June 30, 1986

A U.S. STRATEGY TO SOLVE MEXICO'S DEBT CRISIS

INTRODUCTION

Mexico's international debt problems are once again making Wall Street nervous.[1] The roots of the current crisis go back at least a decade, but the problem first reached a critical stage in August 1982 when Mexico was unable to meet interest payments on its then $80 billion debt. In response, the country's creditors rescheduled Mexico's loans and devised a plan to reduce Mexico's crushing debt burden. This included an austerity strategy imposed by the International Monetary Fund (IMF). Despite these efforts (or because of them) Mexico's external debt now has mushroomed to over $98 billion and the country again faces possible default when $1.8 billion in interest payments fall due on June 30.

In contrast to the IMF's reflexive prescription of austerity, the Reagan Administration correctly urges that only economic growth pulls developing nations out of the debt quagmire and puts them on the road to prosperity. Translating this sound counsel into policy, Treasury Secretary James Baker has made his proposed $20 billion in new private loans and $9 billion in new international organizations loans to debtor countries contingent on those nations adopting market-oriented economic reforms. In the context of the Baker Plan, Reagan Administration officials are working with their Mexican counterparts, IMF and World Bank officials, and private bankers on Mexico's crisis.

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1. For an overview of the debt crisis, see Esther Hannon and Edward L. Hudgins, "A U.S. Strategy for Latin America's Debts," Heritage Foundation Backgrounder No. 502, April 7, 1986.

No doubt they will fashion some short-term arrangement to help Mexico through the difficult months ahead. But if the Baker Plan is to be more than mere words, the Reagan Administration must develop a growth-oriented economic plan for Mexico--otherwise an even greater Mexican crisis will explode in the future.

Mexico's current problems are a culmination of structural deficiencies in its internal economic policies and the result of recent economic and political shocks. The most immediate factor is the 50 percent drop in oil prices since late last year. This has cut sharply revenues from Mexican oil exports, which are critical to the country's foreign exchange earnings, thus making it very difficult for Mexico to meet its debt obligations.

Although the oil price change has provoked the crisis, the underlying factors stem from Mexico's huge public sector, from massive state intervention into the economy, and from restrictive trade and investment policies. Admittedly, there have been signs of positive change in recent years. Budget cuts, for example, have been made. Plans exist to sell to the private sector or close various money-losing state industries. Some investment rules have been relaxed. Freer trade is at least being considered. And special factories near the U.S. border, called maquiladoras, governed by special trade and investment laws, are prospering. But these changes have been too small as yet to overcome Mexico's economic woes.

International help, meanwhile, has been a mixed blessing. The IMF austerity plan under which Mexico has operated for over three years has squeezed hard currency out of the country for debt payments yet failed to promote economic growth. Learning from this experience, the Reagan Administration should support a new IMF strategy for Mexico only if it promotes economic growth rather than economic contraction. The Administration should not be overly concerned about losses suffered by Mexico's creditor banks, for the U.S. banking system is not currently in danger of collapse. The banks are capable of dealing with the debt situation on their own, relying on sound business principles instead of government help.

A sound U.S. strategy for the Mexican debt crisis should be rooted in the Baker Plan. It could encourage, for example, a technique for reducing state holdings in the economy: foreign or Mexican private businesses purchase Mexican debt from banks and forgive the debt in exchange for Mexican government-owned equity in Mexican businesses. The Administration also could encourage Mexico to accelerate market-oriented reforms and structural economic adjustment. Among these are reducing the size of the public sector, deregulating the economy, and cutting taxes. And the U.S. could seek expansion of the maquiladora factory system and offer to cooperate in the establishment of complete free trade and investment zones.

The Mexican people want and deserve the opportunity to work and to prosper. But past statist policies have failed to meet these needs. Yet the current crisis offers Mexico the chance to change directions, to follow the kind of growth-oriented policies that have helped many of the developing countries of the Pacific Rim and are capturing the imaginations of many others. Only a free market strategy will create new, productive jobs, improve Mexican business and labor efficiency, and spur real, non-inflationary economic growth. Only an economically dynamic and growing Mexico will be able to prosper and to meet its debt obligations.

THE CURRENT DILEMMA

Of Mexico's $98 billion foreign debt, nearly $75 billion is owed to commercial banks, with U.S. banks holding about one-third of the IOUs. The rest is owed to other banks worldwide. In the past, Mexico has kept up its interest payments and has been considered the "good pupil" among the debtor nations. This year Mexico will owe approximately $9.2 billion in interest payments, with $1.8 billion due on June 30. While this year's total debt service amount is down from last year's $10.1 billion, thanks to lower interest rates, the 50 percent drop in oil prices has slashed Mexico's export oil earnings from $14.7 billion in 1985 to about around $7 billion this year. Mexico thus faces a 25 percent real decline in government revenues.

Mexico is seeking between $6 billion and $8 billion in new loans and concessions (for example, on interest rate spreads). But the Reagan Administration maintains that most of this shortfall can be made up by Mexican cash on hand plus additional Mexican budget cuts. Indeed, Mexico's cash balances are believed to total perhaps around $6 billion. Nonetheless, Mexico is seeking $2.5 billion in new foreign commercial bank loans, $1 billion each from the IMF and World Bank, and about $600 million from the Paris Club, an informal group of government creditors. At this point, direct U.S. aid is not anticipated.

AMERICA'S ECONOMIC INTEREST IN MEXICO

Mexico's economic difficulties pose a real, though limited, threat to the U.S. economy. Mexico is America's third largest trading partner, selling the U.S. mainly oil, machinery, and transportation equipment. To accumulate currency to pay its debts, Mexico has been

reducing purchases of U.S. goods. American sales to Mexico dropped from $17.8 billion in 1981 to only $9 billion in 1983.[2] And while sales were back up to $13.6 billion by 1985, they are likely to decline again this year.

Manufacturers of U.S. machinery and transport equipment have been badly hit, with sales dropping from $8.7 billion in 1982 to $3.7 billion in 1983. Sales from this sector recovered only up to $6.6 billion in 1985. U.S. farmers, struggling with their own debt problems, also have suffered heavily. The initial crisis in 1982 cut U.S. agricultural sales to Mexico from $1.9 billion to only $680 million. And by 1985 sales were still only $920 million. Clearly, an economically strong and prosperous Mexico is better able to purchase U.S. goods and create American jobs. A stagnant Mexico purchases little and adds to America's export problems.

U.S. SECURITY INTEREST IN MEXICO

The economic crisis in Mexico is creating serious social and political problems that could trigger unrest, posing a security problem for the U.S.[3]

Mexico's economy will contract this year for the third time in the last five years. The debt crisis and the IMF austerity measures have increased unemployment, while real wages for those employed have dropped and the standard of living has slipped back to the 1967 level. Most hard currency goes to debt payments, with little left over for productive investments. Businesses with foreign currency have been placing it in bank accounts abroad, rather than investing in factories at home. To staunch the flight of capital, the state-owned banking system halted nearly all new credit to Mexican businesses. This, of course, cut investment further. Inflation also has been a chronic problem. And prices for basic food products have in some cases quadrupled. Malnutrition and health problems among the poor are endemic and on the rise.

Mexicans are frustrated that there seems to be no end in sight to the economic hardship. For the first time since the 1910 revolution, which established the current system of government, the legitimacy of

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2. Trade figures in this section are from Latin American Trade Review 1985: A U.S. Perspective (Washington, D.C.: U.S. Department of Commerce, International Trade Administration).

3. For an overview of these problems, see Mary Williams Walsh and S. Karene Witcher, "As Debt Turmoil Ebbs and Flows in Mexico, Human Misery Persists," The Wall Street Journal, June 12, 1986.

the government is being seriously questioned. Charges of widespread election fraud undertaken by the ruling Institutional Revolutionary Party (PRI) against the opposition conservative National Action Party (PAN) have intensified political divisions. Even more serious, perhaps, are growing divisions within the PRI itself. The PRI normally governs by a consensus of the various interest groups, including organized labor, party intellectuals, and government bureaucrats. Now these elements, nearly all more leftist than Mexican President Miguel de la Madrid, openly criticize the government and call for more radical socialist approaches to Mexico's economic problems.

While the political stability of Mexico is not yet at stake, further economic decline could unleash violent social unrest. This would only benefit the left. A radical leftist regime in Mexico, friendly to Cuba and the Soviet Union, driving millions of refugees north, would pose one of this century's most serious national security problems for the U.S. Further, Mexico is one of America's most important sources of oil imports. A disruption of the oil flow because of social unrest or a hostile government would also pose a serious security threat.

MEXICO'S PAST ECONOMIC ERRORS

While falling oil prices precipitated the latest crisis, Mexico's economic problems are rooted in its economic system, which relies heavily on socialist and statist economic policies. To take just one barometer of the problem: the government consumed about 26 percent of Mexico's GNP in 1970; now it is 50 percent.[4] Because the political power of the ruling PRI rests to a great extent on its ability to provide public sector jobs to supporters, public sector employment has increased throughout the debt crisis. The industries and enterprises owned by the state, meanwhile, have jumped from 86 in 1970 to over 1,000 today. And trade barriers designed to keep out foreign goods to encourage domestic manufacture have only wasted capital and labor and made the Mexican economy less competitive.

Foreign investment and direct foreign ownership of Mexican businesses might have been expected to provide an infusion of capital and know-how, but such investments have been restricted sharply by the government. This has meant that the government had to raise much of the capital for industry--which the government did by borrowing abroad. The result: Mexico's massive foreign debt. The sudden

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4. Luis Pazos, "The False Austerity Policies of the Mexican Government," Journal of Economic Growth, Vol. 1, No. 1, First Quarter, 1986 (Washington, D.C.: National Chamber Foundation).

nationalization of the banks in 1982 by President de la Madrid's erratic predecessor, moreover, contributed to capital flight by demonstrating that the Mexican government could not be trusted to respect, much less to protect, the rights of private property. Artificial attempts to stimulate economic growth last year by printing new paper money only accelerated the rise in inflation and the drop in the peso to about 750 per dollar from 250 per dollar last July.

RECENT ECONOMIC PROGRESS

A number of Mexican statesmen realize that fundamental economic reform is sorely needed. Small but important first steps have been taken. Example: a number of state enterprises, such as Mexicana Airlines, are to be sold off to the private sector. Others have been shut down, including recently an unprofitable steel mill in Monterrey.

To ease part of its debt burden, Mexico is allowing debt-equity swaps.[5] Foreign banks sell portions of their Mexican debts to other foreign companies which, in turn, can exchange the debts for government-owned equity in both public and private Mexican companies. At least three such swaps, worth $81 million, already have taken place. This is an important development. Foreign businesses that own shares in Mexican companies have strong incentives to see that such companies succeed economically. They are likely to invest more capital and resources to protect their interests and to oppose international action that would constrain the Mexican economy.

Helpful also will be Mexico's imminent membership in the General Agreement on Tariffs and Trade (GATT), the multilateral agreement that governs most world trade. This could lead to trade liberalization and stepped-up foreign investment. Some restrictions on direct foreign investments, in fact, have already been eased. Though foreign companies normally can own no more than 49 percent of a business in Mexico, for example, a 100 percent IBM-owned and operated facility was recently approved by the Mexican government.

One market-oriented policy developed over the last decade, known as the maquiladora factory system, has been very successful.[6] Under this system, U.S. companies have established over 700 plants in the northern border regions of Mexico without the usual requirement of

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5. See testimony by Assistant Secretary of the U.S. Treasury David C. Mulford before the Subcommittee on Western Hemisphere Affairs, Senate Foreign Relations Committee, June 10, 1986.

6. See Aaron Freiwald, "Mexico: A Multinational Haven," Multinational Monitor, November 15, 1985.

having Mexican partners. These plants are allowed to import from the U.S. the capital goods and semi-finished products necessary for production without the need to pay Mexican duties. Goods produced in these plants can be re-exported to the U.S. with tariffs being paid only on the value added to the goods. This allows U.S. companies to take advantage of less expensive Mexican labor. These maquiladoras near Mexico's border with the U.S. are among the few bright spots on a dark Mexican economic landscape.

Some critics may charge that Mexico's economic reforms are too little, too late, or mere token gestures to appease foreign creditors. It is true that these reforms will not restructure Mexico's economy overnight--nothing could do that. There is strong leftist opposition to such reforms. Thus Mexican leaders must fight tough political battles for even small steps.

THE ROLE OF THE IMF

For the past three years, Mexico has been complying with stiff conditions established by the IMF in exchange for financial assistance. But IMF requirements are a two-edged sword.[7] They are meant to generate sufficient hard currency for a country to keep up its debt payments. But while doing so, they may lead to long-term economic distress. For example, while it is economically sound to slash a country's budget deficit through spending cuts, it is economically dangerous to do it by raising taxes. Yet the IMF often encourages tax hikes to cut budget deficits.

IMF conditions usually require increasing exports and cutting imports. But this often deprives businesses of necessary capital goods obtained only from abroad. And inefficient local industries often must make up for lost imported goods which could have been purchased far cheaper than the local industry's production costs. Developing countries, moreover, usually need to import such resources as money and goods to grow. Closing markets to imports thus causes serious long-term economic damage.

Thanks to such IMF conditions, therefore, Mexico is in many ways worse off as a result of international "help." IMF requirements have pulled Mexico away from such growth-oriented policies as tax cuts and freer trade.

7. For an overview of this issue, see Edward L. Hudgins, "An Agenda for the IMF Conference," Heritage Foundation Backgrounder No. 381, September 21, 1984.

THE ROLE OF THE BANKS

During the 1982 phase of the Mexican debt crisis, there was a real danger that defaults by large debtor countries could undermine major U.S. banks heavily exposed in Latin America. Today, however, the banks are in much better financial shape. Profits for eight major U.S. money center banks with large Latin American investments rose an average of 25 percent during 1985.[8] The price per share of their stock has climbed an average of 80 percent since the end of 1982, and dividends increased during the same period by 45 percent.

As profit-seeking businesses these banks took risks in lending money to the governments of developing countries. Many banks no doubt thought that since governments are unlikely to go bankrupt, their loans would be safe. That was a decision made by bankers who took the risk knowingly, expecting to make profits. It is proper, of course, for these banks to seek repayment of their loans. But it is not proper for the U.S. government, nor is it in America's economic interests, to relieve the banks of losses due to poor business judgment, either through taxpayer-financed bailouts or by pressuring Mexico to cripple its economy to meet debt payment schedules.

RECOMMENDATIONS

The objective of U.S. policy toward Mexico and other debtor countries should be to restore their international financial soundness by fostering growth and private enterprise. It should not be to protect businessmen and investors, including bankers, from their own bad judgment. Thus the Reagan Administration's policy towards Mexico in the current crisis should incorporate five basic strategies:

1) Support only an IMF program that promotes economic growth.

The Baker Plan seeks to move away from the austerity policies of the past toward an emphasis on economic growth through free market reforms. This new strategy now faces its first great test in Mexico. If the IMF, with U.S. support, saddles Mexico with loan conditions that sacrifice long-term development for short-term gains, the Baker Plan will crumble along with the Mexican economy.

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8. Figures based on "The Impact of the Latin American Debt Crisis on the U.S. Economy," a staff report of the Joint Economic Committee of Congress, May 10, 1986. Note: Due to its special situation, Continental Illinois was left out of these calculations.

2) Require the U.S. banks to work out their own arrangements with Mexico.

The U.S. government has no obligation to protect American banks--or any other industry--from losses due to bad business decisions. The banks should work out whatever deal they can with the government of Mexico. They have many options. For one thing, the banks could extend new loans and roll over old ones. For another, they could cut their interest rate spreads--the profit margins on their loans--as any other industry would when its market contracts. The banks also could consider a negotiated interest payment cap. For example, they could agree to accept interest payments of 25 percent of Mexico's export earnings. Combined with writedowns and reductions in overall outstanding principal, banks could still profit under this arrangement. While this latter option is the least desirable choice, and would set a bad precedent, it would be less disastrous than bankruptcy.

3) Promote debt/equity swaps.

The Mexican government has shown wisdom in allowing foreign businesses to swap portions of Mexico's debt purchased from creditor banks for government equity in Mexican companies. The U.S. Commerce Department should alert interested U.S. businesses of this possibility and provide them with the appropriate technical information. U.S. banks currently are prohibited from owning equity shares in any businesses, Mexican or American. Yet debt/equity swaps between the banks and the Mexicans would ease further the debt problem and probably fit in well with Mexican attempts to privatize state-owned enterprises. Congress thus should amend the Glass-Steagall Act, which forbids equity ownership by banks, to enable U.S. banks to take possession of equity in Mexican companies under the debt/equity swap arrangement.

4) Continue to encourage Mexico to make market-oriented economic reforms.

The Mexican government is under intense internal pressure to stay with the failed socialist policies of the past. But without basic reforms, easier IMF conditions and bank concessions are worthless. The Reagan Administration therefore must continue to encourage receptive Mexican leaders to make market-oriented reforms. Since the Mexicans are sensitive about foreign pressure, especially from the U.S., this encouragement should be discreet. Public criticism of Mexico is likely to be counterproductive and should be avoided. The U.S. also should ask the Western Europeans and Japan to tender free market suggestions.

5) Explore further special free trade and investment arrangements.

The success of the maquiladora system is a base for further expansion of free trade and investment. Currently, all finished products from maquiladora factories must be re-exported to the U.S. It would be better if Mexico would allow some of these goods to enter the Mexican market. In exchange, the U.S. could cut further the duties on the value of labor added to the products. The possibility of complete free trade and investment zones also should be explored. Ultimately, a complete Free Trade Area between the U.S. and Mexico should be sought, similar to the U.S.-Canada pact now being negotiated.

CONCLUSION

Mexico's economic problems are extremely serious. While the oil price drop was the immediate cause of the current difficulties, Mexico's own statist economic policies are at the root of its problems. But this does not mean that the U.S. can turn its back on Mexico. To the contrary. The economic and security interests at stake are too high. The U.S. must encourage Mexico to embrace the sound free enterprise principles that will restore its economy. Otherwise, the U.S. will soon have far more than merely an economic problem on its southern border.

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