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Karen E. Jones
Lehigh University

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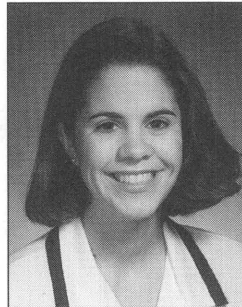
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ECONOMIC LIBERALIZATION IN MEXICO

Karen E. Jones



From Desperation to Liberalization

Mexico shocked financial markets around the world on August 14, 1982, when it defaulted from payment on its skyrocketing public debt. This delinquency caused a surge of capital flight, and coupled with high inflation rates and interest rates caused a further decline in economic growth. The dire state of the economy necessitated dramatic change. Like past Mexican leaders, President Lopez Portillo reacted by increasing the economic control of the federal government. He nationalized the banking industry which was made up of sixty commercial banks and consolidated them into eighteen government operated banks.

When Miguel de la Madrid took office as President on December 1, 1982, he recognized the failure of the inwardly focused economic strategy and initiated liberalization of Mexican markets. He realized that a significant increase in foreign investment and return of capital flight would be necessary to improve the dreadful economic conditions in Mexico. He understood that in order to attract investment, Mexican markets would need to become more

stable and less constrained by regulation. In response, he progressively changed laws to open trade to foreign competition and began reducing the role of the public sector in the domestic economy.

During de la Madrid's six year term as President, tariffs declined from a maximum of 100 percent to a maximum of 20 percent when he left office in 1988. Mexico also saw nonpetroleum exports rise from \$4.4 billion to \$14 billion, and witnessed a reduction in the number of government-owned enterprises from 1,155 in 1982 to fewer than 400 in 1988. (Secretariat of Finance, p. 8) However, although the de la Madrid administration may now be favorably regarded for the structural change it initiated, the immediate reactions were unfavorable due to its failure to deliver economic growth and its reluctance to deal with inflation until Madrid's last year in office.

Carlos Salinas followed de la Madrid as the next PRI (Institutional Revolutionary Party) President on December 1, 1988. He received 50.4 percent of the vote, yielding him just enough to keep the PRI, the ruling party in Mexico since 1929, in power for another six

years. The PRI's waning percentage indicated the dissatisfaction the Mexican people felt with the social and economic conditions in Mexico. President Salinas envisioned further liberalization of the economy as a means to help stabilize and generate growth. He immediately determined his goals and methods of implementation. In a four-page advertisement in various United States newspapers in January 1989, he listed his goals as:

- (1) Maintaining the fight against inflation;
- (2) Encouraging entrepreneurial investment;
- (3) Continuing privatization and deregulation;
- (4) Proceeding with the opening up of the economy.

(Wall Street Journal, January 23, 1989, pp. B7-B10)

Over the last four years, Salinas has achieved all four goals. Inflation has declined from over fifty percent in 1987 to under twenty percent in 1991. The reduction of inflation can be attributed to the stabilization of the economy which was achieved through successful debt restructuring and through the successful divestiture process which began in 1983. In addition, the Economic Solidarity Pact, introduced during the Madrid administration, also contributed to the reduction in inflation.

In September 1989, an agreement concerning Mexico's national debt was negotiated with creditors and implemented over the next few months. It applied to approximately \$45.8 billion worth of debt, equal to approximately one-half of Mexico's total debt, owed mainly to foreign commercial banks. Total monetary transfers abroad (including amortization payments) subsequently declined by \$4 billion per year. This reduction in payments was achieved through lengthened maturity of the debt, net interest reductions, and new money. (Tandon, chap. 15, p. 4) Over \$9 billion in domestic flight capital has returned to Mexico since the debt restructuring. In addition, the Salinas administration has privatized over 150 government-owned companies and has continued to open up the economy to foreign competition.

The Worldwide Shift to Privatization

Great Britain, France, Italy, Argentina, Chile, Mexico, and the Eastern Bloc countries are just a few examples of nations that have privatized formerly government-owned enterprises over the last ten years. Great Britain privatized British Airways, National Freight, and its utilities industries as well as forty-three other large companies. Chile has transformed its formerly socialistic economy to a market-based economy. It privatized over 360 state companies, replaced social security with privately owned pension funds, and privatized its health care system. Why the sudden fascination with privatization? In an essay entitled "Liberalization, Integration, and Privatization," Ira Lieberman asserted that the need for privatization in Latin America and most Eastern European countries arose from the debt crisis which plagued these regions for almost a decade. However, the interesting question is not why they decided to privatize, but whether or not privatization has helped to solve the economic difficulties these countries were experiencing. In a World Bank study which analyzed the outcome of privatization for twelve formerly government-owned enterprises from Chile, Malaysia, Mexico, and the U.K., eleven of the twelve newly divested firms produced a net increase in income. The gains in wealth, according to this study, resulted from higher investment, managerial innovation, better pricing of the firm's services, and shedding of surplus workers. (Tandon, chap. 15, p. 10)

The Divestiture Process in Mexico

Reorganization of state-owned enterprises (SOEs) was a main element in Mexico's plan to reduce government debt and stabilize the economy. Administrators believed that eliminating SOEs would help to cut government expenditures and thus help reduce the massive deficit. Mexico has utilized four types of public sector reorganization: sale to the private sector, liquidation, merger with other public sector enterprises, and transfer of ownership to

regional or municipal authorities. The last two are not modes of privatization, but like privatization transfer power away from the federal government. The method for reorganization was determined according to each company's status at the time of divestiture. Non-priority and non-strategic companies were sold to the private sector. Liquidation was implemented in companies that lacked economic viability, while other companies were merged in order to improve the distribution of their resources prior to privatization. Companies of regional or local importance, related to development programs, were transferred to state and local governments. Liquidation was the method used most frequently in the early phases of the divestiture program (1983-1988) while sales to the private sector have been the most significant method utilized since 1989. (Tandon, chap. 15, p. 6)

A proposal by the coordinating agency (e.g. The Secretary of Agriculture) to the Commission Intersecretarial de Gasto Financiamiento is the first step in the divestiture process. Only non-strategic and non-priority companies are proposed for divestiture, or "disincorporation" as it is called in Mexico. Companies considered "strategic" or "priority" are not considered for divestiture.¹ The Commission analyzes all proposals for non-strategic and non-priority companies and decides on the appropriate form of divestiture: liquidation, merger, transfer, or sale. Once the form of action is determined, an agent bank, one of the eighteen commercial banks in Mexico, is appointed based on its experience and workload. If a sale is decided upon, the agent bank designs a sales strategy, proposes general guidelines, decides on a date of notification to prospective buyers, and publishes an executive summary and a prospectus that contains financial statements, credit history, and the commercial situation of the company for sale.

The next step in the privatization process is a technical financial assessment performed by the agent bank which indicates a reference price for the firm; however, the price for which the company is actually sold depends upon

market conditions. The agent bank then receives the offers in the presence of a public notary. It decides the winner based mainly upon the highest bid, but also considers the prospectus investment plans and payment conditions. The final authorization of the sale is determined by the Finance Secretariat. Proceeds from the sale are deposited in the Federal Treasury. (Secretariat of Finance, pp. 11-14)

Despite the fact that more than 200,000 Mexicans are estimated to have lost their jobs due to the divestiture program, there has been little opposition from organized labor thus far. Authorities attribute this to the provisions that were designed to protect workers. For example, if resistance to a privatization develops, a union can acquire the company being sold by matching the highest bid. Between the period 1989-91, sixteen SOEs were sold to unions in this manner. Furthermore, employees are sometimes sold shares in the company after the divestiture in order to encourage cooperation. During the privatization of Telmex (discussed in detail later in this essay), the Telmex union was sold 4.4 percent of the company's shares for \$325 million. As of April 1992 these shares were worth \$1.37 billion or almost 4.6 times their purchased value. In addition, buyers are forewarned that layoffs are not to occur. In fact, in most cases layoffs have not occurred following privatization. (Tandon, chap. 15, p. 10)

Another factor which helped to gain the vital support of organized labor during the privatization process was the promotion of the program by the Salinas Administration. President Salinas has reminded the public on his weekly tours of the countryside that the money gained from the sales of these companies is being used to build schools, install electricity, and pipe water into rural communities. This reinforces the link in the people's minds between privatization and progress.

The Privatization of Aeromexico

The 1,100 privatizations which have been completed in Mexico over the last ten years have included a wide range of corporations, from small manufacturing companies to the nation's most important banks. Aeromexico, one of the three major Mexican airlines, was nationalized

¹For example, Pemex, Mexico's giant petroleum manufacturer.

during a pilots' strike in 1959. Ironically, in April 1988 during a ground workers' strike, the Mexican Government pushed the firm into bankruptcy and liquidated all its contracts. Soon after, it sold the firm to a private buyer. The sale of Aeromexico was a financial success. After experiencing net losses for three decades before its privatization, the airline turned a small profit (less than one percent of sales) after only one year in private hands. Although Aeromexico lost money overall in 1991, the losses were substantially smaller than the net losses suffered in 1985-1987. (Tandon, chap. 17, p. 10)

Was Aeromexico's turnaround a direct result of privatization? Several factors reveal that an increase in profitability could not have been achieved without privatization. First, since the privatization of Aeromexico, labor costs have been sharply reduced. These reductions were induced by both a significant downsizing of the labor force as well as by a ten percent cut in airline workers' salaries. These cost-saving measures could not have occurred without the declaration of bankruptcy, liquidation, and sale to private investors. Under Mexican law, workers are entitled to job security, so it is extremely difficult for companies to terminate employees even if the company no longer needs them. However, if a company files bankruptcy, its workers can be discharged. In April 1988 after filing bankruptcy, Aeromexico fired all of its workers. It closed operations until early May, and then began flying ten routes with five aircraft and a significantly reduced staff.

After witnessing success at this reduced staff level, the Mexican Government announced its decision to privatize the airline. On September 7, the government created a new company from Aeromexico, called Aerovias de Mexico, with a capital stock of 100 million pesos. This new airline quickly reached contractual agreements with its workers. On September 26, the government offered potential buyers of the airline two options, both of which specified a minimum price. This procedure differed from the majority of Mexico's privatizations not only because it was a sale of assets, as opposed to a sale of an ongoing company, but also because there was a pre-announced minimum price. The winning bid came from a consortium of investors under the

name of Dictum, S.A. de C.V. The airline began operating as a private company at the end of November 1988 under the name of Aeromexico.

The most notable changes since the sale are a reduced workforce, a dramatically smaller capital stock, and an increase in overall labor productivity. The change in capital stock results from the fact that most of the fleet is now leased, not owned. In 1987, Aeromexico owned 24 aircraft and leased 19; but in 1991, only 2 aircraft were owned while 43 were leased. The increased reliance on leasing has caused higher rental unit costs. However, total unit costs have fallen because of the significantly lower labor costs. The reduction in the size of the workforce combined with new pay reductions has nearly doubled labor productivity following divestiture.

Although it is difficult to assess the real winners and losers in the transformation of Aeromexico, the Mexican government gained the most overall. Not only did it sell a firm that had been incurring losses for more than thirty years, but it will collect from the company approximately \$2.12 billion in present value tax revenues over the life of the company. In addition, domestic and foreign shareholders gained due to the increased profitability of the company. However, domestic and foreign consumers lost due to an increase in flight prices following privatization. The airline's employees lost as well due to the substantial reduction in the size of the workforce and the ten percent decrease in salaries. Overall welfare is estimated to have risen by \$2.28 billion, mainly stemming from the labor force reductions allowed after bankruptcy was declared. (Tandon, chap. 17, p. 31)

Effects of Divestiture at Telefonos de Mexico(Telmex)

Another example of privatization in Mexico which resulted in increased profitability was Telmex, one of the largest telephone companies in the developing world. During his 1988 Presidential campaign, Carlos Salinas announced his intention to privatize Telmex. At this time the government owned 56 percent of the company's stock, while the remaining 44 percent was privately owned. In September 1989 it was announced that the capital of the

company was going to be restructured so that only 40 percent of the shares would have voting rights. The government then offered for sale 51 percent of the voting stock, or 20.4 percent of the total stock. Bids were received in November 1990, and the sale was finalized in December to Southwestern Bell, France Telecom, and Grupo Carso, a Mexican holding company controlled by Carlos Flynn, a prominent businessman.

The profitability of Telmex has increased substantially since its sale in late 1990; however, unlike Aeromexico it was not a direct result of privatization. Rather, the increase in profitability resulted from changes in government regulations since 1988. The most significant change in regulation was the massive increases in installation and rental charges as well as price increases on local, domestic, and international calls that the government allowed after January 1, 1988. In a case study published by the World Bank, Pankaj Tandon argues that "it is tempting to assume that the jump in profits emerged from productivity and efficiency improvements; however, ...the primary source behind the upward trend in profitability is revisions in output prices in 1988 which were followed by further revisions in 1990." (Tandon, chap. 16, p. 1)

Telemex's price increases in 1988 and 1990 resulted in a quadrupling in its stock price from 1988 to 1992. In addition, labor productivity has improved since 1988, rising by 15 percent in 1991. Tandon contends that "part of the improvement can be attributed to the prospect and the realization of privatization." (Tandon, chap. 16, p. 29) The increase in labor productivity comes from the improvement in labor relations since 1988. The telephone workers' union has supported the sale of the company ever since the initial announcement in 1988. An April 1989 agreement with the union replaced fifty-seven different contracts with a single one to be negotiated each year. It also allowed greater labor mobility and developed criteria which when satisfied would permit employee layoffs. Fiscal revenues were essentially unchanged; reductions in taxes on Telmex services have been offset by increases in corporate income tax payments. However, faced with a rise in prices (greater than the fall in tax rates

on Telemex services), consumers are worse off by \$33 billion.

Although Tandon argues that Telmex's increased profitability was not a result of privatization, he contends that the disincorporation of Telmex did contribute to the transformation of the Mexican economy, also known as the "Mexican Economic Miracle." It did so by first allowing the government to use the proceeds of the sale (\$10 billion) to retire a portion of the national debt, the reduction of which restored credibility to Mexico in world financial markets. Second, the Telmex sale attracted over \$6 billion in capital inflows in a period of a year and a half. And finally, as Tandon argues, Telmex was a catalyst for the highly successful privatizations that followed. (Tandon, chap. 16, pp. 16-35)

Results of Privatization of Mexico's Eighteen Nationalized Banks

Like the privatizations of Aeromexico and Telmex, the sales of the eighteen nationalized Mexican banks were a terrific success overall. The sales raised more than \$12 billion for the government. This figure represents more than half of all the revenues realized from privatizations completed under the Salinas administration. The sales began in June 1991 and were completed in July 1992 with the sale of Banco del Centro (Bancero). The bidding grew more intense as the program neared completion. Price/book ratios—that is, the price at which the company was sold divided by the estimated book value of the company before the sale—averaged 3.23 for the first six sales, whereas the average rose to 4.22 for the last six banks sold. Bancero, the final bank to be privatized and the smallest of all the banks as measured by assets, was sold for \$279 million, which was 4.65 times its book value. ("Privatizations Transform Mexican Banking System," p. 3)

The Mexican financial system has changed dramatically since the advent of the Salinas administration. Prior to the bank privatizations, the Mexican government controlled nearly all of the country's banking resources. Although ownership of the country's banks has been transferred to private hands, control of the banking system remains concentrated in a few large banks. Currently, Banamex and

Bancomer, two of the country's eight financial groups that operate in the Bolsa (the Mexican stock market) control 67 percent of the assets, 69 percent of the investments in other companies, and earn 71 percent of the profits of all the financial groups combined. All together total assets of the eight groups that operate in the Bolsa measured \$100 million at the end of the first quarter of 1992, which is approximately equal to 31 percent of Mexico's GDP. (*Notimex Mexican News Service*, July 8, 1992) However, although control over the financial system remains centralized, since the privatization of the eighteen national banks the number of shareholders in Mexican banks has increased from 8,000 to 130,000. So, although power remains concentrated the number of participants in the banking system has risen since privatization.

Before initiating privatization of its eighteen nationalized banks, the Mexican government reformed its banking regulations. President and CEO of First Boston Group, John M. Hennessy, has attributed the overall success of the bank privatizations to these regulatory reforms, which provided for a single regulator for all Mexican banks. The Mexican system contrasts sharply with that in the United States, where banks can be subject to regulation by the Federal Reserve Bank, the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency, and state regulatory authorities. Besides the duplication in duties that these regulators often perform, U.S. banks often encounter conflicting advice depending on the regulatory source. With a single regulatory authority, the Mexican banking system will avoid such problems.

Another attractive feature of the recent Mexican bank reform is that it allows for the formation of "universal banks." In addition to banking services, these banks will be able to offer securities brokerage services, leasing, factoring, insurance, and mutual funds, in addition to banking services. The reform also added a tough system to review and control the quality of banks' loan portfolios. Since the reform of the system, more than \$4 billion in flight capital has returned to Mexico, reflecting investor confidence in the new financial system. (Hennessy, p. 13)

Lessons Learned From the Privatization Program

Jacques Rogozinski, director-in-chief of Mexico's Office for Privatization of State Owned Enterprises, recently summarized a set of general principles for successful privatization of state-run industries that Mexico learned through its experience. First, he stressed that small companies should be privatized in the beginning stages of the process, leaving the larger, more important enterprises until the end. This allows the country to correct any problems that arise during the process and perfect the whole program by the time it sells, for example, "the most important bank in the country." Secondly, Rogozinski suggested that officials should wait to announce plans to privatize a firm until it is ready to enter the sales process. An early announcement often invites criticism from the press, which can create negative feelings about the firm being sold, and could lower the market value of the firm. However, once plans are announced, he stressed the importance of keeping the public well informed about the entire sales process in order to prevent false rumors from spreading. (Rogozinski, p. A15)

Rogozinski also noted the importance of confidence in the economic environment. A stable economic climate is needed in order to persuade investors that the investment they are undertaking is secure. For example, Mexican de Aviacion (Aeromexico) did not receive any offers above the minimum when its sale was first announced. However, soon after the foreign debt renegotiation package was signed, four bids above the minimum were received. (Rogozinski, p. A15)

Lastly, he stressed that it is critical to screen investors to ensure that they have the financial resources as well as the qualifications to run the company efficiently and effectively. The Mexican Privatization Committee reorganized the sales process after the privatization program began in order to more effectively screen buyers. It now separates the process into two stages. In the first stage, potential investors are investigated so that those without the necessary qualifications are immediately eliminated. Companies are analyzed for ability to pay, in

addition to ability to effectively manage the company being sold. This allows the administration to focus solely on price during the second stage. (Rogozinski, p. A15)

Additional Changes Needed to Complete Economic Liberalization

In addition to the privatization of government-owned enterprises, Mexico must initiate other major changes in order to induce stable economic conditions and hence attract investment. Trade liberalization must be extended even further to allow for the free flow of imports and exports in Mexico. It is important to realize that many significant changes have already been initiated to open up Mexico's closed economy. For example, President de la Madrid eliminated the requirement of import licenses for some items, although licenses are still required for many other goods. Since 1986 there has been a dramatic reduction in tariffs, which have fallen from an average of 28.5 percent in 1985 to an average of 12.5 percent in 1990. (Nogues and Gulati, p. 7) In 1986 Mexico joined GATT, the General Agreement of Tariffs and Trade, revealing its commitment to a freer trade policy. The signing of the North American Free Trade Agreement (NAFTA) will complete Mexico's efforts to further liberalize trade.

Trade liberalization and the reduction of state ownership of commercial enterprises are just two policy areas that have witnessed substantial structural reform since 1982. Other areas include tax reform, reform of the financial system, agricultural reform, and stricter environmental laws. However, additional reforms are still needed. In particular, restrictions on foreign ownership in the financial sector need to be eased in order to allow Mexico to reap the benefits such investment can provide.

Not only does foreign ownership improve access to technology and management advances, but it provides needed financing as well. Commercial banks currently allow foreigners no more than thirty percent participation in ownership. The NAFTA addresses this issue, and provides for a gradual easing of restrictions for foreign ownership. The NAFTA has also given special attention to environmental problems in the U.S. Mexican border area as well as to problems that will result from liberalized agricultural trade practices.

Conclusion

The Mexican government has executed an immensely successful privatization program. The program's success has been demonstrated by the fact that 86 percent of the companies privatized were sold either at or above the asking price. The proceeds from these sales have helped to substantially reduce the public debt. Another important result of the privatizations is that efficiency has risen at the majority of the divested firms. This increased efficiency will help Mexico's once poorly managed state owned enterprises become more competitive in international markets.

Finally, the privatization program has also been accompanied by financial reform and trade liberalization. Together these fundamental changes in the economic structure of Mexico have induced stabilization in the macroeconomic environment. Inflation rates and interest rates have both subsided, thus making Mexico more attractive to both domestic and foreign investors. Increased investment, of course, is the key which will eventually yield greater growth for the Mexican economy as a whole.

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