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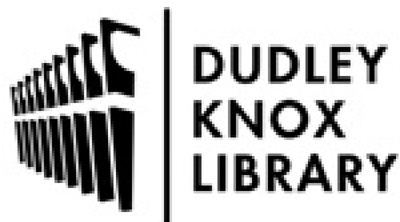

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Prospects for Economic Stability in Mexico

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In 1978 the economy of Mexico began a period of rapid growth, fueled by rising oil revenues, foreign loans and investments, and relative political stability. Mexican investment, consumption, and income rose at impressive rates. By the early 1980s, however, growth had faltered. Rural emigration, rising inflation, and declining productivity were but a few of the problems involved in the major economic crisis in February 1982. Indeed, to many observers, the phenomenal oil revenues only exacerbated many of the long-standing problems facing Mexico.

On November 10, 1982, the Mexican government announced an agreement with the International Monetary Fund (IMF) on a program to ease the nation's mounting foreign debt. Under this letter of intent, Mexico could receive a credit of up to $3.84 billion from the IMF during the next three years on the condition that the government reduce the deficit, raise taxes, and curb imports. An examination of the choices available to the Mexican government and their possible results indicates that if Mexico tries to meet only the narrowest goals outlined in the letter of intent, crises will probably continue to occur in the future. If major tax reforms are enacted at the same time, however, Mexico could return to a pattern of growth.

The recent slowdown in economic growth caused by Mexico's initial austerity measures has already affected the U.S. economy. For example, in 1982 exports from the United States to Mexico declined by nearly $6 billion from a year earlier. This decline resulted in an estimated loss of approximately 150,000 jobs in the United States and had a major effect on the economic recovery that had been predicted for the third quarter of 1982. U.S. administration economists have recently predicted that because of the debt problems of Mexico and other developing countries, the 1983 trade deficit will be between $10 billion and $20 billion larger than it was in 1982—a loss equal to about 0.5 percent of the nation's gross national product (GNP).[1]

The recent avalanche of major government policy initiatives published by the administration of Miguel de la Madrid has led many observers of the Mexican economy to look at 1983 with both caution and concern. On the one hand, they hope for a marked improvement in economic performance, but, on the other hand, they are concerned that the economy will continue to be full of shocks and surprises. Most likely, students of the economy in the coming year will closely watch economic trends—as opposed to day-to-day fluctuations—for some evidence of progress or deterioration in the economy. From the point of view of the U.S. businessman, a wide range of indicators should be examined to judge whether the policies of the de la Madrid administration can be effective in the short run and can at the same time lay the foundations for some form of long-term economic growth.

To identify some of the major macroeconomic variables that could be reliable indicators of the country's medium-term economic prospects, we developed indicators on the feasibility of the stabilization program suggested in the letter of intent. After developing a macroeconomic model of the Mexican economy, using the procedure of optimal control,[2] we conducted several simulations of the economy that represented a different mix of policy options available to the Mexican government or modifications to the stabilization program.

Traditionally, the failure of Mexican economic growth has been analyzed from two different perspectives. Some observers believe that the country suffers from a number of structural problems, including a low-quality and untrained entrepreneurial labor force, an inefficient public sector, an undeveloped capital market, and an inelastic tax system. These observers believe that any solutions must be long term and require careful planning and a substantial allocation of resources to each sector of the economy.[3]

The other major approach (which is followed in this article) suggests that, while long-term structural problems are important, Mexico's problems should be solved through some mix of fiscal and monetary policy with a major emphasis on tax reform.[4] Thus, the current crisis, while serious, can be viewed as a temporary financial imbalance, and the solutions can be seen as short term. The prospects for future economic stability in Mexico would depend on the willingness and ability of the government to enact the necessary monetary and fiscal reforms.[5]

The Current Crisis

Mexico's current economic problems can be traced to both external and internal factors.[6] Primary among the most recent external causes were a weakening of the world

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market for oil and higher international interest rates. While oil exports are still important, they only amounted to $14 billion in 1981, instead of the $20 billion anticipated by the government.[7] Furthermore, the increasing world interest rates, combined with rising debt, drove the interest burden from $5.4 billion in 1980 to $8.2 billion in 1981.

Internal policies adopted by the government tended to exacerbate the problem. While the country's ambitious growth policy resulted in an average growth in real income of 8.2 percent from 1978 to 1981, the long-term growth capacity of the economy was only about 6 percent. The result, as expected, was increased inflation. Because of an apparent unwillingness to reform the tax system, budget deficits had reached 16 percent of gross domestic product (GDP) by 1982. In addition, the authorities maintained a fixed exchange rate for most of 1977–1980 in spite of 23 percent annual inflation. As a result of the overvalued exchange rate, exports (other than petroleum) stagnated.

In February 1982, the Bank of Mexico withdrew from the dollar market and allowed the peso to float freely. The peso depreciated 30 percent immediately and then another 18 percent in May 1982. At the same time, the government instituted a program of "self-discipline" styled after, but independent of, IMF programs. Some of the measures enacted included a reduction of the ratio of the deficit to GNP, price controls on certain basic and industrial products, limits on public-sector and private-sector imports, and nationalization of banks in September 1982.

While well structured, the program was by and large unsuccessful, especially in the key area of public finance; the government was apparently unwilling to sacrifice government expenditures and limit further credit expansion. Unable to raise enough capital in financial markets, the government approached the IMF in the summer of 1982 for a major loan.

The letter of intent signed by the IMF and Mexico in November 1982 outlined a three-year economic adjustment program to reduce the size of the deficit, which was then at its highest level ever–16.5 percent of GDP. Specifically, the letter called for ratios of the deficit to GNP of 8.5 percent, 5.5 percent, and 3.5 percent in 1983, 1984, and 1985–1987. This plan of action, of course, implies major cuts in public expenditures. In addition, the country made a specific commitment that the debt, then at approximately $60 billion, would not increase by more than $5 billion in 1983. The Mexican government initially rejected the fund's proposal to remove exchange controls, eliminate the three-tier exchange rate system, or raise domestic interest rates; but the government has now apparently agreed to a compromise on each point. Incremental movements towards the fund's position will be implemented over time. Many Mexicans, especially politicians, are concerned that the policies in the letter of intent could lead to negative growth rates in the economy during 1983 and perhaps beyond.

Various Stabilization Programs

The two main policy variables in the model developed for our analysis are government investment (the chief instrument of fiscal policy) and credit extended by the Bank of Mexico to the government. In each simulation an objective was specified, and policies were evaluated in terms of the trade-offs associated with their resultant growth paths over the 1982-1987 period.[8]

The effectiveness of each stabilization program is measured by the value of seven economic variables: the average annual growth rates from 1982 to 1987 for private consumption, private investment, total investment (private plus government investment in addition to inventory changes), and GDP; the 1987 external borrowing requirement (exports minus imports) in billions of 1975 pesos; the 1987 rate of inflation; and the 1987 ratio of the deficit to GNP.

The baseline scenario, the mildest option open to the government, assumes an economic status quo and no agreement with the IMF; existing policies are extended and deficits are not controlled. The objective is to maximize real GNP by 1987 but at the same time to reduce the inflation rate to 20 percent. Under this program the inflation rate is below 18 percent by 1987 and at the same time the ratio of the deficit to GNP is stabilized at approximately 11.5 percent, but the external borrowing rate would reach 84.1 billion pesos by 1987–clearly infeasible from Mexico's point of view (see table).

The second program–that under the IMF letter of intent program–is a fairly severe stabilization effort. The major constraints explicitly outlined by the November 1982 letter of intent are that the ratio of the deficit to GNP must be fixed at 8.5 percent, 5.5 percent, and 3.5 percent for 1983, 1984, and 1985–1987. The letter of intent was interpreted to imply an inflation goal of less than 10 percent by 1987 and government borrowing and Bank of Mexico credit limited to a 5 percent average annual increase between 1982 and 1987. Given these constraints, government investment is reduced by the model to a level that still maximizes the real GDP in 1987. Strict adherence to the letter of intent would present the Mexican economy with a fairly severe shock. Despite a positive rate of growth

Effect of Various Stabilization Programs on Selected Economic Variables

Economic variable	Baseline scenario	IMF letter of intent	IMF letter with tax reform
Private consumption*	6.2	3.5	4.8
Private investment*	5.9	−4.1	1.4
Total investment*	6.4	−3.0	2.1
Gross domestic product*	5.9	2.3	4.2
1987 external borrowing rate†	−84.1	0	−27.3
1987 inflation rate	17.4	6.0	3.9
1987 ratio of deficit to GNP (percentage)	11.5	3.5	0.6

*Average annual growth rate, 1981–1987.
†Billions of 1975 pesos.

for GDP and a 6 percent rate of inflation, both private and total investment would have negative growth rates over the period examined because the entire emphasis would be on reducing government expenditures to meet deficit targets.

An alternative program open to the government is to introduce some form of tax reform concomitant with reductions in government expenditures. Thus the burden of reaching specified deficit targets would be spread between less government spending and increases in tax revenues. Assuming that the authorities want to reform part of the tax structure, the second program outlined above was rerun with the additional constraint that government revenues were to increase at an average annual rate of 15 percent between 1982 and 1987. Under this program private investment, total investment, and GDP would increase at average annual rates of 1.4 percent, 2.1 percent, and 4.2 percent. The inflation rate would be reduced to less than 4 percent. More importantly, however, external borrowing would decline to 27.3 billion pesos—an average annual decline of about 11 percent since 1981. Private consumption would expand at an annual rate of 4.8 percent.

Prognosis

A common feature of any program will have to be the severe restriction of government expenditure levels. In addition, our results indicate that if the chosen program goes no further than meeting the basic provisions of the IMF letter of intent, then we can expect repetitions of the crises of 1971, 1976, and 1982. Government policy will continue to be characterized by stop-and-go measures, and real economic growth of the economy will not exceed 2 or 3 percent annually.

If, on the other hand, a major tax reform—which we regard as feasible and long overdue—is enacted at the same time, then the economy should grow at between 6 and 7 percent annually during the current presidency. Stability and the inflow of foreign investment capital depend critically on the ability and the willingness of the present government to increase taxes. If this is done, the inflation rate should decline to approximately the level in the United States. This development would result in a fixed exchange rate between the dollar and the peso, with the obvious implications for trade with the United States and the rest of the world.

In addition to these macroeconomic factors, several other factors are worthy of mention in any discussion of the future course of Mexico. Primary among these is the relation of the government to the private sector in the de la Madrid administration. The president's handling of the debt-ridden state enterprises and the treatment of the nationalized banks will determine whether the private sector plays a dynamic role in the future of Mexico or will only be represented in such sectors as agriculture and services.

A policy, soon to be implemented, to remove many of the restrictions on direct foreign investment will have an important effect on future investor confidence in Mexico. This policy, together with other innovative and concrete steps, will be needed to overcome the loss of investor confidence as a result of the forced conversion of dollar bank accounts into pesos in October 1982.

In addition, factors that are, by and large, outside the control of the Mexican government will affect the country's economy. First, if world oil prices weaken, the country will face added pressure to increase oil production despite budgetary and technical obstacles. Second, should U.S. interest rates increase, the cost of servicing the Mexican debt—estimated to increase by $700 million for every 1 percent change in interest rates—will dramatically hinder the prospects for any form of recovery. Finally, developments in international financial markets will determine whether or not Mexico can obtain the new credit needed to keep its debt under control. The contributions of industrialized countries to the IMF and other last-resort lending agencies, the indebted nations' ability to restructure their combined foreign debt, the financial soundness of major international commercial banks, and the need to recycle the declining amounts of world petrodollars will directly influence foreign credit flows to Mexico.

Notes

1. "IMF Austerity Prescriptions Could Be Hazardous," *Business Week*, February 21, 1983, p. 112.
2. Optimal control is a technique whereby a goal is set for a future date (such as 1987, in this case) and different paths for getting there are examined, subject to constraints such as a given inflation rate, a fixed deficit-to-GNP ratio, and so on.
3. Carlos Tello, *La Política económica en México, 1970-76* (México, D.F.: Siglo XXI, 1979); Nora Lustig, "Characteristics of Mexican Economic Growth," *Journal of Development Economics* (1982), pp. 355-76; Clark Reynolds, *The Mexican Economy* (New Haven: Yale University Press, 1970), and idem, "The Mexican Economy 1982-1987: Key Issues, Policy Alternatives, and Implications for International Business," in Alice Lentz, ed., "Country Risk Analysis: Mexico" (workshop report for the Council of the Americas, New York, May 1982, mimeographed).
4. Abel Beltran del Rio, "Mexico's Troubled Economy: Peso Prognosis," *Wharton Magazine* (Winter 1977), pp. 55-56; idem, "Econometric Forecasting for Mexico: An Analysis of Errors in Prediction," in Jere Behrman and James A. Hanson, eds., *Short Term Macroeconomic Policy in Latin America* (Cambridge, Mass.: Ballinger Publishing Co., 1979); idem, "The Mexican Oil Syndrome: Early Symptoms, Preventive Efforts and Prognosis," in Werner Baer and Malcolm Gillis, eds., *Export Diversification and the New Protectionism: The Experiences of Latin America* (Urbana-Champaign, Ill.: Bureau of Economic and Business Research, University of Illinois, 1981), pp. 115-30; Robert Looney, *Mexico's Economy: A Policy Analysis* (Boulder, Colo.: Westview Press, 1978).
5. Leopoldo Solis, *Economic Policy Reform in Mexico: A Case Study for Developing Countries* (New York: Pergamon Press, 1981).
6. William R. Cline, "Mexico's Crisis, The World's Peril," *Foreign Policy* (Winter-Spring 1983), pp. 107-8.
7. Basil Caplan, "Mexico—The World's New Biggest Borrower," *The Banker* (July 1982), p. 33.
8. The model's exogenous variables were set at the following rates to reflect historical movements: an exchange rate of 90 pesos to the U.S. dollar, the rate of increase in the crude petroleum index at 6 percent, growth of crude petroleum exports at 6 percent a year, growth of U.S. gross domestic product at 2.5 percent a year, and growth of the U.S. consumer price index at 6 percent a year.