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DEJA VU OF POLICY FAILURE: THE NEW $14 BILLION MEXICAN DEBT BAILOUT

INTRODUCTION

On the list of soaring Third World indebtedness, Mexico's $100 billion debt to foreign governments and banks ranks second only to Brazil's. Of this, Mexico owes $80 billion to banks in the industrialized countries, and one-third of that, to banks in the United States. This debt to American banks has meant that the overriding concern of U.S. officials dealing with Mexico's chronic debt difficulties is the stability of U.S. financial institutions.

Since Mexico sparked the international debt crisis in 1982, the U.S. Treasury, along with Federal Reserve Board Chairman Paul Volcker, has encouraged increased borrowing by Mexico through an International Monetary Fund (IMF)-led approach of recurring debt rescheduling and new money packages. The latest package, the 1986-1987 bailout, includes an IMF loan granted last fall and a bank package agreed to by Mexico's foreign commercial creditors this March. These periodic infusions have kept Mexico from defaulting on interest payments due U.S. banks: the new money they have lent Mexico has returned immediately as debt service.

Failing to Spur Growth. Yet the strategy has failed to trigger the sustained economic reform necessary if Mexico ever is to repay all, or even much, of its

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outstanding debt. The rescue package currently underway is unlikely to bring anything new. Bankers are increasingly recognizing this, as manifest in the decision by Citicorp and other banks to take losses this year in order to put aside billions of extra dollars into loan loss reserves.

The 1986-1987 bailout of Mexico is a $14 billion package, which includes $7.7 billion from commercial banks in the U.S. and other Western nations, about $2.2 billion in new World Bank commitments, an IMF "standby" credit facility of $1.7 billion, and extensions in trade credit facilities from creditor governments.

Put together by the IMF, this effort, as its two predecessors, ties the financial rescue of Mexico to desperately needed fiscal reforms. In return for the new cash, Mexico is promising, among other things, to liberalize trade, restructure state-owned enterprises, and bring domestic prices closer to market levels. Though the content of the rescue package is laudable, it evokes a numbing feeling of *deja vu*. Mexico has given similar assurances in the past but seldom fulfilled them. There is no reason to expect this effort to be any more successful. In the 1976 and 1982 IMF rescues from illiquidity, Mexico's ruling Institutional Revolutionary Party (PRI) responded by imposing narrow fiscal restraints borne largely by the poor. And each time, Mexico reverted to its former fiscal habits and reflated the economy about 18 to 24 months after the crisis.

Testing the Baker Plan. In late 1985, the U.S. Treasury changed its strategy, shifting away from the required "austerity" of past IMF programs that aimed at forcing nations to cut back their budget deficits drastically. Treasury Secretary James A. Baker emphasized that debtor countries should be helped to "grow their way out of debt." As such, the new conditions tied to rescues concentrate on structural adjustments to trigger growth, such as trade and investment liberalization, tax reform, and privatization of state-owned enterprises. The $14 billion Mexican package is the first test of the "Baker Plan." While some of the required economic reforms negotiated with Mexico this time are new, there are few signs that its handling of loan conditionality will be any different than in the past.

The U.S. has significant economic and security interests in Mexico. It is America's third largest trading partner, behind only Canada and Japan. In 1986, U.S. exports to Mexico were over $12 billion, while imports from that country were $17.5 billion. Aside from this, a destabilized Mexico would not only invite Soviet-sponsored adventurism but provoke an explosion in the already high flow of illegal immigrants across the 1,950-mile border shared with the U.S.

It thus is a good investment for Washington to prevent the economic collapse of Mexico. It is not a good investment to shore up the same policies of the PRI that have created and perpetuated Mexico's problems. In fact, the Mexican economic crisis is, in large part, a political one.

Web of Regulation. Mexicans endured a revolution from 1910 to 1920 in the name of representative democracy. What they ended up with has been 60 years of quasi-dynastic, one-party rule in which every six years the president chooses his successor, who is then duly "nominated" and "elected." Under PRI-style "Mexican socialism," successive Mexican presidents steadily have consolidated their authority into an almost absolutist presidency, while bringing virtually every basic industry and national resource under state control. Today only about 30 percent of the economy remains entirely in the private sector, which in any event is entangled in a tight web of state regulation.

Organized labor has become almost synonymous with the PRI and fiercely opposes attempts to privatize state-owned enterprises. Corruption and nepotism, meanwhile, pervade the government, the party, and big labor. Large-scale vote fraud has marked all important elections for the past three years. Such political realities are directly connected to Mexico's irresponsible economic policies.

Ironically, but predictably, periodic external financial rescues have proved the enemy of sustained economic reform in Mexico. These rescues do Mexico no good and should be discontinued. The government has a variety of means for raising revenues to service its debt. It should divest itself of most of its inefficient state-owned enterprises, stop impeding the flow of equity capital, and promote the growth of the private sector and domestic capital markets through deregulation and a commitment to the sanctity of property rights.

THE MEXICAN BAILOUT OF 1986-1987

The current rescue package contains about a dozen new loans to Mexico. Among the most important:

1) **IMF stand-by facility of $1.7 billion.** And $720 million committed to commercial banks' oil and growth-rate funds; see below.

2) **World Bank $400 to $500 million** loans for trade liberalization.

3) **World Bank $950 million** loans for the investment programs of government-owned enterprises.

4) **World Bank $300 million** industrial sector loan.

5) **World Bank $700 to $800 million** loans for agriculture credit.

6) **Commercial Banks $7.7 billion** loan package containing $6 billion in new loans at a slim interest rate of 13/16 over LIBOR[1] (partially covered by World Bank cofinancing and guarantees); a $1.2 billion loan, activated if oil prices drop below $9/barrel in 1987; a $500 million loan, activated if Mexico's growth rate falls below 3.5 percent in 1987; a second interest rate reduction on the $43.7 billion in loans rescheduled in 1984 and the extension of their maturities to 20 years from 14; and relief on the payment of the 1983 and 1984 rescue loans.

In exchange for this infusion of capital, the lenders are imposing conditions on Mexico. Among the most important are:

1. The banks' cost of borrowing funds.

1) **The IMF loan insists on** current expenditure cuts, increased public investment, tax reforms, price adjustments to bring prices closer to market levels, and a 3 percent decrease in the fiscal deficit to 10 percent of GDP by the end of this year;

2) **The World Bank trade loans insists on** phasing in of GATT compliance[2] and a move from import quotas to a system based strictly on tariffs with gradual reduction of the latter.

3) **World Bank loans to state-owned enterprises** are linked to phasing out subsidies and are targeted for the steel sector, the fertilizer monopoly, and enterprises with mixed public/private participation.

PROBLEMS WITH THE RESCUE

A central element of the $14 billion package is IMF acceptance of the continuation of a large budget deficit by Mexico: 10 percent of gross domestic product (GDP) for 1987. By the end of this year, Mexico will owe at least an additional $12 billion, plus the corresponding interest. While the Baker strategy encourages Mexico to grow its way out of debt, any economic growth it enjoys in 1987 will come about mainly as a result of a large public sector deficit.

More important, fiscal austerity has never been completely tested in Mexico. The 1976 and 1982 IMF bailout programs required Mexico to halve the budget deficit during 1977 and 1983, respectively (see Table I). Yet the IMF allowed the Mexican government to implement this as it saw fit and even counseled tax hikes in 1983. The result was that Mexicans suffered inordinately because the deficit was cut without cutting the bureaucracy and state-owned enterprises. While genuine fiscal austerity is still desperately needed, the IMF's high deficit target only makes it easier for Mexico once again to put off drastically trimming the bloated state sector.

At Cross Purposes. In fact, IMF and World Bank conditionality even calls for increased investment for government-owned enterprises (GOEs). The World Bank is lending $950 million to GOEs for their investment programs, based upon promises that government subsidies to them will be phased out. This would clearly seem to be at cross purposes with an effort to make these enterprises more efficient or with the World Bank's purported advocacy of privatization of GOEs.

Additional loan facilities tied to the growth rate and price of oil were a key negotiating position of the Mexican government. A $1.2 billion fund will be activated if oil prices drop below $9 a barrel before the end of 1987. A $500 million facility will be triggered if Mexico's growth rate falls below 3.5 percent this year.

Unprecedented Disincentives. Such provisions are unprecedented and provide further disincentives for genuine reform. They imply that a government need not set aside reserves for adversity and that a country's fortunes are determined almost exclusively by external factors. In addition, the manipulation of government policies

2. Mexico joined in 1986 and has until 1994 to reach full compliance.

or the judicious use of statistics can produce a growth rate below 3.5 percent, thus allowing Mexico to collect the extra $500 million loan.[3] Ironically, an IMF economist recently described the new facilities as a significant tactical improvementon debt management since they allowed for the inevitable failure of an assumption or two in the IMF's country-specific economic models. In other words, it is now even more difficult for Mexico to "default."

There are yet no signs that the conditionality in this Mexico package will fare any better than in the past. Recent signals from Mexico City reveal that little has changed. In response to the urging by World Bank officials to privatize, the government has been merging smaller or ailing state-owned enterprises into larger ones. Real divestments have been few and include a hotel chain and a small airline. The government-owned Fundidora steel plant in Monterrey has been closed.

Off Limits. Mexicana, one of the nation's two government-owned airlines, has been up for sale to investors for eighteen months. Its failure to move is no doubt caused by the terms imposed by the powerful labor unions, which would prevent the new owners from dismissing any workers. The more profitable airline, Aero Mexico, is not for sale. Other government-owned concerns likely to remain off-limits include the federal electricity monopoly, and the state sugar, steel, railway, and fertilizer corporations.

The recent sale of stock in the three largest commercial banks nationalized in 1982 was characteristic of Mexican political patronage. In 1983, President Miguel de la Madrid promised to return 34 percent stakes in the banks to private hands by spring 1984. Finally, this March, 34 percent in each of the three was offered in greatly underpriced new capital issues. The share certificates were distributed almost entirely to employees and clients of the banks who are friends of the government.

A HISTORY OF FINANCIAL MISMANAGEMENT

Economic irresponsibility is nothing new in Mexico. The country defaulted on its late 19th century government borrowings in 1914. In the 1920s and 1930s a succession of debt agreements was reached with British bondholders and American and French creditor banks, each of which was followed by breakdown and renewed default. Only after Mexico had begun to receive U.S. assistance during World War II[4] was the debt problem resolved. Debts totaling $510 million in 1942 were paid off for less than $45 million, roughly nine cents on the dollar, despite Mexico's.

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3. Peter Bauer, "Ethics and Etiquette of Third World Debt," Ethics and International Affairs, vol. 1 (1987), p. 83.

4. This included U.S. agreements of 1941-1942 to: purchase silver from the Bank of Mexico up to 6 million ounces/month; purchase pesos up to $40 million to stabilize the currency; and extend Export-Import Bank credits to provide material for the construction of cargo vessels and rolling stock for increasing the capacity of Mexican railroads and to finance industrial development, including the construction of a steel and tin plate rolling mill and a gas refinery.

ability to meet its existing obligations easily--the flow of U.S. aid alone could have done this.[5]

Few instances typify Mexico's self-inflicted economic damage more than does the PRI's mismanagement of the Mexican oil industry. In 1938, President Lazaro Cardenas nationalized the foreign oil companies operating in Mexico. At first, the new state-owned oil company, Petroleos Mexicanos (Pemex), was able to resist the demands of the Oil Workers' Union. By the 1950s, however, all efforts to contain the union and run Pemex by sound business principles were abandoned. The government's direct control over Pemex grew. Said President Ruiz Cortines in 1954: "The role of Pemex was not one of profit but of social service."

Most Inefficient Oil Firm. Domestic oil prices were raised only twice from 1946 to 1974, denying the company the revenues needed for expansion, exploration, or even, at times, the maintenance of day-to-day operations. Friends and relatives of politicians were given Pemex jobs, and lucrative gasoline station concessions were awarded as political favors.

As a result, Pemex became known as the world's most inefficient oil company. Only in 1972 did Mexico finally pump more oil than it had in 1921. By the early 1970s, in fact, domestic demand was so high that Mexico was importing 100,000 barrels of oil a day from Venezuela, where output per worker was four times higher.[6]

THE MOVE AWAY FROM A MIXED ECONOMY

Since World War II, the Mexican government has used high tariffs, import licensing, overvalued exchange rates, domestic subsidies, and state-owned enterprises to achieve growth in selected manufacturing industries. These policies of import protection and selected subsidies of capital and energy predictably impaired Mexico's international competitiveness. Exports fell from 10 percent of gross domestic product (GDP) in 1950 to 5 percent in 1970.

Under President Luis Echeverria Alvarez (1970-1976), the government's role in the economy intensified dramatically. The public sector deficit, which had averaged 3.5 percent of GDP from 1965 to 1970, reached 8.5 percent of GDP in 1975. It is now well over 10 percent. The number of state-owned companies doubled between 1970 and 1976, a rate of expansion much greater than that of the economy in general. Echeverria financed state expansion through oil revenues and heavy foreign borrowing. The foreign public debt, which had amounted to $6.8 billion at the end of 1972, reached almost $21 billion four years later. Echeverria's developing liquidity crisis came to a head in August 1976, just months before his term was to end. He devalued the peso by almost 60 percent, the first devaluation since 1954.

5. See Clifford M. Lewis, "When Countries Go Broke: Debt Through the Ages," The National Interest, Winter 1986/87.

6. See Alan Riding, Distant Neighbors: A Portrait of the Mexicans (New York: Alfred A. Knopf, 1984), chapter 8, "The Oil Is Ours."

Capital Flight. The growing deficit spurred an inflation that encouraged Mexicans to send their money abroad. From 1970 to 1982, the average level of deposits by Mexican residents in U.S. banks rose from $276 million to $6.2 billion. The total capital flight from Mexico from 1974 to 1982 is estimated to be $31 billion. This is close to the $37 billion increase in foreign public debt under Echeverria's successor, President Jose Lopez Portillo (1976-1982).

After taking office in December 1976, Lopez Portillo signed a letter of intent with the IMF to obtain emergency "stand-by" credits to bolster the peso. In 1977, pursuant to the IMF program, he reduced the public sector deficit from 9.9 percent of GDP to 5.1 percent; this was close to the IMF target of 4.5 percent.

Betting on the Price of Oil. In 1977, oil discoveries off the southeast and Gulf coasts boosted Mexico's proven reserves from 6.4 to 16 billion barrels. This oil bonanza, along with rising crude oil prices and the fiscal deficit reduction achieved after 1977, boosted Mexico's credit rating. Foreign lenders competed fiercely to grant new loans to the Mexican government and to public enterprises. This was not project lending, but general balance-of-payments support from foreign commercial bankers. For repayment, they were betting solely on the price of oil, which was widely predicted to increase sharply in real terms for the foreseeable future.

Lopez Portillo paid off the 1977 IMF loan in 1978, a year early. That done, he then abandoned budgetary restraint and returned to the public sector-led growth approach of his predecessors, claiming that the new oil wealth would finance Mexico's development in a noninflationary way. He launched Mexico on a consumption spree, which not only absorbed all of its oil revenues, but also vast sums in foreign loans. Renewed growth in public expenditure fueled unchecked consumer demand.[7] Imports by 1980 were up to $20 billion. Oil exports in 1980, however, at not quite $10 billion, failed to cover even half of Mexico's imports. Since the exchange rate earlier essentially had been fixed, the peso again had become severely overvalued--by 50 percent in 1981. About $8 billion in capital fled Mexico in that year alone.

In an attempt to arrest the growing fiscal deficit, the Mexican Congress approved a fiscal 1981 budget mandating no deficit increase in nominal terms. Lopez Portillo ignored this. As Echeverria before him, he approved grand projects as off-budget items, which ended up being paid for by foreign borrowing. In 1981 alone, Mexico's external debt increased 38 percent. In the Lopez Portillo years, the total external debt rose from $27.3 billion to $84.1 billion. Over 80 percent was owed to private creditors; approximately 75 percent was at floating rates of interest.

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7. Fiscal Deficit (as % of GNP)

1976	9.9	1980	7.9
1977	5.1	<u>1981</u>	<u>14.7</u>
1978	6.7	<u>1982</u>	<u>17.9</u>
1979	7.4	1983	8.7

CORRUPTION UNDER ECHEVERRIA AND PORTILLO

The high level of corruption of the 1970s, excessive even by Mexican standards, played a significant role in precipitating the debt crisis. During Echeverria's tenure, government spending on massive industrial projects and rural public works was audited very casually. Top government officials, responsible for assigning contracts for public works or procurement of locally made goods, made fortunes through kickbacks and granting contracts to companies they owned. When the Las Truchas Steel complex was built 100 miles north of Acapulco in the early 1970s, for example, a consultant from British Steel estimated that $150 million of the $1 billion cost was lost through corruption.

As had several of his predecessors, Lopez Portillo promised to combat corruption. But the wealth of the oil boom soon became irresistible for him and most top officials. Nepotism also flourished at an unprecedented pace. Lopez Portillo gave ministerial and other top posts to his son, two sisters, a cousin, his mistress, and his wife. When he left office in 1982, the Mexican press claimed he had amassed a fortune of $3 billion.[8]

MANAGING MEXICAN DEBT SINCE 1982

After world oil prices declined in the early 1980s, another Mexican liquidity crisis erupted. In August 1982, Lopez Portillo declared a three-month moratorium on principal payments to foreign creditor banks. He then imposed blanket foreign exchange controls and nationalized private banks to stem the flow of capital abroad.

That August also, the IMF granted Mexico a "stand-by" credit facility of $3.7 billion, while foreign commercial banks granted $5 billion as an emergency loan. In return for the loan, the IMF insisted that Mexico cut its federal deficit 49 percent, from 16.5 percent of GDP in 1981 to 8.5 percent of GDP in 1983. By 1983, under President Miguel de la Madrid (1982-present), the deficit was down to 8.7 percent, but GDP had declined by 5 percent. While part of the contraction represented the long-delayed retrenchment of consumption, a large part can be attributed to the government's refusal to reduce its own dole. As Mexican professor Luis Pazos has shown, all austerity demands were made of industry, commerce, and private consumers, not the government.[9]

Growing Bureaucracy. While Mexico's population increased 25 percent from 1975 to 1983, the bureaucracy grew by 85 percent. Even during the ostensible austerity of 1983, the bureaucracy went up another 281,000 jobs. Salaries of ministers, underministers, directors, and high-level bureaucrats increased two to three times faster than the rate of inflation, while junior bureaucrats and labor suffered declining real salaries.

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8. See Riding, op. cit., pp. 113-133.

9. See "The False Austerity Policies of the Mexican Government," Journal of Economic Growth, vol. 1, no. 1, 1986.

To pay for this expanding government, taxes were raised. Upper bracket Mexicans found themselves paying steeper income taxes, and everyone was hit by the hike to 15 percent in the value-added tax. Prices charged by public enterprises for such products as gasoline, electricity, and telephone service were all raised substantially.

Mexico's foreign commercial creditors, concerned that debt repayment remain on schedule, took account only of the country's impressive 1983 trade surplus of $13.7 billion. Both a restructuring accord and a second emergency loan, this one for $3.8 billion, were negotiated in 1984. Yet even as these accords were being reached, Mexico was already violating the earlier IMF agreement; de la Madrid was pumping up the money supply. Again, the availability of foreign loans was exploited as an opportunity for fiscal relaxation.

By 1985, the deficit had mounted to 10 percent of GDP. The money supply was up 63 percent in 1984 after an increase of 41 percent in 1983. Lending to the central government from the nationalized banks reached record levels in 1984 and early 1985. From April 1984 to April 1985, the value of treasury bonds in circulation doubled. In response, the IMF withdrew its loan agreement in 1985 and canceled the last disbursements. Yet, by the summer of 1986, Mexico was back negotiating another financial rescue with the IMF and commercial banks.

THE WORLD BANK AND THE INTER-AMERICAN DEVELOPMENT BANK

Some $13 billion has been loaned to Mexico over the years by the World Bank and the Inter-American Development Bank (IDB). This money was to finance specific projects, in contrast to the general balance-of-payment loans made by foreign commercial banks and the IMF. About 90 percent of these project loans were made to the Mexican government, thus fueling expansion of the public sector. In 1985, for instance, the World Bank loaned $300 million to Mexico's nationalizedrailroad system. The railway's financial troubles should have prompted the World Bank to insist that it not remain in the public sector. Instead, the Bank's financing assured that it would.

The Inter-American Development Bank had approved loans totaling $4.5 billion for Mexico through 1986. The two largest sector recipients were agriculture/fisheries and industry/mining, both of which are owned largely by the government. In 1985, the Bank approved a $300,000 agriculture credit loan from the Fund for Special Operations, its soft-loan window that makes loans at 1 to 2 percent annual interest. Targeted to low-income farmers, these loans will go mainly to the ejidatarios, the farmers who cultivate Mexico's state-run farms.

CHANGING COURSE

With the PRI choice of presidential candidate approaching this September and the formal election following in July 1988, temptations for the Mexican government to inflate the economy are increasing. It happened in Brazil prior to last fall's parliamentary elections. It happened in Mexico preceding the 1976 and 1982 presidential elections and the July 1985 mid-term congressional and gubernatorial elections. The money supply in Mexico is already up. When the $7.7 billion in commercial bank loans of the new rescue package are delivered, Mexico actually will enjoy a temporary cash surplus. This almost surely will be used to inflate.

The IMF's job of providing short-term relief to cash-strapped countries has become discredited. While many countries, such as Mexico, increasingly depend upon such emergency funds, the accompanying IMF policy guidance rarely leads to genuine reform. The end result is that the IMF is becoming entrenched in countries where it has made big loans. This is transforming the IMF into an international FDIC for commercial banks. With the new Mexican bailout, the World Bank is joining the IMF in this role. This was necessary to get the commercial banks to increase their exposure by 13 percent in a country whose debt had declined in the secondary market over the past year from 68 percent of face value to 58 percent.

Dismayed Creditors. From the beginning, the commercial bank package has been very unorthodox. Other debtors such as Brazil, Argentina, Venezuela, and the Philippines have been eyeing enviously the slim interest spread of 13/16 over LIBOR (the banks' cost of borrowing funds) offered Mexico. The banks are not likely ever to agree to such terms again. The dismayed creditors of Mexico contend that the interest spread does not properly reflect Mexican risk at long maturities.

Despite this, the large banks decided it was better to "go the distance" with the $7.7 billion loan to Mexico than to face the alternative of taking large losses in earnings through writing-down the value of their Mexican portfolios. The smaller regional banks have signed on the $7.7 billion package largely because of tremendous pressure from the U.S. Treasury, the Federal Reserve Board, and other Western central banks.

The recent decision by Citicorp, Bank of America, Chase Manhattan, and other banks to increase substantially their loan loss reserves signals an end to the post-1982 strategy of lending new money to Latin debtors so it can come right back from them as interest payments on their debt. The banks' actions are an admission that the bad Latin debts are not worth one hundred cents to the dollar and probably never will be repaid fully.

85 Cents on the Dollar. Late last year, Republic National Bank of New York took a still more drastic step and became the first of Mexico's major U.S. creditors to revalue, or "write-down," a significant portion of its Mexican public sector debt. First, it sold off some of its Mexican debt to third party investors at a $2 million loss. Next, in preparation for further sales, it moved some loans into its investment account, where they must be carried at market rather than face value. Republic's effective write-down amounted to $39 million. The combined $41 million loss and write-down constituted roughly 15 percent of Republic's $257 million in loans to Mexico. The bank in effect said that the nation's loans are worth only 85 cents on the dollar.

U.S. banks are increasingly able to make such moves because they have been steadily strengthening their capital bases since 1982 through enhanced internal capital generation and substantial cutbacks in loan expansion. A recent study by a leading investment firm, Salomon Brothers, contends that the banks' improving equity ratios will allow them to absorb modest write-offs on bad loans and still maintain capital bases that are satisfactory when viewed in an historical framework.[10]

What is often forgotten in the debt debate is that the rates for U.S. banks' loans to Mexico and Latin America reflected the high credit risk. They have therefore already taken out much of the profit against the possibility of future default. Even after the 1982 crisis, bankers were charging front-end fees of 3 to 4 percent of the new loans. The bottom line is that the banks were funding Mexican current account deficits by betting on oil revenues, and it proved to be a bad bet.

CONCLUSION

Debtor governments, such as Mexico's, will modify their policies only if continued pursuit of these policies leads to economic breakdown threatening the ruling parties and elites. If Mexico and similar countries are rescued, they will continue their suicidal policies. As such, the bailout is the enemy of sustained reform in Mexico. A government that has subjected its populace to cuts in consumer subsidies, drastically increased taxes, and a real wage cut of 50 percent between 1983 and 1985 without a mass revolt surely can survive the divestiture of the bulk of its inefficient state-run enterprises and substantial cuts in its bloated bureaucracy.

There are many ways in which Mexico can find resources for paying its debt. These include:

1) **the sale of some state-owned enterprises** in their entirety or in part;

2) **the lifting of the 49 percent ownership** limit and other restrictions on the flow of foreign direct investment;

3) **the reduction of extravagant** public spending; and

4) **the pursuit of market-oriented** policies to encourage growth, such as dismantling many of the controls on the heavily regulated private sector.

As a start, the government should privatize Pemex through a genuine public sale of shares. Second, it should divest the remaining two-thirds of the nationalized banking system in like manner. Most important, in order to rein in its claim on domestic credit expansion and its appetite for foreign loans, it should make drastic cuts in the federal bureaucracy.

Mexico has the resources to honor its debts. The U.S. should expect its southern neighbor to behave as an economically responsible member of the community of states. As President Reagan said in 1983, "If policies are irresponsible, all the aid in the world will be no more than money down the drain."

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10. Salomon Brothers, "Bank Weekly," January 20, 1987.

TABLE I:
A CHRONOLOGY OF REFORM AND RETREAT

1976	IMF stand-by facility of $963 million. Mexico agrees to reduce public sector deficit from 9% of GDP in 1976 to 4.5% in 1977, and to liberalize trade and enter GATT.
1977	Deficit down to 5.1% of GDP. Inflation has come down, domestic savings up, current account deficit down, and capital flight down significantly. Vast new oil reserves discovered.
1978	Mexico pays off the IMF early. (Crude oil prices more than double between 1975-1980.) Portillo revives public sector-led growth. Plans to liberalize trade and to join GATT abandoned.
1979	The 1977-1978 adjustment in the current account deficit is lost. While the value of oil exports has quadrupled, merchandise imports still running ahead of oil revenues.
1981	Mexico's total external debt rises by 38% this year.
1982	IMF stand-by facility of $3.6 billion arranged. Mexico is to cut budget deficit from 16.5% of GDP in 1981 to 8.5% in 1983, reduce foreign borrowing to $5 billion in 1983, raise taxes, cut subsidies, and limit wage increases.
	Emergency $5 billion loan subscribed pro rata by foreign creditor banks on basis of exposure as of August 1982. Banks offered spread of 2.5% over LIBOR or 2.125% over Prime; maturity requested only 6 years; 3-year grace period; substantial commitment/facility fees attached.
1983	Fiscal deficit down to 8.7% of GDP, near the target.
1984	Fiscal deficit down to 7.4% of GDP. Restructuring accord reached with Mexico's largest foreign creditors, covers roughly half the $97 billion of debt outstanding. Creditors get choice of LIBOR + 1.875% or Prime +1.75%; a still attractive 1% restructuring fee; maturities stretched out over 14 years.
	2nd emergency loan ($3.8 billion) from commercial creditors. Option of LIBOR + 1.5% or Prime + 1.125%; maturity is 10 years; 5 1/2 year grace. Money supply on the upturn: up 64% in 1984 from 41% in 1983.
1985	Fiscal deficit back up to 10% of GDP, instead of target of 4%. IMF withdraws facility, cancels last disbursement.