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Mexico:

the plan and the

current situation

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Two disequilibria are intertwined in the Mexican economy: incomplete modernization of institutions and production, and external imbalances that have made the country unable to service its external debt. In a context of liberalization, this combination has been conducive to sharp depreciations, as evidenced by recent events. The success of the adjustment exercise will depend on the progress of the retooling and expansion of production. This article analyses the main objectives of the National Development Plan for 1995-2000 and the policies that have been implemented to realize them, and shows that the current situation is a patchwork of progress and setbacks. Examples of progress are the restoration of a number of macroeconomic equilibria, an increase in exports, a tight monetary policy, the stock exchange's recovery and a revitalizing dynamic that prevents fiscal and monetary discipline from crumbling. Setbacks include the worst depression of the last 50 years, with concomitant falls in investment and savings; the undermining of the financial system, the doubling of open unemployment and a drop in real wages. After considering various socio-political factors in the analysis, the author concludes that the National Development Plan is a reflection of an appropriate long-term view, but that it is inadequately coordinated with short-term adjustment policies, so that it cannot be implemented until the post-devaluation situation has been resolved, which will entail the adoption of recessionary measures. The principal weakness of the chosen strategy may be its adoption of sequential formulas. What is needed is to devise integrative formulas capable of coping with the complexity of the economic modernization process.

I

Introduction

The Mexican economy continues to be profoundly affected by two disequilibria which, by feeding back into each other, have had a devastating effect on production and employment. The first is structural in nature: the modernization of the country's institutions and production facilities is still not complete, and this has hindered the formation of linkages with the international economy and made it more difficult to fully absorb the adjustments associated with the changing model of development. The second problem is one of liquidity: internal resources are not sufficient to deal with the vast accumulation of external debt maturities.

The vicious circles set in motion by these two imbalances are of a complexity that goes far beyond the economic sphere. Briefly, their direct interaction may be summarized as follows: the opening-up of the economy, in combination with the insufficient competitiveness of the bulk of Mexico's agricultural and industrial enterprises from 1988 onwards, produced growing deficits in the balance-of-payments current account which had to be funded, to a large extent, through short-term or extremely short-term external credits; side-effects of this situation included consumerism and a reduction in national savings.

Structural deficiencies eventually made it impossible to continue financing external payments, not so much because of capital flight, but because incoming flows—a monthly average of US\$2.5 billion during 1993—began to dry up, foreign exchange reserves

evaporated and the exchange rate depreciated sharply. This devaluation triggered the collapse of the entire existing structure of economic strategy, and the Government was therefore obliged to begin rebalancing the economy all over again, no matter what the cost. However, it was now a question not simply of easing inflationary pressures, but of making a concerted effort to narrow the gap between purchases and sales, servicing the debt and regaining much-needed international prestige.

In response to these two pressures, the Government has chosen a recessionary route to adjustment. This also accords with the wishes of external creditors. The social costs are exceedingly high, and industry and agriculture will emerge weaker overall. Like it or not, the demands of stabilization are hampering the retooling and expansion of production, on which the fate of the export strategy, employment and indeed the reestablishment of the capacity for growth itself will depend in the long term.

Nevertheless, the short-term strategy has been designed to produce a sharp, intense and inevitably painful recession; the hope is that the recession will be short-lived and will enable the country to re-embark on the road to prosperity and well-being under improved circumstances. To this end, a fiscal austerity policy has been introduced, along with a tight monetary policy and a floating exchange rate.¹

¹ Trade liberalization, the abolition of capital controls, and other measures to open up the financial sector of the economy (such as the acquisition of public domestic debt paper by external agents) limited the autonomy of economic policy and hence its ability to absorb external shocks or changes in the behaviour of international

financial markets. There is a clear incongruity between the structure of trade (a mere 100 companies account for over three quarters of export earnings) and the creation of a liberalized financial regime, particularly when the exchange rate is used as an instrument to maintain domestic price equilibrium.

II

The main features of the Plan

The National Development Plan ² is a general programming document. It does not enter into detail on short-term policies, but rather delineates State action in broad terms.

This document, perhaps like no other before it, eschews the overly economic approach of previous programmes in order to propose a set of goals which address the essence of Mexican civil society: the further development of national sovereignty and of the rule of law; democratic modernization; the reduction of distributive inequalities; and renewed access to steady, sustainable growth.

This updated reformulation of guiding principles takes on special importance in a rapidly changing world where new technologies are constantly being developed, national frontiers are fading away, new private actors –which overshadow the previously dominant influence wielded by Governments– are emerging and new links are being forged through the conclusion of treaties that oblige us to construct and abide by a new international order.

In the same way, the programmatic core for this institutional remodelling effort contains a number of innovative elements: it responds to demands voiced by the population and transmitted from the bottom up, it brings legislation into line with the economic regime which the country hopes to establish, and it is geared to protecting human rights and the environment. This society, faced with the threat of corruption, uncertainty, disorder and acts of impunity, and crying out for the reestablishment of, and respect for,

a State based on the rule of law, yearns for a reaffirmation of individual and property rights, a guarantee of public safety and of the impartiality of justice, a reversal of the deterioration of the environment and ways of combatting drug trafficking.

The Plan embodies the idea of rapid advancement towards a modern democracy. Mexico aspires to be not only a State based on the rule of law, but also a democratic, multi-party State in which the transfer of power by electoral means no longer causes socio-political trauma or leads to a decline in standards of public administration.

Neither democratization nor a State based on the rule of law will be possible without a conscious effort to right a wrong that has deeply entrenched historical roots: the inequality of income distribution. Mexico has always been a land of contrasts, but in recent years its social polarization has become appallingly pronounced. The Plan's analysis of this situation is unusually candid, and it makes a number of novel proposals. For example, it explicitly recommends using active policies both to deal with demographic issues and to attack extreme poverty.

This may explain why the Plan comes back to the idea of development as fundamental to a systematic improvement of the welfare of the population.

Further, it proposes strengthening the federalist system in the political and economic domains. A review of the division of functions among the federation, states and municipalities will make it possible to come up with responses that are geared to the specificities and civic aspirations of each area.

III

The short term and the long term

Thus far we have dealt with the basic approaches which determine the lines of government action to be pursued in 1995-2000. As regards the instrumental

links designed to bridge the gap between these broad lines of action and measures for dealing with the short-term crisis in order to form a coherent whole, the document is often on target, but does not deal fully with the question.

In the area of monetary and exchange-rate policy, the document proposes an initial, very important

² See Mexico, Poder Ejecutivo Federal (1995) and Grupo de Economistas Asociados (1995).

link with export strategy. The exchange rate will essentially be determined by market forces, and efforts will be made both to maintain its real parity in order to prevent productivity gains from leaching away to the exterior and to control excessive external borrowing.

Savings and its promotion –by means of fiscal and institutional instruments, among others– are an extremely high priority. The country and its companies need to recover the autonomy which comes from financing investment with predominantly domestic funds.

A third link between the long and the short term is forged by what are called sectoral policies. In the face of increasingly public demands on the part of the business community, the document only reluctantly acknowledges the need for industrial policies designed to facilitate the modernization of production, particularly in small and medium-sized industries.³

As regards the alarming imbalances in the country's labour markets, the Plan's proposals are cautious and indirect. As is to be expected, it calls for measures to enhance human capital –such as education, training and technical refresher courses– and to reduce payroll taxes, which keep wages artificially high and depress the demand for labour. In light of this and of rising unemployment, it is to be expected that labour laws will be revised with a view to making them more flexible. However, solving the problem of insufficient job creation is mainly considered as a by-product of investment and of the resulting recovery. Similarly, wage improvements are made dependent on productivity increases.

This approach is not carried through to its logical conclusion here, however; instead this is left up to a subsequent analysis of the factors which “affect the production sector's absorption of labour” (Mexico, Poder Ejecutivo Federal, 1995, p. 151). Perhaps it could not be otherwise, considering that the recessionary adjustment policy and the retooling of pro-

duction capacity in those Mexican firms that have survived liberalization have costs that are reflected in unemployment.⁴ Yet, in view of the stifling effects of this situation, it would be socially and politically justifiable to introduce active employment policies and expand the emergency programmes run by the Ministry of Social Development and other government departments, especially since the worldwide technological revolution and economic globalization have severed the organic links between growth and employment.

It is undoubtedly of prime importance to restore the country's major macroeconomic equilibria. There is an urgent need to promote actions and processes to eliminate the balance-of-payments deficit and price differentials. Equally pressing is the need to realign labour laws to reflect the realities of international competition in a country which is moving away from protectionism. However, under current circumstances, abandoning the labour market to its fate and wringing further concessions from a labour movement which is facing an erosion of real wages and employment could rend the social fabric and trigger an immediate and deeper depression of the domestic market.⁵

In the economic and social sphere it is often counterproductive to pursue isolated goals while neglecting others with which they are interconnected or, even worse, interdependent. Thus, at the beginning of the 1980s, there was an obsessive effort to achieve specified growth targets, with little thought for their inflationary repercussions, while, during the last Administration, the fixation was on reducing inflation to single-digit levels, regardless of such a policy's devastating effects on the balance of payments and companies' microeconomic variables. Neither of these very different structural reform strategies went far enough or was sufficiently thought through, and the country was therefore exposed to severely destabilizing processes.

³ There are leftover traces of the model in vogue during the previous six years, which denied the virtues of any industrial policy whatsoever; it is still considered difficult to “pick winners” –however little doubt there may now be as to the desirability of promoting automotive-industry suppliers or the petrochemical industry, or of increasing the integration of the *maquila* industry– and it seems highly unlikely that the State will provide a deliberate boost for export activities (through subsidies, credit, capital inputs, marketing support, etc.) in the manner of the South-East Asian countries.

⁴ Taking the period from 1980 to 1994 as a whole, industrial employment has come to a standstill, and the agricultural sector's ability to retain labour is declining, while the drop in the rate of population growth has not yet begun to slow the expansion of the labour force (Clavijo and Casar, 1994; Ibarra, 1995a; and Bank of Mexico, 1995a). Indeed phenomena ranging from the intensification of migration to the United States to the Chiapas disturbances seem to be related in some way to poverty resulting from imbalances in the labour market.

⁵ The President's Report itself recognizes that the economic crisis is not over and that the most important task remains to be completed: “to create more productive, well-paid jobs through the structural transformation of industry” (Zedillo, 1995a and 1995b).

IV

Policies

It is thus appropriate to look more closely at economic trends during 1995.

Fiscal policy aimed to create a primary surplus of 4.4% of output and to pare down programmable spending by 9.8%. On the revenue side of the equation, the value added tax was raised by 50% and the prices and charges for goods and services provided by the public sector were increased (gasoline and diesel-oil by 35%, and electricity and natural gas by 20%).⁶

Monetary policy was designed to be extremely restrictive. The expansion of Central Bank credit was subject to a nominal ceiling five-sixths lower than that of the previous year (not exceeding 10 billion new pesos). At the same time, interest rates were allowed to rise so that they could accommodate the pace of inflation; at first this took the form of a lagged adjustment but later these rates began to move in line with expected inflation. The financial intermediation programmes of the development banking system were considerably curtailed in real terms. A large part of the financial package negotiated with the United States Department of the Treasury, the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) was earmarked to re-

deem Tesobonos and other short-term public and private debt paper (IMF, 1995; ECLAC, 1995b). The parity of the peso ceased to be used as an anchor to restrain inflation and the exchange rate was allowed to float more or less freely, with the aim of holding its real value steady. As regards wage policy, real wages are to be permitted to decline further.

The Government also continues to promote reforms with a view to structural change and to attempt to supplement the fiscal budget with special funding. Despite the rising tide of criticism about many earlier moves towards privatization and nationalistic resistance to the dismantling of *Petróleos Mexicanos* (PEMEX) and the Federal Electricity Company, three port terminals were taken out of public-sector management at the end of June, and plans are proceeding apace to do the same with, *inter alia*, the railways, natural gas distribution facilities, petrochemical plants, airports and electrical power plants. Similarly, the Government is proceeding with its deregulation plans, which range from the simplification or abolition of paperwork to measures which will intensify competition in the domestic market, such as those anticipated under the new telephone regime.

V

The facts

Although it is too soon to attempt a rigorous evaluation, thus far the results of the economic emergency programme, the Agreement to Unite to Combat the Economic Emergency (AUSEE) and the Programme of Action to Reinforce the Agreement to Unite to Combat the Economic Emergency (PARAUSEE) have produced a patchwork of progress and setbacks (Valenzuela, 1995).

1. Progress

On the positive side, there has undeniably been steady progress in restoring some macroeconomic equilibria, in defusing the destabilizing effects of the bubble created by the build-up of external debt maturities and, in certain areas of economic activity, the consolidation of many companies' financial position and international competitiveness. In this last, more microeconomic area, a new export sector is emerging which has stronger linkages with transnational production and trade networks and access to foreign re-

⁶ Information from the Ministry of Finance and Public Credit, the Senate, Mexweek (1995) and the Grupo Financiero Bancomer.

sources.⁷ Some businesses –especially large ones– have retooled and have rationalized their costs. Major inroads have also been made in the exploitation of comparative advantages, as is attested to by the expansion of the *maquila* industry, motor vehicle exports and tourism.

The stabilization programme has also recorded successes, as seen in the reduction of post-devaluation inflation and the correction of external accounts. As regards inflation, while there were sharp rises in producer and consumer prices in the first half of 1995 (36.3% and 32.3% respectively), the rate of increase has slowed since April.⁸

In the first half of 1995 exports responded satisfactorily (up 32%) compared with the same period of the preceding year (in August the figure was 32.5%).⁹ The export sector increased its share of output as a whole and took a leading role as a major driving force in the economy.

Imports contracted by nearly 7% (7.8% as of August), with a particularly steep drop being seen in imports of consumer goods¹⁰ (40% in the first half-

year, 42% as of August) and capital goods (30% in the first half-year, 32% as of August). Purchases of intermediate goods, which already accounted for more than three quarters of the total, continued to rise (4% in the first half-year, 3.4% as of August), albeit at a much lower rate than in previous years.

As a result, there was a turnaround in the balance of trade from a deficit of over US\$8.8 billion in the first half of 1994 to a surplus of nearly US\$2.9 billion in the same period of 1995.¹¹

Monetary policy has maintained an unwaveringly restrictive course. During the first half of 1995, credit from the Bank of Mexico was reduced by over 40 billion new pesos (71 billion new pesos as of September), the monetary base shrank by 18% and the money supply by 20%,¹² while interest rates rose in real terms in the wake of the stronger inflationary impact of April's devaluation.¹³ The sum of government domestic debt securities in private hands went down by 21%, or 33 billion new pesos.¹⁴ A particularly noteworthy decrease was seen in the level of tesobonos, which accounted for US\$29 billion in December but had been reduced by two thirds by the end of June and were expected to drop to between US\$2 billion and US\$3 billion by September.

The financial package put together by the United States Treasury and international institutions (US\$47.75 billion) not only enabled Mexico to service its external debt normally –despite the huge accumulation of short-term maturities– but also made it possible for its international reserves to be gradually replenished.¹⁵ The establishment of a market for peso

⁷ Although only a small number of companies are sizeable exporters, they account for a considerable share of production and foreign exchange earnings, though not of employment (see footnote 1). The export sector now accounts for 25% of output and is the only segment that has not succumbed to the crisis. Imports to this sector have, accordingly, continued their robust growth (intermediate goods are up by 30% and capital goods by 36%), whereas imports by companies serving the domestic market have fallen by 28% and 46% respectively (information from INEGI (1995), Grupo Financiero Banamex-Accival, Grupo Financiero Bancomer, Bank of Mexico and Grupo Financiero Inverlat).

⁸ The rise in the consumer price index in April 1995 was 8%, but fell to 2% in July-August. Not only did the economy absorb the effects of the devaluation, but also of the internal shocks caused by the rise in taxes (VAT), increases in the prices of a large number of public-sector goods and services, and the two wage adjustments. As of July, the consumer price index had climbed by 35.6%, producer prices by 39.3% and the basic shopping basket by 42.1%. In September, October and November, prices surged owing to seasonal factors and, in particular, to the interest rate rise (information from INEGI, Grupo Financiero Banamex-Accival, Grupo Financiero Bancomer, Bank of Mexico and Grupo Financiero Inverlat).

⁹ Exports of agricultural products rose by 63%, minerals by 60% and manufactures, excluding *maquila* products, by 44% (notably textiles, iron and steel products, metal products and machinery, chemicals and paper).

¹⁰ Domestic consumption of both imported and domestically-produced goods contracted owing to actual or expected declines in people's wealth or income. This was the reverse of what happened in 1988-1994, when the peso was rising and the economy was opening up.

¹¹ As of August there was a trade surplus of US\$4.5 billion, as compared with a deficit of US\$12.1 billion in 1994.

¹² According to information from the Bank of Mexico, current-account deposits fell by 41% (annualized), M1 dropped by nearly 34% and real M4 by 12.6% in real terms as of July. However, it may be that the replenishment of international reserves had the effect of lowering Central Bank credit statistics.

¹³ Interest rates on deposits were negative for the first four months of 1995, but then reversed direction and reached high levels –between 8% and 9%– during the following few months. Nevertheless, in nominal terms these rates declined from 70% in March to somewhat over 30% in August.

¹⁴ Part of this reduction was accounted for by the conversion of domestic debt into external debt (financing the redemption of Tesobonos and other instruments out of the loan capital provided in the financial package).

¹⁵ A total of US\$23.9 billion had been received as of August. The Bank of Mexico used around US\$13.4 billion of this amount and the federal government the remainder (Zedillo, 1995b).

futures on the Chicago Mercantile Exchange was another extremely important step forward in the stabilization of the exchange system.

There was also a major recovery in the Mexican Stock Exchange. At the beginning of March 1995 the prices and quotations index was down nearly 40% from the end of the preceding year, and although by July the 1994 level had been exceeded (2 550 points on 9 August), at the end of September a further fall, associated with the instability of the relevant financial markets, was beginning to take shape.

Timidly, and despite high costs (and short terms of between three months and two years), Mexico is re-entering international capital markets, as is demonstrated by the recent issues floated by two credit institutions, Banco Nacional de Comercio Exterior and Nacional Financiera, at spreads of between 400 and 500 base points over LIBOR. Foreign investment in the stock exchange picked up slightly in May, only to fall back from September onwards.¹⁶

The way in which public finances have been managed has helped to make the Government's rigorous macroeconomic adjustment programme more effective. An effort is clearly being made to balance government accounts, in line with the aim of eliminating the inflationary effects of the devaluation, and this effort is succeeding. The first six months of 1995 saw a primary surplus of 2.9% of the product and a financial surplus of 1%;¹⁷ programmable spending was cut by 14.3% in real terms (compared with the same period in 1994).¹⁸ Spending levels are lower across the board, but the deepest cuts have been in capital expenditure (nearly 60%).¹⁹ Meanwhile,

revenue dropped slightly (2%); however, thanks to the rise in tax rates (50% on VAT) and higher charges for power and other public services, to the upswing in oil prices in the first months of the year and to other special operations, the effects of the downturn in tax receipts were all but offset.²⁰

Lastly, the most encouraging aspect of the President's first report was the establishment of one of the most important links between the Government's short- and long-term strategies. A policy of economic revitalization was proposed that, despite a certain hesitancy as to its size and scope, is to rest on the following actions: giving freer rein to public investment expenditure, which had been constrained during the first half of the year (three quarters of the investment budget may be spent during the second half of the year); promoting a special housing programme which is expected to create 200 000 jobs; establishing an infrastructure investment fund of 1.6 billion new pesos, to be financed with public, private and credit resources; alleviating the problem of delinquent debtors in the banking system; promoting national saving; and giving incentives to foreign capital (Zedillo, 1995a and 1995b). The recent formation of the Alliance for Economic Recovery²¹ reflects the intention to make development targets a higher priority and constitutes a first step towards the democratization of economic policy.²² It was emphasized, however, that this revitalization will not entail any relaxation of fiscal and monetary discipline whatsoever.²³

¹⁶ From January to the beginning of August, Mexican share prices (ADRs and investment funds) marked up sizeable losses on United States stock exchanges. For example, ADRs issued by Vitro, Telmex and the Grupo Mexicano de Desarrollo had dropped by 31%, 17% and 50% respectively. Meanwhile, Fondo México, the Emerging Mexican Fund and Mexico Equity & Income were down by 18%, 30% and 26% respectively (Grupo Financiero Inverlat, various issues).

¹⁷ The targets agreed upon with the International Monetary Fund were a 4.4% primary deficit and a 1.6% financial deficit (IMF, 1995; Ministry of Finance and Public Credit, various issues, and 1995).

¹⁸ The target for cuts had been set at the more modest level of 9%.

¹⁹ Programmable spending and investment spending needed to be curtailed, in part, to allow payment of the interest charges on the public debt, which soared by 53% in the first half of 1995 (Zedillo, 1995b).

²⁰ Domestic public debt fell by 15% (to 8.5% of GDP) as the main result of the redemption of tesobonos; by contrast, external government debt rose 10% to almost US\$94 billion, and this figure does not even include the loans on the Bank of Mexico's accounts (Zedillo, 1995b; Ministry of Finance and Public Credit, 1995).

²¹ See Grupo de Economistas Asociados (1995) and Ministry of Finance and Public Credit (various issues and 1995).

²² The task of the Alliance is to attain a growth rate of 3% and inflation of 20% in 1996. To that end it is envisaged that, among other measures, tax credits will be granted for productive investment and employment, taxes on the assets of small businesses and on new automobiles will be abolished, the minimum wage will be raised and energy prices will rise.

²³ A loosening of restrictions on public spending could force the Bank of Mexico to tighten up on monetary policy. In fact, the difficulty of reconciling the revitalization of the economy with the Government's anti-inflationary targets can only be eased by continued high rates of idle production capacity.

2. Problems

As is to be expected, the main cost of the Government's post-devaluation policy has been an excessive contraction of the economy. Output fell nearly 5.8% in the first half of 1995 and almost 10.5% in the second half, thereby throwing the country into the worst depression of the last 50 years (Bank of Mexico, 1995).

The inevitable transitional effects of the structural reform process undermined the Government's claim to legitimacy based on its performance in terms of growth and income distribution.

The recession affected both companies and aggregated variables such as investment and savings. Gross fixed investment dropped by 35% and, within that aggregate, public capital formation fell even further (over 60%). Consumption slumped by 14%.

This compounded the already endemic decline in savings and capital formation. In fact, despite the elimination of the public-sector deficit, national saving has declined steadily (by 6-8 points of GDP in total) since the 1980s, and the average growth rate of investment has gone down considerably, with the exception of the period 1992-1994.²⁴

Public debt, which had fallen from 79% to 23% of GDP between 1986 and 1992, rose once more, reaching 47% in the first half of 1995. This was basically due to the devaluation, since external debt grew by some US\$11 billion and domestic debt by 3 billion new pesos.

Technological modernization and the recession accentuated the imbalances in the labour market. The open unemployment rate more than doubled between December 1994 and May 1995, reaching the record figure of 7.3% in September. If part-time workers are included (under 35 hours per week), this figure goes up to 25% of the economically active population. The number of persons registered with the Mexican Social Security Institute fell by more than 775 000 (7.5%) and, as of August, the decrease amounted to

more than 842 000 (Ibarra, 1995a). The end results of this situation included an explosive surge in the informal segments of the economy, the intensification of migratory pressures, the spread of poverty and a deterioration in the financial standing of the country's social security institutions.

In addition, pressure is being exerted by the business community to make labour legislation more flexible and to cut the taxes, social security payments and contributions to the National Fund for Workers' Housing (INFONAVIT) that keep labour costs artificially high and thus make Mexican industry less competitive. It should come as no surprise, then, that real wages are declining and will continue to do so; this erosion of wage levels will almost certainly total no less than 10%-20% in 1995 and will thus compound the effect of the other factors that are causing the domestic market to shrink.²⁵

On the real side of the economy, the recession has had across-the-board effects, hitting nearly all production activities and sectors. Manufactures dropped 5.5% in the first half of the year (6% as of July). The industrial sector as a whole²⁶ contracted by more than 6% (7% as of July) and the services sector by 5%. Agriculture, after a fairly favourable first quarter (2% growth), went sharply into reverse and posted a half-year average of -9.8% due to the overwhelming impact of a drought, lack of access to credit and high interest rates.²⁷

There were spectacular downturns in construction (16%; 18% as of July), the textile and clothing sectors (19%) and metal products and machinery and equipment (12%); within this last sector, production in the automotive industry tumbled by over 20%. In the services sector, commerce was down by 13%.

²⁵ The average reported wage of workers covered by the social security system fell 9.6% in the first six months of the year while, according to INEGI, between January and May annualized real wages dropped by 6.3% in manufacturing and by 8.6% in commerce. Taking 1978 as a base year, real minimum wages, although less representative than before, had lost more than two thirds of their purchasing power as of June 1995 (see also Grupo Financiero Banamex-Accival, 1993).

²⁶ According to the Chairman of the Entrepreneurial Coordinating Council, Héctor Larios Santillán, "industry is functioning at 30%-50% of capacity" (*El Economista*, Mexico City, 3 August), thereby reducing competitiveness and putting inflationary pressure on costs.

²⁷ Grain production declined nearly 27% in the first six months of 1995.

²⁴ Had it not been for the financial package, flows of external saving would have been severely restricted. In the first half of the year, the capital account yielded net income of little more than US\$3 billion, compared with US\$10 billion in the same period the year before. Foreign direct investment and portfolio investment, taken together, dropped by US\$9.5 billion. By contrast, loans rose to over US\$13 billion. By March, credits and foreign investment in domestic debt paper would have fallen by nearly US\$8 billion, had they not been offset by these special inflows.

Like it or not, the short-term financial stabilization process is weakening the microeconomic foundations of the national system of production. The recent depreciation of the currency and the upturn in interest rates have dealt further blows to Mexican companies. In the recent past, this situation became an intolerable source of trade and external-payment imbalances (Ibarra, 1995b; Centro Tepoztlán, 1995; Servitje, 1995). Today, it translates into equally intolerable misalignments in the labour market, a failure to take advantage of the opportunities for growth being opened up by the liberalization of the economy, and damage to the national financial system.

3. The problem of bank claims

The accumulation of overdue portfolios is nothing new. Between 1988 and 1994 these obligations had steadily mounted up, reflecting the turbulence caused by the adjustment to an open, competitive regime, the absence of industrial policies to make the process easier, and the use of high interest rates as an instrument to achieve external equilibrium. However, it was the combination of these factors with the devaluation²⁸ and depression of 1995 that exacerbated borrowers' insolvency problems to such an extent that the stability of the national financial system, and thus the very progress of the adjustment programme, was jeopardized.

According to information from the Bank of Mexico, by the end of 1994 medium- and high-risk credits made up 8% of the commercial banking sector's portfolio and 14% of that of the development banking sector (i.e., nearly three and four times more, respectively, than international standards). Moreover, the first of these figures doubled during the first half of 1995 to around 16% (100 billion new pesos).

Financial institutions have been forced to increase their loan-loss provisions—thereby reducing profits—and to make greater efforts to build up their capital at a time when the market value of their shares has been dropping sharply.²⁹ At the same time, assets and liquidity have risen as delinquent clients' collateral has been called in.

²⁸ Many companies with obligations in foreign currency saw their liabilities, and their corresponding debt service payments, soar.

²⁹ Under current regulations, banks must maintain capital reserves equivalent to no less than 8% of their exposure.

For their part, the financial authorities and the Bank of Mexico have also attempted to alleviate the problem. By June 1995, 21.5 billion new pesos and more than US\$1.5 billion had been channelled through the Bank Savings Protection Fund (FOBAPROA) in order to help improve the banking system's capital position. The Temporary Capitalization Programme (PROCAPTE) also transferred nearly US\$3.5 billion,³⁰ and nearly US\$1.75 billion has been committed by the World Bank and the Inter-American Development Bank (IDB) to finance support programmes for the banking system.³¹

In 1995, with State assistance, three bank debt restructuring programmes were drawn up which covered a total of nearly 150 billion new pesos. The first, for 76 billion new pesos, benefits small and medium-sized enterprises.³² Similar schemes have been developed to help restructure mortgage loans (33 billion new pesos) and loans in foreign currency (US\$6 billion).

Lastly, the federal government and the Mexican Bankers' Association have drawn up an Agreement for Immediate Debtor Assistance (ADE), which contains a complex set of measures geared towards alleviating the problem of the accumulation of overdue portfolios (Grupo de Economistas Asociados, 1995). More specifically, this agreement lowers interest rates for certain groups of debtors for a period of one year, provides incentives for them to fulfil the terms of their contracts, facilitates adoption of the UDIs regime and strongly promotes loan restructuring agreements. Furthermore, it is designed to assist small and medium-sized debtors as a group, as negotiation on a case-by-case basis is neither practical nor

³⁰ This aid does not involve real transfers of resources, but is effected through the exchange of securities between the banks concerned and the Central Bank.

³¹ Out of a total of US\$2.763 billion in credits from the World Bank and IDB, 63% was allocated to the banking system.

³² Overdue portfolios are to be transferred (with a maximum per bank equivalent to 20% of each institution's loan portfolio) net of reserves. In return, the banks will receive an equivalent amount of Government zero-coupon bonds which will pay interest at the same rate as 28-day treasury certificates (CETES). This will allow corporate debt to be restructured and expressed in Investment Units (UDIs) with a real interest rate of up to 12%, a maximum term of 12 years and a grace period of up to seven years. The trust funds will be financed through an issue of UDIs with a spread of four points, which is to be covered by the federal government.

viable.³³ The cost of the programme is by no means negligible: before interest rates began to rise in October 1995, it was estimated at 17 billion new pesos. This cost is to be borne by the Government and the banking system and does not include the 13 billion new pesos to be provided by the Government as backing for the UDIs regime.³⁴

Furthermore, the myriad support programmes now being drawn up to help get the banking system back into shape are clear evidence of the huge direct and indirect costs—both monetary and in terms of the deterioration of national production facilities—of waiting until problems become really critical before attempting to find solutions. In such situations, policies are reactive—and at times contradict the broad lines of government strategy—rather than giving a clear indication of the course to be followed. The direct or indirect socialization of these costs gives rise to external diseconomies or adds to the burden to be shouldered by a population and a business community already overwhelmed by economic depression.

The problem of overdue loan portfolios has had, and continues to have, damaging consequences for the national economy. In the first place, it gives rise to flaws and breakdowns in the process of financial intermediation and makes it more likely that a tight monetary policy will trigger a recession, since the banking sector will prefer to invest its meagre de-

posits in State securities, rather than meeting the needs of private companies.³⁵

Second, this situation splits the business community and works against ethical business practices. Tensions accumulate between creditors and debtors and between debtors and the Government.³⁶ Each group struggles to gain influence and to offload onto the others the burden of existing or future losses.

As long as a large number of bank customers are insolvent, the problem of the accumulation of unpaid debts is bound to recur in an increasingly virulent form. It is thus essential to relax the country's rigorous adjustment strategy somewhat and stimulate a cautious, general revival of Mexico's production activity.

As can readily be understood, since the privatization of banking services, there has been a lack not only of effective risk-reduction policies but also of fundamental strategic thinking as to the most suitable direction to take in carrying forward the structural modernization of such services. In the banks' defence, mention should be made of the unforeseeable effects of an unexpectedly severe crisis and the damaging consequences of the misalignment between macroeconomic and microeconomic strategies.

4. Other problems

The portfolio problems of the banking institutions are mirrored in magnified form among other financial intermediaries. Credit unions and cooperatives, leasing companies and independent factors—i.e., companies which are not members of financial groups—are in an even more difficult situation since they suffer from similar problems of delinquency while their

³³ More concretely, the programme will last for one year (until September 1996), except for the agricultural sector, where it will continue until February 1997. Non-delinquent debtors and delinquent debtors who agree to restructure their debts will automatically be eligible for ADE benefits; in addition, the latter will be exempt from penalty interest payments. Credit card interest rates, which normally hover around 70%, will be cut to 38.5% for the first 5 000 new pesos; the rate on consumer credit and personal loans will be set at 34% for the first 30 000 new pesos (the market rate is usually over 50%); for the first 200 000 new pesos of corporate debts, the rate will be 25%; and for housing mortgages, it will be 6.5% in UDIs on the first 200 000 new pesos owed, for the 12 months following signature of the restructuring contract, subject to the availability of UDIs. Lastly, a three-month debt holiday has been declared by the courts for delinquent debtors. This may be extended for up to one year upon signature of letters of intent to restructure.

³⁴ Before the recent rise in interest rates, the fiscal cost for 1995 was estimated at 2.5 billion new pesos, to be financed by expenditure cuts (20%) and from the surplus already generated (80%). The costs to be borne by the banking sector are somewhat theoretical, since they are based on income streams which are going to dry up and which would in any case have been uncertain because they would be derived from overdue portfolios.

³⁵ It is not only a question of legal restrictions on the expansion of bank credit (capital reserve requirements) but also of a preference for bolstering financial accounts and results by purchasing government securities instead of financing production activity. According to information from the Bank of Mexico, between the end of 1994 and July 1995 the commercial banking sector's portfolio of government securities grew fivefold (from 6 billion to 32 billion new pesos); since December 1993 it has increased by a factor of 11. As of mid-1995, commercial bank holdings accounted for around 20% of all the government bonds in circulation.

³⁶ Populist movements, such as the Barzón movement, are becoming widespread, as is the practice of suspending payment (in some instances for no justifiable reason) as part of a so-called "no-pay culture", while banks resort to draconian measures to recoup their loans, even going so far as to refuse all financial services to delinquent companies or individuals.

sources of financing are becoming increasingly expensive and scarce.³⁷

These are not the only major financial problems that the federal government will have to face in the immediate future. A serious imbalance in social security institutions' accounts is already in the making,³⁸ and the toll-roads system, which originally served as a basis for the award of private concessions for building and operating roads, is now the object of a bail-out operation.

External debt pressures have not been entirely resolved. Public- and private-sector loans amount to around US\$150 billion, and in the three-year period 1996-1998, annual payments on loan principal will fall due which, when added to the country's interest payments, will require very substantial outlays; a major portion of these maturities will have to be refinanced through sophisticated operations in the international capital market. Dealing with these emerging demands will solve major problems which have been brewing for some time, but will restrict the State's manoeuvring room for revitalizing the economy in the short term without relinquishing its aim of stabilization.

The breakdown of the financial conduit for bank credit, which has ceased to fulfil its function as a source of corporate finance, is compounded by a further, equally dangerous state of affairs. As a result of the instability of the exchange rate, or, to put it another way, the limited reserves of the Central Bank, exporters are recycling less of their proceeds in the domestic market. While this is a legitimate procedure in a context of free trade and free movement of capital, it weakens the peso, and the Government lacks the instruments to prevent this by any other means than raising interest rates, which are already at levels that are intolerable for both producers and debtors. This reinforces regressive biases in distribution which can lead to huge shifts in income towards speculators and exporters, to the detriment of the rest of the population, and makes it impossible to put off a fundamental restructuring of the financial sector's

institutions and of its linkages with the national economy at the microeconomic and macroeconomic levels.

Moreover, these failings, together with the uncertainty associated with the economic depression, could set off further dangerous fluctuations in financial markets.³⁹ The recent movement in the exchange rate and the abrupt rise in interest rates have stymied the Government's stabilization efforts and forebode a prolongation of the economic recession and the possibility of a further period of hyperinflation. Neglect of the microeconomic situation and of disequilibria in certain markets (such as the financial and labour markets) seems to have created the need once again to dampen the upward, redistributive pressure on prices.

To summarize, a thorough reconstruction of the country's main financial circuits is a task that can no longer be put off. Piecemeal measures to cope with this or that specific problem once it has reached critical proportions are no longer sufficient. The main breakdowns have occurred, as pointed out above, in the following areas: i) the banking system has ceased to fulfil its basic function of intermediation, i.e., financing production activity; ii) the export sector is dynamic, but reluctant to bring back into the country a large part of the net foreign exchange it obtains abroad, and this, combined with the low level of value added to these exports, exerts pressure on the foreign exchange market which is very difficult for the Government to counter with the instruments at its disposal, except by tightening its recessionary monetary policies (Ibarra, 1995b); and iii) the timetable for external debt payments is still oriented to the short term and the amount of incoming foreign savings is limited, rather than being the abundant inflow on which many of the hopes of economic revival rest. These constitute formidable obstacles to the revitalization of production activity, in the absence of which the symptoms of social discontent and ungovernability could go beyond reasonable levels.

³⁷ In July 1995, factors' overdue portfolios averaged 25%.

³⁸ In the first half of the year payments to the Social Security Institute itself contracted by 14% and those to the Social Security and Social Service Institute for State Workers by 24% (Zedillo, 1995b).

³⁹ For these and other reasons, the interbank exchange rate went up from 6.26 new pesos to 6.83 new pesos to the dollar, while December contracts climbed from 6.7 new pesos to 7.0 new pesos (on the Chicago exchange). More recently, prices have exceeded 8 new pesos to the dollar. Meanwhile, interest rates (28-day CETES) surged from 33.5% in mid-September to 42% in the second half of October and 54% in November.

VI

Epilogue

The ideological erosion of the Mexican revolutionary movement makes it necessary to build new political consensuses, which, however, will not entirely replace neoliberal doctrine. What is more, the impoverishment of national values and popular objectives in the institutional reforms of recent years demands some form of legitimization in order to render the increasing imbalance in the distribution of income and wealth politically tolerable while the political modernization of the country moves forward.

Paradoxically, the problems of adjustment experienced by a highly protectionist, Statist system in making the transition to an open, market-based economic scheme have, for the moment, slowed the pace of development, while accentuating the country's distributive problems and undermining the bases of national production.

The National Development Plan is a reflection of an appropriate long-term view of the processes of economic and democratic modernization and of the further development of a State based on the rule of law. However, it is inadequately coordinated with short-term adjustment policies, and therefore cannot be implemented until the post-devaluation situation has been resolved, which will entail the adoption of recessionary measures.

When radical reform is undertaken –as now– it would be a miracle if major, albeit temporary, upheavals did not take place in the economy and in income distribution as new forms of growth establish themselves. With the consolidation of a competition-based system that is open to the outside world, it is natural that a number of companies and individuals should become redundant. In other words, stabilization and structural adjustment programmes normally slow the momentum of growth owing to the accommodations and sectoral reallocation of resources they inevitably bring about.⁴⁰

Social life involves complex relations of interdependence which make it essential to achieve overall dynamic equilibria if change is to be assimilated and progress is to be compatible with sustainable systems for promoting social equity. Moreover, *a posteriori* solutions to problems that have previously been ignored usually occasion exponentially higher costs.

Mexico runs the risk of exacerbating systemic or structural misalignments between the microeconomy and the macroeconomy and between its economic and its social or political policies.

There is a danger of triggering a financial disaster which, fortunately, the country has so far been able to avert through support measures for credit intermediaries. Nevertheless, as long as production capacity remains impaired, the national banking system will be in poor health and the costs of financial intermediation will be high.

By the same token, the emergency ought not to lead to a delay in implementing measures to alleviate social polarization and stem the spread of poverty. Here, too, there are hazards that are beginning to make themselves felt in an upsurge of conflicts and ungovernability and in abrupt swings of electoral mood which, while in themselves reflecting democratic progress, also express voters' dissatisfaction with the way federal or local governments are being run, regardless of their ideological hue.

The principal weakness of the National Development Plan may lie in its adoption of sequential formulas for action. The first step is stabilization of the rate of inflation and of foreign exchange markets, or divestiture of assets, and only then will there be an attempt to resume growth, create jobs, promote retooling or correct social inequities.

Unfortunately, the organic interweaving of elements of social life is rarely amenable to solutions of this type, where priorities are set and actions selected in a temporal sequence. One of the most discussed,

⁴⁰ See IMF, 1995. Note that between 1940 and 1980 real output grew at an average annual rate of 6.4% and per capita income at a rate of 3.1%. By contrast, between 1980 and 1994 these rates were a scant 1.9% and -0.2% respectively. Labour productivity also fell. Comparing the periods 1970-1981 and 1981-1991, it can be seen that the annual growth rate of the level of value added in the manufacturing sector dropped from 2.95% to 1.98%. Had the historic growth rate been maintained, total GDP in 1994 would have been 80% higher than it was, and per capita GDP would have been 50% higher. To a certain extent, this lost income is part of the cost of the changes in Mexico's institutional structure and pattern of development that began to be discernible at the beginning of the 1980s.

and least clear, of all socio-economic policy issues is the optimum sequence of actions and reforms and how to combine them at each stage (Bruno and Pleskovic, 1994). The need for reconciliation and coherence always makes it necessary to move forward on several different fronts, even though progress on each one may be limited.

Without underestimating the depth of the devaluation crisis, nor external contingencies, this concept of policy hinges on the assumption that the national production base and a marginalized labour force have retained not just their discipline and some reserves of strength, but also the ability, later on, to fuel a rapid recovery; it also assumes that external debt, concentrated in the short term, can easily be refinanced in the future. If it should prove otherwise, the proposals put forward in the National Development Plan will be overshadowed by the fallout from the emergencies which will inevitably continue to arise in the immediate future.

The task ahead is by no means simple, but it may still be feasible. The inertia inherent in current problem-solving methods will need to be overcome, national priorities will have to be integrated in a more balanced way, and fresh socio-political consensus must be reached. However, the National Development Plan—the content of which is virtually unassailable—could end up as just another of the myriad “approaches” which have lost touch with reality to such an extent that their true features are obscured.

At the same time, international understandings will have to be reached in which finding solutions to the backwardness of the Third World is perceived not as the art of imposing standardized models that are essentially restricted to an economic focus but as the

art of devising integrative formulas that address the true complexity of the phenomenon of economic modernization. The timely rescue operation by which Mexico was bailed out of its financial crisis made it possible to limit, to a very large extent, the danger of international repercussions in other markets. The lesson must now be learned, and work must begin on perfecting joint—and, in so far as possible, depoliticized—international strategies. Given the current situation in Mexico, it would be advisable to make the conditions attaching to these financial packages more flexible, undertake to rollover or renegotiate the debt, and allow first priority to be given to the pressing issues of unemployment and the deterioration of production capacity and of the banking system. Unfortunately, the economic management of Mexico is more than ever hamstrung by the vagaries of United States internal party politics.

The achievement of a reasonable and realistic accommodation seems important not only from the standpoint of the soundness of the Mexican economy, but also in terms of the development of the regional and global economic system. Mexico's problems have called into question the value of the so-called Washington Consensus regarding the economic reforms that have been implemented in virtually the whole of Latin America since the 1980s (Williamson, 1990; Hurt, 1995; *The Economist*, 1995). The crises in Venezuela, Argentina and Nicaragua, or the one which may be approaching in Brazil, with all their similarities and differences, bear witness to strategic weak points which need to be remedied or reinforced before the socio-economic regression of this hemisphere spreads further and takes root.

(Original: Spanish)

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