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**MEXICO'S ECONOMIC CRISIS:
CHALLENGES AND OPPORTUNITIES**

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THE MEXICAN ECONOMY: PROBLEMS AND PROSPECTS

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Introduction

For a country that normally plays a marginal role in the great world events of our time, Mexico certainly precipitated a major international financial crisis when it ran out of dollars in the summer of 1982. One prominent economist wrote that the Mexican situation "takes on global dimensions."¹ The flash point came on August 17, when Jesús Silva Herzog, Mexico's widely respected Minister of Finance, traveled to Washington, D.C. to explain to U.S. treasury officials that the Bank of Mexico was dangerously low in foreign reserves and could not continue to service the country's enormous foreign debt.

Many observers were as astonished as they were alarmed. Mexico's economic growth had been so outstanding during the 1950s and 1960s that its performance was commonly referred to as the "Mexican miracle," but in 1982 the economy was facing negative growth rates, soaring inflation, and deep imbalances in the external sector: Mexico possessed huge reserves of the world's most dear resource — petroleum — yet in 1982 it lacked the foreign exchange with which to pay its foreign debt or buy its imports. The Mexican political system was considered a model of stability and continuity in a politically volatile region; in 1982, however, commentators wondered whether the system would survive the economic crisis. Foreign companies, individuals, and international bankers had rushed to Mexico to invest and to loan, but in 1982 a widely held view was that Mexico was finished as an attractive site for external capital, whether equity or debt.

How did this situation come about? What is the magnitude and nature of the Mexican economic crisis? How is the Mexican government dealing with the country's problems and what are the prospects for success? As a contribution to the analysis of

1. William R. Cline, "Mexico's Crisis, The World's Peril," *Foreign Policy* 49 (winter 1982-83): 107.

these issues, this essay attempts to provide an overview of Mexico's crisis, austerity program, and development strategy. The other essays in the volume explore specific dimensions of the crisis, including the role of the United States, trade and investment policy, the labor market, the position of organized labor, and the political aspects of the austerity program.

The Origins of the Crisis

Writers about Mexico tend to offer one of two broad explanations for the origins of the economic crisis. One posits that it was imported from the United States and the other industrialized countries. Holders of this view stress Mexico's vulnerability to external forces and argue that Mexico could do nothing to protect itself against the adverse effects of high international interest rates, recession in the industrialized countries, and the collapse of markets for its major export products, especially petroleum. The other view locates the cause of the crisis within Mexico and cites inefficient utilization of resources, mismanagement of the economy, poor planning in both public and private enterprises, and flagrant corruption to support its position.

Any crisis that brings a vibrant and booming economy to the brink of bankruptcy must have multiple causes. As is usually true in such cases, both internal and external factors influenced the seriousness, the nature, and the timing of the crisis. While the origins of the crisis are to be found deep in Mexican history, in a development strategy that relied heavily on external financing of the country's capital needs, the more proximate causes are the economic policies that the government adopted as of 1978 in response to both domestic and external circumstances.

The administration of President José López Portillo (1977-82) inherited a serious economic crisis from that of its predecessor, Luis Echeverría (1970-76).² In an effort to improve Mexico's economy, López Portillo's economic advisors devised an economic strategy that, they believed, would first stabilize the economy, then allow it to expand. The growth was to occur through an increase in demand, while a rise in both production and imports would combine to hold down inflation. Oil export revenues, supplemented by foreign borrowing, were to pay for the strategy. The officials assumed that the strategy would result in an improvement in the standard of living and a rise in employment, and so the benefits of Mexico's oil wealth would be shared by all Mexicans.

2. For a discussion of economic policy-making during the Echeverría administration see Leopoldo Solís, *Economic Policy Reform in Mexico: A Case Study for Developing Countries* (New York, 1981).

The stabilization program's objectives included restoring confidence among investors and savers, bringing a halt to capital flight, stimulating the weak financial markets, and raising government revenues. The administration faced an uphill battle. Mexico experienced a serious reduction in economic activity in 1977: real production that year increased by only 2.8 percent as all aspects of aggregate demand were affected by the previous devaluation. Imports of capital goods fell by 14 percent in that year compared with 1976; total gross investment fell by 7.6 percent in real terms; and inflation at the retail and especially the wholesale levels became noticeable.

By 1978, however, the stabilization program had begun to take hold. Gross domestic product grew 7 percent in real terms; inflation declined. Aggregate demand rose as a result of increased public and private spending, and private investment picked up, stimulated by an increase in the supply of credit from the banking system. During the second and third trimesters of 1978, the supply of credit was 84 percent greater than it was during the same period of 1977. As confidence spread through the private sector, investment rose. Public-sector spending grew at a 9.3 percent annual rate.

According to one leading Mexican economist, public confidence increased largely because of an announcement by the government that oil revenues were much greater than anyone had imagined earlier: up to 16,000 million barrels, an increase of over 4,000 million barrels from the previous year's estimate of 11.2 thousand million barrels. Meanwhile, Pemex's share of public sector spending increased to 30 percent as of 1978.³

The Good Times

As 1978 began, Mexicans and foreigners alike had a much more optimistic view of Mexico's economic future than they had had a year before. The announcement regarding the increased hydrocarbon reserves sparked the renewal of confidence. Mexicans believed that the petroleum reserves were sufficient to support the renewed expansion of spending in both the private and the public sectors. As of 1978, the recuperation of the economy was on: average annual growth of the gross domestic product between 1978 and 1980 was 7.6 percent. Spending appeared to have no brakes; officials were prepared, in that classic phrase, to "let the good times roll."

3. Leopoldo Solís, "El papel del endeudamiento externo de México desde el desarrollo de los sesentas," paper delivered at the Ciclo de Conferencias de El Colegio Nacional, draft version, August, 1983, pp. 24-27.

The boom that occurred was based on rising oil revenues and on a high level of public and private expenditures. In 1981, public expenditure as a proportion of gross domestic product (GDP) amounted to some 36 percent compared with 29 percent in 1976 and 20 percent in 1970. As during the 1930's, this expenditure was seen as the major way in which demand would be stimulated, and as such it worked. Real per-capita income during the boom years increased by some 25 percent while unemployment fell.

The architects of this economic strategy recognized that inflation could be a serious problem. They were right. With the expansion of production and the rise in demand, the pressures for price rises became intense. The government's response was gradually to overvalue the peso, which meant that imported goods became less expensive relative to Mexican ones and that Mexican exports became more costly relative to other goods on the world markets in which Mexico competed (oil excepted). Mexico's ability to import goods at favorable prices acted to counter domestic inflationary pressures in two ways: it reduced the pressure for wage hikes and cut down the cost of foreign credits to businessmen who wanted to borrow abroad to finance the growth that would allow them to meet the demand in the booming economy. By overvaluing the peso, in other words, the government put the burden of the inflationary pressures on the external sector, which allowed it to contain the rise in domestic prices.

For several reasons, the burden placed on the external sector was too great. In 1980 the deficit in the current account of the balance of payments was 4 percent of gross domestic product. Although the contribution of Pemex to public savings increased from 1.4 percent of gross domestic product in 1975 to 6.2 percent in 1980, public-sector savings exclusive of Pemex turned negative. Subsidies, specially of foodstuffs and gasoline, reached 10 percent of gross domestic product in 1980. Moreover, the real value of the peso relative to the dollar and to other currencies began to fall because of the increasing differences between international prices and domestic prices, a difference not reflected in the exchange rate. In 1980, inflation in Mexico reached 30 percent; in the U.S. that year it was 14 per cent.⁴

Oil revenues continued to increase, but not at a rate sufficient to offset two negative consequences of the overvalued exchange rate. One was the increase in imports, since these were less expensive. The other was the fall in non-petroleum exports, since these were more costly. The result was a deficit in the trade balance and in the current accounts of the balance

4. Solís, "El papel del endeudamiento externo," pp. 28-29.

of payments. The immediate deficit in the current accounts was covered by foreign borrowing, but the interest payments on the new borrowing proved a serious drain on the current accounts.

Figures describe the situation well. The value of Mexico's merchandise exports increased from \$9.3 billion in 1979 to \$19.8 billion in 1981. With the rise in imports, however, the trade deficit increased from \$2.8 billion in 1979 to \$3.4 billion in 1981. Most serious was the increase on the current account deficit, from \$5.4 billion in 1979 to \$12.9 billion in 1981. Clearly, the external sector of the Mexican economy was in trouble. In mid-1981, the development strategy began to come apart.

For one thing, 1981 saw a serious weakening in the world petroleum market. The Mexican government had anticipated revenues of some 20 billion dollars from petroleum exports; the actual receipts in 1981 were 14 billion dollars. The 6-billion dollar shortfall was a serious blow to the country's international balance of payments. For another thing, the vast public spending in combination with the decline in oil revenues meant that federal expenditures outran federal revenues, producing a public-sector budget deficit that by 1981 had reached almost 15 percent of GDP. Faced with a dramatic increase in the trade and current-accounts deficits, the Mexican government had to make a choice between cutting back on its ambitious development projects and adjusting to the new external circumstances conditioning its major export product on the one hand, and financing the growing deficit by borrowing in the international capital market on the other. It chose the latter, a decision that proved extremely expensive.

The Debt Factor

Among the developing countries, Mexico was one of the major recipients of the recycling of petro dollars through the international financial system. Mexico was extremely active in international capital markets during the López Portillo period, receiving an average of 10,000 million dollars during each year of the administration. The inflow of debt permitted the financing of the growing deficit in the current account of the balance of payments. In this immense movement of capital, international commercial banks played their historic role as financial intermediaries.⁵ The petrodollars provided a source of capital that the banks were delighted to loan abroad. Through much of the

5. A very well written analysis of this recycling process is Anthony Sampson's *The Moneylenders: The People and Politics of the World Banking Crisis* (New York, 1981). For a somewhat different view see Morgan Guaranty Trust Company of New York, *World Financial Markets* (Feb. 1983).

1970s, the return on foreign loans surpassed that on domestic loans. Even when increasing competition among the bankers, aggravated by the entry into sovereign lending of regional and local banks in the U.S. and by banks from Europe and Japan, reduced the return on sovereign loans, the eagerness did not abate. "In this era of aggressive bank expansion," wrote one economist, "growth of assets was more important than return on assets."⁶ Moreover, the banks were protected against the risk that the cost of funds would rise faster than the income from the loans by floating interest rates that were adjusted every six months or so to reflect market rates. And, with its black gold as collateral, and its long history of political stability, Mexico seemed an ideal borrower.

Both the size and the structure of Mexico's external debt were sources of difficulty for the country. Much of the 1981 deficit was financed by short-term borrowings in the international capital market.⁷ Mexico's foreign short-term public debt increased from \$1.5 billion at the end of 1980 to \$11 billion by the end of 1981. This debt was particularly troublesome in 1981 because it was used to support the government's expansionary fiscal policies through financing of the government's long-term capital projects, and to support the balance of payments, rather than being applied to the trade financing that is normally associated with short-term credits.⁸ These credits, when combined with long-term debt service payments, amounted to huge repayment obligations for 1982.

The payment of the service of the debt, which had risen rapidly between 1977 and 1978, was reduced in 1980, but rose again in 1981 and 1982. The rate of service of the debt (i.e. proportion of interest payments plus medium- and long-term amortizations relative to income from exports) increased some 60 percent in 1978 to 67 percent in 1979, fell to 33 percent in 1980, rose to 36 percent in 1981, and reached 42 percent in 1982.⁹

Their huge debt was all the more troublesome at this juncture because international interest rates were rising. By 1982, Mexico's interest payments on its foreign debt amounted to 37

6. Karin Lissakers, "Dateline Wall Street: Faustian Finance," *Foreign Policy* 51 (summer 1983).

7. Japanese banks were especially active in short-term lending to Mexico. For an explanation of why and of the consequences to the banks see "The Mexican Shokku," *Euromoney* (Nov. 1982).

8. The Federal Reserve Bank of Chicago, *International Letter* 489 (Dec. 17, 1982).

9. Solís, "El papel del endeudamiento externo," pp. 39-40.

percent of its exports of goods and services, as against 30 percent in 1981 and only 20 percent in 1977. Half of the increase in Mexican interest payments was due to an increase in the outstanding debt. But the other half of the rise in interest payments was due to the rise in interest rates internationally. Between 1978 and 1981, the 6-month LIBOR on dollar deposits increased from an average annual rate of 9¼ percent to 16 percent. During the first six months of 1981 the rate averaged 15 percent, but Mexico had to pay increasing spreads over the LIBOR. Given the size at the time of Mexico's floating rate debt, every 1 percentage point rise in the LIBOR sustained over a year cost Mexico approximately \$600 million in additional interest payments.¹⁰

The structure of the debt was especially troublesome. Of the total of the public-sector foreign debt, 15 percent was short term and 85 percent was medium term. The vast majority of the longer-term debt had been contracted with private creditors as various forms of debt. In general, it was contracted with a spread above a floating indicator, such as the U.S. prime or the LIBOR. Between 1978 and 1981, Mexico achieved a significant reduction in this spread because of bank confidence in the country; in fact, despite the huge volume of debt contracted in 1981, the spread did not rise. However, the effective interest rate that Mexico paid increased from 12.7 percent in 1981 to 13.6 percent in 1982.¹¹

In general, between 1977-1980, great efforts were made to reduce short-term indebtedness and Mexico actually had a reasonable debt profile through the middle of 1981. In December 1980, the public short-term debt was 1,500 million dollars. However, because of the collapse of oil prices, during the second half of 1981 Mexico borrowed frenetically in the short-term capital market, so that by December of 1981 the figure was 11,000 million. In fact, over 50 percent of the public debt for 1981 was short term.¹²

With respect to the destination of external debt capital, there is no question but that the public sector was the major recipient of external financing, contracting some 35,000 million dollars between 1978-1982. During the same period, the private sector took on some 15,000 million dollars in obligations. The foreign indebtedness of the public sector rose an average of 14

10. Federal Reserve Bank of Chicago, *International Letter* 489 (1982), note 4.

11. Solís, "El papel del endeudamiento externo," pp. 38-39.

12. Separate remarks by Rosario Green and Eduardo Suárez to the "Mexico and the World" conference, Center for U.S.-Mexican Studies, San Diego, California, April, 1982.

percent annually between 1976 and 1980, to grow spectacularly at 56 percent in 1981 and 10 percent in 1982. By the end of 1982, it was to reach a total of 59,000 million dollars.¹³

The Crisis

In 1982, everything came apart. Politically the year saw an election and change of presidential administration, as well as growing uncertainty and increasing tension. Economically it saw a fumbled effort to stabilize the economy, two major devaluations, nationalization of the domestic banking system, imposition of exchange controls and of a multiple-exchange-rate system, a humiliating trip to Washington in search of an emergency bailout package, and the start of negotiations with the foreign commercial bank creditors and with the International Monetary Fund. Domestically the year began with an increase in the pressure on the exchange rate; externally it began with recession in the United States, high interest rates, and a weak international petroleum market. Mexico clearly was in trouble.

Mexican authorities had hoped that the efforts begun in 1981 to reduce the current-account deficit would have a positive effect and slow capital flight and the loss of confidence in the economy. They also were counting on an international recovery that would improve the demand for Mexican exports. They hoped in vain.

By February 1982, the situation required serious government action. Payment of the short-term debt from the second half of 1981 and the decrease in oil export revenues affected public-sector finances to the extent that the cash deficit of the federal government to the end of January was over three times greater than that for the same date in 1981. To correct the rising deficit, with international reserves dangerously low and capital flight increasing, the authorities devalued the peso by 67 percent, from 26.5 to 46 per dollar, an action that the market judged as insufficient given Mexico's increasing inflation rate. In March, Jesús Silva Herzog became Secretary of the Treasury and Miguel Mancera Director of the Bank of Mexico.

In April the government announced an economic adjustment program that included a reduction in the public-sector budget deficit of 8 percent and in net public-sector external borrowing, and the imposition of strict monetary targets for the central bank.¹⁴ Appropriate in theory, the program was implemented poorly as the administration refused to hold down wages and

13. Solís, "El papel del endeudamiento externo," pp. 37-38.

14. Poder Ejecutivo Federal, "Medidas para afrontar la situación económica," *Comercio Exterior* (May, 1982): 559-560.

reduce the public-sector deficit to the extent necessary to make the devaluation effective. Mexican financial authorities thought that exchange controls were not appropriate instruments with which to slow down capital flight or to reduce the current-account deficit in the balance of payments. Unwilling to use such controls, they turned to other instruments of policy, including a rise in interest rates and exchange rates, as well as other measures designed to reduce the budget deficit and reduce both imports and external indebtedness.¹⁵

During the summer the government's efforts to reduce inflation actually aggravated the financial difficulties. In July it announced 100-percent price increases in bread and tortilla prices and a 50-percent increase in gasoline. The purpose was to reduce the budget deficits caused by official subsidies, but in the short run the price rises provoked inflation even more and stimulated the conversion of pesos to dollars. Its exchange reserves falling, the Bank of Mexico suspended foreign-exchange trading, imposed a two-tiered exchange rate, and announced that domestic dollar deposits in banks would be redeemable only in pesos. When the foreign exchange trading resumed, the peso went from 70 to 120 per dollar.

As the government's measures failed to improve the condition of the economy, so its borrowing could not keep pace with the capital flight that began to constitute a serious drain on the country's foreign reserves. Historically in Mexico, dollarization, or a flight out of pesos and into dollars, has increased substantially with rises in expectations of devaluation and with perceived increases in political risk associated with changes of administration.¹⁶ At such times, regulations regarding the Mexican dollar market and financial policy generally are most subject to change. In 1982, most observers were convinced that the peso would be devalued yet again, and they were uncertain as to what the scheduled change of administration would mean for Mexico. The response, entirely rational in individual economic terms, was capital flight in enormous quantities. Mexican deposits in foreign bank accounts and securities and purchases of real estate in the United States rose phenomenally. Mexico was in the midst of what one economist has called appropriately "an old-fashioned financial panic."

15. Guillermo Anaya Prats and Hilda Sánchez Martínez, "México 1982: corolario de la política financiera en el reciente período de expansión," *Economía de América Latina* 10 (first semester 1983): 129.

16. Guillermo Ortiz, "Currency Substitution in Mexico: The Dollarization Problem," *Journal of Money, Credit, and Banking* 15: 2 (May, 1983): 176-177 and note 4, p. 176.

The government tried to cope with the draining reserves. In February the Bank of Mexico drew on its savings line with the Federal Reserve Board, which allowed it to get dollars for pesos quickly without buying them in the open market. The drawing quickly was repaid, but the reserve and cash-flow problems remained. In April, the Mexican Central Bank came back to the Federal Reserve Board for another \$600 million; in June for \$200 million; in July for \$700 million; and on August 4 for another \$700 million.¹⁷ By August, Mexico was experiencing falling foreign exchange earnings, depleted reserves, massive capital flight, and an enormous maturing international debt. In the words of one study of Mexican financial policy in this period, "Throughout 1982, but especially from mid-April through the end of August, all the measures seemed insufficient and, on occasion, counter-productive."¹⁸

The situation had deteriorated so much that some members of the cabinet urged López Portillo to explore with Brazil and Argentina, two other major Latin American debtors, the possibility of jointly declaring a default on their outstanding debts. That action, one official argued, would leave Mexico with a substantial surplus on its current account within the year. The Mexican president apparently did consult with his counterparts regarding a default, but they refused to join Mexico in such a move.¹⁹ Unwilling to take so drastic a step unilaterally, López Portillo had no choice other than to accept the advice of other cabinet members who had been urging accommodation with the foreign bankers and the International Monetary Fund.

Having decided to work with the creditors, Mexico's actions were both international and domestic. Internationally, the government's first significant public action was to close the exchange market. They reopened a few days later with a two-tiered exchange system that involved a preferential rate and an official free-market rate. The two-tiered system was designed to avoid an excessive increase in the cost of necessary imports and debt servicing in order to contain inflationary pressures, and at the same time to restrain capital flight's drain on international reserves.

On September 1, the date of his final state-of-the-union speech, López Portillo took far more significant action. He

17. Lissakers, "Faustian Finance."

18. Prats and Sánchez Martínez, "México 1982," p. 128.

19. Television program *Frontline*, telecast entitled "Moneylenders," originally broadcast on the Public Broadcasting System on July 18, 1983; see program transcript, pp. 6-7.

announced the nationalization of all private banks in Mexico, thereby converting their private debt into public debt and making them and their extensive assets part of the state. He also broke a long Mexican tradition and imposed generalized exchange control in a futile effort to slow capital flight.²⁰

Internationally, Finance Minister Silva Herzog made his August pilgrimage to Washington to explain the situation to U.S. officials. He could not have been displeased with the U.S. response. Fearful that the Mexican crisis might lead to a breakdown of the international financial system, Paul Volcker, Chairman of the Federal Reserve Board, worked with U.S. Treasury Department officials to put together an arrangement that included a \$1 billion advance payment for exports to the United States Strategic Petroleum Reserve, \$1 billion in U.S. guarantees for the purchase of U.S. agricultural products, and a \$1.85 billion bridge loan from the Bank for International Settlement.

Moreover, Mexico quickly became the subject of a massive international rescue effort. Under pressure from central banks and the International Monetary Fund, Mexico's international banking creditors agreed to a 90-day rollover for all amortization payments due on the public sector debt. Meanwhile, Mexican authorities began negotiating for an IMF loan and for the rescheduling of the public and private foreign debt.²¹

The negotiations with the International Monetary Fund were a politically charged affair in Mexico. For one thing, López Portillo's nationalization of the banking system and imposition of a preferential exchange rate and an ordinary rate, the first at 50, the second at 70, with limited access to both, threatened to delay negotiation of the stabilization program. For another, on September 1 he appointed Carlos Tello as director of the Central Bank. Tello was well known in Mexico for his unorthodox economic policies and his criticism of IMF monetarist policies. Third, labor and the press bitterly attacked the IMF for its austerity programs and their social effects in the third world. The political controversy notwithstanding, Mexico and the International Monetary Fund reached an agreement in November, 1982.

20. The nationalization and exchange control decrees are reprinted in Banco Nacional de Comercio Exterior, *Comercio Exterior de México*, 28: 1 (Oct. 1982): 350-356. For an analysis of aspects of the nationalization see Alan Robinson, "Portillo Pockets the Banks," *Euromoney* (Oct. 1982), and José Manuel Quijano, "La banca nacionalizada: antecedentes y consecuencias," in José Manuel Quijano, et al., *La banca: pasado y presente* (México, 1983): 343-365.

21. On the U.S. response to the crisis and the entry of the IMF into the crisis see Lissakers, "Faustian Finance"; "How Mexico Lined Up Credits," *New York Times* (Aug. 31, 1982).

The depths of the crisis, and the task facing Miguel de la Madrid when he took the presidential sash and the office from López Portillo, are revealed in bold statistics. In terms of output, real GDP had increased between 1978-1981 at an average rate of 8.5 percent; it was negative 0.2 percent for 1982. Gross fixed investment in 1982 fell 16.8 percent in real terms, whereas in 1981 it grew 14.7 percent. Public investment fell 12.7 percent, private investment fell 20 percent; in 1981 they had grown at 15.8 percent and 13.9 percent, respectively. The manufacturing sector, hurt by exchange restrictions that made imports costly, showed a decline of 2.4 percent for the year. Agricultural output, aggravated by drought, fell 0.4 percent. Only mining, which included the energy sector, showed a rise of 9.6 percent against 1981, but total employment in the economy, which had risen at an average annual rate of 5.4 percent between 1978-81, fell by 0.8 percent in 1982.²²

Price controls and the overvalued peso had contributed to domestic prices rises of 20-30 percent between 1978-81; by the end of 1982, that figure was up to 98 percent. The rise in prices was both cause and consequence of the crisis. The monetary base had increased by half in order to finance the public-sector deficit. The peso had suffered a huge devaluation (from 27 to the dollar in January to 95:1 at the preferential rate and 150:1 at the official free-market rate in December). And during the second half of 1982, the government had relaxed the price controls that had been used to keep inflation low in previous years.

Public finance was a major problem area. Total public-sector expenditure had risen from 29 percent of GDP in 1979 to over 46 percent in 1982, because of increased subsidies, capital investment, and a rising interest rate on the public debt. Unfortunately, the ratio of total public sector revenues to GDP increased very little. As a result, the public-sector deficit increased dramatically, from an average of 7 percent of GDP per year during 1977-80, to 14.5% in 1981, and almost 18 percent in 1982. The peso lost 450 percent of its value relative to the dollar. Since the rising public-sector deficits and private-sector expansion were financed largely by foreign borrowing, total public and private external indebtedness rose from \$34 billion at the end of 1978 to \$82 billion at the end of 1982.

Not captured by the figures is the tremendous uncertainty and pessimism that permeated Mexican society. The flight of capital out of the country was the clearest indication that many Mexicans had lost confidence in the ability of the government to

22. Prats and Sánchez Martínez, "México 1982," p. 127. "Mexico" in Inter-American Development Bank, *Economic and Social Progress in Latin America* (Washington, 1983): 265-271.

manage the country's affairs. As the presidential administrations changed in Mexico, many observers inside and outside of the country were asking — with both hope for the best and fear for the worst — “Can de la Madrid's administration turn the economy around? Will the political system hold together while he tries? What are the political and social costs of the stabilization effort?”

Stabilization

The tasks facing the new president were as clear as they were difficult: resolve the short-term foreign exchange crisis and lay the basis for long-term recovery, while preserving the basic political and social structure of Mexico. Toward that end de la Madrid assembled an economic team that was determined to apply its formidable technical skills and educational training to the country's problems and to demonstrate to a watchful world that the administration had the competence and the will to “turn Mexico around.”

The guiding principle of the new administration's economic program was fiscal austerity, an approach in keeping with the country's agreement with the International Monetary Fund. As part of Mexico's effort to cope with its debt problem, the López Portillo administration had reached an agreement with the IMF in November 1982 by which Mexico could draw on IMF lines of credit for up to 3.9 billion dollars over 1983-85.²³ Not only did the agreement make IMF resources available to Mexico, but the commercial banks holding Mexico's foreign debt required it before they committed themselves to make new funds available to the troubled country.

In keeping with traditional IMF stabilization programs, the agreement set out severe austerity objectives for the new administrations, objectives that were designed to reduce inflation, stabilize foreign exchange operations, and assure the continued servicing of the foreign debt.²⁴ Specifically, the public-sector deficit was to be reduced from the 17.9 percent of GDP in 1982 to 8.5 percent in 1983, 5.5 percent in 1984, and 3.5 percent in 1985. The agreement also severely limited the amount of public-sector foreign borrowing in 1983 to 5 billion dollars. The IMF argued that “successful adjustment in Mexico's

23. International Monetary Fund, *IMF Survey* (Jan. 10, 1983).

24. See the “Carta de intención de México al FMI” (10 nov. 1982), signed for Mexico by Finance Minister Silva Herzog and Bank of Mexico Director Tello in *Economía de América Latina* 10 (first semester 1983): 165-168.

present circumstances requires the rapid reduction of the large imbalance in the public finances." Toward that end, stated the Fund, "the key aim of the three-year extended arrangement with Mexico is to bring about a substantial improvement in fiscal performance and a strengthening of domestic savings."²⁵ Silva Herzog put it more succinctly: Mexico, he said, must adopt and implement a policy that "increased income and decreased expenditures."

These objectives, of course, are easier to state than they are to achieve. What has the government done to meet its objectives? What have been the results of the austerity program so far? How is the Mexican economy doing?

The administration, naturally, points with pride to its achievements, and indeed, there is much to praise in its management of the economy thus far. As de la Madrid emphasized in his annual speech on September 1, 1983, the government's policies have curbed inflation, stabilized the employment situation, and improved the country's international balance of payments. Both the de la Madrid administration and the International Monetary Fund have identified high inflation as one of the worst ills plaguing the Mexican economy, and so one of the major objectives of the austerity program is to bring about its reduction. Because the country's almost 100-percent inflation rate in 1982 was caused by several factors, the problem must be tackled on several fronts. Most observers agree that the major cause of the raging inflation was an expansionary fiscal policy that led to large deficits in the public sector. Not only did those deficits have to be financed through internal and external borrowing, but the country's productive apparatus was unable to satisfy the demand that the high level of public spending stimulated, so imports increased dramatically.

The administration's strategy in the war against inflation is to control aggregate demand; its weapons have been monetary, fiscal, and wage policies. Because public finance — and especially the public-sector deficit — is blamed as a source of the demand and therefore of the inflation, the government is committed to its reduction. In order to reduce the deficit, the government has cut public spending, raised taxes, and readjusted the price of public goods and services.

The administration wants not only to reduce the size of the public-sector deficit, but to change its method of financing as well. According to a report by the Wharton Econometric Forecasting Associates, credit to the public sector in 1982 from external sources was 350 billion pesos, while in 1983 this

25. International Monetary Fund, *IMF Survey* (Jan. 10, 1983).

source is expected to provide 600 billion pesos.²⁶ The expectation is that an increase in external financing of the deficit will ease the pressure that domestic financing in general and Bank of Mexico financing in particular feel from the public deficit. This effect, together with restrictions on the issue of new money, should help to control the money supply, one of the major causes of inflationary pressures.

Along these same lines, the government's interest-rate policy seeks to make domestic savings in financial instruments attractive by providing a positive expected real interest rate. The assumption is that this will limit demand and so help to finance the public deficit through domestic savings, rather than through the creation of new money. And, in its war against inflation, the government has not allowed nominal wages to rise enough to offset labor's loss of purchasing power from the inflation that already has taken place.

Given that de la Madrid and his advisors consider inflation to be one of the worst evils bedeviling the Mexican economy, it is not surprising that the president is proud of the reduction that has taken place in the rate of inflation.²⁷ After reaching growth rates of over 10 percent monthly in December 1982 and January 1983, inflation has been declining, albeit slightly. The consumer price index increased only 4.3 percent in May and 3.8 percent in June, while the wholesale price index stayed at a higher rate, 8 percent. The annualized inflation rate as of August 1983, was 46.8 percent.

The reduction in inflation implies the effective use of one of the administration's weapons, control over public spending. Mexico's agreement with the International Monetary Fund commits the government to reducing the public-sector deficit each year, from almost 18 percent in 1982 to 8.5 percent during the first year alone. Many observers believed that the government could not possibly meet the target and roundly criticized both the IMF and the administration for establishing it. Not only has the administration achieved the target, but it has exceeded it by a wide margin, at least for the first trimester of 1983.

The stabilization effort also includes a much greater reliance on market signals than has been the case in recent

26. Wharton Econometric Forecasting Associates, *The Diemex-Wharton Mexico Project. Volume 1: Analysis* (Philadelphia, July, 1983): 10.

27. "Mexico's President Meeting the Test," interview in *The Wall Street Journal* (Sept. 2, 1983). The country's recently announced development plan notes that the government's major short-run objectives are to fight inflation and to protect employment. See Poder Ejecutivo Nacional, *Plan nacional de desarrollo, 1983-1988* (México, D.F., 1983): 13.

Mexican history. The de la Madrid administration is committed for several reasons to doing away with what it views as major inefficiencies inherited from a now outdated development strategy, including government subsidies, protective tariffs, and inefficient state enterprises. One reason is that the subsidies have consumed major portions of public-sector spending, and their maintenance would prevent the government from achieving its targets in the area of public-sector deficit cutting. In 1980, for example, subsidies, especially those on foodstuffs and gasoline, reached 10 percent of the gross domestic product.

The subsidies, one of the major components of what de la Madrid has referred to as the "fiction economy," are also seen as distorting the way in which resources in the economy are allocated, and as such, as distorting the costs and relative prices of domestically produced goods. To the extent that imported goods also were subsidized through the exchange rate, the low cost of imported capital goods led to a productive process that favored capital-intensive protection over labor-intensive production.

Finally, subsidies, in the administration's view, although intended to aid primarily the poor, in fact end up benefitting primarily middle- and upper-income groups. As such, the administration favors moving toward "real prices" for the goods and services provided by the public sector, and believe that in so doing they will release resources that may be invested in more socially desirable projects, especially those that create large numbers of permanent jobs.

As the crisis originated in the external sector, so that part of the economy has been a major area of concern. Indicators for the external sector for the first few months of 1983 showed a balance-of-payments profile not unlike that of the end of 1982: a strong surplus in the merchandise account because of a decline in imports and a positive balance in border transactions, tourism, and in the overall current account. But the economy still was suffering serious foreign exchange shortages, which were alleviated somewhat by the reestablishment of external credits, by a reduction in capital flight, and by an increase in commercial transactions.

In terms of trade itself, on the import side, the first five months of 1983 reflected a shortage of foreign exchange and a decline in domestic demand. Total merchandise imports equaled 35 percent of the value of imports for the same period in 1982. For the entire period of October 1982 through May 1983, when the foreign-exchange crisis was at its worst, the value of imports was \$5 billion against \$13.9 billion for the same period in 1981-82.

With respect to exports, the glut in the international petroleum market led to a reduction in Mexico's export price

from \$32 per barrel for its light, finer grade Isthmus crude to \$29 per barrel, and from \$25 per barrel for heavy Maya crude to \$23. Along with the price drop, the government set an export ceiling of 1.5 million barrels per day for 1983.²⁸

From January through May 1983, the total value of oil exports amounted to \$6.172 billion from shipments of 1.529 million barrels per day at an average price of \$26.73 per barrel. Non-oil exports over the same period were at the same value as in the same period in 1982. The net result was a trade surplus of \$5.5 billion in the first 5 months of 1983 against the 0.289-billion dollar deficit for the same period in 1982. This, with positive border transactions and tourism, led to a positive balance in the current account.

Overall, then, the austerity program seems to be working, at least in terms of getting Mexico through the immediate liquidity crisis. Many observers have chosen to fix on the positive economic facts, and perhaps on their own hopes, and have concluded that the de la Madrid administration, as Willard Butcher, Chairman of Chase Manhattan Bank said, is "doing the right things." One banker, observing that Mexico was meeting the IMF targets, stated, "That's good enough for me." Donald Regan, U.S. Treasury Secretary, declared several months ago that the worst of the Mexican debt crisis was over.²⁹ So pleased have Mexico's foreign creditors been that Jesús Silva Herzog, Mexico's Minister of Finance, was named "Foreign Minister of the Year" by the widely respected financial periodical *Euromoney*.

Others, perhaps more realistic or focusing on other facts, share the view of the Wharton report that despite the generally satisfactory quantitative data, "it is too early to conclude that the economy is out of the woods." If those who are optimistic about Mexico's future have facts which they recite in support of their view, so too do those who are less sanguine. Inflation has been curbed, but the rate of inflation still is high, and in order to continue to try to control it, the government must continue to keep a lid on public spending, thus reducing the largess that it has to distribute. Unemployment has not increased, but job creation has been painfully slow, and the prospects for expansion in an economy in which output is stagnant are bleak. The government is coming to terms with international creditors, but Mexico still

28. *The Diemex-Wharton Mexican Project, Volume I*, p. 12. Remarks by Marcela Serrato to the Executive Workshop on "Mexico's Economic Stabilization: Challenges and Opportunities" (La Jolla, Calif.: Center for U.S.-Mexican Studies, University of California, San Diego, June 1983).

29. For a sampling of views within the financial community see Alan Robinson, "Is Mexico Making a Comeback?" *Euromoney* (July 1983).

has an enormous foreign debt, interest rates remain high, and the prospects for new funding are uncertain. The foreign-exchange situation has stabilized, but the foreign-exchange reserves of the Bank of Mexico still are extremely low, despite the increase from \$1.8 billion on November 30, 1982, to \$3.5 billion now. The international balance-of-payments picture has improved, but the surplus on current account is due to a reduction in imports; there is no indication that markets are opening to non-petroleum exports from Mexico, or that Mexico is geared up to produce competitively in world markets anyway.

Indeed, while the stabilization effort seems to be taking hold, serious problems still remain for the Mexican economy, even in the short term. There is fertile ground for both pessimists and optimists to make their cases. A recent report by Wharton's Mexico Project has noted that the Mexican economic program generally had overachieved the performance targets in the IMF agreement. The result has been a trend toward stabilization in the economy, as shown by a declining inflation rate and orderly management of the exchange rate. However, the report observed, the recessionary impact of the austerity program has aggravated the paralysis in economic activity since the second half of 1982, and both production and employment continued to fall in the first half of 1983.³⁰

The crisis in the private sector threatens the surplus in the current account of the balance of payments, a surplus that has restored the confidence of many Mexico observers. As we have seen, the surplus was the result of severe cutbacks on imports rather than of a significant expansion of value-added exports. But if import restrictions and the lack of foreign exchange with which to pay for private-sector imports have helped the government deal with the immediate financial crisis, they have wreaked havoc with the country's productive apparatus. An analysis of the financial well-being of 80 firms on the Mexican stock exchange led the chairman of a prominent investment house to call this "the most critical moment in the country's history" as far as the private sector is concerned. The analysis showed that many firms are operating at less than half of capacity, are desperate for capital, and are unable to pay their debts or to

30. The *Diemex-Wharton Mexico Project, Volume I*, p. 17. Also remarks of Abel Beltrán del Río, Director of the Mexico Project, to the Executive Workshop, "Mexico's Economic Stabilization: Challenges and Opportunities," (La Jolla, Calif.: Center for U.S.-Mexican Studies, University of California, San Diego, June 1983).

secure necessary imports.³¹ One consulting firm reportedly has warned its clients that inventories of materials and parts in Mexico are at a dangerously low level and that many Mexican companies will be forced to declare bankruptcy.³² In order to get production going again, the government will need to permit the private sector to acquire the imports it requires. The release of still scarce foreign exchange by the Bank of Mexico, however, may seriously erode the current-account surplus that has been so important, really and symbolically, to Mexicans and foreign observers alike.³³

More importantly, as the Wharton report observed astutely, "the more visible and quantifiable aspects of Mexico's current economic crisis, namely the external debt repayments problem, the size of the fiscal deficit, and the scarcity of foreign exchange, are now being addressed and are in the process of being resolved." However, added the report, "there are some aspects of the crisis for which there are no immediate indicators and [that] are not easy to measure."³⁴ Those aspects include expectations about inflation and the value of the peso, confidence among the private sector and among foreign creditors and investors, and the forces in the labor sector and Mexican society more generally that make the political situation highly uncertain.

No one doubts that social and political pressures have been accumulating as a result of the adverse impact of the austerity program on many groups in Mexico. If a social explosion is to be averted, Mexico must return to expansionary economic policies. The demographics alone require it. After all, the economy has stagnated for two years, during which 1.6 million new job-seekers entered the country's labor markets.³⁵

31. Remarks by Roberto Hernández, chairman of Acciones y Valores de México, to the Executive Workshop, "Mexico's Economic Stabilization: Challenges and Opportunities," (La Jolla, Calif.: Center for U.S.-Mexican Studies, University of California, San Diego, June 1983). The analysis of the firms is in Acciones y Valores de México, *Análisis Financiero y Bursátil* (May 1983).

32. As reported in *Latin America Weekly Report* (Sept. 30, 1983): 5. For additional views on the state of the private sector see Juan Vásquez, "Recovery of Mexico Seen as Temporary," *Los Angeles Times*, (Oct. 23, 1983).

33. "Can de la Madrid Continue to Walk an Economic Tightrope?" *Business Week* (Sept. 5, 1983): 49-50.

34. *Diemex-Wharton Mexico Project, Volume I*, p. 37.

35. Wayne Cornelius, "De la Madrid is Winning His Economic Battle in Mexico," *San Diego Union* (Sept. 25, 1983).

Mexico's open unemployment rate is at least 13 percent, and another 45 percent of the population is underemployed. According to one of Mexico's leading demographic experts, during the next decade the country will experience the most severe demographic pressure on the labor market in its entire history.³⁶

Thus far, as Barry Carr points out, organized labor in Mexico has been relatively quiescent, given the decline in real wages that Mexican workers are experiencing.³⁷ How long labor will accommodate itself to the austerity program in the absence of positive gains beyond a reduction in inflation is anybody's guess. The assault on populist policies and rhetoric that the current administration has adopted as part of its austerity approach may, if it is not relieved by benefits associated with positive economic growth, result in a loss of the support that the government requires to keep the entire system together.³⁸ Mexico not only has to grow, but it must do so at a rate sufficient to accommodate the tremendous growth of population and the pressures that have been accumulating.

But mere growth is not enough. The administration is committed to bringing Mexico out of its immediate crisis in such a way as to assure that the country's future growth does not lead to a renewal of its current difficulties. The National Development Plan states it concisely: "If the deep-rooted causes which generated the current situation are not solved, the crisis will manifest itself again when economic activity recovers and expands."³⁹

It is one thing for the Mexican economy to stabilize, quite another for it to achieve recovery in the form of significant and sustainable growth in the medium and longer term. The Mexican government predicts that the economy will return to positive rates of growth during the second half of 1984, during which year it anticipates a 1/2 per cent to 2 1/5 per cent rate of growth. But most observers agree that for the economy to reach respectable levels of increase in the gross national product, a serious restructuring of the economy will have to take place.

36. Francisco Javier Alejo, "Demographic Patterns and Labor Market Trends in Mexico," in this volume.

37. Barry Carr, "The Mexican Economic Debacle and the Labor Movement: A New Era or More of the Same?" in this volume.

38. For a view critical of the current administration's tone, see Lorenzo Meyer, "Mexico: The Political Problems of Economic Stabilization," in this volume.

39. Poder Ejecutivo Nacional, *Plan nacional de desarrollo, 1983-1988* (México, D.F., 1983): 116.

The restructuring must include strong policy measures and new orientations, must involve both trade and financial aspects, and must take into consideration Mexico's relationship with the United States.

Development Strategy

Mexico's development strategy in the post-World War II period, like that of many other Latin American countries, was based on capital formation through import substitution industrialization (ISI).⁴⁰ The idea was to make the country less dependent on foreign exchange and imported goods and less vulnerable to fluctuations in the market prices for raw material and agricultural exports by improving internal manufacturing capabilities, starting with the production of consumer goods previously imported from abroad.

Since the strategy of ISI was intended to service the domestic market, goods produced in Mexico did not have to be competitive in international markets. In fact, high import tariffs and other barriers to entry allowed many an inefficient operation within Mexico to survive and prosper. Thus, the products produced under high cost and inefficient methods were not able to compete in world markets and made no contribution to the country's foreign exchange earnings as exports.⁴¹ Quite the contrary. The strategy was in part to save foreign exchange by cutting down on imported goods. But as the domestic producers demanded increasing raw material inputs that came from abroad — technology, fuels, and especially capital goods — import substitution industrialization became a drain on foreign reserves.

Mexico clearly can no longer rely on import-substituting industrialization, a strategy that has left a legacy of agricultural problems, external imbalances, an inefficient industrial sector, sustained levels of unemployment and underemployment, and high rates of inflation. The long-term solution to Mexico's economic problems will require that the country rely on various development strategies, including expanding the capacity for raw-material exports, strengthening its import substitution indus-

40. For a concise and excellent treatment of ISI see Albert Hirschman, "The Political Economy of Import Substitution in Latin America," *The Quarterly Journal of Economics* (Feb. 1968).

41. A good discussion of import substitution in Mexico is René Villarreal's *El desequilibrio externo en la industrialización de México, 1929-1975: un enfoque estructuralista* (México, D.F., 1976).

tries, and increasing the export of value-added goods.⁴² The export orientation will be especially important, since the country probably will not have access to massive new foreign credits and it has learned to avoid excessive reliance on revenues from petroleum exports. As Miguel de la Madrid has said, Mexico's "capacity to import and, in consequence, of growing, will be very closely linked to our capacity to export goods and services." If Mexico is to escape from long-term balance-of-payments difficulties, exports must play a leading role.

The president has declared that this will be done through policy tools, including a realistic exchange rate. Mexico's major problem in this regard, he claims, is its lack of marketing skill and connections, an ignorance of how to sell its goods to the outside world. What Mexico really needs, according to the President, is contact with large marketing channels abroad and a generalized export orientation, and he observed that export-oriented firms in Mexico are doing better in the recession than those whose entire production is aimed at the domestic market. Mexico, of course, will need much more than simply improved marketing skills if export of value-added products is to be the basis for its restructured and expanding economy. For one thing, it will need to confront the competition. Many other developing countries are playing the same game, looking to exports to the industrialized countries to bail them out of economic difficulties.⁴³

To date, there is little evidence that the industrialized countries have themselves recovered sufficiently to absorb substantial amounts of value-added imports from the developing countries that are competing with each other to service those markets, although the future in this regard appears to be looking better as the prospects improve for an extension of economic recovery beyond the United States.⁴⁴

More importantly, the very success of the efforts by Mexico and other developing countries to sell more manufactured goods to the industrialized countries may itself be counterproductive. If the industrialized countries were sufficiently healthy economically to absorb large amounts of third world imports without

42. See Van Whiting, "Markets and Bargains: Foreign Investment and Development Strategies in Mexico," in this volume.

43. Remarks by Albert Fishlow to the Executive Workshop, "Mexico's Economic Stabilization: Challenges and Opportunities" (La Jolla, Calif.: Center for U.S.-Mexican Studies, University of California, San Diego, June 1983).

44. Morgan Guaranty Trust Company of New York, *World Financial Markets*, (Sept. 1983).

appearing to affect economic well-being within their own borders, the conflict between the industrial interests of the exporters and those of the importers might well be minimized. In current circumstances, however, with the United States and other industrial countries struggling to redefine their own economies, and with many traditional industries on the wane, the assault on domestic markets by developing countries engenders serious political and economic pressures for protection.

Furthermore, the very efforts of developing countries such as Mexico to aid their exporters often conflict with U.S. understanding of what constitute fair trading practices.⁴⁵ Mexico's struggle to export its way out of its economic difficulties, much though the winning of that struggle is of vital importance to the United States for financial, economic, and security reasons, may well generate countermeasures in the United States that serve to make the winning of that struggle all the more difficult.⁴⁶

If Mexico is to export its way out of its economic stagnation, it must produce the goods that it would send abroad. To do that requires that it finance the production that such a strategy presupposes. What, then, are the prospects for the financing of Mexican development? In this regard, Mexico faces a serious problem. Just at the time that it needs lots of capital to get production going again, and so to stimulate economic growth, the external and internal resources available for this objective are shrinking.

Under the corrosive effects of inflation and economic stagnation, domestic savings in Mexico have shrunk noticeably in real terms. The banking system has shown relatively high liquidity, but this may be a temporary phenomenon due largely to peso deposits that belong to firms that owe dollars which they have not been able to get in order to settle their foreign accounts.⁴⁷ Once mechanisms for the payment of foreign debts are functioning smoothly and demand for loans starts to increase with the pick-up of economic activity, that liquidity will disappear. As to external resources, the sources of external funding for Mexican development are also down. According to one set of figures, while in 1981 Mexico got 23 billion dollars in such loans,

45. David Mares, "Prospects for Mexico-U.S. Trade Relations in an Era of Economic Crisis and Restructuring," in this volume.

46. For an argument that the United States has a special stake in how Mexico deals with its crisis see Clark Reynolds, "Mexico's Economic Crisis and the United States: Toward a Rational Response," in this volume.

47. Fernando Solana, in Banco Nacional de Mexico, *Review of the Economic Situation of Mexico (July 1983)*.

the projected total for 1983 is \$5 billion, a credit flow that is expected to decline even more over the next few years.

A shortage of financial resources could not come at a worse time, and it constitutes a major bottleneck in the recovery effort. "The present financial problem," according to the head of the Banco Nacional de México, "pivots on the obtainment of funds and their most rational channeling in order to meet the objectives of the National Development Plan." But if the production requires the utilization of savings, the current economic situation hampers their generation. The vicious circle continues until it is broken. In the words of the Minister of Finance, "We need more savings and must invest them better."

This imperative places a special burden on the recently nationalized banking system to recapture public confidence in the country's financial system and especially to develop instruments with which to attract savings that can be channeled into the long-term investments that industrial production requires.⁴⁸ For its part, the Bank of Mexico is offering high deposit rates to encourage depositors. According to the head of the Banco Nacional de México, this has raised the level of deposits placed with the Mexican banks; during the first half of 1983, inflow to Mexican commercial banks was 509 billion pesos, as against 421 billion in the first semester of 1982, for a 1983 annual growth rate of 56.4 percent as against the 1982 level of 62.2 percent.⁴⁹

Despite the government's intention to have domestic savings carry a larger share of the burden of financing Mexican development, that source is not likely to be sufficient to support recovery by itself. Mexico clearly will need to supplement domestic savings with external capital, as it has done before. And, as before, that means foreign capital in the form of equity (through direct investment) or debt (in the form of loans).

Mexican authorities are the first to concede that foreign investment will play a significant role in the restructured economy. In practice they already have relaxed investment controls, including those that allow exceptions to the basic rule limiting foreign investments to a 49-percent share in Mexican concerns. President de la Madrid has said that there is no need actually to change the foreign investment law, since, in his words, the

48. Remarks of Luis Chico, Director General of Banco B.C.H. to the Executive Workshop on "Mexico's Economic Stabilization: Challenges and Opportunities" (La Jolla, Calif.: Center for U.S.-Mexican Studies, San Diego, June 1983).

49. Fernando Solana, Banco Nacional de México, *Review of the Economic Situation of Mexico*, (July 1983).

government has "the flexibility to adapt to prevailing circumstances . . ." The administration has declared its intention to keep out speculative investments, especially those that want to buy established Mexican firms because the foreign exchange rate is favorable to do so. Special opportunities do arise. Concerned to cut back the state's role in the economy and to encourage certain types of production, a rule now allows up to 100-percent foreign ownership of auto assemblers. Under this provision, Renault of France recently bought the government's majority interests in Renault de México and UAM, a locally owned assembler of Mexican Motors Corporation vehicles.⁵⁰

The foreign-exchange rate, of course, is one of the major attractions for investment in Mexico at this time. Still, investors are cautious, enticed by the opportunities and by the fact that in the long term Mexico appears to be a healthy market, but scared by the political and economic uncertainties that still characterize circumstances in that country. Total foreign direct investment is expected to drop to \$400 million this year, down from \$1 billion in 1981.

If the situation in terms of equity is uncertain, so too is that in terms of debt. The short-term debt/liquidity problem was what set the whole crisis off. The immediate foreign-exchange problem has been worked on: additional financing is being obtained, and the rescheduling process is going forward. Mexico has received cooperation from the international financial community for reasons having little to do with Mexico *per se* and having much to do with concerns about international financial stability and about the U.S. domestic banking structure.

When Mexico first submitted its proposed plan for dealing with its foreign debt in August of 1982, its foreign bankers were not pleased. Still, the Mexican Advisory Group, a committee of 13 international banks set up in August 1982 to represent all of Mexico's creditor banks in the restructuring negotiations, and the IMF, urged all of Mexico's commercial creditors to comply with the proposals.

To promote a positive response on the part of Mexico's creditors, the managing director of the IMF, Jacques de Larosiere, indicated that the IMF would officially approve Mexico's loan if it received assurances from the international banks that sufficient external financing and debt restructuring on "realistic" terms would accompany the IMF program.⁵¹

50. "Can de la Madrid Keep Walking an Economic Tightrope?" *Business Week* (Sept. 1983): 49-50.

51. The story of the negotiations between the banks and Mexico remains to be written, but see Karin Lissakers, "Faustian Finance," Federal Reserve Bank of Chicago *International Letter* (Dec. 1982).

To promote acceptance of the arrangements by the U.S., private banks, the Federal Reserve Board and the Comptroller of the Currency indicated that for bank regulatory purposes they would consider private loans on which interest payments in pesos have been made to the Bank of Mexico as current, "assuming a satisfactory overall structure resulting from the responses to the Mexican request for the new money facility by the international banking community." The stakes were enormous, of course. U.S. banks had over \$11 billion in outstanding loans to private Mexican borrowers. Mexico's gross outstanding debt to banks in major industrial countries as of the end of June 1982 amounted to almost \$62 billion. At the end of June, U.S. banks alone had \$25 billion, an amount equal to over 37 percent of their capital and reserves. For the nine largest U.S. banks, claims on Mexico equaled about 50 percent of capital. Under the rules normally applied by the U.S., regulatory agencies such loans would have to be placed on "non-accrual" status once interest payments were more than 90 days overdue, thus reducing bank earnings. When the arrangements were finally agreed upon, they were mutually advantageous, providing a breathing spell for the Mexican economy and helping to avert a loan default that would have seriously damaged Mexico's credit standing for a long time. They also helped to prevent what might have been a major weakening of the United States financial system and of the international financial system in turn. Because of the indirect exposure to Mexico of many more banks through the Eurocurrency interbank market, a Mexican default could have a domino effect that would threaten the entire international banking system.

In August of this year the Mexican government and its international creditors agreed to postpone repayment of \$11.4 billion in principal that the government owes the banks. The agreement was signed, with lots of publicity, on a special occasion at Lincoln Center's New York State Theater, and it allowed de la Madrid to proclaim in his September 1 address that Mexico "has recovered a good part of its prestige abroad." In September the government and the banks announced agreement on the restructuring of another \$8,432 billion of public-sector foreign debt. The result is that only 5 percent of Mexico's short- and medium-term public sector foreign debt remains to be restructured and scheduled to be so within the next few weeks. Indeed, of the major Latin American debtors, Mexico is the only one whose situation has improved in recent months. Argentina, Brazil, and Venezuela all appear to be in increasing economic difficulty.

What does the future hold in terms of new loans to Mexico? The international capital markets reacted quickly and harshly to Mexico's announcement of its debt-servicing difficulties, and it has taken time to arrange the new loan

commitments that came as part of the debt rescheduling and IMF-supported austerity program. Much of the new money that has been committed to Mexico has been involuntary lending, loans that have been forthcoming in order to protect existing obligations, and sometimes committed only under pressure from financial authorities and the IMF itself. Given the problems of other Latin American countries, Mexico may actually begin to look good as a credit risk in the region, but banks in general, and especially the regional institutions in the United States, are taking a much harder look at international operations in general and at sovereign lending in particular.⁵² In the competition for scarce new debt capital beyond the involuntary lending, Mexico will be in stiff competition not only with other Latin American countries, but also with developing countries that may look better from a risk perspective, including, for example, Spain and some countries in Asia. With the growing strains on the resources of the International Monetary Fund and other multilateral agencies, Mexico may have to fall back upon reliance on a special relationship with the United States if it is to secure the financing that it will require for its long-term economic growth.

Challenges and Opportunities

The administration of Miguel de la Madrid looks forward to a future in which Mexico experiences lower rates of inflation, less vulnerability to changes in the external environment, and fewer harsh variations in economic activity. It is a future that would be appealing to Mexicans and to those foreigners who wish it well. It is not a future that will be easy to achieve.

Mexico has done extremely well in terms of achieving its external objectives. The improvement in its trade position has been stunning, due largely to a decrease in merchandise imports. But so low an import level is not sustainable, and the improvement in the external balance followed the adoption of a severe austerity program. This program has generated serious political and social pressures and has come at the cost of employment, wages, and production. If the pressures are not to explode, Mexico must begin soon to reverse the trend of economic stagnation and to experience positive economic growth. But the productive capability upon which that growth must rely — and the resources available for financing it — have been casualties of the crisis. Mexico's liquidity problem is fading; its solvency difficulties are just beginning. Whether external conditions, such as international interest rates, economic activity in the industrialized

52. See, for example, "Rethinking International Banking," *Institutional Investor* (1983).

countries, and the world petroleum market facilitate or obstruct Mexico's development effort in the coming years remains to be seen. Mexico may well emerge from this most serious crisis in its modern history an economically and perhaps politically stronger country that offers increased well-being to many of its people - that is the opportunity. Assuring that it does is the challenge.