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MEXICO'S ECONOMIC CRISIS: CHALLENGES AND OPPORTUNITIES

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MEXICO'S ECONOMIC CRISIS AND THE UNITED STATES: TOWARD A RATIONAL RESPONSE

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Critiques and Crises

Every decade or so development economists reappraise Mexico's growth performance, generally in the context of a current crisis. Shortly after the Second World War, Sanford Mosk wondered in print whether the import-substituting industrialization program under President Miguel Alemán could lead to efficient, sustained growth; in fact rapidly rising inflation and balance-of-payments problems led in 1954 to a major devaluation.[1] The subsequent recovery and stabilization of prices was again challenged in the early 1960s. Raymond Vernon expressed in print the misgivings of many observers who believed that aggregate demand constraints would limit the ability of the economy to continue growing.[2]

In the mid-1970s, a balance-of-payments crisis, capital flight, and inflation raised doubts that growth without price stability could be sustained, especially in view of slowing productivity growth in agriculture and manufacturing. My own research indicated that the modern sectors of the economy that had led the "miracle" of the preceding thirty years were no longer capable of absorbing the accelerating number of workers on small farms and in urban slums.[3] A new productivity revolution was required

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1. Sanford A. Mosk, *Industrial Revolution in Mexico* (Berkeley, Calif., 1950).

2. Raymond Vernon, *The Dilemma of Mexico's Development* (Cambridge, Mass., 1963). For a Mexican expression of concern regarding the economy, see Raúl Ortiz Mena, Víctor Urquidi, Albert Waterston, and Jonas Haralz, *El desarrollo económico de México y su capacidad para absorber capital del exterior* (México, D.F., 1953).

3. Clark W. Reynolds, *The Mexican Economy: Twentieth Century Structure and Growth* (New Haven, Conn., 1970).

that would have to come from the renovation of aging industries and maturation of inefficient "infant industries." The renovation could be achieved through an opening of the economy to increased international competition and a widening of the domestic market, as well as through changes in relative prices and regulations so as to favor abundant labor rather than scarce capital.

Adroit public policies and favorable external market conditions overcame or postponed all of the preceding "dilemmas." In the most recent instance, Mexico benefited from newly discovered petroleum and natural gas reserves that lent themselves to exploitation in the heart of a global energy crisis. In addition, foreign borrowing, beginning in the 1960s and rapidly accelerating during the 1970s, capped by an explosion of debt in the last few years, helped Mexico to disprove those who said in the 1970s that the economy could not continue to grow.

Now, however, it is evident that the Mexican economy cannot return to the old growth track of 6 to 6.5% real increases in GDP per annum without a major readjustment (see table 1). Is there another *deus ex machina* that will do the trick? This time all of the previous admonitions seem to apply cumulatively. We now pay close attention to the inequitable distribution of income in Mexico. Growth has taken place for the benefit of a few, especially those in the urban middle sectors, with the poorest households only marginally affected.

The three critiques of the postwar development strategies may be summarized as inefficient import substitution; inadequate effective demand; and decelerating productivity growth (in both rural and urban activities). These factors clearly are interdependent. The creation of protective barriers for the support of domestic investments in manufacturing has had an undoubtedly high cost in terms of efficiency. Import substitution has tended to concentrate incomes in a privileged segment of the labor force, with the owners and managers of these enterprises serving a select, high-income, middle-class market. Moreover, it has not permitted the scale economies or cost- and price-reducing pressures from competition that might have obtained under a more open system.

These factors account in part for declining productivity growth; in a vicious cycle, domestic production substitutes for imports one by one, so other domestic firms must pay more for previously imported inputs. Finally, gains from productivity growth in the rural sector had been extracted in the form of depressed prices and financial flows; now they have run out. Policymakers and small-scale farmers also need to transform traditional agriculture and they cannot do so by lowering input costs or making credit cheaper and more available. In addition, no more easily opened new regions for capital-intensive cultivation exist.

TABLE 1

Year	Nominal GDP Billions of Pesos	Real GDP Growth
1977	1,849	3.4%
1978	2,347	8.1%
1979	3,067	9.0%
1980	4,276	8.3%
1981	5,857	8.1%
1982	9,372	-1.5%
1983	17,820	-2.5%

Sources: 1977-81 Nominal GDP from IMF *Financial Statistics;* 1982-83 estimates of nominal GDP and real GDP growth from Banamex, *Review of the Economic Situation of Mexico* (Jan. 1983); 1980-81 GDP growth rates from the Banco de México *Informe anual* (1981); 1977-79 GDP growth rates from United Nations, *Economic Survey of Latin America, 1980.*

The earlier critiques did not reckon on the discovery of large hydrocarbon resources or on the international energy situation as factors, of course. The oil boom provided a windfall of additional income that did not depend on increased productivity of the non-oil sectors of the economy or on broadened domestic markets. It also promised a surplus that could be used, in principle, to alleviate poverty and underemployment without taxing the middle class or major wealth holders or unduly burdening production in other sectors of the economy. The freedoms provided by the oil bonanza were seized upon by government policymakers who adopted a fast-track growth strategy that was both capital and import intensive in the extreme.

Some cautionary flags were waved in the early years of the José López Portillo administration, warning that the economy might be going too far too fast on the wrong track. But government officials and observers of development policy did not conduct a public debate that might have given the President pause. Instead, they expressed their measured warnings in confidential memoranda or in closed discussions. By and large, even the major international banks failed to air effectively their concerns about the pattern of oil-based, fast-track growth, even as late as

early 1982, when it had been already apparent for more than a year that the exchange rate was moving out of equilibrium, hurting exports, accelerating imports, and spurring capital flight.

The oil boom made possible an overvalued currency that exacerbated the noncompetitiveness of Mexico's import-competing industries. The boom fueled investment in further efforts at import substitution, particularly in capital-intensive refineries and petrochemical complexes, capital goods production, and infrastructure such as "development ports." The government even invested in nuclear power plants, the first effort of which — Laguna Verde — was plagued with cost overruns and start-up problems. When the capital cost of oil and gas production proved to be much higher than anticipated, and the cash flow of the oil sector remained negative into the 1980s, the government had to mortgage future oil revenues through foreign borrowing in order to pay for the accelerating imports caused by the fast-track growth strategy (see table 2). Meanwhile, external conditions over which Mexico had little control, affecting the energy market and real interest rates, caught the government in a vise just at the time that it needed more breathing space.

The government hoped that the immense expenditure in infrastructure, plants, and equipment during the boom years would pay off in increased productivity in the years ahead. A similar strategy had postponed problems anticipated by Mosk in the late 1940s and early 1950s. Postwar investments in production capacity in both agriculture and industry began to come to fruition in the 1950s and early 1960s. They allowed the peso to remain below purchasing power parity in real terms for a number of years following the 1954 devaluation. The economy was able to grow with less strain in those years because output per unit of capital, while not rising, at least remained at fairly steady levels.

The 1970s were a time of concentrated capital investment once again, both under Echeverría in his last four years, and then during the last four years of López Portillo's administration. An open question is whether President Miguel de la Madrid's administration will inherit significant benefits from drawing into production the two waves of investment from the past decade.

Developments in the U.S.-Mexico Economic Relationship

The United States and Mexican economies are linked as never before, so how Mexico's economy is doing matters a great deal to the United States. Recent events have brought this to the attention of both countries in many unsettling ways. We have seen that the potentially destabilizing implications of the links between the countries might have been less severe had the Mexican government managed its oil surplus and growth strategies more cautiously, and had U.S. firms and banks applied

TABLE 2
MEXICAN BALANCE OF PAYMENTS
(millions of U.S. dollars)

	1979	1980	1981	1982	1983
Current account	-4,856	-6,761	-11,704	-4,500	-3,380
receipts	16,132	25,021	30,556	29,813	33,720
outlays	-20,988	-31,782	-42,260	-34,313	-37,100
Capital account	4,332	9,798	18,153	1,535	5,000
public sector	3,332	4,126	14,505	10,100	--
private sector	981	5,672	3,648	-8,565	--
SDR	70	73	70	N.A.	--
Errors and omissions	873	-1,960	-5,506	-1,870	--
Changes in residence	419	1,150	1,013	-4,835	1,620

Sources: 1979, 1980, 1981: Banco de México, *Informe anual;* 1982, 1983 estimates: Banamex, *Review of the Economic Situation of Mexico* (Jan. 1983).

more realistic risk discounts to their decisions involving Mexican trade, investment, and finance. But that is the wisdom of hindsight. The question now is, what may be learned from the experience and how might it be applied to future relations?

Two kinds of ties increasingly bound the two countries in the 1970s and early 1980s. The first was an increasingly interdependent growth, based on the natural evolution of comparative advantage of each country in response to its particular pattern of economic activity. The second set of ties were distortions in the growth just mentioned in response to shifts in relative prices, exchange rates, labor and capital costs. The shifts resulted from government policies, including taxation and direct controls on trade and investment. Imperfections in private-sector markets also contributed to these distortions. One cannot fully determine which behaviors in the increased silent integration of the U.S. and Mexico were "natural" and which were "policy-induced," and many of the policy measures are well supported in terms of their immediate objectives. Still, policy distortions probably had the unintended consequence of intensifying and destabilizing the relationship.

The Mexican government tended to keep domestic prices high and import prices low while overheating the economy through 1981. During the same period, successive U.S. administrations engaged in deficit spending on the one hand, while introducing tight monetary policies on the other. The monetary policy reforms of Paul Volcker, Chairman of the Federal Reserve Board, imposed in reaction to inflationary deficit spending, caused interest rates to soar, led to a reduction in private-sector demand, and hastened the arrival of the day of reckoning in Mexico. Such policy "distortions" make it impossible to know what kind of "silent integration" might have been pursued between the U.S. and Mexico under conditions of greater fiscal and financial stability. We do know that there is a wide gap between the marginal efficiencies of investment, wage rates, and effective cost of capital (not interest rates) in both countries. Therefore, we may suppose that bilateral exchange in all areas would have grown somewhat more slowly than it did in the boom years, while still at a rate exceeding the growth of the GNP in both countries.

Had Mexico's exchange rate been permitted to adjust to relative price changes, with a lower rate of domestic inflation, its non-oil exports to the U.S. almost certainly would have followed an upward trend, especially after the 1976 devaluation of the peso. This would have added to the increased revenues from oil exports, although the latter probably would have grown more slowly. Mexico's imports from the U.S. would have increased, but at a reduced and steadier rate, and the U.S. positive trade balance would not have risen as it did from 2.6 billion dollars in 1980 to 3.6 billion in 1981, only to collapse to a negative 3.7

billion in 1982 (see table 3). In short, U.S.-Mexican trade relations would have grown more slowly and steadily, leaving U.S. exporters with more certain markets over the long run and with less anxiety. Instead, Mexico's trade deficit contributed to the current foreign exchange crisis. The country has been forced to cut back imports to the bone — leaving many domestic producers, including actual or potential exporters, without the intermediate goods needed to expand trade.

In the area of migration, a more balanced development path by both countries in the 1970s, including avoidance of overheating in the U.S. and Mexico and equilibrating exchange rate adjustment by Mexico, would have reduced somewhat the slower-growth "pull" factors in the U.S. Such policies would probably have had the opposite effect on "push factors" from Mexico. Mexico might well have adopted a strategy more responsive to its abundant unskilled labor — one which would have increased the demand for labor relative to capital and which would have raised the rate of growth of employment relative to output.

Instead of such strategies, the government opted to stimulate the economy artificially with foreign borrowing to feed highly capital-intensive investments. Although this approach created new jobs, much of the labor market tightness proved to be short-lived. Workers were only temporarily drawn out of agriculture and certain services. When the bottom fell out of the economy, their only recourse was to return to small farming or migrate to the U.S. The temptation to migrate was greatly enhanced by the drastic exchange devaluation since early 1982 and falling real wages in Mexico. The wage gap between the two countries more than tripled in a single year.

In the area of finance, a more balanced development path in both countries, and particularly in Mexico, would have reduced the demand for borrowing to cover the government deficit. This finance could only have come from a diversion of private savings to the public sector, from foreign borrowing, or from the inflation tax (on the value of cash and other financial assets which lose their real value through inflation). It tended to crowd out funding for private expenditure, increasing the government share of the economy *a fortiori.* To the extent that government expenditure was less subject to efficiency criteria and the scrutiny of investors, this might have added to the increased capital-output ratio and reduced productivity growth. However, the boom mentality afflicted firms in the private sector as well. Even some of the most enterprising private firms, such as ALFA, were caught overinvesting in areas which did not assure steady, long-term profits. Those who did so found themselves in a severe cash squeeze even before the government debt crisis was generally known.

TABLE 3
U.S. TRADE WITH MEXICO
(billions of U.S. dollars)

	1980	**1981**	**1982**	**% change 81-82**
U.S. Exports	15,145	17,360	11,817	-32%
U.S. Imports	12,520	13,765	15,566	+ 13%
crude petroleum	5,927	5,893	7,563	+ 28%
other products	6,593	7,872	8,003	+ 2%
U.S. Balance	2,625	3,595	-3,749	--

Source: U.S. Department of Commerce, *Foreign Economic Trends and Their Implications for the U.S.* (E.T. 83-002).

Any boom economy is likely to experience a wave of bankruptcies during the resulting downswing, as the restraining forces of real growth require a correction in effective demand. Both the public and private sectors fall victim to irrationally optimistic expectations of the boom; when the adjustment comes, it is not surprising that credit markets, irrationally perhaps, also swing to unduly negative expectations. Hence, in the upswing capital is too cheap, and in the downswing it is too dear. The same holds for exchange rates. The peso, having been at least 30% overvalued at the beginning of 1982, is now more than 30% undervalued.

The destabilizing policies in the U.S. and Mexico have left a trail of negative economic factors. Expired loans remain outstanding; Mex-dollars are redeemable only in depreciated pesos; high interest rates inhibit further borrowing; working capital is scarce, as is foreign exchange for vital imports; real wages and salaries are falling; future policies are uncertain; investment plans have been shelved; the value-added tax (IVA) was increased by 50% (to 15%) in January, with future tax reforms promised; access to dollars at the preferential rate is limited; the free rate is quixotic and undervalued.

All of these factors are further clouded by Mexico's looming public and private debt, the settling of which has been postponed but is far from resolved. The fact that gross claims of U.S. banks on Mexico are partly offset by Mexican deposits in this country is of little consolation to Mexico's financial authorities, since they have little or no access to the overseas holdings of their citizens. For the forseeable future, foreign exchange reserves will be barely adequate to cover even the most essential imports plus government debt service requirements, much less the private sector demand for dollars to service its own debt at the (already much devalued) preferential exchange rate.

Toward a Rational Response

Under such circumstances, Mexico's present problems are also those of the U.S. The irony in this is that Federal Reserve policies in the U.S. raised real interest rates, triggered recession, and reversed energy prices, and so passed the consequences of our own U.S. macro-economic difficulties to Mexico. Indeed, the shared problems of both countries are related to the efforts of each to restore domestic balance in an economy that had been seriously distorted. Just as financial crises in one part of the United States historically spread to other regions, today's crises in Mexico impact on the U.S. Just as depressions in the economy of some regions of the U.S. could not be isolated from other areas, growing trade interdependence between the two countries is causing recession in one to be felt in the other, a phenomenon

that occurs not only along the border, but well into the industrial heartland. The fact that Mexico and the United States share a highly permeable common frontier, with a growing exchange of goods and services, capital, and labor flows, makes efforts at independent fiscal, financial, and exchange rate policies extremely destabilizing for both partners.

With respect to Mexico's debt, the situation has reached the point where even if Mexico were able to repay its dollar debt obligations to the United States, it could do so in real terms only by exporting goods and services in greatly increased amounts, while contracting imports still further. Between 1981 and 1982, United States exports to Mexico declined by 32%, while imports rose by 13% (petroleum imports, about half the total, rising by 28%). The U.S. trade balance with Mexico, as we have seen, shifted from positive 3.5 billion dollars to negative 3.7 billion, or a total downswing for the U.S. of 7.2 billion — a significant share of the total U.S. deficit on current account with the rest of the world. Enforced rapid debt settlement would more than double this deficit, forcing on the depressed U.S. market goods and services from Mexico that under the present undervalued exchange rate could seriously undercut U.S. products. The effect would be to throw the trade flows so far out of balance that Mexico could be accused of "dumping," when in fact it was only attempting to settle its financial obligations.

The lesson of debt history is that creditor nations must either accept net imports from borrowing nations once new lending dries up or be willing to postpone repayment. Given the proportions of the Mexican case, which is virtually unprecedented in history, the U.S. must facilitate debt rescheduling in such a way as to lengthen the period for repayment and to lower the real interest rate.

Mexico's debt was contracted under what in retrospect appear to have been unrealistic expectations on the part of both lenders and borrowers about long-term energy prices and real interest rates. One solution to the resulting debt problem would be to create a stabilization fund for Mexican debt service, the purpose of which would be to transform short-term obligations linked to LIBOR or money market rates in the United States into long-term obligations in constant real interest rates that approximate those in effect at the time of the initial contacting of the debt. The United States might well consider such a scheme for Mexico, in view of the unusually high degree of interdependence of the two economic systems and the fact that both of their economies would be adversely affected by premature attempts on Mexico's part to honor its legitimate obligations through an

increasingly large balance-of-trade surplus with the United States.[4]

Such a scheme should be coordinated as a separate program to deal with the claims of commercial banks *vis-à-vis* Mexican obligations. To the extent that banks hold Mexican debt instruments against deposits and other liabilities that are subject to short-term interest rate fluctuations, the stabilization of real interest rates to borrowers would place financial intermediaries in a squeeze when stabilized interest rates on assets fell below the cost of liabilities plus allowance for a reasonable spread. Moreover, the extension of Mexican debt repayments could lead to rescheduling problems for banks which had previously secured short-term liabilities with Mexico's short-term obligations.[5]

The U.S. should facilitate an adjustment of the Mexican debt with a reasonable projection of Mexican capacity to service its obligations through trade in goods and services. It also should consider mechanisms whereby trade in goods and services between the two countries can be made consistent with economic recovery, growth, and efficient restructuring of both economies in ways that assure the operation of mutual comparative advantage.

Farsighted public and private sector leaders in the U.S. soon will need to contemplate ways in which the future development of the national economy can be made consistent with international trends in production and employment, particularly with regard to those trading partners (such as Mexico and Japan) which are employing various forms of indicative planning and industrial policy in their own right. The U.S. already is beginning to demonstrate the vitality of venture capital and the responsiveness of investment to research and development (R & D) incentives. But it is becoming apparent that it will not only become an international price-taker but a technology-taker if it permits other countries with strong savings, investment, and R & D potential to set the pace of recovery, growth, and restructuring.

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4. This does not take into consideration the likely social and political consequences to Mexico of running an austerity program that would unduly tax middle- and lower-income groups so as to provide real goods and service transfers to the U.S., nor does it consider the response in the underemployed U.S. labor market to the perception of jobs lost because of "flooding" of Mexican imports and low-cost Mexican labor.

5. One might argue that, to a considerable extent, Mexico's debt increase in 1981-82 offset the expansion in deposits and other physical and financial claims on the U.S. by Mexicans seeking to hedge against peso devaluation and other risks in their own country.

For reasons of both socioeconomic security and the continued prosperity of the North American region, the fact that Mexico anticipates a major national planning effort under the new administration suggests that the U.S. should begin to consider (alone and in conjunction with Mexico) possible patterns of production sharing, market sharing, coinvestment, and trade and financial relations, as well as labor-market sharing. The objective is to permit both nations to maximize the benefits of managed interdependence and minimize the costs of the destabilizing bilateral dependence that has characterized the relationship in recent years.

Mechanisms already exist to facilitate policy coordination between the U.S. and Mexico in the area of trade policy, but few have been put into practice to bring about the kind of bilateral trade agreement which would permit Mexico to expand its exports without unduly disrupting U.S. markets. The answer lies neither in chipping away at the categories of the Generalized System of Preferences (e.g., beer and balloons), nor in discussing "graduation" without considering longer-term benefits to be gained from facilitating various bilateral flows. The answer is not to propose a "North American trade area," but rather to call for an active discussion of ways and means to achieve the most harmonious recovery and restructuring in both countries, while respecting the rights, privileges, and national autonomy of each.

Such an approach will build upon the positive relationship between the U.S. and Mexico that has roots extending back to the era of "good neighbors," and which is well within the interests and capabilities of our two nations. Significantly, the public in both countries, increasingly exercising its political voice, is beginning to recognize the fact of interdependence and the mutual respect which is essential to its effective management.