STRUCTURAL REFORM AND THE DEBT STRATEGY: THE MEXICAN CASE

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I. THE DEBT STRATEGY

The basic purpose of the "Program for Sustained Growth" proposed by Secretary of the Treasury Baker in October of 1985 (also called the Baker Plan) is to implement a practical debt strategy recognizing both political and economic realities. It focuses on the fundamental need for stronger growth in debtor nations as a prerequisite to solving the debt problem. Achieving strong growth and long-term development requires economic reforms by debtor nations to enable them to use domestic and external resources more efficiently, and supportive financing by the international financial institutions and the commercial banks.

The success of this strategy ultimately depends on the willingness of the debtor nations to initiate their own growth-oriented reforms, including both macroeconomic and structural elements. Most of the major debtor nations face a number of fundamental problems that need to be addressed in order to facilitate stronger growth and development.

First, these debtor nations' economic policies have tended to depend excessively on external borrowing. This has substantially increased those countries' external debt, without improving their ability to service that debt. While some supplementing of domestic savings with foreign financing is necessary for rapid growth, so is avoiding increasing debt at a pace that exceeds the debtor countries' capacity to service that debt. Debtor countries must reduce their dependence on foreign borrowing and enhance both domestic savings and non-debt financial flows to foster stronger growth.

It is essential to ensure that confidence, as the domestic economy improves, encourages new foreign direct investment and stimulates the repatriation of flight capital. It is necessary to implement policies which assist in reducing inflation, assuring positive real interest rates, and developing the domestic capital and financial markets. In

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addition, a more open investment climate and growth-oriented tax reforms will facilitate renewed confidence. Only the debtor nations themselves can create the economic conditions which attract new capital. For them to succeed, they must make this a top priority.

Second, debtor nations need to shift their development strategies toward a more externally-oriented approach. In much of Latin America, for example, highly protective trade regimes and domestic incentive systems have encouraged inefficient import substitution and provided a bias against export growth. These policies have skewed domestic resource allocation, insulated firms from international competition, and reduced incentives to control costs and innovate.

There is a need to stimulate more efficient allocation of resources and increase production of competitive goods for domestic use and export. This requires a process of liberalizing trade, more market-oriented pricing, and setting realistic exchange rates. This should be attempted in conjunction with development strategies in order to improve investment productivity.

Third, large public sectors, ranging from 30% to 60% of the gross national product in most Latin nations, have absorbed a substantial share of domestic savings and investment. During the 1970s and the early 1980s, the number of state-owned enterprises increased dramatically. For example, in 1982 Mexico had more than a thousand public sector enterprises. Such enterprises tend to be heavily subsidized and contribute to large government deficits.

II. PROGRESS UNDERWAY

Despite the relatively short period that has passed since the debt initiative was proposed, considerable progress has been made.

First, many debtors are already taking important steps toward increasing savings and investment, improving their economic efficiency, converting public enterprises to private enterprises, and encouraging the return of flight capital.

Second, the International Monetary Fund (IMF) has negotiated new standby programs with eight out of fifteen major debtors since October 1985, including new loan commitments of $4.7 billion.

Third, the World Bank has negotiated $2.9 billion in new policy-based loans with ten major debtors, and is discussing nearly $5 billion in additional policy-based loans for the fifteen major debtors. Aggregate World Bank loans to these debtors increased by 40% during its 1986 fiscal year. A substantially larger share of loans are
now based on structural policy reforms.

Finally, the commercial banks have agreed in principle to provide $10.3 billion in new loans including a $7 billion package for Mexico, a $320 million new money package for Nigeria, and a $220 million oil facility for Ecuador. The commercial banks have rescheduled nearly $110 billion in outstanding debts since October 1985. Other financing packages and rescheduling are also under discussion.

All of this has been done while external forces have been conducive to growth. International interest rates have declined by nearly four percentage points since 1984, saving the major debtors over $11 billion in interest payments annually. Recent fluctuations in the exchange rates among the major currencies should improve the export potential of debtors vis-à-vis countries with appreciating currencies. Furthermore, efforts are under way to achieve stronger growth in other industrial nations, and to open global markets through the new multilateral trade negotiations. Both should contribute to stronger markets for debtor nations' exports.

Progress in the United States economy may herald improvement for the others. The United States economic expansion is extending into its fifth year, exceeding in duration five of the previous seven expansions. There is every indication that it will continue unabated through 1987 and beyond. Inflation has decreased drastically since the early 1980s (with 1986 having the lowest rates than any year in more than two decades). Employment increased by 2.5 million jobs in 1986, and the prime interest rate declined by two full percentage points during the year.

These figures reflect solid economic performance, and should set the stage for a year of increased real economic growth and employment in 1987. Indeed, real growth is expected to average 3.25% during this year, one percentage point higher than the 1986 average. This should additionally benefit developing countries, supporting their efforts to achieve stronger growth under the debt strategy.

III. The Mexican Economic Program

The Mexican program fits squarely within the overall debt initiative, and provides an excellent example of those countries that are moving toward less government-directed, more market-oriented economies as a prerequisite to stronger growth. The Mexican program is based on a comprehensive three-year economic plan developed by the Mexicans. The plan is supported by a $1.5 billion
growth-oriented IMF standby program. This program exists in conjunction with $2.7 billion in net new disbursements by the World Bank and Inter-American Development Bank, in support of structural reforms, and with a $7 billion new money package by commercial banks. The Mexican program includes a number of important structural reforms, which require detailed discussion.

IV. PRIVATIZATION

The current Mexican government recognizes that reducing the role of the public sector in the Mexican economy is necessary for revitalizing, increasing efficiency, and enabling it to compete internationally. The government, therefore, has set the target of reducing the number of public companies from 1155 (in 1982) to 500 by the end of 1988. By mid 1986, the Mexican authorities had authorized reductions in the number of parastatals to 697 through sales, transfers or mergers. This was no easy task. For example, the liquidation of a steel mill in Monterrey resulted in a sizeable number of workers being displaced.

Unfortunately, the reduction in the number of parastatals has not proportionately impacted on the budget. About 75% of parastatal subsidies are concentrated in three entities—the Agriculture Marketing Agency, the Federal Electric Company and the Mexican Fertilizer Company. This concentration is one area of the federal budget where the Mexican government expects to make more progress in the future.

V. TRADE LIBERALIZATION

Mexico has also made progress in increasing the international competitiveness of its economy. Of key importance was the decision to join the General Agreement on Tariffs and Trade (GATT). As part of its accession to GATT, Mexico has undertaken significant trade liberalization measures, replacing licenses with tariffs for all but 436 of its import items and reducing tariffs on over 4,000 import items. Mexico has also announced new export promotion measures consisting of tax rebates, credit facilities, relaxation of exchange controls, and automatic approval of imports to be used in production for export.

In support of these trade liberalizing measures, Mexico has received a World Bank trade policy loan for $500 million. Additional trade policy loans are now under consideration to support further reforms.
VI. FOREIGN DIRECT INVESTMENT

Mexico has also made progress in one area that received considerable criticism in the past—foreign investment. During the past year, the Mexican government has begun applying its foreign investment law more liberally, realizing that relying mainly on external borrowing to finance economic development puts too heavy a burden on the economy. The government has reduced red tape for foreign investors trying to receive approval to purchase Mexican equities; more applications have been approved. For example, IBM, Hewlett-Packard, and Honda have received permission to establish 100%-owned subsidiaries. Recently, the government also introduced changes in its intellectual property law, which have partially satisfied United States Government demands for patent protection.

Finally, in the sensitive pharmaceutical area, the Mexican government has agreed to provide full patent protection for production processes phased in over ten years, and has made changes in generic labeling requirements. Additionally, the government has pledged non-discriminating marketing rights to non-Mexican firms. Nevertheless, in this area as in others, there is concern about the use of local content and export performance requirements. Further progress should be made to reduce impediments to foreign investment.

VII. DEBT/EQUITY SWAPS

Closely linked to promotion of foreign investment is a new Mexican policy permitting debt/equity swaps. Under these provisions, foreign investors who have purchased Mexican government foreign debt obligations (mainly from commercial banks at a substantial discount) can exchange these debt instruments for pesos at the Central Bank for nearly the original peso value of the debt. A similar program in Chile is considered to have contributed to an expansion of foreign investment inflow there.

The swap program in Mexico encourages tourism investments or export-oriented industries that will expand foreign exchange earnings. Working capital and the purchase of imported goods cannot be financed through swaps because such transactions are not permanent additions to Mexico's capital stock.

The biggest attraction of debt/equity swaps could be for residents who take advantage of the discount on Mexican debt instruments to repatriate some of the vast sums of money and liquid in-
vestments held abroad. Current regulations also exclude foreign portfolio investors from using swaps to purchase Mexican financial assets.

Nevertheless, between May 1986 and mid-January 1987, the Mexican government retired almost $520 million in public sector debt under its program for substituting public sector debt with investment. The auto industry has dominated the debt/equity swap program with $340 million equivalent in peso disbursements. Chrysler’s was the largest swap at $110 million, while Ford has had a $50 million swap. In total, 130 applications for swaps were received and 60 have been approved so far. Reportedly 70 debt/equity swap applications were received in January 1987 alone, verifying the popularity of the program. The Mexican government estimates that $660 million in private sector debt was converted into equity in Mexican debtor companies in 1986.

The potential of the debt/equity swap facility as an instrument for encouraging foreign capital inflows is considerable. The potential for this result is considerable, as has clearly been demonstrated in Chile and other countries. According to the Mexican government, however, the swaps’ impact on the country’s $100 billion plus debt service burden is marginal. Apparently, the program’s inflationary impact was considerable causing the government of Mexico to suspend it in early November 1987. The program is expected to resume at reduced levels.

CONCLUSION

The debt strategy, economic program, privatization, trade liberalization, and foreign investment are some of the areas where the Mexican Government has made recent progress in its overall effort to improve the efficiency of the economy. The task has not been easy, nor is it complete. Much remains to be done, and the government is committed to continue the effort.

When one reads about Mexico in the United States press, the focus is usually on what is wrong with the Mexican economy. While Americans recognize that Mexico’s economic problems are not fully resolved, we are also concerned that, regarding Mexico, we are quick to criticize and slow to praise. Mexico needs our support to achieve stronger economic growth and to improve the quality of life for its citizens. We must provide that support for a growing Mexican economy. It is in their interest as well as our own.

For the debt strategy to succeed, it is essential that all of the
following elements be met:

First, industrial nations must maintain sufficiently strong growth in their own economies, and they must provide access to their markets for developing nations' exports. Trade protectionism can only hurt everyone.

Second, the commercial banks must do their part in providing new loans to the debtor nations, and must resolve among themselves any differences about base periods for new loans, exit vehicles for those who want to stop lending, and similar issues.

Third, it is essential to maintain creditor nations' and United States Congressional support for multilateral development banks. In addition, it is important for the United States to restore quickly its funding shortfalls to the multilateral development banks. If these shortfalls continue, our allies might conclude that we are not committed to these organizations. Such an unwarranted conclusion would adversely affect the ability of the United States to continue to exercise leadership in the multilateral development banks and in the broader international economic arena. This would, in turn, limit the effectiveness of United States action to achieve crucial foreign policy objectives.

Finally, the debtor nations themselves must maintain the progress now under way by continuing their efforts to improve their growth prospects through additional reforms at home.

With patience, sensitivity, and mutual effort in all of these areas, the international debt situation can remain manageable in the period ahead.