August 4, 1989

IMPROVING U.S.-MEXICAN ECONOMIC RELATIONS

INTRODUCTION

Mexico's economy depends enormously on the United States. The U.S. is Mexico's main trading partner, absorbing 60 percent of all Mexican exports while providing 65 percent of all Mexican imports. The U.S.-Mexican economic relationship, however, is not symmetrical. Mexico, though the U.S.'s third largest export market, receives only 6 percent of all U.S. exports and provides only 6 percent of all U.S. imports. Even so, a strong Mexican economy is in the U.S. interest. A robust Mexican economy could be a larger export market for the U.S. and could enable the Mexican government to reduce its huge debt to U.S. banks. More important, economic health could prevent social unrest in Mexico.

For the past seven years Mexico has been suffering an economic crisis. Real wages have declined about 40 percent, and the real gross domestic product (GDP) has fallen 16 percent. Mexico has become the largest debtor in the developing world after Brazil, amassing a total debt of around $107.4 billion as of today.

This is the thirteenth in a series of Heritage studies on Mexico. It was preceded by *Backgrounder* No. 700, "A 15-Point Program to Stem the Flow of Drugs from Mexico (April 12, 1989); *Backgrounder* No. 694, "U.S.-Mexican Economic Ties" (March 6, 1989); *Backgrounder* No. 688, "The Security Component of U.S.-Mexico Relations" (January 26, 1989); *Backgrounder* No. 679, "A Review of 150 Years of U.S.-Mexican Relations" (October 31, 1988); *Backgrounder* No. 638, "Evolution of Mexican Foreign Policy" (March 11, 1988); *Backgrounder* No. 611, "Privatization in Mexico: Robust Rhetoric, Anemic Reality" (October 22, 1987); *Backgrounder* No. 595, "Keys to Understanding Mexico: The PAN's Growth as a Real Opposition" (July 29, 1987); *Backgrounder* No. 588, "Deja Vu of Policy Failure: The New $14 Billion Mexican Debt Bailout" (June 25, 1987); *Backgrounder* No. 583, "For Mexico's Ailing Economy, Time Runs Short" (June 4, 1987); *Backgrounder* No. 581, "Mexico's Many Faces" (May 19, 1987); *Backgrounder* No. 575, "Mexico: The Key Players" (April 4, 1987); and *Backgrounder* No. 573, "Keys to Understanding Mexico: Challenges to the Ruling PRI" (April 7, 1987). Future papers will examine other aspects of Mexican policy and development.

Fed by the U.S. Mexico has become dependent on the U.S. to feed its increasing population. Between 1982 and 1988, agricultural production grew at an average annual rate of only 1.46 percent while population during the same period grew at an annual rate of 2.1 percent. Mexican food imports are expected this year to reach an all time high of $2 billion.

An economic crisis in Mexico could trigger unrest and social revolution that could propel as many as 10 million Mexicans across the U.S. border. Some observers estimate that to seal the border effectively would take billions of dollars worth of sophisticated electronics and at least half the U.S. Army's divisions.

The current crisis of the Mexican economy is for the most part Mexico's responsibility and Mexicans alone must resolve it. Steps in the right direction were taken between 1982 and 1988 by Miguel de la Madrid when he was Mexico's president. These steps include liberalizing trade practices, privatizing some state companies, cutting corporate taxes, widening the corporate tax base, and a more receptive attitude toward foreign investment.

Combatting Corruption. Since Carlos Salinas de Gortari became president of Mexico last December, some additional steps have been taken to resolve the economic crisis. One of the most important has been the relaxation of foreign investment regulations. The imprisonment of Joaquin Hernandez Galicia (nicknamed *La Quina*), the top leader of the corruption-ridden oil union, moreover, demonstrates that the new president is serious about combating the corruption that stands in the way of economic recovery.

Much remains to be done, however. Measures Mexico could take to improve its economy include:

♦ ♦ **Deregulating the economy.**

This would release the entrepreneurial spirit of the Mexican people. It could also give Mexicans with funds deposited in overseas bank accounts an incentive to bring their estimated $50 billion to $80 billion back to Mexico for productive investments.

♦ ♦ **Returning the banking system to the private sector.**

This would channel more credit resources to finance productive activities in the private sector rather than to finance public spending and inefficient state-owned companies, as is now the case.

♦ ♦ **Privatizing state-owned companies.**

State-owned companies, or parastatals, are inefficient, absorb large amounts of federal subsidies, and are a leading cause of inflation. The Center for the Study of the Free Enterprise in Mexico has identified nine parastatals that could be sold to private investors. The proceeds could pay much of the Mexican internal debt, which is more costly to Mexico than its external debt.

◆ ◆ **Continuing to liberalize foreign investment regulations.**

A positive step was taken on May 15 when a new set of regulations was passed relaxing somewhat the long-established restrictions on foreign investment. More steps should be taken in the future to liberalize foreign investment regulations.

◆ ◆ **Reducing the excessive bureaucracy.**

This would help to reduce public spending and the public debt.

◆ ◆ **Extending real property titles to peasants.**

A large proportion of Mexican peasants who are under the land tenure system known as *ejidos* are not real owners of the land they farm. Making them real owners would encourage them to become more efficient producers.

The best way that the U.S. can help Mexico to resume economic growth is to:

◆ ◆ **Continue keeping its borders open to Mexican imports.**

If Mexicans make some deep reforms, they would become more productive and need access to the U.S. market.

◆ ◆ **Continue the process of bilateral trade liberalization with the long-term goal of establishing a free trade area (FTA) between the U.S. and Mexico.**

Although both countries would benefit from free trade relations, Mexico would derive more benefits in the long run. Free trade would stimulate private initiative and keep the American market open to Mexican exports.

A U.S.-MEXICO ECONOMIC PROFILE

Trade

U.S. and Mexican trade relations are extensive. U.S. manufacturers employing 375,000 workers last year exported $20.6 billion worth of goods to Mexico, while Mexico exported $23.3 billion to the U.S. Overall trade between the two nations last year increased 25 percent over 1987. Although this impressive rise is not likely to be repeated this year, some increase is anticipated.

Intermediate goods, such as automotive and electronic parts, accounted for much of the U.S. exports to Mexico in 1988. Also near the top of last year's U.S. export list to Mexico were some U.S. primary goods, such as synthetic resins and chemicals, and such agricultural products as corn, soybeans, and meat.

From Telecommunication Equipment to Sporting Goods. The U.S. Department of Commerce and the U.S. Embassy in Mexico have identified several types of products as excellent prospects for U.S. exports. These are telecommunications equipment; computers; mining and construction equipment; sporting goods; consumer electronic devices; household appliances; graphic arts and printing equipment; petroleum and petrochemical industry equipment; agricultural machinery and equipment; pollution control equipment; machine tools; electricity production and distribution equipment; hotel and restaurant equipment; food processing and packaging equipment; and plastic industry equipment and supplies.

Most Important Export. Crude oil and its derivatives continue to be the principal products imported from Mexico by the U.S. In 1988, oil represented around 40 percent of Mexican total exports to the world and was its most important export to the U.S. Other top imports from Mexico are such agricultural products as coffee and tomatoes. Mexico has increased substantially exports of manufactured products to the U.S., including car engines and parts, cars and buses, manufactured iron and steel, and artificial and synthetic fibers. Mexico also earns a significant amount of hard currency from the tourist trade. Americans make up the majority of visitors to Mexico.

Mexico has taken significant steps to remove trade barriers since 1985 and is liberalizing import regulations faster than required under the terms of the General Agreement on Tariffs and Trade (GATT), a multinational arrangement established in 1947 to set rules to promote international commerce.

Resolving Differences. On November 6, 1987, the U.S. and Mexico took an important step to improve trade relations by signing the Bilateral Commercial Framework Agreement. Known as the "Framework Agreement," this establishes principles emphasizing liberal trade and investment practices, and sets up a mechanism for consultation to clarify trade policies, resolve specific disputes, or negotiate the removal or reduction of barriers. In the past, U.S. requests for consultation with Mexico regarding trade and investment issues had been taken in Mexico as acts of interference. The Agreement is a recognition by Mexico that problems and differences can and should be discussed in a non-confrontational and technical fashion. At the same time, it is a recognition by Mexico of its great dependence on the U.S. market. In December, negotiated agreements were formalized involving beer, wine, distilled spirits, and agricultural seeds, among other products. The Agreement, is in fact, a maturing of the trade relations between the two countries.

Investment

While the $24 billion that Americans have invested in Mexico represents only a little over 2 percent of total U.S. investment, it accounts for 62 percent of all foreign investment in Mexico. More than 75 percent of U.S. investment in Mexico is concentrated in the electronics, automotive, and foodstuff industries. Economist Norman Bailey, a specialist in Latin America, considers overall foreign investment in Mexico small in relation to its potential. According Mexico's central bank, *Banco de Mexico*, the inflow of

Foreign Investment in Mexico

Country	Percentage of Total Foreign Investment
U.S.	62.1
Britain	7.3
West Germany	6.6
Japan	5.5
Switzerland	4.2
France	3.1
Spain	2.6
Other Countries	8.6

Source: Banco de Mexico

capital from direct foreign investment decreased from $3.2 billion in 1987 to $2.6 billion in 1988.

Mexico's laws discourage foreign investment. The 1973 "Law to Promote Mexican Investment and Regulate Foreign Investment," for example, does not promote foreign investment at all; it preserves key sectors of the economy, like mining, energy, railroads and wireless communications, exclusively for government investment. This law, passed during the presidency of populist Luis Echeverria, limits the profits that can be remitted overseas as payments for royalties and patents. It also requires that a certain percentage of the production must be exported to earn foreign exchange, and limits foreign ownership of a Mexican corporation to 49 percent of the total stockholdings. Exceptions to this are sometimes permitted, as in IBM's wholly owned computer plant in the state of Jalisco. Exceptions are more likely to be granted to large companies, which have greater bargaining power and which can lobby the Mexican investment authorities.

Profitable Plants. Exceptions also apply to "*maquiladoras*," or plants that assemble industrial and consumer products strictly for export. Products assembled at these plants include transportation equipment, television sets, and bicycles. Established in 1965 as part of the government's industrialization scheme, the *maquiladora* program allows foreign corporations to establish wholly owned subsidiaries in Mexico provided they produce almost exclusively for export. The plants receive imported components and raw materials duty-free for assembly in Mexico. This, plus cheap Mexican labor, serves as an incentive for foreign investments. In addition, U.S. law gives special tariff breaks on imports manufactured from American-made components. Thus, the majority of these factories are American-owned, although Japanese firms increasingly are taking advantage of the program. *Maquiladoras* employ an estimated 350,000 Mexican workers and generate foreign exchange second only to the petroleum industry. Some 100,000 jobs have been created in the U.S. to supply these plants.

This May 15, the Mexican government announced that it was reforming Mexico's foreign investment regulations. The new investment procedures will permit foreign investors 100 percent ownership in sectors like tourism, for example, and will allow foreign investors to hold minority ownership in some areas of the petrochemical industry, which in the past had been completely barred to foreigners. According to the new procedures, new foreign investments will be approved automatically if they satisfy the following conditions:

♦ ♦ The amount of investment cannot exceed $100 million.

♦ ♦ The investment is made outside the areas of huge industrial centers, such as Mexico City, Guadalajara, and Monterrey.

♦ ♦ The investor maintains a positive balance of payments throughout the first three years of operation.

♦ ♦ Adequate technologies are used and legal provisions are observed.

♦ ♦ The investment is made with foreign resources.

Trimming the Review Process. Any investment of more than $100 million must be reviewed by the National Foreign Investment Commission (NFIC). Such a review could discourage investments of more than $100 million because the approval process at the NFIC is extremely cumbersome and time-consuming. It normally takes about 365 working days to complete a review, although Mexico's Commerce Secretary Jaime Serra Puche claims that the process now will take no more than 45 days.

The state will continue to retain ownership rights in so-called strategic industries such as oil, primary petrochemicals, banks, and certain mining operations. Some Mexican analysts argue that the new regulations do not go far enough to attract substantial amounts of new foreign investment. It is too early to tell, but it certainly is a step in the right direction.

Oil

Mexico is the noncommunist world's fourth largest oil producer, with proven reserves exceeding 48 billion barrels. The U.S. has bought 55 percent of Mexican oil exports in the past eleven years. Mexico currently supplies one-eighth of U.S. oil imports and consistently has been one of America's three primary suppliers of foreign oil since 1984.

While oil production has been a part of the Mexican economy since the turn of the century, the discovery of extraordinarily large deposits in 1976, coupled with the rapidly rising world crude prices, fueled an explosive growth in public spending and foreign borrowing. By 1980, Mexico was relying on foreign loans to sustain economic growth and on its oil exports to repay the loans. Very optimistic assumptions about Mexico's oil revenues fueled very heavy borrowing by Mexico. Then, in the fall 1981, oil prices started plummeting, and with them Mexico's hopes of economic development sustained mostly by oil exports. While oil exports in 1982 represented 79 percent of Mexico's total export earnings, this had fallen to 32.5 percent by last year.

Debt

Mexico has the second largest foreign debt in the non-industrialized world – an estimated $107.4 billion, trailing only Brazil's debt of $125 billion. Public sector debt – that of the central government and state-owned parastatals – amounts to an estimated $83 billion. U.S. banks hold almost one-third of Mexico's commercial bank debt, which adds up to approximately $70 billion. Of this, $54.5 billion in medium- and long-term debt, owed to approximately 530 commercial banks, recently was renegotiated.

The main U.S. banks holding this debt are: Bank of America, $2.33 billion; Citibank, $2.3 billion; Chemical Bank, $1.7 billion; Manufacturers Hanover Trust, $1.7 billion; Chase Manhattan Bank, $1.5 billion; Bankers Trust, $1.3 billion; Morgan Trust, $800 million; and First Chicago, $600 million.

The other two-thirds of commercial bank debt is owed mostly to Japanese, British and other West European and Asian banks.

Worsening the Crisis. Mexico's debt problems came to international attention in August 1982 when the government announced it was unable to make the payments on its foreign loans. Since then, Mexico has added more than $20 billion to its foreign debt. Almost all of the $20 billion of new debt since 1982 has been used by Mexico to meet its interest payments. Two multibillion dollar International Monetary Fund rescue packages have not ended the crisis and probably have worsened it since these loans have been used almost exclusively to pay interest on the existing debt rather than to finance productive investments.

Mexico spends about 28 percent of its exports earnings on servicing the interest payments of its foreign debt. This is about the same proportion that Brazil has to spend on servicing its foreign debt. Mexican government officials believe that the debt burden must be eased if Mexico's stagnant economy is to grow again. They argue that, after servicing the foreign debt, there are no resources left for investment. Mindful of this, in his December 1, 1988, inaugural address, President Salinas declared, "The priority will no longer be to pay, but to return to growth."

PLANTING THE SEED OF THE CRISIS

Economists called it the "Mexican Miracle." Between 1940 and 1970, the Mexican economy grew at an average annual rate of 6 percent, a pace rivaling that of such economic dynamos as Japan, South Korea, and West Germany. Annual inflation over those three decades averaged less than 5 percent. All the major economic indicators in that period pointed to sustained economic growth and development.

Protectionist Policies. Between 1950 and 1970, the government adopted a strategy called "stabilizing development," which used revenues from agricultural exports to finance rapid industrialization. Under this policy, the government, the private sector, and organized labor cooperated to protect industry against foreign competition by imposing tariffs on export goods. This protectionism, however, limited economic growth and thus carried the seed of the current crisis, because in the long run it made Mexican companies inefficient and unable to compete with more dynamic foreign companies.

Economic Policies Under Echeverria

The seeds of Mexico's economic crisis began to sprout in the early 1970s under the economic policies of President Luis Echeverria. He was convinced that the roots of Mexico's economic problems were in the private sector and in the country's dependency on foreign investments.

Echeverria's approach to the economy was classically populist. He decided to expand substantially public sector spending on welfare programs and to further restrict foreign investment. To achieve the double purpose of reducing the growth of foreign investment and continuing the public sector overspending, Echeverria decided to borrow heavily from overseas commercial banks. The availability of cheap foreign credit enabled him to expand public spending. Mexico's foreign debt jumped from $4.2 billion in 1970 to $19.6 billion in 1976.

Predictable Consequences. Foreign loans were used to finance not only the expansion of the public sector, including the rapid establishment of government-owned enterprises, but also to fund government operations. The consequences of this were predictable: The balance of payments deteriorated and inflation, which had been kept from 3 percent to 5 percent during the previous twenty years, rose to 12 percent in 1973 and 23.8 percent in 1974.

By 1976, Mexico was finding it difficult to service its foreign debt. The pressure to devalue the Mexican currency was strong and encouraged capital flight. In an act of desperation, Echeverria devalued the peso in 1976 for the first time since 1954. He blamed the private sector for the country's increasing economic problems, and just a few days before the end of his term, he decided to punish it by expropriating 89,000 hectares of rich farmland in the northern state of Senora.

Lopez Portillo's Legacy

At the beginning of the presidency of Jose Lopez Portillo (1976-1982), it seemed as if he would move the country away from his predecessor's populism. Lopez Portillo in 1976 began to ease the worries of the private sector and over the next two years confidence and economic stability were restored.

His coming to power also coincided with the discovery of huge oil deposits. At the same time, world oil prices rose dramatically. This gave Mexico the opportunity to finance its economic growth by mortgaging its new oil wealth and borrowing heavily overseas. It also made it possible for Lopez Portillo to resume heavy public spending. Public spending rose from 32 percent of gross domestic product in 1978 to 48 percent in 1982. The size of the government bureaucracy at the end of his administration in 1982 was 85 percent larger than in 1975. He and his predecessor increased the number of state-owned enterprises from 70 in 1970 to 1,100 in 1982.

Between 1978 and 1981 the economy reached average annual levels of growth of 8 percent, but at a cost of accumulating a huge debt. Over the six years of the Lopez Portillo presidency, the public and private sector borrowed $60 billion abroad. One-third of that amount was in 1981 alone. By 1980, growth had become structurally dependent on borrowing. Without borrowing, Mexico was not able to keep the economy and the government working. Inflation accelerated toward 100 percent, and despite a good oil price of $36 a barrel, the current account deficit widened to 6 percent of GDP in 1981. The Mexican peso, which was fixed against the dollar, became greatly overvalued, which hurt non-oil exports while encouraging massive imports.

Skyrocketing Interest Rates. Global economic conditions also contributed to unleash the financial crisis of August 1982. In that month, Mexico declared that it was unable to service its foreign debt. The onset of global recession in 1981 slowed the demand for oil, and interest rates which had stood at 9 percent in 1978 skyrocketed in 1981 to 17 percent. This sharply increased the cost of servicing the foreign debt.

The fear of another devaluation encouraged massive capital flight. Lopez Portillo tried to find a scapegoat for the financial crisis. He blamed the banks and nationalized them on September 1, 1982.

De la Madrid Reforms

Miguel de la Madrid Hurtado became president of an economically crippled country in December 1982. Inflation raged at 100 percent annually. Approximately 70 percent of the economy was owned or controlled by the government or by labor unions affiliated by the ruling Institutional Revolutionary Party (PRI). Where public spending in 1970 was 26 percent of the gross national product, by 1982, it had soared to 48 percent. Foreign debt was up to $80 billion from only $4.2 billion in 1970.

The debt crisis brought Mexico a new International Monetary Fund (IMF) agreement in 1982. The agreement called for economic adjustment to reduce Mexico's inflation as well as its trade and fiscal deficits. De la Madrid quickly applied the IMF's harsh prescriptions. The government raised prices on basic goods, including gasoline and electricity, increased taxes, lowered public spending and investment, and slashed credit lines to the private sector. The strategy cut the annual inflation rate to 80 percent by the end of 1983; it also produced a deep recession. Gross domestic product dropped by more than 5 percent in 1983. Unemployment jumped from 8.4 percent in 1982 to 13 percent in 1983.

Broken Agreement. De la Madrid, under pressure from labor unions and PRI's left wing, broke the IMF agreement in summer 1984 and resumed an expansionist and inflationary fiscal policy. The economy grew 3.5 percent in 1984 and 2.8 percent in 1985. The inflation rate, which had dropped from almost 100 percent in 1982 to 59.2 percent in 1984, jumped back to 105.7 percent in 1985. Government banks returned to underwriting the expenses and debts of the public sector, committing 60 percent of available funds to this end.

Hard Lesson. The February 1986 world oil price collapse ended the temporary respite in Mexico's economic woes. The loss in export revenues as a consequence of falling oil prices was equivalent to 6 percent of gross domestic product. It was clear by then that to recover from the economic crisis, Mexico had to embark on a more serious and sustained program of structural economic reform.

This the government tried last year. For example, the government broadened the corporate tax base while cutting the effective tax rate from 42 percent to 25 percent, thus providing an incentive for new investments. The government also reduced individual income tax by 12 percent to 15 percent for middle-income earners. More important, Mexico joined GATT in 1986 and started a program of trade liberalization. The average tariff for imports currently is only 10 percent; it was 45 percent in 1982. While 95 percent of all imports needed licenses in 1982, today only 6 percent do.

Candidates for Privatization. The government also began a limited program to privatize state-owned enterprises. Although the number of state-owned enterprises has been reduced from over 1,100 in 1982 to about 394 in 1988, this program so far has not included and is not likely to include the largest state-owned companies that absorb most of the federal government's subsidies. Five of these companies alone consumed 85 percent of the $4.57 billion paid by the federal government in 1987 to government-owned enterprises. They include: the Federal Electricity Commission (CFE), the Basic Commodities Marketing and Supply Agency (CONASUPO), Mexican Fertilizers (FERTIMEX), the National Railroads (FERRONALES), and the steel company known as SICARTSA.

A Mexican think tank, the Center for Research of the Free Enterprise, estimates that the whole internal debt of approximately $50 billion could be cancelled if the government decides to sell nine parastatals. Candidates for privatization include a telephone company, *Telefonos de Mexico* (TELMEX); an airline, *Mexican de Aviacion*; three banks, *Banco de Comercio* (BANCOMER), *Banca Serfin*, and COMEREX; two steel mills, *Las Truchas* and *Altos Hornos de Mexico* (AHMSA); a fertilizer company, *Fertilizantes Mexicanos* (FERTIMEX); and the company that controls the commercialization of tobacco, *Tabacos Mexicanos* (TABAMEX).

However, even with the limited privatization, budget transfer payments to state-owned companies declined by 22 percent between 1986 and 1987.

Pact to Control Inflation. A broad-based plan to combat an inflation rate reaching 159 percent was launched by de la Madrid in December 1987. Known as the Economic Solidarity Pact, this agreement between government, industry, and labor to control inflation included a wage, price, and exchange rate freeze plus the liberalization of trade laws. The Pact succeeded in reducing the annual rate of inflation from 159 percent in 1987 to 51.7 percent in 1988. The Pact was replaced in December 1988 by another agreement known as the Pact of Stability and Economic Growth (PECE). Although with a different name, PECE was in fact a continuation of the Economic Solidarity Pact.

The Pact has continued to keep the inflation rate down. Inflation during the month of May 1989 was down to 1.4 percent from 15.5 percent in January 1988, one month after the Pact was launched.

The Pact was to have expired on July 31, 1989, but last month it was extended to the end of next March. The Pact, however, is contrary to the operation of a free market system because it is based on wage and price controls. The extension is a clear admission on the part of the Mexican government that if the Pact expires, inflation would resurge. The main cause of inflation is the fiscal deficit. Although the Mexican government reduced it by more than 20 percent last year, the reduction has been insufficient to prevent the resurgence of inflation if the wage and price controls of the Pact were terminated. This suggests that inflation has only been suppressed but not defeated.

SALINAS: BACK TO THE FUTURE?

During his election campaign last year, Mexican President Carlos Salinas de Gortari promised to accelerate the market-oriented policies began by his predecessor, but linked reform to reduction of the foreign debt. Announcing his economic policy in May 1988, Salinas proclaimed, "If we [Mexico] fail to grow because of the foreign debt load, we will not pay." This statement suggests that Mexico may be tempted to scuttle such free-market measures as trade liberalization if the economy does not revive soon. Salinas repeated this point in his inaugural address.

Salinas came to power promising free market reform. His proposals include further privatization of state-owned enterprises and liberalization of trade. Salinas's proposal for continued and expanded economic liberalization, however, already has run into a wall of political opposition from organized labor, and leftist political parties such as those grouped in the coalition known as the National Democratic Front (FDN), which is made up of businessmen accustomed to government protection and subsidies. Some of these businessmen are members of Salinas's ruling party, the PRI. The danger persists that he, like de la Madrid, may backtrack in an attempt to quell discontent, thereby delaying permanent economic recovery.

Disturbing Tax. A sign of this danger is found in an attempt in January by the Mexican government to raise funds by imposing a 2 percent tax on corporation assets. This tax discourages investments on new machinery and equipment which has retarded the modernization of the industrial base.

In his most recent submission to the Mexican Congress on May 31, President Salinas proposed his 1989-1992 National Development Plan. His proposal recognizes that a "close, protected, and inefficient economy is unable to fulfill the needs of the population." The Plan, however, cautiously mandates that price controls be kept in place to protect the purchasing power of salaries, and until the government is sure that the free market can work.

NO DEBT RELIEF, NO GROWTH?

The Mexican government has argued that some 5 percent of the country's gross domestic product goes to service the foreign debt each year. Without debt relief, it maintains, there will be little or no resources left to finance economic growth. But while the internal debt is indeed a burden, debt relief will not solve Mexico's economic problems. At various times since 1982, new loans or the rescheduling of old debts have offered temporary relief. Yet during those periods, economic reforms have been minor or uneven. Sometimes relief simply has allowed the Mexican government to continue irresponsible economic policies. Major and sustained market-oriented economic reform is the only means for promoting long-term economic growth and higher living standards for Mexicans. And only with economic growth can the debt problem be eliminated.

Further, Mexico's internal debt, due primarily to high levels of government spending and high budget deficits, is far higher than the external debt.

The largest outlay in the Mexican budget is for servicing the internal debt created by the Mexican government's using the resources of the state-controlled banking system to finance budget deficits. In this year's budget, for each peso spent, an estimated 59 cents will be for debt service: 13 cents for the foreign debt and 46 cents for the internal debt. Thus, even if its foreign debt were totally forgiven, the Mexican economy would not necessarily improve in the long term.

Mexico and the Brady Plan

The debt relief plan concluded in late July between the Mexican government, the creditor banks, and the U.S. government is the first test of the Bush Administration's so-called Brady Plan. This was announced March 19 by U.S. Treasury Secretary Nicholas Brady to find a solution to the debt problem in less developed countries like Mexico. The Plan envisages Western debt relief in exchange for economic reform in the debtor nations. Its basic assumption is that the lack of growth of many less developed countries is the result of foreign debt, which has undermined their economies. The Plan therefore proposes to trim these countries' foreign debt by at least 20 percent. It emphasizes such debt relief measures as rescheduling debt payments and readjusting interest rates. This is an improvement on the previous U.S. policy of encouraging new loans to debtor countries to help them meet their payments. Such loans only add to the overall debt and require even higher future interest payments.

The Plan also suggests that the International Monetary Fund or the World Bank provide guarantees to private banks involved in debt reduction transactions. The purpose would be to reduce the losses that commercial banks would incur from forgiving or adjusting Mexico's foreign debt.

Mexico has already negotiated agreements with the IMF to borrow $4.08 billion over three years. Some 35 percent to 40 percent of this amount would be available for debt service or reduction. Up to $1.05 billion of this will pay off debts to commercial banks. The World Bank, meanwhile, will provide Mexico approximately $6 billion in loans over three years, with $1.7 billion of that sum available for debt servicing or reduction. Part of this can also be used to pay off loans from commercial banks.

Relief Agreement. On July 23, the Mexican government, the creditor banks and the U.S. government reached a relief agreement for payments on $54.5 billion in medium - and long-term debt. Under this agreement, creditor banks will have a choice of three means to deal with their Mexican loans: they can cut 35 percent from the face value of the loans still outstanding; they can reduce interest rates paid on these loans to 6.25 percent from the current rate of over 12 percent; or they can extend new loans to Mexico. The debt and interest reduction options will involve some form of guarantee backed by World Bank, or IMF funds. In both of the debt service options, some $7 billion in IMF, World Bank, or other funds would be used to guarantee the remaining payments on these loans. For example, Mexican bonds might be issued using U.S. Treasury bonds purchased with these funds as collateral against default. Details are still being worked out on these guarantees. It is expected that banks holding over half of the rescheduled debt will choose to reduce interest payments. The government of Mexico hopes to reduce its annual $15 billion debt service payment by at least $1.5 billion and as much as $3 billion.

The Mexico debt service plan avoids to a great extent the problem, found in past plans, of piling up more debt with more loans which, in the future, would mean more interest payments. But the Mexican plan still has shortcomings. First, the plan is not tied to specific economic reforms in Mexico. While enforcement or conditions attached to past agreements were lax, at least there was an attempt to hold Mexico to certain standards. The World Bank and IMF do place conditions on their loans to Mexico, but these are to a certain extent independent of the new debt service plan. Yet if history is any indication, allowing the Mexicans an internationally sanctioned "breathing space" could remove pressures for economic reforms.

Bank Bail-Out. Second, this plan actually could slow down the debt reduction process. Foreign banks made bad loans to Mexico. If the World Bank, IMF, and U.S. government had failed to step in, the banks might have been forced to write down their bad loans or come to terms with Mexico more quickly. The commercial banks have held out for some form of U.S.

government assistance to head off major losses and they seem to have been successful.

Third, World Bank, IMF, or U.S. government guarantees to commercial banks for payments of Mexican debts set a bad precedent. If Mexico fails to make growth-oriented economic reforms, and finds it impossible in the future to meet its payments, the World Bank, IMF, and U.S. could be pulled even deeper into covering bad debts to protect the Mexican government and the foreign commercial banks from the consequences of their economically irresponsible actions.

Fourth, the Mexican government is doing nothing to employ the one debt reduction technique that has the most promise: debt for equity swaps. Under such an approach a commercial bank sells its bad Mexican debt to an investor at a discount. The investor then "forgives" the debt, that is, exchanges it with the Mexican government either for local currency for investment or government-owned equity shares in a business or enterprise. The Mexican government argues that buying back debt with local currency would be inflationary. Yet experience shows that exchanges for equity shares would not be. The government of Chile has reduced its debt substantially without inflation using this technique. No such technique was part of the new Mexican debt service plan.

EXPANDED REFORMS

Mexico will not resume economic growth by debt reduction alone. More is necessary. While Mexico has made significant progress toward restructuring its economy since 1985, additional measures would hasten economic growth. They include:

♦ ♦ **Deregulating the economy.**

The Mexican government should allow more private foreign and national companies to participate in the many economic activities currently reserved only for government or subject to its control. This would release Mexican entrepreneurial forces and raise productivity by allowing companies to respond to the market and not governmental decrees.

♦ ♦ **Privatizing the banks.**

A privatized banking system would allow banks to redirect available credit to productive companies rather than to finance public spending and unproductive state-owned enterprises. The return of the banking system to the private sector also would create economic confidence and thereby encourage Mexicans to repatriate and invest a substantial portion of the estimated $50 billion to $80 billion they have taken out of the country since 1982.

♦ ♦ **Privatizing state-owned companies.**

Mexican state-owned enterprises, known as parastatals, are inefficient, feed corruption, consume huge public subsidies, and are a leading cause of inflation. Selling parastatals to private companies could provide revenues to reduce Mexico's internal and foreign debt. One Mexican think tank estimates that the entire internal debt of about $50 billion could be cancelled if the government decided to sell nine parastatals.

More privatization also would free bank credit for the private sector. State-owned companies are inefficient and absorb substantial amounts of credit that could be used more productively by the private sector. Labor objections could be quelled by selling parastatals to workers through Employee Stock Ownership Plans.

♦ ♦ **Liberalizing foreign investment restrictions.**

Mexico places severe restrictions on foreign investment. The 1973 Foreign Investment Code allows foreign investors to own only up to 49 percent of a Mexican companies' stock. The remaining 51 percent must be owned by Mexicans. New procedures adopted this May 15 will permit foreign investors to have 100 percent ownership in companies in the tourist industry and to hold minority ownership in some areas of the petrochemical industry, which in the past has been completely barred to foreigners. The May 15 regulations, however, do not allow the conversion of foreign debt into equity shares in Mexican companies, which prevents a ready source of foreign investment to be used to reduce Mexico's foreign debt.

♦ ♦ **Cutting the size of the bureaucracy.**

Mexico, with one-third the population and gross domestic product less than 4 percent that of the U.S., employs 3.29 million federal bureaucrats – 190,000 more than in the U.S. The Mexican government employs 159 persons for every 1,000 private workers compared to a ratio of 27 per 1,000 in the U.S. This bloated bureaucracy should be cut drastically to reduce public expenditures and the public debt.

♦ ♦ **Extending real ownership titles to peasants.**

Almost 70 percent of Mexico's arable land has been parceled to peasants in small plots called *ejidos*. The plots cannot be sold, bought, or rented. Lack of real ownership is the root of low productivity and poverty among peasants. Real land ownership would go far toward eliminating this problem because privately owned farms tend to be more productive than those controlled by the government. With real ownership, the peasants would have the right to sell, rent, and mortgage the land. Limited access to credit has been a major impediment to improved farm productivity.

The U.S. can encourage Mexican economic reform by:

♦ ♦ **Keeping its borders open for Mexican exports.**

Over 80 percent of Mexican exports to the U.S. enter at a duty rate of between zero and 5 percent. There is, however, a constant pressure in the U.S. Congress from interest groups to erect barriers to imports from Mexico. The possibility of such barriers discourages export-oriented Mexican entrepreneurs from making new investments to expand Mexico's export capacity. The U.S. Congress should resist the interest groups' pressures. At the same time, some products which the U.S. imports from Mexico, such as textiles, are restricted by quotas. Textiles is one of the industries on which Mexico enjoys productive comparative advantage. The Mexican textile industry should be allowed more access to the U.S. market.

♦ ♦ **Continue the bilateral trade liberalization process with the long-term goal of establishing a free trade area (FTA) agreement between the U.S. and Mexico.**

Free trade is in the long-range interest of Mexico, but Mexican leftists and nationalists are strongly opposed to a U.S.-Mexican free trade zone. Partial free trade agreements covering limited sections of the economy, however, could erode the opposition of the Left, lead to expanded trade integration, and perhaps create a favorable climate for a comprehensive free-trade agreement including the U.S., Canada, and Mexico.

CONCLUSION

Mexico's economy is stagnant. The Mexican government is primarily to blame because of years of corruption and excessive government control of the economy. The continuation of the economic crisis in Mexico could lead to a social revolution that would have serious consequences for the U.S. Some observers believe that a Mexican civil war coming on the heels of economic collapse could send as many as 10 million Mexican refugees fleeing into the southern states of the U.S. Billions of dollars would have to be spent to seal the border. In addition to this the U.S. would lose an important trading partner.

Road to Lasting Growth. Debt relief by itself is by no means a permanent solution to Mexico's economic crisis. For Mexico, the only true road to lasting growth hinges on deregulating the economy, denationalizing the banks, continuing the liberalization of foreign investment regulations, privatizing the public sector of the economy, cutting the size of the bureaucracy, and extending real ownership titles to peasants. This is something that only the Mexicans can do. If Mexico decides to take the path of economic growth, it would release the currently repressed entrepreneurial creativity of the Mexican people, who then would be encouraged to invest in own their country.

The U.S. could help by keeping its borders open for Mexican exports and consulting with Mexico about the possibility of creating a free trade zone between the U.S. and Mexico. This would reassure Mexican entrepreneurs that the U.S. market will remain open to their products and encourage them to make investments in lucrative expert industries. As for the U.S., a U.S.-Mexican free trade zone would greatly increase opportunities for expanded trade and investments in Mexico.

Good Start. In his eight months as president of Mexico, Carlos Salinas de Gortari has made some dramatic actions to combat corruption and made some welcome changes in foreign investment regulation. It is a good start. If he continues reforming the Mexican economy, and uses debt relief to spur rather than hinder these reforms, economists once again could be speaking of a "Mexican miracle."

Jorge Salaverry
Policy Analyst

Edward L. Hudgins, Ph.D., Director of The Heritage Foundation's Center for International Economic Growth, contributed to this study.