate, private investment will make a modest gain of 2% in 1986, compared wtih the 17% increase in 1985, while public investment, due to acute fiscal strains, is projected to decline by as much as 15% in 1986. "Business Outlook: Mexico, "Business Latin America, March 31, 1986, p. 94.

[13] The recent relaxation of government regulations governing foreign investment has given rise to a modest increase in foreign investment activities, geared mostly toward the export market. Approval of new investment in 1986, for example, is expected to reach $2 billion.

figures of $33 billion to $40 billion in 1982.[14] There has been a fear that banking loans may flow out of Mexico almost the moment they get in. If rich Mexicans decided to return what they own in property and bank accounts abroad, Mexico's debt would easily be halved.[15]

Nationalization of the banking system in 1982 was the first step taken by the government to curb capital flight. In a further attempt to keep dollars at home, the government has subsequently raised real interest rates, trying to maintain realistic exchange rates at the same time. It recently permitted the reopening of dollar accounts in domestic banks, which had been closed since September of 1982. There is no evidence, however, that these measures alone would be sufficient to stem the tide of capital outflow. It seems that there has to be a much stricter enforcement of exchange controls and a heavier penalty on illegal capital movements. This would mean adopting new measures aimed at halting capital flight, with the government reforming itself internally to curb any looting of the nation's coffers at the same time. One clear reason for the reluctance of foreign investors to invest in Mexico has been their disenchantment with corruption and red tape.

In addition, for purposes of mobilizing domestic savings it is imperative for the nationalized banking system to recapture public confidence in the financial system. In this regard, the recently instituted high deposit rates by the banks seem to have encouraged

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[14] An estimate by the Bank of Mexico puts the total capital flight between 1975 and 1985 at $40 billion. This is the most conservative estimate in comparison with other sources. One form of capital flight is export under-invoicing. Comparison of 1984 trade statistics in the United States and Mexico showed a discrepancy of as much as $4 billion. In addition, according to a CEPAL estimate, as of September 1985, Mexicans' deposits in foreign banks amounted to $21.5 billion.

[15] Wall Street Journal, "Real Foreign Debt Problem," April 8, 1986, p.32. For the entire Latin American countries, the total capital outflow, as of the end of 1985, constituted 28.8% of their external debt. Excelsior, May 22, 1986. p 22-A.

domestic savings.[16] It is clear, however, that domestic savings alone are not likely to be sufficient to support economic recovery. Mexico will need to supplement domestic savings by external capital. There is a much larger role to be played by foreign investors in the restructuring of the economy. There is a need to define areas within the industrial sector and types of production in which to encourage foreign investment, and to reexamine possibilities of redirecting the role of foreign investment. This is not an easy task to accomplish. Foreign investors have been cautious, given the economic uncertainties prevailing in the country.[17] Moreover, in the present context foreign direct investment must play a key role not only in the easing of Mexico's foreign exchange constraint but also in the transfer of technology for purposes of facilitating, for instance, import substitution in capital goods or other technically complex industries in Mexico.

There is one caveat about the expected role of foreign investment: Except for offshore asemblies in the "border" industry, which accounted for 10% of total multinational sales in the pre-crisis period, foreign investments have in the past been primarily geared for production toward local markets. Foreign-invested firms in Mexico are now running at a substantial excess capacity. Earlier investments were directed toward an "oil-drenched internal market that never materialized."[18] It thus seems unlikely, at least until the time of complete recovery of domestic markets, that new direct investments in significant quantities will take place in Mexico. Mexico may then have to insist on loans from nonprivate institutions (such as the World Bank) for use in a longer-term policy for structural changes.

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[16] According to an estimate, deposits placed with the banking system increased to 509 billion pesos during the first half of 1983, as compared with 421 billion pesos in the first semester of 1982. See F. Solana, Banco Nacional de México, Review of the Economic Situation of Mexico, (July 1983).

[17] Total foreign direct investment fell from $1 billion in 1981 to $400 million in 1983.

[18] Kenneth Flamm, "Comments on Foreign Financing," in P. B. Musgrave, ed., Mexico and the United States, Studies in Economic Interaction, (Boulder and London: Westview Press, 1985), p.76.

The Need For International Cooperation

The past strategy followed by creditors in dealing with the Mexican debt problem has been to procrastinate about any real solutions while ensuring the servicing of the debt and doing nothing to build the country's capacity for repayment: That is, the burden must be borne entirely by the indebted country. This strategy was based on the assumption that Mexico's adjustment efforts would be temporary, and when the industrialized center resumed its recovery, this would bring about dynamic growth in exports from Mexico sufficient to pay off the debt.

This assumption must, however, be challenged in view of world trade prospects for the coming years. Although some recovery of the industrialized countries is expected, it is by no means certain that their growth rates will reach those achieved before the debt crisis. Moreover, there is little evidence to indicate that the terms of trade facing the developing countries will soon improve. The recovery of the terms of trade is likely to be slow and uncertain, while protectionism in the industrialized world threatens to remain, restricting the access of developing country exports.

Under these circumstances, the austerity program imposed on the debtors can no longer be viewed as transitional in nature. Given the gravity of the crisis, it now seems realistic to assume that Mexico's debt will not be paid off within the foreseeable future. Thus, an alternative strategy in which to carry out the longer-term adjustment within the context of sustained growth must be sought on the basis of international cooperation: Suitable domestic policies by Mexico alone are not likely to be sufficient without adequate collaboration from creditors. The new strategy must at least ensure that growth in the debt will not be any faster than economic growth. As admitted by an American banker,[19] "There isn't any fat in the financial program that Mexico presents to the banks."

There are two important ways in which the lenders could cooperate: First, as regards trade relations, the industrialized countries must make every effort to open access to debtor-country exports by reversing protectionist trends. One direct form of debt relief that can be provided by the United States as Mexico's creditor concerns U.S. purchasing policies in the oil market. Since oil is so cheap generally, the United States could afford to purchase Mexican oil at a higher price than OPEC oil by imposing a surcharge on imports from the latter. (The United States could use the Mexican oil to replenish its Strategic Energy Reserves, which dwindled from the level of 750 million barrels in the late 1970s to the current level of 500 million barrels.)

Secondly, real relief from the debt service burden must be provided to a level that a debtor country could afford without significantly affecting the process of economic and social development. The fact that debt problems must be resolved within the context of economic growth requires that capital flow to Mexico must be substantially increased over and above what will be required for the servicing of the debt. In return, Mexico of course must show more responsibility in the control of capital flight. The accelerated process of reversed capital flow from Mexico to the United States is clearly incompatible with the objective of growth.

The Baker Plan, introduced in late 1985, called for $29 billion in additional loans over the span of the next three years for 15 debtor nations including Mexico as the Plan's major beneficiary. The loan agreement stipulates certain policy measures that must be taken by the debtor nation: privatization of state enterprises, promotion of direct foreign investment, liberalization of trade, prevention of capital flight, and adherence to the IMF austerity measures.

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[19] The remark was made by an investment firm economist (Shearson Lehman Brothers, Inc.), Wall Street Journal, October 2, 1986, p.1; "Mexico at the Brink."

Fair enough: But strict adherence to the Plan agreement could invite more problems for Mexico. First, there is the question of how much longer Mexicans could tolerate austerity programs, since they are now enduring their fourth year of fast-declining living standards. Secondly, it is not all clear that the immediate impact of import liberalization would be positive. As Mexico moves decisively on import liberalization, it is likely to incur massive casualties among protected industries in the short run. Any increases in imports, such as would result from liberalization, simply add to the debt burden as exports are linked to the debt-servicing. Finally, the amount pledged in the Plan, since it was drafted at a time before the worst of the current oil slide, falls far short of Mexico's needs. Even for the proposed amount, there is no assurance that the international banking community would be willing to assume a new risk.

The recent agreement by which Mexico is to receive $1.5 billion in new credits from the IMF, to be disbursed over 18 months beginning in September 1986, is likely to pave the way for additional credits from Western and Japanese banks as well as from the World Bank. It is important that Mexico have sufficient funding to support the economy during the transition period until definitive policy measures promoting growth can be implemented: Otherwise fresh credits will provide only a temporary solution to the debt problem.

Policy Options for Economic Restructuring: Suggestions

Within the sphere of domestic policy, the Mexican government has already taken steps to deal with the crisis, including measures to cut government spending, sell off state enterprises, and shift debt into equity. On the structural side of readjustment, of course, the immediate revitalization strategy must include the options of creating new opportunities for export industries as well as gradually reducing import-dependency, in particular, to compensate for the long-term loss of oil revenues. This is particularly important since joining GATT is likely to ease Mexico's entry into industrialized countries' markets.[20] The overriding condition likely to be insisted on by creditors for new loans will be an assurance by the Mexican government that loans would be used to boost exports in order to increase the capacity to service its debt.

The export of raw materials, especially oil, has so far been the major source of foreign exchange revenue for Mexico, accounting for 70 to 75% of total export earnings. As the recent oil slide begins to inflict a severe setback in the country's effort for financial stabilization, Mexico is compelled to depend more on nontraditional exports. In this regard, the government has been actively promoting foreign investment in the "maquiladoras" as an integral part of the plan for revitalization of the economy and for the paying-off of debts. There are currently some 700 "maquiladoras"--those foreign (mainly U.S) owned factories scattered mostly along the 2000-mile border with the United States that import materials and components duty free but must reexport up to 80% of their assembled products outside Mexico. They brought in $1.3 billion in net export earnings in 1985, second only to crude sales. The low real wages and the undervalued peso have helped to stem the leakages of Mexican income spent across the border.

There are, however, noteworthy problems with this grand vision as regards the maquiladoras as a major mechanism for the reconstruction of a faltering economy. First of all, although these plants currently serve as the only viable sector generating new jobs,[21] they are not effectively integrated with the rest of the economy: Not only has the local

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[20] At the time of Mexico's joining GATT there were some 25 pending cases of countervailing duties against Mexican exports imposed by the United States. By virtue of the accord in GATT, bilateral trade restrictions against Mexican exports are likely to be reduced.

[21] According to an estimate by the Maquiladora Association in Juarez, each maquiladora job generates 1.5 positions in the local economy. Including the indirect employment effect, the total employment generated by maquiladoras was about 600,000 in 1985.

content in their resource use been very low,[22] but also their linkages to the interior economy are virtually non-existent. Mexico's infrastructure is still woefully inadequate with its underdeveloped highways and communications network. The imminent issue would be: What must be done to ensure an increased share of local content for Mexico, and to strengthen the linkages of maquiladora industries to the rest of the economy?

More importantly, unless the maquiladoras can be shown to have played the role of a catalyst in the transfer of advanced technologies, their long-term benefits to Mexico can be questioned. Most Mexican workers in the maquiladoras still earn the pitifully low Mexican minimum wage--$3.70 a day in 1985. The continued decline of the peso has been a significant factor for the recent flooding of foreign investment in this sector. It is debatable whether the maquila sector should ever constitute a mainstay of Mexican industry from a longer-term perspective.

Another essential ingredient of the IMF-backed corrective policies is exchange-rate adjustment. While a case can perhaps be made for the longer-term need for a major reallocation of resources through price changes, the rationality of continued devaluations as a main, corrective instrument must be questioned not only in terms of their efficacy but also in terms of their social and political costs. One general problem with devaluation in a developing country is that any adjustment in the tradeable sectors requires a long gestation period.[232] Over this period, as revealed by the recent Mexican experience, attendant inflationary pressures will set in motion the subsequent, nominal devaluations

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[22] According to a government source, the local material content averaged at about 6% in 1985.

[23] The post-1981 devaluation episode tells us that the improvement in Mexico's current account was largely the result of a severe cutback in imports through import controls rather than through an expansion of exports. Available evidence indeed shows that the overvalued exchange rate which prevailed during the 1978-1981 period did not deter the steady growth in Mexican exports. Total exports rose by 9% annually in real terms in comparison to 6.7% increase in the 1971-1976 period. The post-1981 decline in manufactured exports cannot solely be attributed to an overvalued peso. More likely, the world-wide recession had more to do with decreased demands for manufactured exports from developing countries.

of the currency, larger every time, with the resulting reduction in the real wage rate and its adverse impact on income distribution.

In addition, the Mexican economy has structural characteristics that would reduce the efficacy of exchange-rate policy: First, the bulk of Mexico's export earnings come from oil and oil-related products, whose supplies are relatively price-inelastic. If anything, large devaluations are likely only to cause a deterioration in the country's terms of trade. Secondly, in Mexico more than a half of total exports in manufactured goods--more than three quarters in metal mechanical products--take the form of intra-firm transactions by multinational firms. In the capital-goods industry, subsidiaries of multinationals carry out most of capital goods exports. Relatively few exports, mainly in equipment for the oil industry and agricultural implements, are handled by Mexican firms. Since many multinationals resort to the so-called transfer pricing, and since their export of such products as automobiles and automobile parts is regulated under the export-import link system, a devaluation of the domestic currency is unlikely to have an important influence over Mexico's export activities.

More importantly, the success of devaluation policy also depends on the tolerance of the trade unions and workers to accept the reduction in real wages that normally accompanies a devaluation in the short run. Apart from the question of whether or not Mexican workers will in the national interest accept any prolonged stagnation in their living standards,[24] the policy of devaluations had its costs in terms of undue burden imposed on less privileged classes: As already mentioned, inflation accelerated by massive devaluations of the peso has caused real income of Mexicans to fall by about

[24] For the first time since the initiation of economic austerity, several thousand unionized workers have recently taken to the streets to protest high prices and demand a renunciation of the foreign debt. The government still has a tight grip over the vast majority of organized union workers.

40% since 1982.[25] In addition, repeated devaluations of the peso have increased the debt-service burden, in particular, of Mexican private-sector borrowers, since external debt is denominated in U.S. dollars. The plunging peso and attendant inflation since 1982 have been the key factors contributing to the persistence of general turmoil in Mexico's financial markets, causing uncertainty about economic outlook and precipitating capital flight from Mexico. At any event, if an overvaluation of the domestic currency does impede export activities, other policy instruments are available for correcting distortions without subjecting the economy to inflationary and other damaging repercussions.

To be fully effective for revitalization of the economy, the strategy of import substitution must on the other hand continue to exploit possibilities in capital and intermediate goods industries. Mexico's domestic market potential for these industries seems far greater than that of either South Korea or India, both of which have a far more advanced capital goods industry. Judging by Third World standards, Mexico possesses adequate technological and scientific infrastructure, along with a sizable skilled labor force, to develop these industries. As Mexico moves into more advanced import-substitution sectors, industries with the potential for sizable domestic markets must be selected. In this regard, Mexico must learn to exercise caution in the planning and implementation of measures for import liberalization, as required by the GATT regime.

Of course, economic restructuring should by no means be limited to foreign trade areas. Other priority issues should concern increased roles to be played by private-sector firms as well as greater rationality in public enterprise performance. The "paraestatales"--the companies run with state participation in Mexico--have been very important in the Mexican economy, and recently accounted for as much as 60% of manufactured value

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[25] In the absence of an effective wage and price freeze, inflation is expected to rise at least 80% in 1986. "Business Outlook: Mexico," Business Latin America, March 31, 1986, p. 94.

added.[26] Many of them, established to achieve political stability and other nonprofit related objectives, have been operating at a heavy loss. They were kept afloat by subsidies that tended to crowd private companies out of credit markets. With the deepening of the debt crisis, the "paraestatales" have been increasingly accused of inefficiency, corruption and budgetary overruns.[27]

On the other hand, government-private sector relations have given way to much uncertainty that has adversely affected the development of the private sector. Mexican private firms showed in the past the capacity to compete in international markets.[28] The key effort of the government must now be aimed at restoring a more balanced role of the private sector in a mixed economy. Such revitalization efforts would clearly call for the reversing of the past deflationary policies, which included high real interest rates and rapid paces of devaluation, thereby discouraging investment and raising the propensity of the corporations to engage in destabilizing capital outflow. A healthy development of the private sector in a mixed economy is important, for it could stimulate competition with state-run businesses. Moreover, in the current context of economic recession, such development would be conducive to increased domestic savings, investment, and exports without recourse to increased government budget deficits and external debt.

To summarize, the key elements of structural adjustment, at least until the time of recovery from the current crisis, are likely to consist of continued reliance on oil exports, increased efforts for maquiladoras activities as well as intensification of efficient import-

[26] Currently, in response to pressures from the United States, the de la Madrid administration has authorized partial liquidation of public enterprises to the private sector. So far, the government liquidated only public-sector firms considered of marginal importance to the economy.

[27] A classic example of budgetary overrun is the Sicartsa steel mill in Las Truchas. Completion of installations for operation is at present estimated to cost an additional $1.8 billion, and the completed plant is considered to operate at a loss. The debt obligations of the mill currently cost more than 30% of its revenue. New foreign loans are needed to keep up with the debt.

[28] They have been successful, in particular, in the areas of automotive parts and chemical products.

substitution industrialization by strengthening the industrial sector's productive capacity, possibly with the help of direct foreign investment. In all these efforts, Mexicans will have to tolerate the fact that direct foreign investment will play a much bigger role in Mexico than before.

The longer-term challenge facing Mexico is the sustenance of socially acceptable economic growth without incurring external deficits that exceed the financial capacity of the economy. Acceptable growth can be understood as one that can provide both productive employment to the rapidly growing labor force and basic-needs goods for a population that will reach 100 million by the end of this century. Without real growth, the very legitimacy of the government and its political system can be questioned.

The development strategy, then, must aim at the restructuring of industry to provide better for basic needs and at the same time at improvement of industrial productivity to make the economy more competitive as both an exporter and import-competitor in world markets. Mexico's growth in industrial productivity in recent years has been lower than that in other newly industrializing countries. There is an urgent need to modernize the plants, especially those of private firms, which will need all possible support and incentives from the government.[29] In this regard, the long-term strategy must define positions on the issue of how much of the emphasis is to be placed on import substitution v. export promotion, along with the choice of strategic sectors as growing points of the economy. The recent experience under the administration of Lopez-Portillo reveals the importance of implementing sectoral policy as an integrated part of an overall macroeconomic policy framework: Open-economy liberalization, combined with expansionary domestic policy, proved incompatible with a sustained industrial-sector development in the face of uncertain external conditions. It seems that if the domestic productive structure is to be strengthened and economic revitalization is to be ensured

[29] See A. Cristina Laurell, "Crisis y salud en América Latina," Cuadernos Políticos, (Ediciones ERA, Mexico, D.F.), No. 32 (July-September 1982).

for Mexico, unrestricted trade and capital-market liberalization schemes should be avoided.

As for the industry, the conventional, infant-industry argument would still be applicable to the sectors with a clear dynamic comparative advantage potential. Of course, care must be exercised to ensure efficiency in the development of domestic industry. For instance, the level of protection needs to be gradually diminished as industry develops. At the same time, one has to be aware of the limits of import substitution for Mexican industry as well as the potential contribution that can be made by certain branches of export industries. Thus, there is a need to take into consideration specific sectoral conditions in the plan for industrial development.[30] The development strategy for Mexico must be based on a more eclectic approach combining the notion of maximally exploiting domestic market potentials and that of industry-selective export-promotion measures.

[30] Such branches of industry as light consumer goods, textiles and shoes are known to have a saturated domestic market, limiting further possibilities of import substitution.

Appendix Table: Macroeconomic Indicators

	1978	1979	1980	1981
GDP (a)	711,982	777,163	841,855	908,765
Per capita GDP (b)	10,843	11,510	12,131	12,734
Investment (a)	164,472	193,418	235,974	272,782
Total exports (c)	6,063	8,913	15,134	19,420
Oil exports (c)			9,880	13,830
Imports (c)	7,918	12,097	18,822	23,930
External debt (c)			50,700	74,900
Debt service (c)	7,306	11,406	9,397	13,006

	1982	1983	1984	1985
GDP (a)	903,839	856,174	885,928	909,848
Per capita GDP (b)	12,360	11,418	11,527	11,645
Investment (a)	194,486	146,050	153,901	159,749
Total exports (c)	21,230	22,312	24,054	21,835
Oil exports (c)	16,480	16,020	16,600	14,770
Imports (c)	14,437	8,550	11,254	13,993
External debt (c)	92,100	96,700	97,700	101,500
Debt service (c)	19,051	15,571	16,445	14,500

Notes: (a) in millions of 1970 pesos; (b) in 1970 pesos; and (c) in millions of U.S. dollars.

Sources: Banco de México, Nacional Financiera, & BANAMEX; and also E. Ortiz, "The Debt Crisis: Limits of Stabilization Policies and Alternatives for Development," paper presented at the conference on Mexico's external debt, UNAM, Mexico City, May 18-22, 1986.