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The Mexican Economy in the 1990's

Markets are In; State Control is Out

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The dramatic changes in Mexico's macroeconomic policies have shown that the Government is prepared to alter the course of the Mexican economy to keep pace with new global realities. Initiated in December 1987, these policies are moving Mexico toward a more open economy based on the principles of free trade and competitive enterprise. The United States benefits not only from a more secure and stable southern border, but also from a potential boost in trade (fig. 1). Inflation declined after the Mexican Government reduced foreign debt, decreased trade constraints, increased foreign investment, reduced the budget deficit, and slowed the depreciation rate of the peso. Economic growth has accelerated, averaging 3.5 percent in 1989-91, compared with less than 2 percent in 1982-88. Growth is expected to continue over the next 5 years.

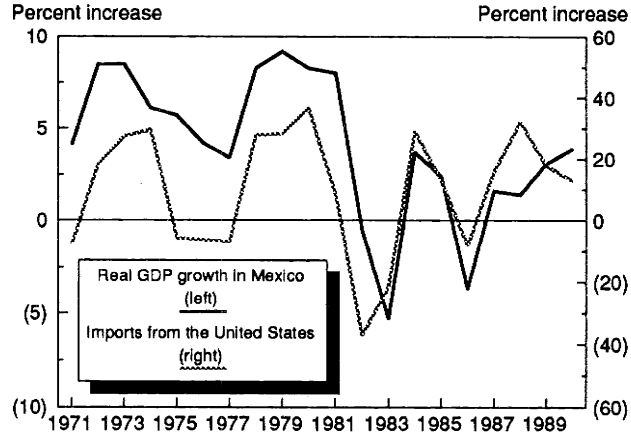
The ruling Institutional Revolutionary Party has embarked on a course of unilateral reform that reverses the direction the Mexican Government has pursued in this century. Inward orientation and state control of key industries are giving way to freer trade and a greater reliance on private ownership. Although not as well publicized as reforms in Central Europe and the U.S.S.R., the efforts of the Mexican Government are dramatic and important for the economic health of the United States.

Mexico is the third largest trading partner of the United States. Mexico also has been the third- or fourth-largest market for U.S. farm products in each of the last 3 years. The United States purchases half of Mexico's oil exports and over three quarters of its other merchandise sold to foreign countries. Of Mexico's merchandise imports, 65 percent are of U.S. origin (1985-90 average). Canada, Mexico, and the United States could make up a free trade area larger than the European Community, in both population and economic activity. Furthermore, as a neighbor, Mexico is politically strategic for the United States.

Mexico has joined with Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua to create a free trade zone among those six countries by the end of 1996. There is a further commitment to encourage the economy to develop according to comparative advantage and not to interfere with the necessary adjustments which that entails. The Mexican Government is convinced that freeing up the economy is a precondition to sustained growth and development. The stated objective is to bring the per capita income level to that of an industrial country over the next 20 years. The proposed United States/Mexico free trade agreement is one way to institutionalize Mexico's current reform efforts.

Figure 1
Mexico grows, U.S. trade expands

Faster economic growth in Mexico means a faster growing market for U.S. exports.



Source: International Monetary Fund

Down with Inflation; Up with Enterprise

Inflation, the most obvious sign of economic inefficiency, is the first target of reform in Mexico.

The desire to reduce inflation explains many Mexican policy changes since December 1987. Growth in gross domestic product (GDP) declines when inflation accelerates (fig. 2). Resources are used less efficiently when inflation rises: people spend more time evading price increases and less time working, investment declines sharply as future values become uncertain, capital that could be used domestically is transferred overseas, savings decline, and real wages erode. Innovation and entrepreneurship are channeled into unproductive activities. Income distribution worsens as the wealthy protect themselves and the poor cope with less. The bottom line is, with inflation, the present is valued more highly than the future. A poor country, such as Mexico, only makes itself poorer over time with a high-inflation policy.

The reduction in Mexican inflation is the most visible sign that the future is playing an important role in economic policymaking. A slowdown in the rate of growth of money is critical to easing inflation, yet fiscal policy and monetary policy in Mexico are not independent. Excessive Government spending always involves borrowing from future generations. This is accomplished by creating money. Thus, the cost of weighing the present more heavily than the future is seen immediately in inflation. When the fiscal deficit rose to 16 percent of GDP in 1987, inflation surged to over 130 percent. The decline in Government borrowing, to 3.5 percent of GDP in 1990, puts much less pressure on the monetary authorities, and inflation falls (fig. 3).

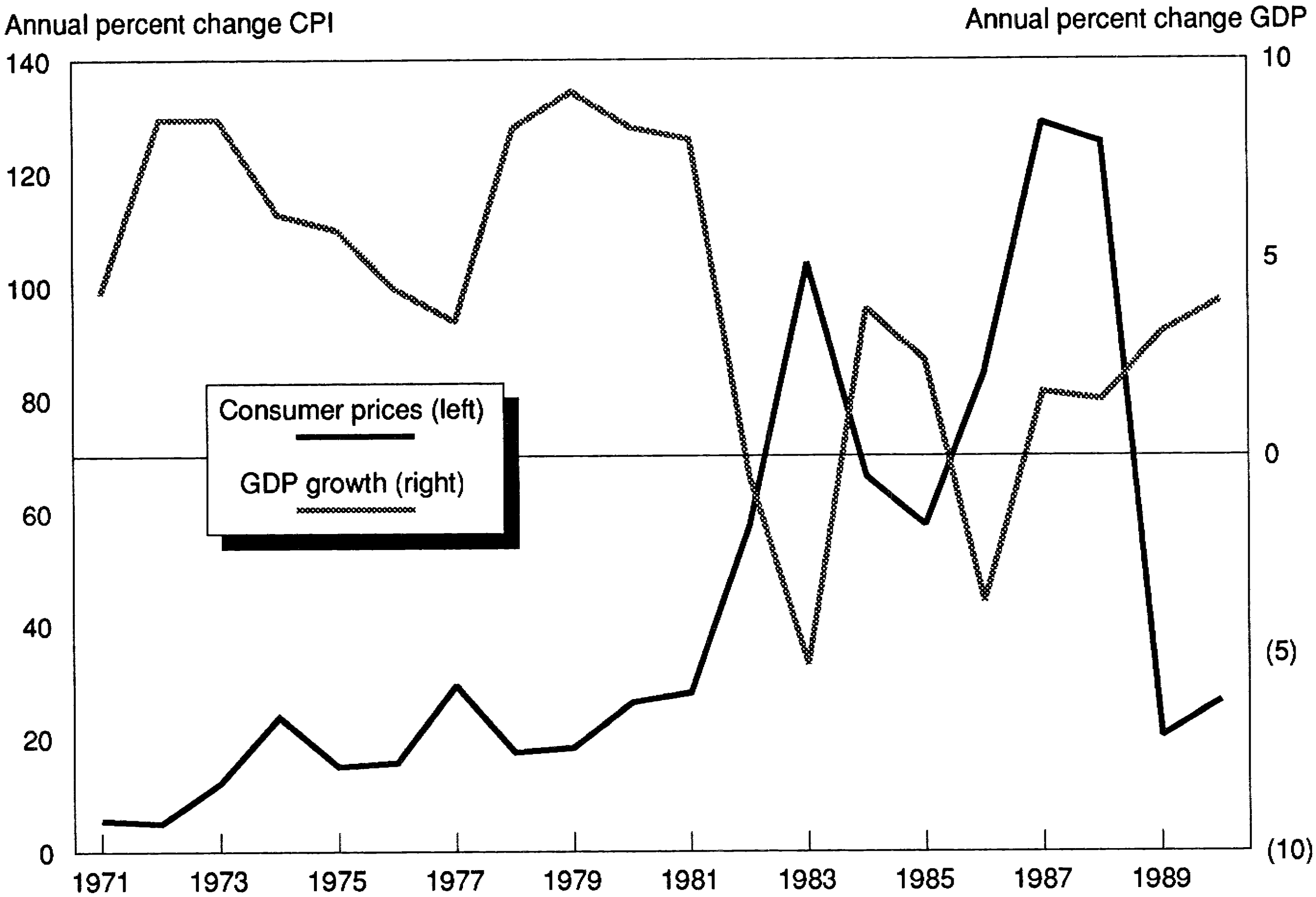
Inflation may also be controlled by exchange rate policy (fig. 4). Mexico has slowed the depreciation rate of the peso against the dollar to under 5 percent per year by using a preannounced crawling peg (devaluing by 1/100 cent per day). The long-term objective is to stabilize the peso and dollar exchange rate once the inflation rate achieves the 6-percent current target. This means that the central bank, the Bank of Mexico, may expand its money supply only in accordance with monetary policy in the United States. Mexican inflation will then partly depend on inflation in the United States. During the last period of fixed exchange rates, from 1971 through 1976, Mexico had its lowest average rates of inflation in the past 20 years. The 1980's saw the peso alternately undervalued and then overvalued, making planning and long-term contracting very difficult.

Increasing competition may also control inflation. Rewards in competitive industries, over time, go to those who can reduce costs and offer lower prices. The Mexican Government has increased competition in three ways: by eliminating monopolies (in the form of state-owned enterprises), by opening Mexico to foreign competition, and by eliminating regulations (especially in overland transport) that tended to raise costs and restrict the availability of some goods and services.

The decision to privatize many Government enterprises has had two further benefits for fiscal policy. First, subsidies to Government-owned enterprises have been reduced. Second, some of the revenues from the sale of Government-owned businesses have been placed in a stabilization fund both to reduce debt and to use as a hedge against future uncertainties. This fund currently is in excess of $1 billion.

Figure 2
Inflation and GDP growth in Mexico

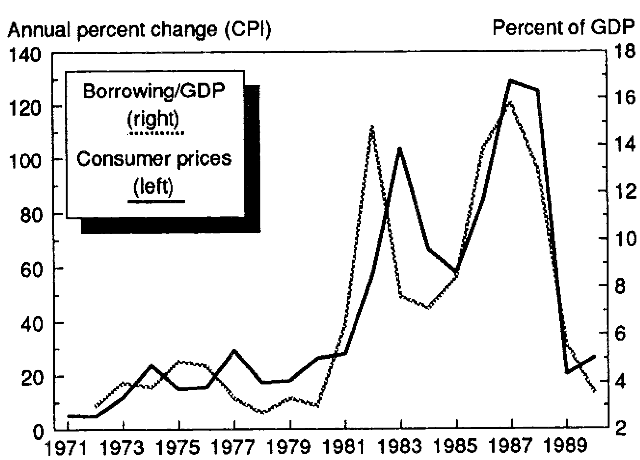
Lower rates of inflation mean higher rates of economic growth in Mexico.



Inflation is measured by the change in the consumer price index (CPI).
Source: International Monetary Fund, ERS estimates.

Figure 3
Government borrowing and inflation in Mexico

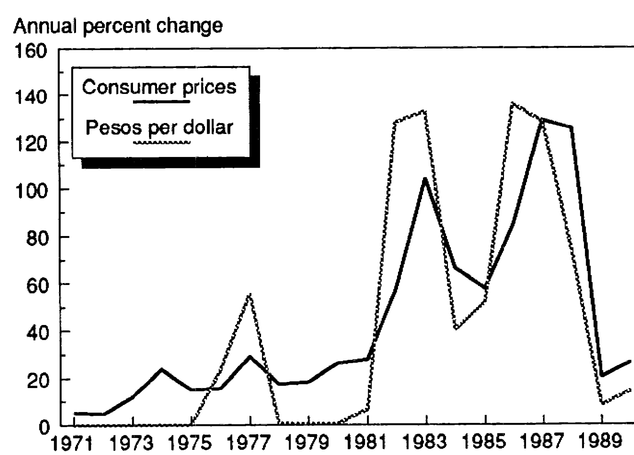
A slowdown in government borrowing slows inflation.



Source: International Monetary Fund, ERS estimates.

Figure 4
Exchange rates and inflation in Mexico

A slower devaluation helps reduce inflation.



Source: International Monetary Fund.

Debt Service Reductions: Inflation Busters

Pesos once earmarked for repayment obligations have been freed up for domestic investment. As the Government rids itself of subsidized industry, entrepreneurs are ridding Mexico of its debtor stigma.

The reduction of Mexico's foreign debt in 1989, under the auspices of the Brady Plan (see box), has had a substantial effect on the conduct of fiscal and monetary policy, the investment climate, and the outlook for the economy. Total external debt fell from $101 billion at the beginning of 1989 to $87.5 billion by the end of 1990. The result has been a fall in the debt-to-GDP ratio from 59 percent in 1988 to 39 percent in 1990. More of Mexico's output can now be used for investment rather than paying for past borrowing. The Brady Plan has increased the optimism of investors, consumers, and Government officials in Mexico.

The most important benefit of debt reduction has been the lowering of current obligations. Debt repayments took one-half of all export earnings as recently as 1986, and over 45 percent as of December 1987. However, that ratio declined to below 30 percent in 1990 and should be near 25 percent by the end of this year. The net outflow of resources was 6 percent of GDP during 1982-88, but is now slightly over 2 percent. At 6 percent, the reward for resources producing $100 of income was only $94. Viewed this way, the debt was a significant drain on economic incentives.

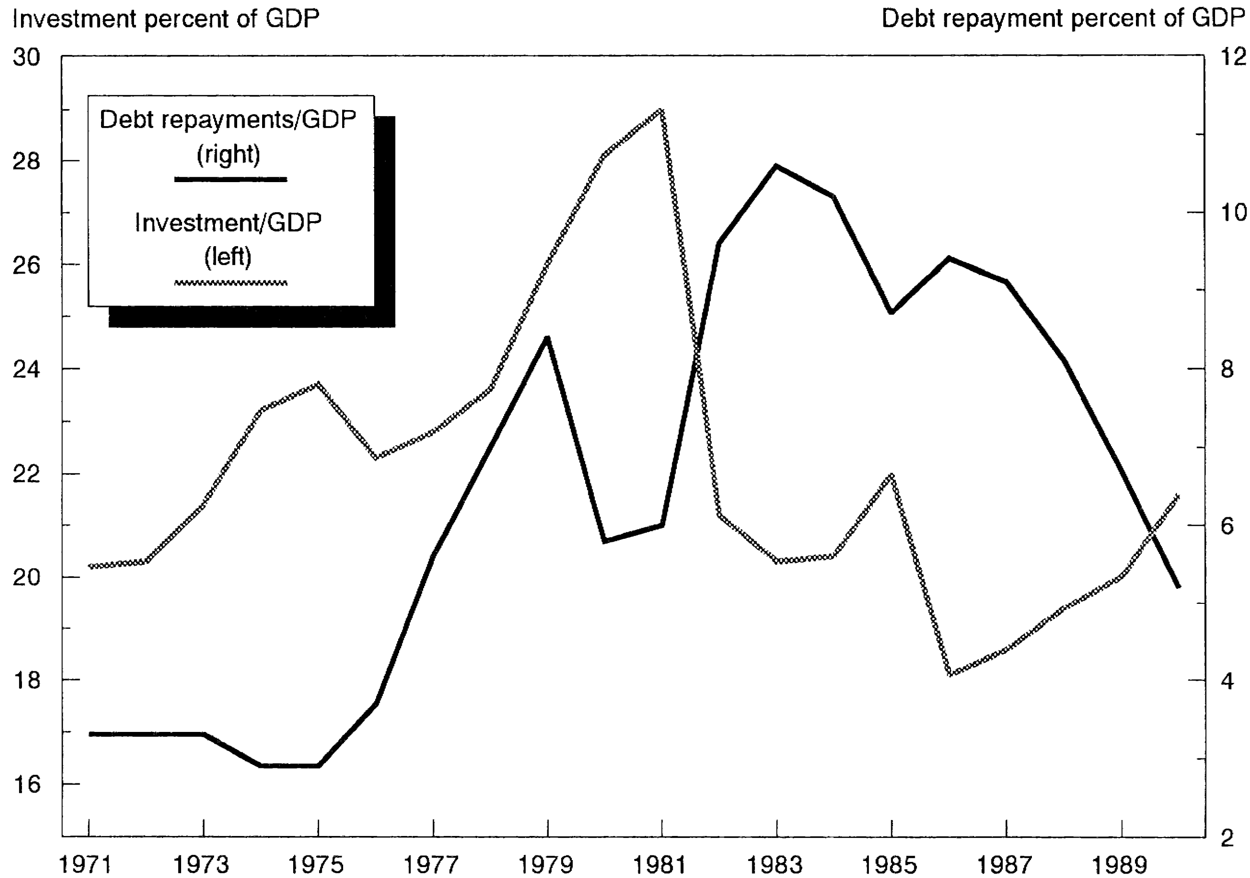
Debt service repayments displace investment on more than a dollar-for-dollar basis. For example, debt repayments as a percent of GDP rose from 6 to 11 percent between 1981 and 1983. At the same time, investment fell from 29 to 22 percent of GDP (fig. 5). A rise in repayments of $1 will reduce investment by more than $1. Repayments for past obligations represent funds that could be used for investment. Second, productivity is eroded as more output must be used to make payments, leaving less for workers and owners. Debt service on guaranteed debt also competes with other fiscal obligations. This may prove inflationary. The reduction in current repayments is thus an important element in the fight against inflation.

The decline in repayment obligations is critical for sustaining and expanding capital inflows into Mexico. Moody's Investment Services, in December 1990, rated Mexico's foreign currency debt at Baa (a bond rating higher than some U.S. municipalities have), the first rating for Mexico issued by Moody's since 1982. This means that, for the first time since 1982, Mexico has the potential for borrowing on the international commercial market.

Figure 5

Debt repayments and investment in Mexico

Higher debt repayments in the 1980's were accompanied by lower investment.



Source: International Monetary Fund, Government of Mexico.

The Brady Plan

U.S. Treasury Secretary Nicholas Brady, in March 1989, announced a set of policies designed to help heavily indebted countries reduce the burden of their external obligations. The objectives were to reduce the current level of debt and provide for new lending. Lower repayments permitted imports to rise, and new lending freed domestic resources for investment. The approach is case-by-case, recognizing the considerable differences among countries. The Brady Plan has been implemented successfully for Mexico, the Philippines, Venezuela, and Costa Rica.

Mexico has provided the largest and most difficult test. However, the Mexican Government's earnest reform process has made debt reduction easier. The Brady Plan emphasized that economic reform was an important prerequisite for participation by the International Monetary Fund (which provided a new lending facility), the World Bank (structural loans), commercial banks, and the United States. The result was a creative scheme that lowered repayments and the debt. The U.S. Government did not directly "forgive" any of Mexico's debt or repayments, but created conditions under which debt reduction could be less painful for all parties.

Creditors had three options. They could reduce the face value of their loans (by 35 percent) and receive guaranteed interest payments based on current market conditions. Alternatively, principal payments were guaranteed, but at a lower interest rate (6.25 percent). Last, they could offer additional lines of credit. About 40 percent of Mexico's creditors took the discounted face value, 47 percent opted for lower interest rates, and the remainder took advantage of Mexico's renewed creditworthiness. One additional novel feature of the new bond issues is that the payments depend on Mexico's oil revenues. Starting in July 1996, 30 percent of the per-barrel price above $14 (adjusted for inflation) will go to bondholders, up to 3 percent of face value.

International Structural Reform: Open-Door Policy for Trade and Investment

Mexico's radical structural reform program has significantly reduced trade constraints between Mexico and the United States, and has paved the way for Mexican economic growth through direct foreign investment.

All imports into Mexico in 1982 were subject to import licenses. However, by the end of 1989, only 2 percent of imported items were subject to licenses, and current plans call for a total elimination of import licenses over the next 5 years. Furthermore, average tariff rates in 1982 were 85 percent. Maximum tariff rates are currently 20 percent, and average rates are under 10 percent. There is, and will continue to be, free access to foreign exchange, eliminating an additional hidden import barrier.

The United States has experienced substantial increases in both imports to and exports from Mexico over the last several years, due to the reduction in trade constraints and Mexico's increased economic growth. The projected growth in Mexican income from the change in Government policies is also likely to bring substantial increases in demand for U.S. products in the future, including large growth in food grain, feed grain, and livestock exports to Mexico.

The Mexican Government is encouraging direct foreign investment as a further structural reform. Benefits of the encouragement of foreign investment are immediate: the current account deficit can be financed by private investment flows, rather than Government borrowing. Thus, inflationary pressures are again reduced, and an automatic stabilizing mechanism comes into play; foreign investment now means more exports later. We can expect flows of goods to service private debt, rather than flows of international borrowing to service publicly guaranteed debt.

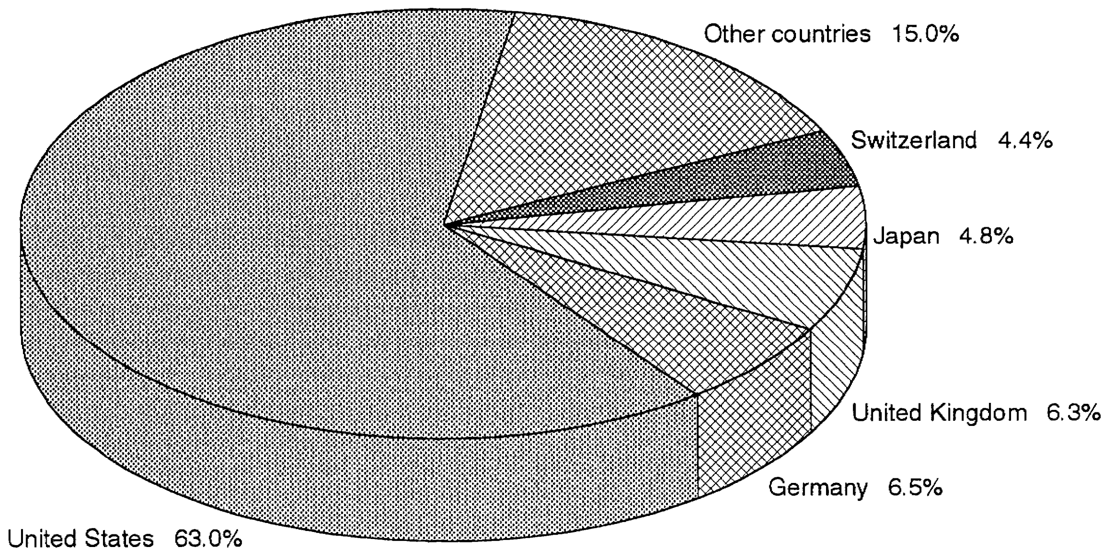
The Government recognized that direct foreign investment is a substitute for foreign debt, but with several distinct advantages. There are no explicit repayment requirements. The risk is largely transferred abroad. Investment is specific in enterprises that promise to produce an excess of social value. The new regulations specify that two-thirds of all business activities require no prior approval. These include projects that are outside of major cities, consist of investment funds from abroad, and will lead to a net outflow of funds from Mexico in the first 3 years of operation. The purchase of Mexican companies is subject to the same criteria. Otherwise, the project must be approved by the National Foreign Investment Commission within 45 working days of the date the application was submitted. Failure to act within 45 days means that the project is automatically approved.

The objective of the Mexican Government is to double the level of direct foreign investment by 1994, or to obtain a total of $60 billion from 1989 to 1995. Registered investment in 1990 was $4.4 billion, double the level of 1989. The United States provided the bulk of foreign investment (fig. 6), which was centered in the industrial sector (fig. 7). The proposed United States/Mexico/Canada free trade agreement would lead to an additional 33 percent in direct foreign investment per year.

Associated with fewer rules regarding direct foreign investment are arrangements for increased technology transfer. New laws provide for more certainty regarding the ownership of intellectual property rights, particularly franchise licensing and patent protection.

Figure 6
Composition of foreign direct investment in Mexico

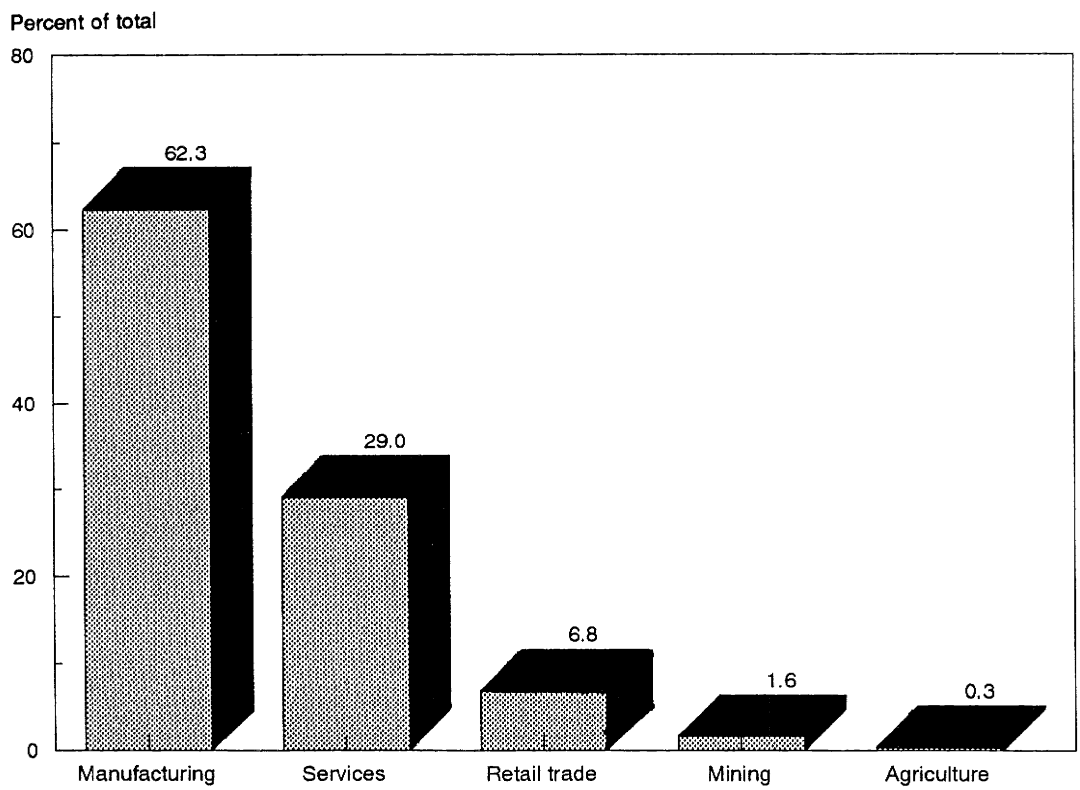
The United States invests more in the Mexican economy than all other countries combined.



Source: Government of Mexico.

Figure 7
Industrial composition of foreign direct investment in Mexico

Manufacturing and services make up over 90 percent of foreign direct investment in Mexico.



Domestic Structural Reform: Who Benefits?

Financial deregulation and industrial divestiture free the Mexican Government to invest in the average citizen. The result could be better public health, education, and transportation facilities.

There were 1,155 public enterprises in Mexico in 1982. About 425 remained by the end of 1990, with another 200 scheduled to be either divested or liquidated. These Government divestitures include Government-owned hotel chains, sugar refineries, steel mills, insurance companies, the telephone company (TELMEX), banks, and other companies. The most successful firms were sold first, making further divestitures increasingly difficult. Nonetheless, divestiture of nationalized banks, a large insurance company, steel mills, fertilizer plants, a railroad manufacturing company, and the national airlines is being planned. The national petroleum company (PEMEX) will remain a part of the Government; it contributes about 20 percent of total Government revenue.

A massive program of deregulation and reregulation has been undertaken. This is viewed as perhaps the single most important element of the reform program. Major reforms in regulations have been instituted in banking and finance, transportation, insurance, packaging, customs, petrochemicals, sugar, cocoa, and direct foreign investment. The improvement in efficiency generated by deregulation is one important explanation for the reinvestment and growth in the Mexican economy despite a contraction in Government expenditures.

There has also been a significant liberalization of the regulation of banks and other financial institutions. Prior to 1988, the Government dictated loan portfolios, interest rates, and liquidity requirements. Banks were used as a means of raising capital for the Government, via increasing reserve requirements at the central bank, whenever new Government financing was needed. As a result, there was little private financial intermediation. Interest rates have now been largely freed. Lending is by discretion, rather than by Government rules. Reserve requirements have now been fixed at 30 percent of deposits, rather than changed arbitrarily.

Several important consequences of the deregulation process are evident. There has been a substantial increase in the flow of savings into financial institutions (29 percent in 1989 and a further 13.5 percent in 1990). This was associated with the freeing up of interest rates and the movement to very high real rates of return from previously controlled rates at negative real returns. Consequently, credit to the private sector has increased dramatically in real terms (by 67 percent in 1989 over 1988, and a further 28 percent in 1990). This has allowed private investment to largely replace Government investment, and has encouraged capital inflows.

The freeing of many formerly regulated prices is viewed as largely responsible for the jump in inflation in 1990. Subsidies on basic foodstuffs have also been cut, which has raised the prices of staples, such as beans, for the urban poor. (Consumer prices are still controlled for basic staples, though these controls may also be removed.) However, at least some of the money saved from this and other subsidies has been redirected to urban and rural health and education. One objective of the rural focus is to encourage people to remain in less crowded rural areas, relieving the strain on a heavily populated Mexico City.

An increased emphasis on infrastructure is one way in which lower subsidies and sales of Government enterprise can be used to solve serious competitive disadvantages in Mexico. Transport costs, for example, are much higher than in the United States or Canada. Increased public investment in new and improved roads, along with deregulation of inland conveyance and port facilities, should help Mexico on the drive to the 21st century.

One question that immediately arises is whether the most affected interest groups have had a chance to protest deregulation and restructuring. The Mexican solution, for those who may object to the direction of reform, is to unilaterally make changes without consultation with affected parties, then let results build a new clientele for liberalized policies.

The Mexican Economy Carries on Progress Rather Than Carrying Over Debt

International investment and domestic optimism in Mexico step up the current production of goods and services and provide for future growth.

The positive signs of economic liberalization point to early success for Mexico's economic program. Real GDP growth from 1982-88 was less than 2 percent per year. However, real GDP growth increased from 1.4 percent in 1988 to 3.1 percent in 1989 and 3.9 percent in 1990. Furthermore, real GDP growth is projected to return to rates in excess of 6 percent by the mid-1990's, a rate comparable with those experienced in the 1960's.

Gross domestic investment has steadily increased to 21.6 percent of GDP in 1991, from only 18.1 percent in 1986. A rise in investment means that more goods and services will be produced in the future, setting the stage for more rapid growth. Savings have also risen, which indicates that people will be able to buy those additional goods. The fastest growing developing countries, such as South Korea and Taiwan, have saving and investment rates of over 30 percent.

Finally, the Government deficit has been reduced from an average of 12.5 percent of GDP from 1982-88 (reaching 16 percent in 1987) to under 4 percent in 1989 and 1990. This Government fiscal control is projected to continue over the next 5 years. Rather than servicing its debt, the Government can concentrate on more serious problems, such as health and education.

The only potentially distressing news is that Mexico has switched from a merchandise trade surplus to a deficit, measured in U.S. dollars, rising to $5 billion in 1990. Service flows (including debt repayment) mean a current account deficit of about $7.7 billion. Part of the rise in imports of goods and services stems from the increase in investment from overseas, estimated at almost $12 billion in 1990. The interpretation should be positive; a country that, on net, attracts direct investment is viewed as having positive growth potential. This increase in investment more than makes up for the current account deficit, and reduces the need to incur debt to buy imports. Declines both in foreign debt and in Government borrowing requirements free domestic resources for investment. Further, Mexicans will be working more for themselves, rather than to pay off unproductive debt incurred in the past.

Mexico's economic reforms have:

* Produced higher economic growth
* Lowered inflation
* Reduced the debt burden
* Lowered the Government deficit

People now have a positive outlook, reflected by:

* An increase in savings
* An increase in investment, both from Mexican sources and overseas

Anticipated Benefits Under Mexican Economic Liberalization

A market-oriented economy may enrich the lives of Mexicans at many levels, and it may support U.S. interests.

Government

* Financial resources transferred from public subsidies to stabilization fund
* Freedom to concentrate on improvements in infrastructure
* More stable macroeconomic environment

Entrepreneurs

* More investment opportunities
* A market-responsive interest rate
* Less constraint to trade
* Greater access to credit

Citizens

* Improved education, health, transportation, and communication systems
* More job opportunities due to changing environment
* Favorable interest rates on savings

United States

* A stable and secure southern border
* Less restraint on trade
* An increase in investment opportunities

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