# THE MEXICAN ECONOMY AS 1987 BEGINS

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Successive external shocks have battered the Mexican economy since 1982. Mexico has experienced one of the most severe cases of structural over-indebtedness in the developing world, a devastating earthquake, and a collapse of the international price of crude oil. However, the Mexican economy has not undergone fundamental structural changes since the oil boom of the late 1970s. Existing structures and procedures have absorbed these external shocks. The elastic nature of these structures has ended with the latest series of orthodox "settlements" between Mexico and its public and private creditors.

The July 22, 1986, agreement between Mexico and the International Monetary Fund (IMF) was for $12 billion in new external financing. This agreement represented an important retreat in the monetary authorities' tactical approach to the Third World debt crisis. The IMF, under significant pressure from the U.S. Federal Reserve and the United States, agreed to a number of Mexican demands it had previously rejected. In a desperate effort to stave off willful default by Mexico on its external debt, the monetary authorities accepted the proposal that Mexico would not make any serious economic adjustments. Mexico's demands of the monetary authorities and creditors included:

1. The advancement of new creditor loans sufficient to finance Mexico's interest obligations while allowing the Mexican economy to grow at a 3-4% annual rate;

2. The abandonment of fiscal and monetary adjustment targets that would constrict Mexico's ability to grow at a 3-5% annual rate (To accomplish this objective, Mexico sought IMF and creditor acquiescence in new methods of miscalculating its fiscal deficits in a way that systematically underestimated them.);

3. The creation of a contingency fund that would advance Mexico additional loans if the price of petroleum sank further; and finally;

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4. Real debt relief.

The monetary authorities ultimately agreed to the first three demands, but rejected the last demand for real debt relief. Mexico retreated from that demand and accepted a larger foreign debt and powerful domestic inflationary pressures as prices of growth. To avoid immediate default, the monetary authorities agreed to abandon their demands for adjustment discipline and to increase Mexico's total foreign indebtedness by 12% in 1987, guaranteeing recovery from Mexico's second depression in five years.

The package presented to Mexico in 1986, while forestalling default, illuminated the growing political weakness of the monetary authorities, the growing incentives for default among debtors, Mexico in particular, and the ineffectiveness of the monetary authorities' approach for resolving Mexico's debt problem. Our forecast is that the package will probably stay intact for the next six to twelve months. As it unravels and Mexico faces its next payment crisis, resort to the same formula is less likely. In response to a new payment crisis, Mexico will either resort to unilateral means for reducing its debt burden or come to terms with its creditors on a partial write-off of its debt. Lack of relief, combined with a substantial new debt, and depressed oil prices over the next two years, could cause Mexico to face its third depression this decade in 1988-89.

The 1986 depression was the second depression of the decade. It was precipitated in part by the collapse in oil prices. This downturn heralded a 4% decrease in growth, a 10.7% reduction in gross fixed investment, a 3.8% decline in manufacturing activity, and a loss of 1.5 million jobs. The collapse of the value of crude oil exports (down from $13.3 billion in 1985 to $5.4 billion in 1986) shattered Mexico's trade and current accounts as well as its ability to service its debt. The reduction in oil revenue also led to an explosion of fiscal deficits, rising to nearly 15% of GDP. This depression made continued economic adjustment completely unthinkable for the Mexican government. In the midst of this depression, the government rejected a further decrease in imports and government spending. As new deficits arose, Mexico's inflation surged 104% at the end of 1986, up from 63.7% at the beginning of the year. In order to ensure the competitiveness of its non-oil exports and restrain sudden capital flight, Mexico depreciated its currency, from 445 pesos to the dollar at the beginning of 1986, to 900 pesos to the dollar at the end of the year.

Twelve billion dollars in foreign loans injected into the economy during 1987 will ease the pain of the 1986 inflationary depression. The depression should end in 1987, but inflation will probably continue. Of the $12 billion in foreign loans, approximately $6 billion will be needed to service Mexico's foreign interest payments. This forecast is predicated on the Mexican government's optimistic projection that 1987 oil exports will earn $1.5 billion more in 1987 than in 1986. A further decrease in oil prices and failure of the new OPEC pricing agreement in 1987 would mean that the trade surplus would not reach the projected $2-3 billion. This could increase Mexico's interest payments to approximately $8 billion. Additionally, the government anticipates a $1.1 billion increase in non-oil exports borne of its competitive devaluations of the peso. This estimate assumes a recession-free OECD economic environment and containment of OECD protectionism, neither of which are certainties in 1987.

Any diversion of the remaining $6 billion will come out of the hide of the Mexican economy. Already the government has reduced its growth estimate for 1987 from 3.5% to a more realistic target of 2-3%. The domestic social pressures and the 1988 election campaign make it unlikely that the government will accept any lower growth rate. Political prioritization of growth and short-falls in projected export earnings together represent a primary avenue of possible renewed payment difficulties that Mexico could experience before the end of 1987.

Another avenue of possible payments difficulty is Mexico's continuing inflation and the depreciation of the peso. The persistent fiscal deficit of 1987, combined with social and political pressure on the government to reverse the 1986 depression, mean additional inflationary pressure. In order for the government to retard an explosion of its fiscal deficit, it will index prices of many goods to inflation. This will be done in order to ensure sufficient revenues. The need to subsidize consumption particularly in the election period will create pressure to increase wages. (At the end of 1986, real wages were only 57% of what they were at the end of 1978.)

Finally, the need to boost non-oil exports will mandate a government policy of competitive devaluation. This will also stoke inflationary fires. After rising substantially in 1986, inflation will probably continue to rise in 1987, perhaps reaching 150% by the end of the year. At the same time the peso will probably continue to depreciate to as low as 2000 pesos per dollar. The dynamics of rising inflation and sharply declining currency mean instability for Mexico, which could spark disinvestment and a consequent payments crisis.

In 1988, Mexico will continue to have huge deficits without the benefit of $12 billion in fresh money that it receives in 1987. Mexico's creditors are increasingly arguing that the dynamics defined above will generate a new payments crisis. The only question is, when?

Resolution of the next payments crisis will determine whether Mexico institutes fundamental internal structural reform or whether it can sufficiently modify the external environment to adjust and maintain existing structures and procedures. It is possible and desirable to combine domestic change with a more benign external environment. Whatever happens, it will have crucial implications for the prosperity, peace, and security of Mexico, the United States, and the world.