

# ECONOMIC STRUCTURE OF MEXICO

## CHANGING ECONOMIC STRUCTURE OF MEXICO

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### INTRODUCTION

Every country experiences important changes in its society, political system, and economy while developing and growing. Social mobility and economic deprivation; rapid economic advancement and social dislocation; political demands and economic diversification; are all normal outcomes of the process of development. As Mexico's economy evolved from the 1920s on, its society became more diversified and increasingly complex. This brought about increasing social and political pressures. During the 1960s those pressures became paramount.

By the late 1960s Mexico's economy was under pressure to expand. This was difficult because the domestic market was too small to support an economic scale that would manufacture products that measured up to world price and quality standards. In addition, agricultural exports, which had been used to finance industrial imports, declined while the population increased. This situation compelled the government to change course by gradually allowing foreign imports, thus forcing industry to compete and generate exports to pay for its own imports.

During the 1970s Mexico's government, like many other governments in the world, used public spending to enhance the domestic market and to reduce social and political pressures. From 1972 through 1981 the artificial growth of the internal market combined with massive inflows of foreign exchange which resulted from foreign indebtedness and oil exports. This allowed continuous economic growth. By the early 1980s, the scheme began to fail and the country found itself in the midst of a deep recession. Additionally,

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Mexico faced extremely high levels of foreign debt and an industrial program that has not, and cannot, work in the 1980s.

### I. COPING WITH THE 1982 CRISIS

In 1982 Mexico found itself in the midst of its worst crisis in recent history. The rapid accumulation of foreign debt increased the debt service cost far beyond the country's means and the reticence of the government to devalue the peso fostered capital flight. There was an enormous growth in imports and a virtual elimination of manufactured exports. By the end of 1981 the combination of these factors made 1982 a year of crisis. In August of 1982, when international banks ceased to roll over existing short term credit, the debt bomb exploded.

Other things also went wrong during 1982. Employment in the manufacturing industry fell by 7% in one year. Real interest rates declined by more than 65%. Prices soared and the economy imploded, shrinking by one-half of one percent. Inflation was 38% in 1981 and ended 1982 at 100%. In September of 1982, the government expropriated private banks and introduced exchange controls. On December 1, 1982, the current administration came into office and immediately set out to reverse these imbalances and overcome the crisis situation. Four years later, the current government shows little promise of reversing the imbalances and overcoming the crisis.

The aftershocks of the 1982 crisis have been severe and prolonged, due to the lingering effects of some poor decisions. The high disequilibrium in the public sector's deficit, together with the rapid debt accumulation of previous years, threw the economy into a tailspin, as foreign credits were suspended. The new government that entered in December 1982 also had to cope with plunging confidence levels created by the abrupt and unexpected expropriation of the Mexican-owned private commercial banks. This included the establishment of controls on all foreign currency transactions and the forced liquidation of dollar denominated deposits in Mexican banks.

The establishment of currency controls has been damaging to confidence because the population had repeatedly been assured, through the years, that currency markets would remain open. Also, Mexico's proximity to the United States makes the operation of controls unworkable. Without going into the administrative details, suffice it to say that more than five million Mexicans live in the Mexico-U.S. border area and that people of both nationalities cross

the border up to 275 million times per year. This situation clearly makes exchange controls impossible.

In 1982, the government had to cope simultaneously with foreign banks suspending credits, considerable arrears on private debt, declining terms of trade, and a stunned population uneasy about the future.

When the administration took over, production and employment declined while inflation rose. The government imposed harsh fiscal discipline in order to improve the battered economy. The government trimmed the budget through steep increases in taxes, increases in the prices of goods and services provided by the government, and lowered expenditures. In 1983 falling wages and profits halved the public deficit and improved the balance of payments. For the first time in over four decades, Mexico had a surplus in its current account, meaning that exports of goods and services were greater than imports, including interest payments on the debt. Although inflation reached a historical high of 117% in April 1983, it fell almost continuously afterwards and output began recuperating by the end of the year.

The recovery program initiated at the end of 1982 was an immense success. In spite of the overall decline in standards of living and the small growth in the economy from 1982 to 1984, the economy showed major improvements in performance aggregates. However, three things happened to impede a complete reversal of Mexico's financial difficulties.

First, the financial adjustment program was not immediately followed by an all-encompassing structural change program. Rather than initiating such a program as early as 1983, the government waited until late in 1985. Then, after three years of austerity, the Mexican citizens would not support another correction program.

Second, oil prices decreased from almost \$40 per barrel in 1981, to \$25 per barrel in 1985. In February, 1986, oil prices collapsed to below ten dollars per barrel. Since oil accounts for 60% of the country's foreign exchange and over 30% of government revenue, the impact of the declining oil prices was massive. Regardless of efforts which had already taken place to reduce the government deficit the decline in oil prices hit hard. Assessing the government's actions should take into account the recent fall in oil prices, a major event for which the Mexican government cannot be blamed. It is critical to assess what the government has done and has not done since the end of 1982. Finally, the public deficits the country in-

curred through the 1970 were paid and continue to be paid even though there has been an adjustment in public finances. Payment of previous deficits and the decline in oil revenue are still responsible for an enormous gap in government accounts.

## II. GOVERNMENT FINANCES

The main thrust of government economic policy since 1982 has been to reduce the gap between government income and expenditures. That deficit was reduced from 18% of the Gross Domestic Product (GDP) to 9% in 1983. However, it has since remained stagnant at around 9% indicating that the effort has fallen short of both the avowed governmental goals and the economic need. For example, the financial sector has had to finance that deficit, which has consumed most of the resources available, causing credit for private firms to be very scarce and very expensive.

The government has been forced to allocate the largest share of the budget to peso debt servicing. Due to the very high levels of inflation, the cost of government debt is inflation plus a real interest. By separating the government figures and isolating the real rate of interest that the government pays on its debts in pesos, the fiscal deficit changes significantly. Over one-third of what the Mexican government spends goes to service its debt in pesos. By separating the real rate of interest from the nominal one, the amount the government spends on paying salaries, making investments, and servicing inflated debts incurred in the previous decade can be accounted for. The government has been able to reduce its "operational" deficit quite dramatically from 1982 through 1985, to a point where it even attained a surplus in 1983 and 1984. In 1986, the operational deficit increased to 4% of the GDP because of the decline in revenue due to the fall in oil prices. Considering that the decline in oil revenues amounted to 6% of the GDP and that government accounts were already in balance in 1985, the obvious conclusion is that the government adjusted its accounts by 2% of the GDP. In spite of this, the financial deficit (the more conventional measure of the deficit, which includes all interest payments), will probably rise to approximately 17% of the GDP in 1986.

When adjusted for inflation, public finances have actually been considerably strengthened. This has been done essentially by increasing public sector income from 27.8% of the GDP in 1981 to 32.2% in 1985, including direct taxes as well as sales of goods and services by parastatal firms. On the other hand, public expenditures

which had increased from 41.4% of the GDP in 1981 to 46.3% in 1982 have declined to 40.6% in 1985. If one deletes the nominal interest payments on government debt, the figures are significantly smaller.<sup>1</sup>

Table 1<sup>2</sup> implies that non-interest expenditures have been reduced by an astounding 9.1 percentage points of GDP from 1982 to 1985, a reduction unparalleled in any other country. This has resulted from lower real wages, diminished public investment, and some trimming of the public sector. Because real wages and investment have been so depressed, any future budgetary adjustments will have to lean more on the reduction of the parastatal sector. Obviously, for economic growth, government investment in the infrastructure and real wages would have to be increased. Neither can be done at present given the current size of the public debt, both foreign and domestic. If raw percentages do not convey a concrete picture regarding the budgets performance in the past few years, consider the following examples on the income side.

From December 1981 to July 1986 the consumer price index has risen 13.8 times. However, from December 1981 to August 1986 the price of bread has risen 24 times, the price of tortillas 17.4 times, the price of sugar 9.4 times, monthly telephone bills 20 times, gasoline 21 times, diesel fuel 43 times, kerosene 92 times, and laminated steel 15 times. These substantial relative price increases have strengthened public finances directly, have reduced the need for transfers, and have curtailed public investment needs artificially induced through subsidized prices. Needless to say, these price increases have dramatically altered the spending patterns of the average Mexican. While minimum wages have lost about 40% in terms of purchasing power since 1981, prices of basic staples have increased faster than inflation. But many of these prices had been stagnant for more than a decade. For example, the charge for a subway ride had been one peso from the 1960s until 1985. So, the

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TABLE 1

NON-INTEREST PUBLIC EXPENDITURES AS PERCENTAGE OF GDP

1981	36.2
1982	37.7
1983	30.2
1984	29.2
1985	28.5

Source: Fiscal Information. Treasury Department

2. See *supra* note 1.

impact of these increases may not be that harsh. However, the necessary corrections have taken place in a very short time frame, with obvious consequences.

### III. OTHER GOVERNMENT ACTIONS, 1982-1986

Aside from adjusting the government budget and the size of the public sector, other policies have also begun, such as gradually opening the economy to foreign trade.

Foreign trade has been managed, since the 1960s, essentially through import quotas controlled by import permits. These quotas have been used to either ban imports or to direct industrial production. Though the original purpose of this policy was to promote development of a competitive domestic industrial base over the years, excessive protection has led to inefficiency, inflexibility and incapacity to generate exports.

The current administration started out with a tight trade policy because of the lack of international reserves. As the reserve situation improved, restrictions on imports were gradually lifted. By the end of 1986, over 80% of all products will have no import permit requirements. Furthermore, in 1986 Mexico joined the General Agreement on Tariffs Trade (GATT). Though much remains to be done in setting of import tariffs, bureaucratic procedures, and others, the stage is set for an almost complete external liberalization of the economy within the next two years.

There is still a long way to go in revising industrial and trade policy. Much remains to be done in the sphere of government owned firms, but there is no question that the policy direction has firmly changed for the first time in twenty-six years and that the achievements have been noteworthy. Furthermore, the recent trade liberalization contains the basic ingredient to make it successful: it has been consistent. Even with the collapse of oil revenues in 1986, this policy has survived, thus providing a substantial increase in non-oil exports. These would have been aborted had the government clamped down the controls, as it did in previous foreign exchange crises (1975-1976 and 1981-1982).

A considerable improvement in overall economic aggregates has been accomplished. Mexico's 1986 recession resulted from decreasing revenue due to declining oil prices rather than a major alteration in the correction program. Yet, some problems remain unaltered and are a formidable hindrance to renewed growth. Some of these problems are internal and must be addressed, but others lie

beyond Mexico's borders.

In order to benefit the country's future output, Mexico's enormous debt should have been used for high-yield investments in infrastructure, education, and health. If the debt had been channelled to productive projects which contributed to higher levels of production, more efficiency, and more competitiveness, then it would have been fully payable and Mexicans would be thriving. Mexicans recognize that the debt incurred over the last decade is too large, and is unsupported by an equivalent level of assets. Obvious manifestations of these recognitions are that Mexicans feel burdened by debt and have implicitly been seeking to evade its repayment through migration, capital flight, and by disuse of the established financial system to obtain cash and credit. This negative response engenders negative expectations, and has contributed to a loss of confidence.

The total foreign debt has increased from 85 billion in 1982 to an expected 110 billion in 1987. Most of the additions to the 85 billion of 1982 have been borrowed to keep interest payments current. This is clearly no solution because it means that the country has to pay more interest every year for money whose use it never enjoyed. It should come as no surprise that secondary markets are discounting Mexico's debt quite heavily.

While the financial adjustment has been very thorough, its social consequences have been heavy. During the past four years real minimum wages have declined by up to 40%, and the per capita income of the Mexican people has declined by close to 10% since 1981. Though relatively few people have lost their jobs, very few young people entering the labor force have been able to get jobs. This might not sound so bad. However, the problem is that many perceive that there will be no better future should the same policies be pursued. Negative expectations have made a difficult situation into a potentially unbearable one.

Arguably, a vicious circle like this can be severed if there is large enough and rapid enough internal adjustment. A drastic approach may have merit, particularly if its result could reverse negative expectations. However, the size of the adjustment needed, given the enormous size of the foreign debt, is too large to be borne internally. Mexico's current debt problem is similar to reparations imposed upon Germany after World War I. Germany suffered a substantial real transfer of resources to the rest of the world. Eventually, such a burden became too harsh to bear. Mexico's debt should be viewed in this light and under this focus Mexico's debt

burden should be shared.

#### IV. CONCLUSION

The only way out of the vicious circle into which the present levels of foreign debt have led Mexico is a radical shift in the structure of the country's economy. This must occur in the context of a radical shift in the size and structure of the country's debt. This would entail incorporating the country's economy into world trade patterns in such a way that Mexico becomes a highly competitive economy. Of course, this is easier said than done. First of all, it would be impossible to carry out such a program without a dramatic change in the present structure of foreign debt servicing. The burden of that change would have to be shared by the creditors and country alike. The second major hindrance is the nature and dimension of the necessary structural shift, which would create many dislocations and political pressures. The situation does not call for abandoning the restructuring. It calls for a carefully planned process of gradual adjustment allowing for a transition period, and mechanisms that would avoid high unemployment and other unacceptable consequences. Finally, for such a program to be successful, political participation would be necessary. Without these elements, structural change could not take place and the population at large would not accept its costs, no matter what the theoretical benefits.

Nobody doubts the need to restructure Mexico's economy. The issue is how to deal with the domestic realities. There is the need to adjust the economy and at the same time compensate for the negative by-products of the adjustment process. There is the unavoidable need to re-think debt and debt servicing, both in Mexico and within the international financial community. Without the adjustment, Mexico's economy will not be able to advance; but without a radical change in debt policy, the economy cannot adjust further.