January 25, 1995

THE BAILOUT OF MEXICO: A COSTLY MISTAKE?

INTRODUCTION

Congress should hold off approving the $40 billion in loan guarantees for Mexico. The Clinton Administration's proposed bailout plan for Mexico will only postpone a final reckoning for Mexico's state-controlled economy at great potential cost to U.S. taxpayers. It will not fix the underlying structural weaknesses of the Mexican economy that caused the collapse of the Mexican peso in the first place. The emergency economic reforms proposed by Mexican President Ernesto Zedillo Ponce de Leon on January 3, 1995, will not fix the country's problems either. Zedillo's emergency program does not go far enough, reflecting the continued resistance of Mexico's traditional business and labor elites to free-market reforms that threaten their way of life. Before rushing into approval of the Clinton bailout plan, Congress should pause and examine the causes of the Mexican failure and ask whether Clinton's remedy will work.

There are many reasons to believe that it will not. The proposed loan guarantees may bail out Mexico this year, but they will not prevent another crisis unless the Mexican government corrects the fundamental structural problems that caused the peso's collapse. If the Mexican government fails to change the structure of the economy, the bailout will be only a temporary quick fix. A year or two from now, the Mexicans will be back asking for yet more credits to relieve them of yet another debt crisis. This debt relief package may keep the patient out of the emergency room for a year or so, but if history is any indication, it will only be a matter of time before the patient ends up back in the hospital. Mexico has a long history of recurring debt crises involving defaults, reschedulings, and new money loans, sometimes combined with actual reductions of principal.[1]

1 Walker F. Todd, "A History of International Lending," *Research in Financial Services, Private and Public Policy*, Vol. 3, JAI Press, 1991, pp. 201-289. In this century alone, Mexico was in default on most of its foreign debts from 1914 until 1930. In 1942 and 1946, Mexico negotiated a 90 percent reduction of foreign debt principal. Meanwhile, Mexican oil

The economic disease afflicting the patient is an overly centralized and still heavily regulated economy. Notwithstanding the progress Mexico has made in economic reform —and that progress is real—its economy is still mostly unfree.[2] The Mexican peso collapsed not because of the free-market pressures created by the North American Free Trade Agreement (NAFTA), but because the Mexican government artificially inflated the value of the peso for political reasons—that is, to help secure the victory of Ernesto Zedillo Ponce de Leon, the candidate of the long-ruling Institutional Revolutionary Party (PRI), in the presidential elections of August 21, 1994. This old-fashioned manipulation of the economy is still quite prevalent in Latin America. In order to get Mexico's economy on track, major economic surgery must be undertaken. The last thing Mexico needs is a heavy dose of debt-relief narcotics that eases the pain for now but does nothing to cure the underlying ailment.

To avoid debt crises in the future, the first step is to restore confidence in the stability of the Mexican peso and the credibility of the Mexican government's monetary authorities. To do this, the Zedillo administration should consider replacing the Banco de Mexico with a currency board. The peso's convertibility would be linked to the U.S. dollar at a fixed rate[3] and could be capitalized with part of the earnings from the government's privatization plan, which should be expanded to include the state-owned petroleum and electrical power industries. In addition to a currency board and more aggressive privatization, the Mexican government should reform the tax system, slashing personal and corporate taxes to stimulate more investment. President Zedillo also should abolish all wage and price controls and eliminate the economic stability pacts negotiated annually by the government with a small group of business and labor elites. Finally, Mexico must create the conditions for domestic savings growth and a more equitable distribution of income by privatizing the inefficient social security system and creating private pension funds for the social security benefits of Mexican workers. A strong domestic savings sector would provide a new source of funds for investment in Mexico's development and growth, reducing the country's excessive reliance on foreign capital sources to finance Mexico's economic development.

At the very least these measures should be conditions for granting the loan guarantees to Mexico. But the problem with conditions is that Mexico gets the debt relief now while the U.S. has to wait for years to see whether the reforms are being made. In the meantime, after the loan guarantees are approved, the U.S. loses leverage over Mexico that cannot be regained until another debt crisis occurs and the request for further debt relief is made. On top of that, Mexicans resist conditions being imposed on them. For domestic

nationalization claims of 1938 were not fully resolved until 1959. Mexico defaulted again in 1982, triggering the Latin American debt crisis. The bonds-for-debt exchange under the Brady Plan in March 1990 reduced Mexico's external debt to about $91 billion, from $103 billion at year-end 1989. Since 1990, Mexico's total foreign debt has increased to $160 billion.

2 Bryan T. Johnson and Thomas P. Sheehy, *The Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation, 1995), p. 157. "[D]espite the NAFTA, Mexico still imposes limits on economic freedom....Mexico's political system has not been reformed as rapidly as its economy....Government corruption continues...."

3 The fixed rate could be one peso per U.S. dollar, or 3.5 pesos to the dollar, and the currency board could be capitalized by pledging part of the assets of the state oil monopoly Petroleos Mexicanos (Pemex) and the electrical power monopoly Comision Federal de Electricidad (CFE).

political purposes, President Zedillo will resist agreeing to U.S. conditions because he will not want to be seen as kowtowing to "Yankee" pressures from the North.

There is clearly no easy solution to the Mexican economic crisis. But one thing is certain: throwing good money after bad will not solve the problem. There is no reason to rush into a decision without first understanding all of its ramifications. Congress should pause and consider the wisdom of a policy that not only may not work, but could needlessly cost American taxpayers billions of dollars.

THE CLINTON BAILOUT PLAN

The Clinton and Zedillo administrations are telling congressional leaders, the American people, and international investors that the peso's nearly 40 percent devaluation since December 19, 1994, is a temporary liquidity shortage that will end as soon as confidence in the Mexican economy recovers. To restore confidence, they assert, Mexico must borrow tens of billions of dollars so that it can repay tens of billions of dollars in debt obligations maturing during 1995. If the U.S.-backed loan guarantees are not approved quickly, they warn, Mexico may become insolvent and be forced to declare a debt moratorium, which could unleash a new debt crisis throughout Latin America and a huge wave of illegal Mexican migration to the United States.

Since the peso's meltdown one month ago, the bailout package cobbled together by the Clinton Administration has swelled to $58 billion,[4] which is equivalent proportionally to 36.2 percent of Mexico's total foreign debt. However, this may not be enough to cover all of the debts coming due in Mexico this year.

To "fix" the Mexican crisis, President Zedillo has proposed a "two-month emergency plan"[5] that includes restrictions on wage increases;[6] government spending cuts equivalent to 5.2 percent of the budget, or about $3.75 billion; an increase in the corporate tax rate from 34 percent to 35 percent, plus higher income taxes for upper-bracket taxpayers and an increased tax on luxury automobiles; higher rates and prices for publicly provided goods and services;[7] and the privatization of a broad range of government-owned assets, including railways, petrochemical plants, ports, satellite systems, power plants, and toll roads. Mexico's new Finance Minister, Guillermo Ortiz, told foreign investors and bank-

4 "After the Mexican Crash," Baring Securities Inc., New York, January 10, 1995. The report estimates that Mexico's projected foreign debt obligations for all of 1995 include $9 billion of public sector debt; $15.9 billion of foreign-owned Tesobonos (short-term Mexican T-bills guaranteed in U.S. dollars); $9.6 billion of private sector debt; and $5.1 billion of Cetes and Ajusta-Bonos. Cetes are short-term peso notes and Ajusta-Bonos are linked to the Mexican consumer price index.

5 *Latin American Weekly Report*, "Two-month plan will take a bit longer," Latin American Newsletters, January 19, 1995.

6 Workers earning the minimum salary (10 percent of the economically active population) will receive a 4 percent increase, raising their daily wage this year to slightly over $3, and will be able to negotiate a further 3 percent increase against higher productivity. Those earning up to two minimum salaries (61 percent of the workforce) will also get a refund equivalent to 3 percent of deducted income tax. This compares to a new official inflation target of "no more than 16 percent" for 1995, although independent analysts in the United States and Mexico project that inflation may average at least 20 percent, and possibly more if the peso fails to stabilize at the Zedillo government's projected level of 4.5 to the dollar.

7 The government has pledged that such increases will be "by an amount lower than devaluation."

ers in New York that the government expects to raise at least $14 billion from these planned privatizations.

However, these proposed privatizations are little more than a repackaging of existing schemes, which have in some cases been stalled for years.[8] Moreover, the Zedillo administration will not be able to sell any of these assets quickly; nor will it earn the full $14 billion projected by Finance Minister Ortiz. The peso's meltdown and the resulting economic crisis have destroyed investor perceptions that Mexico was a stable economy, which means that market valuations of the assets up for sale may be significantly lower than the Zedillo administration has projected in its plan. More important, the assets of greatest real value—the oil monopoly Petroleos Mexicanos (Pemex) and the state-owned power utility Comision Federal de Electricidad (CFE)—are not part of the privatization scheme.

The Mexican government predicts that its economic reforms will result in a gross domestic product growth rate of 1.5 percent to 2 percent for 1995, an inflation rate below 16 percent, an exchange rate of 4.50 pesos per U.S. dollar (compared to 5.58/5.63 on January 20, 1995), and a 50 percent reduction this year in Mexico's current account deficit. It also predicts that exports will rise by 16 percent in 1995 (compared to 7.4 percent last year), while imports will increase by 13.2 percent.[9]

However, these official projections may be too optimistic. Measured in U.S. dollars, the collapse of the peso has evaporated nearly 40 percent of Mexico's national wealth. Even with the U.S. loan guarantees, Mexicans will not recover from this blow for many years. For Mexico, the immediate outlook probably will include zero to negative economic growth, higher inflation, more unemployment, depressed demand, and increased illegal migration to the U.S.

A conclusion is inescapable: The Zedillo reform plan will not have the desired effect. It will not produce the projected rates of economic growth and, as a result, will not get Mexico out of its economic crisis. Thus, even if the loan guarantees are approved, Mexico will still be in deep economic trouble. There is little reason to believe that the Zedillo plan will restore confidence in Mexico's suffering economy.

A FREE MARKET CURE

The cure for the Mexican crisis is in Mexico City, not in Washington. While the loan guarantees would ease the pressures on the peso and on the Zedillo presidency, they will not tackle the underlying problems of Mexico's economy. Only President Zedillo can do that. To get the crisis under control, President Zedillo needs to:

- ✔ **Convince the Mexican people and the world that he is capable of leading Mexico out of this crisis.** If Zedillo does not reassert his leadership, his presidency in all probability is doomed, and Mexico's economic modernization will stall for years. To

8 Daniel Dombey, "Underwhelming Proposals," *Business Latin America*/The Economist Intelligence Unit, January 16, 1995.
9 Kevin G. Hall, "Exports Seen as Crucial to Ending Mexico's Peso Devaluation Crisis," *The Journal of Commerce*, January 6, 1995.

assert his presidential leadership, Zedillo must act swiftly to terminate the simmering crisis in Chiapas where the Zapatista rebels are challenging government authority. Negotiations with the rebels have dragged on for a year, and it is clear that the aim of rebel leader "Subcomandante Marcos" is to prolong the conflict indefinitely and to destabilize Mexico by undermining the authority of the presidency and strengthening internal political and popular opposition to the country's economic and democratic modernization. The Chiapas rebellion contributed to the collapse of the peso by greatly undermining investor confidence in Mexico's economy.

To end the Chiapas conflict and to restore confidence in the Mexican economy and President Zedillo's leadership, the Mexican President should announce a deadline for a binding negotiated settlement. In addition, the Zapatistas should be offered the opportunity to join the democratic process, either by creating their own political party or by joining existing parties. After the final deadline for a settlement passes, President Zedillo should order the Mexican army to occupy the rebel strongholds and disarm the Zapatistas by whatever means are necessary.

In addition, President Zedillo should consider the following structural economic reforms to restore confidence in Mexico and prevent yet another debt crisis in just a few years:

✔ **Replace the Bank of Mexico with a Currency Board.** Because the Bank of Mexico failed to maintain a stable currency, it is time to look at alternatives. One idea is a currency board. A currency board issues a local currency that is fully backed by reserve assets denominated in a widely used and well-respected foreign currency, such as the U.S. dollar. The local currency—in this case the peso—could be converted into the reserve currency—in this case the dollar—at a pre-established fixed rate at any of the board's offices. Under a currency board, the local currency supply can expand only in proportion to an increase in net exports or capital inflows. As a result, the inflation and interest rates in the local currency will closely resemble those rates in the country that supplies the reserve currency. A currency board invests its reserves in high-quality, interest-bearing notes and bonds denominated in the reserve currency. These earnings should more than cover the board's operating expenses.

Replacement of the Bank of Mexico with a currency board, whose reserves could be held in U.S. dollar assets, would immediately reassure the Mexican market and restore confidence in the peso. Inflation and interest rates now likely to soar instead would subside to rates similar to those in the United States. Selling part of the state-owned oil monopoly Petroleos Mexicanos (Pemex) and the electrical power monopoly Comision Federal de Electricidad, could capitalize a currency board more than adequately.

Over sixty countries have had currency boards during this century. Argentina has been using a variant of the currency board since 1991. In each of these cases, a currency board system killed the deadly virus of high inflation, lowered local interest rates to manageable levels, and encouraged direct foreign investment in the local economy. Institution of a currency board in Mexico may be the most important reform that the Zedillo government could initiate.[10]

✔ **Be more aggressive in privatizing state-owned monopolies.** Privatizing the state-owned oil and electricity monopolies has been taboo in Mexico. There are even constitutional restrictions on doing so. However, if Mexico is to solve its economic crisis, the Zedillo administration must begin to privatize Pemex and CFE. The assets gained from selling these monopolies to the private sector of the economy could be used not only to capitalize a currency board, but also to capitalize the private pension funds that would result from privatization of the social security system and to help repay part of Mexico's huge foreign debt.

✔ **Overhaul Mexico's tax system.** Mexico's progressive income tax regime, which begins taxing income at $5,000 a year and rises progressively to 34 percent for individual taxpayers, should be replaced with a flat tax of 17 percent.[11] The corporate income tax, which Zedillo proposes to raise to 35 percent from 34 percent, should be halved to a flat rate of 17 percent. The corporate assets tax, now at 1.6 percent from 2 percent originally, should be eliminated. The value-added tax, now at 10 percent, should be reduced to 8 percent.[12] Mexico also should follow the example of the Asian Tigers and eliminate all capital gains taxes.[13]

✔ **Abolish the economic and social stabilization pacts.** Begun in the mid-1980s, these one-year wage and price stabilization pacts have been renewed annually in high-level negotiations between the government, organized labor, and business. Essentially manifestations of the corporatist state, these pacts are incompatible with the free-market model Mexico purports to be following. All wage and price controls should be abolished, allowing market forces to set wage and price levels in the Mexican economy.

✔ **Privatize the social security system.** Mexico needs to reduce its excessive reliance on short-term capital inflows from abroad and develop new domestic funding sources for productive investments. In addition, one of the key challenges facing the Zedillo administration is to start correcting the unequal distribution of income in Mexico. Privatizing the social security system would accomplish all of these objectives.

A privatized social security system based on the Chilean model of privately managed pension funds could be capitalized by selling off part or all of the assets of Pemex and CFE. The creation of privately managed pension funds also would promote the growth of a healthy and diversified equities market that could draw on the savings of Mexican workers, rather than foreign lenders and investors, to finance the growth and development of the Mexican economy. In turn, this would reduce income inequality in Mexico, fostering the emergence of a strong middle class and creating the bases of formal, individual property rights essential to a sound free-market economy.

---

10 In Mexico's case, the reserve currency should be the U.S. dollar.

11 The income tax withholding "floor" also should be increased from $5,000 to $10,000.

12 This would improve Zedillo's low popularity with the Mexican people.

13 Currently, only companies listed on the Mexican stock exchange are exempted from capital gains taxes.

CONCLUSION

Unless these reforms are enacted, any debt relief package would only prolong Mexico's long-term structural problems with its economy. As Congress debates the wisdom of the Clinton plan, it should focus on what Mexico can do to solve its own problems. However, making these measures conditions for assistance is problematic. The Mexicans will probably reject outright conditionality, and even if the conditions were accepted, there is no guarantee that they will acted upon in the future.

In the end, the Clinton bailout plan seems not only unwise economically, but patently unfair to the American people as well. The U.S. government is not bailing out California's Orange County, which is bankrupt today because of the unwise investment decisions of its financial managers. Similarly, the U.S. government does not make a habit of bailing out private investors who lose money on speculative investments.[14] Yet that is precisely what will happen if the loan guarantees are approved. The full implications of the Clinton plan should be aired by Congress, including the downside to letting Mexico default on its loans in the absence of the loan guarantees, but if the November elections showed anything it is that business as usual is no longer the order of the day. Congress should take a cold, hard look at the bailout plan before risking billions of taxpayer dollars on a scheme that most likely will do nothing to solve Mexico's economic problems.

John P. Sweeney
Policy Analyst

14 U.S. investors have lost at least $25 billion on their Mexican investments since the peso was devalued on December 19, 1994.