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FOR MEXICO'S AILING ECONOMY, TIME RUNS SHORT

INTRODUCTION

Cesar Albondigas and his brother, Jorge, own a small tailor shop in the Mexican port city of Veracruz. The Albondigas brothers wish to begin manufacturing souvenir T-shirts to sell to tourists and sailors. Cesar applies for a business loan at the state-owned bank. After waiting seven months, he borrows 50,000 pesos from a moneylender to buy a "birthday present" for the loan officer. His loan is disbursed the following week. The brothers then are told by the local union chief that the union will select six of their ten employees for them. Two of the employees turn out to be relatives of the union boss. They show up for work only on Tuesdays and Thursdays. When Cesar fires them, his telephone and electrical service are mysteriously cut off, and his cloth supplier in Monterrey informs him that there will be a delay of uncertain duration in his next shipment. When the bank calls in the Albondigas brothers' loan early, they close up their little factory and make plans to emigrate illegally to the United States....

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The economic tribulations and frustrations of Cesar and Jorge Albondigas (fictional names and characters in an all too typically real situation) are the tribulations and frustrations of Mexico. In starkly personal terms, they explain why, despite an abundance of natural resources and a hard working and entrepreneurial people, Mexico is the "sick man" of North America. Yet just a decade ago it was viewed as a model for other

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This is the fourth in a series of Heritage studies on Mexico. It was preceded by Backgrounder No. 581, "Mexico's Many Faces" (May 19, 1987), Backgrounder No. 575, "Mexico: The Key Players" (April 4, 1987), and Backgrounder No. 573, "Keys to Understanding Mexico: Challenges to the Ruling PRI" (April 7, 1987). Future papers will examine other aspects of Mexican policy and development.

developing countries. Today, Mexico is crushed by a $105 billion foreign debt, an annual inflation rate of 114 percent, continuing capital flight, and a declining current account balance. Even with world oil prices edging up from last year's lows, it is clear that there is little hope for a long-term economic turnaround during the remainder of this decade without sweeping economic and political reforms.

Deadly Combination. These reforms will have to address the paternalistic political system that is the fundamental cause of Mexico's economic ills. As discovered by the Albondigas brothers, a deadly combination of statism and institutionalized corruption stifles individual initiative. The system fosters corruption by concentrating control of vast financial resources in the hands of a relative handful of officials accountable only to themselves. It is not surprising that the popular view is that the government has forgotten the common man and instead misdirects investment and wastes billions of pesos on unproductive enterprises.

Under pressure from the United States and international financial institutions, the Mexican government has enacted some structural and sectoral economic reforms. Yet these have been largely cosmetic. Without genuine reforms that allow economic growth and greater pluralism, Mexico's problems will mount until radicals exploit them politically. For Mexico and its needed genuine and fundamental economic liberalization, time is running short.

ECONOMIC STRENGTHS

Mexico is rich in human and material resources. Its citizens through the years have contributed significantly to the worlds of art, literature, and international business. With a population of 80 million (the globe's eleventh most populous country), it is impressive that the adult literacy rate is 74 percent, one of the highest in the developing world. Mexicans, moreover, have demonstrated a remarkable capability for resilience and private initiative, as demonstrated by their stunning response to the 1985 Mexico City earthquake.[1]

In contrast to many other developing countries, Mexico is rich in natural resources and industrial capacity. The nation's estimated oil deposits of 49 billion barrels make it the world's fourth largest in terms of petroleum production and fifth in terms of reserves. Mexico also ranks seventh in the world in natural gas reserves, has proved coal deposits of 643 million metric tons (compared to 490 billion metric tons in the U.S.), and is one of the world's largest silver producers. The country also contains important deposits of copper, zinc, lead, fluorspar, and iron ore.

Agriculture, comprising 9 percent of the country's gross domestic product (GDP), is Mexico's largest industrial sector. Mexico ranks tenth in the world in terms of GDP originating from manufacturing and alone accounts for more than 10 percent of the developing world's total manufacturing output. In absolute terms, the value of Mexico's industrial output is twice that of South Korea and more than five times that of Israel's.[2]

ECONOMIC WEAKNESSES

Despite Mexico's economic strengths and enormous potential, the economy in recent years has found itself in a crisis so serious that only periodic infusions of external financing

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1. The Wall Street Journal, October 15, 1985.

2. James H. Street, "Mexico's Development Crisis," Current History, March 1987, p. 101.

have kept it from collapsing. Last year, GDP fell 3.5 percent. The peso, which five years ago was trading at 24 to the dollar, has suffered such severe devaluations that today one U.S. dollar buys more than 1,000 pesos.[3] Mexico's external debt has tripled in less than a decade. Servicing the debt now consumes 16 percent of GDP. While the debt soars, at least $6 billion to $7 billion per year is lost in capital flight, as Mexicans secretly move assets abroad where they are presumed to be safer or to earn a better real rate of return than they would if kept at home in Mexico. Meanwhile the current 114 percent inflation rate means that real per capita income is declining steadily, while nearly half of the labor force is unemployed or underemployed.

Falling Output. Last year was particularly bleak for the Mexican economy. In addition to the sharp fall in the peso's value, agricultural production slipped by an estimated 2.9 percent, industrial production was off 5 percent, and domestic commerce declined.[4] Increasing numbers of Mexico's entrepreneurial class sought better opportunities elsewhere, as unprecedented numbers of middle-class Mexicans attempted to slip into the U.S. illegally.[5]

Mexico's rapid population growth--a demographic factor which, if coupled with a vibrant economy, could be a great resource--contributes to economic destabilization. Although its current annual population growth rate of 2.9 percent has declined from the 3.3 percent clip of the 1960s, Mexico still has one of the fastest growing populations in the world. Nearly 60 percent of Mexicans are under age 20. By the turn of the century, the Mexican population is expected to be 110 million, growing to 182 million by 2050.[6]

This burgeoning population means that one million Mexicans annually enter the Mexican labor market. To provide jobs for them, the GDP needs to expand at 7 to 8 percent. Last year's decline in GDP dims employment prospects for young Mexicans. There has been only a minimal increase in new jobs. A notable exception is the free market-oriented "Maquiladora" program, whose payroll jumped about 25 percent last year, adding about 50,000 new jobs and now employing a quarter million Mexicans.

THE BURGEONING PUBLIC SECTOR

The Mexican government is publicly committed to a mixed economy. Its policies, however, contradict this. Following the 1982 nationalization of Mexico's private banks, government ownership of the means of production grew to 55 percent, leaving only 45 percent in private hands. More important perhaps than state ownership of key industries is a pervasive, yet subtle, control that the government exerts over the private sector through a system of complicated regulations, corruption, and an alliance with organized labor. This is what suffocates the entrepreneurial efforts of the likes of the Albondigas brothers.

The state owns more than 900 enterprises, including banks, hotels, factories, shipping and air lines, and major utilities.[7] Last year, to qualify for a $12 billion international rescue

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3. The Washington Post, February 8, 1987, p. H2.

4. Banco Nacional de Mexico, Review of the Economic Situation in Mexico, November 1986, pp. 440, 442, 448.

5. Information from FAIR (Federation for American Immigration Reform), Washington, D.C.

6. The World Bank, World Development Report, 1984 (New York: Oxford University Press, 1984), p. 193.

7. U.S. Department of Commerce, "Foreign Economic Trends and Their Implications for the United States - Mexico," November, 1986, p. 13.

package, Mexico promised to reduce the size of its bloated and corrupt bureaucracy. So far little has happened beyond a reshuffling of state employees. Mexico also has made a pretense of divesting parastatal (state-owned) enterprises to satisfy its international creditors' demands for structural reforms. This February, for instance, the government offered to the public 34 percent of the stock in two major Mexican national banks. Most of these shares, however, were sold beforehand at bargain prices to insiders and supporters of the ruling political party, the Institutional Revolutionary Party or PRI.[8]

An office manager for a small Mexican company discovered that, after the company moved to new quarters, mail deliveries stopped, and the missing mail could not be found. One day, out of exasperation, the office manager gave the new postman 5,000 pesos and asked him to try to find the missing mail. He was back in a day or two with it. Now, once a month, the postman is given 5,000 pesos and a bottle of tequila, and the company has no more mail problems.[9]

Institutionalized Corruption. Corruption in Mexico is so institutionalized that it is accepted as a necessary part of any transaction, from parking a car to winning high political office. Bribes grease the wheels of Mexico's ponderous government bureaucracy. Americans interested in investing in Mexico often give up rather than wade through the swamp of corruption. For example, after the U.S. Foreign Corrupt Practices Act of 1978 prohibited U.S. companies from paying bribes abroad, American subsidiaries in Mexico insisted that they lost business to European and Japanese competitors who were not subject to similar restraints.[10] Corruption, of course, also impedes structural and sectoral economic reform, as those who benefit from graft strongly oppose changes that might jeopardize their privileged status.

State ownership of the giant oil industry, PEMEX, and other enterprises has enabled corrupt officials to steal billions of pesos from the state. Jorge Diaz Serrano, a Mexican federal senator and director general of PEMEX during the late 1970s, was accused of embezzling $34 million on the purchase of two oil tankers. According to Alan Riding of The New York Times, former president Luis Echeverria, in office from 1970 to 1976, is believed to have stolen between $300 million and $1 billion during his term in office, while his successor, Jose Lopez Portillo became one of the richest men in the world at the expense of his fellow citizens, misappropriating between $1 billion and $3 billion.[11]

THE PRIVATE SECTOR

Roadblocks to Private Investment

Despite Mexico's serious need for venture capital to spur economic growth, government policies seem designed to discourage domestic and foreign direct investment. The spate of

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8. The New York Times, February 23, 1987.

9. William Stockton, "Bribes Are Called a Way of Life for the Mexicans," The New York Times, October 25, 1986, p. 3.

10. Alan Riding, Distant Neighbors (New York: Alfred A. Knopf, 1985), pp. 131-133.

11. Riding, op. cit., p. 123.

nationalizations in the 1970s and early 1980s, combined with the government's rhetorical hostility toward businessmen, spawned uncertainty and slowed private investment. In this period, instead of putting their money into productive investments in their own country, wary Mexicans sent some $50 billion abroad, much of it going into U.S. real estate and bank accounts.

According to the U.S. Commerce Department, Mexico, "in theory" welcomes foreign direct investment, yet, in reality, "foreign investment as a whole has been subject to increasing government scrutiny and regulation."[12] To be sure, the current administration of President Miguel de la Madrid has sought to promote foreign investment by stating that it will be "flexible" in administering the restrictive Foreign Investment Law. Actually the de la Madrid government is now officially encouraging foreign investment, both in rhetoric and otherwise. The impediments to business are more subtle--corruption and bureaucratic obstacles.

Whims of Officials. In theory, foreigners are allowed to own up to 100 percent of a Mexican company's shares at the discretion of the foreign investment authorities. In fact, this appears to be restricted mainly to the free zone or Maquiladora program. Foreigners are also now permitted to buy shares in Mexican businesses, as long as the purchases do not exceed 10 percent of the share capital of the enterprise and total foreign investment does not exceed 40 percent. In fact, few foreign investors are willing to risk large sums in a country whose laws are subject to the interpretive whims of officials. Current agreements may be ruled invalid by President de la Madrid's successor, a point supported by a decline of more than 400 percent in the foreign direct investment inflow to Mexico between 1982 and 1984.[13]

The Maquiladora Program

In 1965, the Mexican government launched a program to create jobs and spur economic development along the northern zone that borders the U.S. Called " Maquiladora"--roughly meaning "hands on"--it has sought to attract subassembly operations to the region. Plants participating in the program are allowed to import raw materials, components, and machinery free of Mexican duties, provided that most of the production is exported. A few Maquiladora plants recently have been allowed to sell up to 20 percent of their output in Mexico.[14]

The Maquiladora program has become one of the most important sectors of the Mexican economy, second only to exports of oil and petroleum as a foreign exchange earner. The U.S. General Accounting Office predicts that the Maquiladora program by 1995 could comprise 1,500 factories employing one million workers.[15] The modernization and growth of the Maquiladora program, however, is constrained by the inadequate infrastructure, as well as a shortage of skilled labor, especially in high technology operations.

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12. U.S. Department of Commerce, International Trade Administration, Overseas Business Reports series, "Investing in Mexico," December 1985, p. 3.

13. United Nations, Foreign Direct Investment in Latin America: Recent Trends, Prospects and Policy Issues, August 1986, p. 3.

14. U.S. General Accounting Office, Commerce Department Conference on Mexico's Maquiladora Program, December 10, 1986, pp. 6-7.

15. Ibid., p. 8.

Exponential Success. The Maquiladora program has been phenomenally successful--in some Mexican cities growth has been exponential. Chihuahua, for example, doubled Maquiladora employment in 1985. Although there has been harassment of Maquiladoras by Mexican unions, the relatively large number of women employed has probably kept this to a minimum, as few women belong to Mexican unions. The Mexican government has also adopted a more or less laissez-faire policy toward the industry, most likely because the Maquiladoras are Mexico's second largest source of foreign exchange.[16]

MEXICO'S ROAD TO STATISM

The powerful government influence in every facet of the Mexican economy--as well as its politics, culture, and society--is rooted in the national desire for a strong central authority after decades of weak governments and concomitant instability following independence from Spain in 1821. The violence and widespread suffering brought about by the Mexican Revolution of 1910 to 1920 deeply shaped how Mexicans view politics by molding a consensus favoring consolidation of political power in a single entity. After various incarnations, the political movement Institutional Revolutionary Party (PRI) emerged as that entity.

The PRI's system of institutionalized authoritarianism worked well for a number of years. It provided stability and impetus to move Mexico from a largely agrarian, pre-capitalist society to a modern industrialized state. However, instead of adapting to a changing economy and society in response to Mexico's development, the PRI became ossified, resisting the changes necessary for continuing stability.

Blessing and Curse. The discovery of massive oil deposits in the Gulf of Mexico in the 1970s proved to be a blessing and a curse. While providing modern Mexico with an extraordinary bonanza of wealth, the oil also raised false expectations and masked the severe mismanagement and antibusiness policies of President Luis Echeverria (1970-1976). His administration made the huge government bureaucracy even more interventionist by bringing in young, university-educated specialists, or technicos. Echeverria assumed that market forces had little bearing on a nation's economy and believed that the inefficiencies of a statist economic system could be rectified through technical expertise.

Echeverria's policies and hostility to the business community led to a significant reduction in private investment. A leading player in the United Nations debate over the "New International Economic Order," Echeverria expropriated private lands on a massive scale and frightened away foreign investors by adopting a strongly pro-Cuban, anti-Western foreign policy. At the same time, the government began heavy borrowing abroad to finance its own growth and development projects in every economic sector. In 1970, public spending accounted for 26 percent of GDP; when Echeverria left office in 1976 it was 35 percent and by 1982 more than 50 percent of GDP.

Fear of Default. The technicos, moreover, were not able to manage the state's development projects. There was administrative confusion, squandering of resources, and heavy capital flight of the borrowed funds. The Mexican economy, which had been relatively stable during the 1960s, sunk into recession. Fearing that Mexico might default on what was then a comparatively minor external public debt of $27 billion, the U.S. joined with the International Monetary Fund (IMF) and the World Bank in 1976 in an extraordinary financial rescue effort.

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16. Council of the Americas, Washington Report, February 1987, p. 1.

The exploitation of Mexico's oil discoveries allowed President Lopez Portillo (1976-1982) to avoid the austerity measures that, regardless of their value, were prescribed by the IMF. He thus also avoided addressing the structural and sectoral problems that undermined the Mexican economy. A massive infusion of petrodollars allowed the Lopez Portillo government to launch a national development program, dwarfing that of his predecessor. This program, largely the creation of Mexico's current President, Miguel de la Madrid, who was then Minister of Planning and Budget, called for construction of state-owned industrial seaports, steel mills, automobile plants, and other factories. All were protected by high tariffs under the government's strict import substitution policy, which erected high levies and other barriers to imports ostensibly to force development of domestic-oriented industries.

Consumer Buying Binge. Determined to make the national development program a success before the expiration of his presidential term, Lopez Portillo accelerated the projects. This led to poor planning, considerable inefficiency, and widespread corruption. In the meantime, Mexicans went on a gigantic consumer buying spree fueled by the state's infusion of billions into the income flow and an overvalued peso. Because the rudimentary Mexican industrial sector was unable to meet consumer demands, imports of smuggled goods soared. The result: petrodollars flowed out almost as fast as they flowed in.[17]

With Mexico's 1982 external public debt standing at more than $80 billion (three times that of the "crisis" of 1976), the Reagan Administration launched another rescue effort to prevent a default. Yet instead of acknowledging that the true causes of his nation's economic debacle were government mismanagement and corruption, President Lopez Portillo sought a private sector scapegoat. He accused the private banking community of undermining the economy by sending too many dollars abroad. Using this lame accusation as an excuse, on September 1, 1982, he nationalized the banking system along with all of its investment holdings. To halt the dollar exodus and stabilize the peso, the Mexican government imposed exchange controls. These actions shocked the international financial community. Predictably, new investment in Mexico, foreign and domestic, dried up.

DE LA MADRID'S POLICIES

Miguel de la Madrid assumed the presidency in December 1982 bearing the burden of executing the strict austerity plan that comprised the conditions of a new $3.9 billion IMF loan. These measures were designed to reduce inflation, cut imports and the public sector deficit by two-thirds, rebuild reserves, and produce trade and current account surpluses. Although de la Madrid complied with the austerity measures, the fall in oil prices in 1984 led to further economic contraction, steady devaluation of the peso, and unchecked dollar outflow.

Yet another bailout for Mexico--this one consisting of $12 billion in new loans over 18 months--was put together by U.S. Treasury Secretary James Baker last summer. The latest rescue called for private U.S. banks to provide roughly half of new lending, with the other half to be furnished by multilaterals. The bankers were reluctant to contribute to the bailout unless Mexico agreed to major structural economic reforms.

Token Steps Toward Reform. De la Madrid agreed to the conditions of the new loan, promising to reduce the government deficit, privatize or dismantle parastatals, decontrol prices, reduce subsidies, allow the peso to float, cut the size of the government

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17. For example, although Mexico's export earnings increased substantially during the late 1970s and early 1980s, the balance of payments current account showed a deficit in 1981 and 1982, and there was only a temporary increase in monetary reserves. Street, op. cit., p. 102.

bureaucracy, and join the General Agreement on Tariffs and Trade (GATT). Mexico's entry into GATT ostensibly obligated it to reduce protectionism and force its industries to become more efficient by facing competition in the international marketplace.

The results so far have been mixed. In fact, evidence suggests that the latest loan bailout, coupled with a rise in oil prices and a decline in international interest rates, is being used as a windfall to allow continuation of the PRI's disastrous statist policies. Only token steps toward structural and sectoral reforms have been taken so far. Other "reforms," such as retrenchment of the bureaucracy, have simply involved a reshuffling of government workers with no real reduction in total personnel. No significant government ministries have been abolished, there has been no repeal of the law requiring majority Mexican ownership of enterprises, and returning the banks to the private sector has been a sham.

Ignoring the Evidence. Even though de la Madrid may be sincere about privatizing parastatals, the sale of state-owned enterprises has been fiercely resisted by the ruling PRI and its leftist allies in the labor movement and academia. Many influential Mexicans reportedly agree with leftist political scientist Froylan Lopez Narvaez' sentiments that "reforms do not help the economy and are contrary to the socialistic aims of the nation."[18] Other Mexicans, of course, and almost all economists in nations lending to Mexico disagree with this. They cite overwhelming historical evidence that the free market reforms are the only prescription that can aid the ailing economy.

Although the government-owned Acero steel plant in Monterrey has been shut because of unprofitability, the government has sold only relatively minor state assets such as a hotel chain, a bottle company, a bicycle factory, and a few other small enterprises. Even the actual number of parastatals is uncertain. One U.S. Commerce Department report in fact indicates that the number of parastatals may not have been cut at all. The report cites a leading Mexican financial newspaper that, while Mexico had 849 parastatals in November 1982, the number was up to 971 last November.[19]

De la Madrid recently said that his goal was to cut in half the state-owned entities. Some of this, however, will not be by privatization.[20] Even the Mexican government admits that about 50 state-owned enterprises simply will be merged with others, while other sources say that many of the other parastatals scheduled to be sold or dissolved exist only on paper.[21] The six major state companies,[22] which together account for more than 20 percent of the public sector deficit, are not being considered for divestment.

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18. Robert M. Press, "Mexicans split on issue of economic reform," The Christian Science Monitor, September 11, 1986, p. 12.

19. U.S. Department of Commerce, "Foreign Economic Trends and Their Implications for the United States - Mexico," November 1986, p. 13.

20. Mexico City XEW Television Network, March 27, 1987; FBIS Latin America, April 2, 1987, p. M2.

21. Larry Rohter, "Divestment Efforts in Mexico Debated," The New York Times, April 14, 1987, p. D10.

22. These are Conasupo (distributer of basic necessities to low-income groups), the federal electricity monopoly, and the state sugar, steel, railway, and fertilizer monopolies.

MEXICO'S ECONOMIC FUTURE

Despite entrenched PRI opposition to reforms, Mexico's private sector appears to be responding cautiously to the relaxation of government controls forced by international loan conditionality. Whether these changes are to be permanent or merely tactical will only be revealed by future PRI actions. The government's 1987 budget promises to fuel moderate economic growth by giving businesses access to 20 percent more credit, in real terms, than in 1986. The American Express Company has negotiated a deal with the Mexican government to convert $100 million (16 percent of Mexico's debt to the U.S. company) into equity in joint ventures to build hotels in major Mexican tourist areas.[23]

Over the past year, foreign companies have swapped about $1 billion of Mexico's external debt for equity, and a further $700 million is being processed. Mexican investors are also being allowed to buy public sector foreign debt with dollars and convert it at a discount to peso investments. Demand for debt/equity swaps is reportedly so great that the Mexican Finance Ministry has set a limit of $100 million per month on such conversions. Although wary of the concept at first, the Mexican government now views debt/equity swaps as a means of repatriating the $30 billion to $50 billion believed held abroad by Mexican nationals.[24] Another encouraging sign is the announcement last week that the Mexican government will sell its monopoly share in Mexicana airlines as part of the continuing effort to slim down the public sector.[25]

Lingering Economic Malaise. Other signs of recovery are appearing. The Mexican stock market rallied in February indicating investor confidence in anticipation of disbursements from the new commercial bank loan package as well as the government's promised incentives for private sector investment. The cheaper peso, combined with the sharply higher prices facing U.S. visitors to Europe, is expected to revitalize the Mexican tourist industry. Real GDP per capita is expected to grow 2 percent in 1987, and oil export earnings are expected to rebound by nearly a third, to $8 billion for the year.[26] It is expected, however, that inflation will top 125 percent, the government deficit will increase as a percentage of GDP, and the current account balance will decline by 1.2 percent, indicating that the economic malaise has not been cured.

CONCLUSION

Without fundamental reforms, Western lenders may either tire of bailing out Mexico or not have the resources to do so. This certainly is the message of the recent decision by Citicorp to begin planning for write-offs of its Third World loan portfolio. Although the Mexican government's recent overtures to the private sector appear promising, they may be only a tactic to spur some growth as the 1988 national election approaches. There is fear among economists that, once Mexico receives a new infusion of foreign loans, it will relax its monetary reins on the public sector and disregard its promised structural reforms.

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23. The Wall Street Journal, March 19, 1987.

24. Financial Times, March 3, 1987. See also Morris B. Goldman, ed., Debt/Equity Conversion: A Strategy for Easing Third World Debt (Washington, D.C.: The Heritage Foundation, 1987).

25. Financial Times, May 27, 1982, p. 28.

26. International Country Risk Guide, February 1987, p. 20.

There also is a possibility that pessimistic, or realistic, Mexican investors will put their share of the new loan dollars into paper assets rather than productive ones, thus continuing the capital flight. Without confidence in Mexico's future, investors will be unwilling to risk their capital internally.

Mexico has the resources to become a lasting "success story" for the developing world. Whether it becomes so is ultimately a question of whether Mexico's leaders have the political sense and courage to begin a fundamental dismantling of state control and ownership of Mexico's economy.

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