

# BUSINESS

## Frontier

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## The Mexican Economy At a Crossroads:

### Facing the Challenges of a New Growth-With-Equity Policy

Mexico has left behind the days of acute inflation and depressed growth that characterized it during most of the 1980s. Thanks to a comprehensive program of reforms that started in the previous administration and continues today, Mexico has a stable, growing economy. However, Mexico is finding out that while it has been transforming its economic fundamentals, its progress in the sociopolitical sphere has lagged. Stated a different way, the full benefits of economic reforms have yet to trickle down to the population, whose demands are no longer silent. Mexico is thus at a crossroads right now, facing the challenges of building a growth-with-equity policy that addresses sociopolitical concerns while maintaining a stable economy on its way to sustained growth.

## Mexico's Economic Transformation

The economic reform program Mexico has followed over the past decade has comprised tight fiscal and monetary policies as well as structural change measures. Another key component of the reform program has been the so-called Pact for Stability and Economic Growth—initiated in 1987 and now known as the Pact for Stability, Competitiveness, and Employment—which has essentially been directed at bringing down inflation through direct price controls, especially the control of the economy's key price—the price of the peso in relation to the dollar—in other words, the exchange rate.

This multiprong reform program has brought about an acute economic transformation that is apparent in Mexico's current profile:

- **A 180-degree turnaround in public finances.** Mexico recorded a financial surplus of 3.4 percent of gross domestic product (GDP) in 1992, a switch from the 16-percent deficit it recorded in 1987.

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Even discounting the extraordinary income earned in 1992 due to the sale of public enterprises, Mexico posted a surplus of 0.5 percent of GDP in 1992. In 1993, Mexico maintained a financial balance surplus of 0.7 percent of GDP.

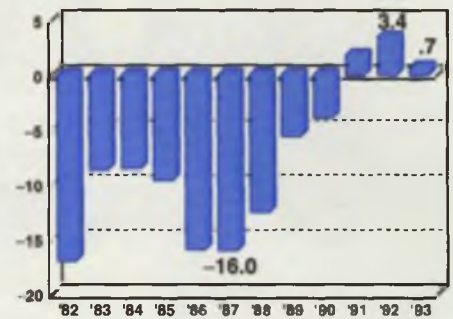
- **An 80-percent divestment of state-owned companies.** An important structural reform that Mexican authorities initiated in 1982 was the privatization of public enterprises. Efforts in this regard were accentuated in the latter part of the 1980s and during the Salinas administration. As a result, the number of state-owned companies in 1992 totaled some 200, down from more than 1,150 in 1982—a divestment of more than 80 percent of public entities. Some of the more dramatic examples of the success of the privatization program lie in the sale of the telephone company (Telmex), the airlines, and the commercial banks.

- **Significant external debt reduction.** In 1982, Mexico announced to the world that it was unable to meet its obligations to external creditors. This event unfolded in what became known as the Latin American debt crisis, as other countries in the region presented the same symptoms as Mexico. The external debt problem became so pronounced that by 1986, Mexico's external debt equaled 78 percent of GDP.

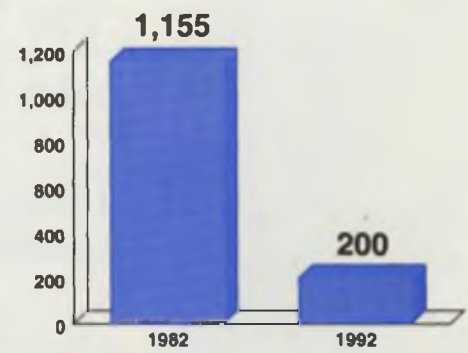
Through debt renegotiation and restructuring efforts, as well as direct payments later made possible by a healthier economy, Mexico's external debt was brought down to 29.6 percent of GDP in 1992. In essence, the country has managed to reverse the net transfer of resources abroad. During the 1983–88 period, Mexico's net transfer of resources abroad averaged 6 percent of GDP per year; in 1992, Mexico became a net recipient of resources from abroad in the same degree—funds worth 6 percent of GDP entered the country.

- **GATT membership and passage of NAFTA.** One of the country's most important and radical structural reforms has been its trade liberalization. Mexico in 1986 joined the General Agreement on Tariffs and Trade (GATT), thus abandoning a decades-long policy of protectionism. Mexico's trade-opening efforts first involved dismantling its heavy-handed import-license system. Before 1986, import licenses covered more than 90 percent of the economy's production sectors; by 1992, this figure had been cut down to less than 19 percent. The maximum tariff charged before 1986 was 100 percent; by 1992 it had dropped to 20 percent. The trade-weighted average tariff in 1992 was even lower, at 10 percent.

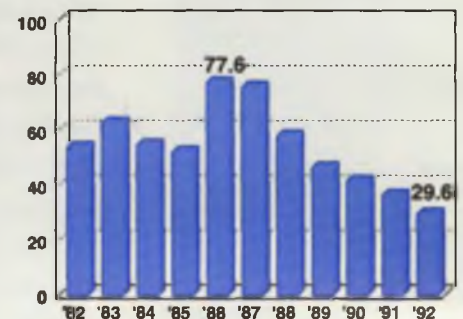
**FINANCIAL BALANCE**  
(as a percentage of GDP)



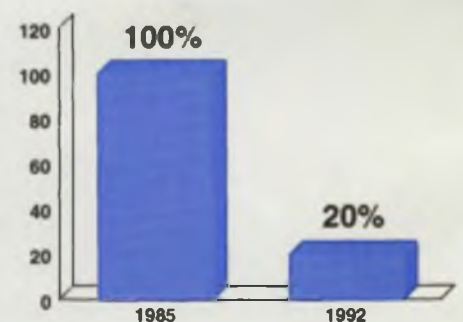
**STATE-OWNED COMPANIES**



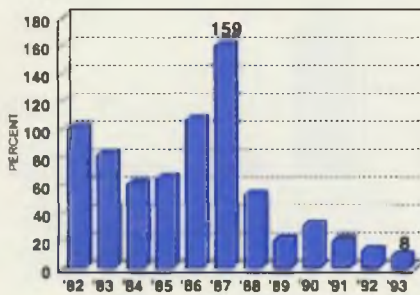
**EXTERNAL DEBT**  
(as a percentage of GDP)



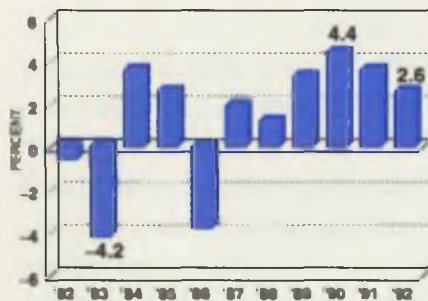
**MAXIMUM TARIFF**



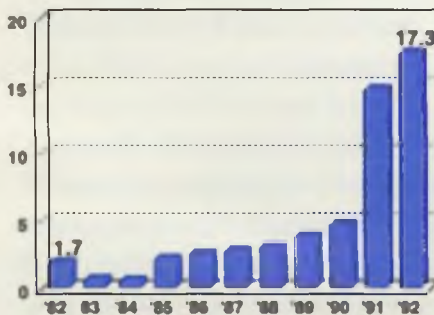
## INFLATION (CPI - Annual Growth Rate)



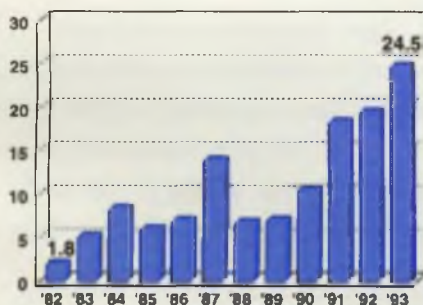
## GROSS DOMESTIC PRODUCT (Annual Growth Rate)



## FOREIGN INVESTMENT (Billions of Dollars)



## INTERNATIONAL RESERVES (Billions of Dollars)



Mexico did not stop with these unilateral steps to open trade. In 1990, the country began pursuing freer trade with the United States, its main trading partner. These efforts eventually culminated in passage of the North American Free Trade Agreement (NAFTA), which formed a trading bloc among Canada, Mexico, and the United States. NAFTA took effect January 1, 1994.

- **Single-digit inflation.** The central goal of Mexico's economic reforms has been to eradicate high inflation by reducing its level to single-digit rates. Mexico's inflation reached 11.9 percent in 1992, down from almost 160 percent in 1987. In 1993, it slowed further to 8 percent, thus reaching the much-hoped-for single-digit rate.

- **A stable exchange rate.** Mexico's unpredictable maxi-devaluations of the 1980s, especially 1982-83 and 1986-87, have been replaced with preannounced, daily peso depreciations. As a matter of fact, the exchange rate has been under direct control through provisions of the pact and has thus served as the anchor for inflation-fighting measures.

- **Growth recovery.** After exhibiting zero average growth during 1983-88, Mexico's real GDP recovered in 1989 with growth of 3.3 percent—a rate higher than the

country's population growth of 1.9 percent. In the following years, Mexico managed to continue growing at rates surpassing population growth: real GDP rose 4.4 percent in 1990, 3.6 percent in 1991, and 2.6 percent in 1992.

- **Investment rebound.** During 1982-87, gross fixed investment contracted 7.1 percent on an average annual basis, falling by as much as 28 percent in 1983 and almost 12 percent in 1986. Investment registered an important 5.8-percent rebound in 1988 and continued to show positive rates in the following years, with double-digit growth of 10.8 percent in 1992.

The foreign component of investment in the country showed a more dramatic turnaround. Foreign investment averaged less than \$2 billion a year during 1982-87 but reached almost \$3 billion in 1988 and \$4 billion in 1989. It progressed in geometric increases in the succeeding years, eventually totaling \$14.6 billion in 1991 and \$17.3 billion in 1992.

The dynamic performance of foreign investment in recent years can be attributed to several factors: more liberalized regulations for foreign direct investment as of 1989, a new intellectual property law that took effect in 1991, new access to portfolio investments by foreigners, the general state of recovery in the



***Though inflation in 1993 finally dropped to a single-digit rate, growth was barely positive.***

economy that bolstered investors' confidence in the country's growth prospects, and finally, anticipation of NAFTA.

International reserves, thanks to this extraordinary performance of foreign capital inflows, have reached unprecedented levels—close to the \$20 billion mark in 1992, up from less than \$2 billion in 1982. Last year, reserves were nearly \$25 billion.

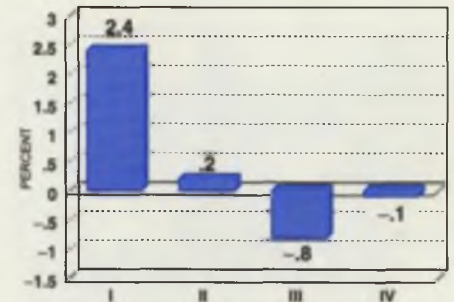
### **1993: The Mexican Economy At an Impasse**

The economy's performance in 1993 showed mixed results. Inflation last year dropped to a single-digit rate of 8 percent, while GDP growth was barely positive at 0.4 percent for the year as a whole. In fact, the last two quarters of the year showed *negative* growth of -0.8 percent and -0.1 percent. Not since 1986 had the Mexican economy exhibited negative growth rates. What happened?

The reasons behind the deceleration and eventual contraction in the growth numbers during 1993 are varied:

- Tight fiscal and monetary policies that have been behind the anti-inflation effort
- Intense import competition in some sectors, which in more

**1993 QUARTERLY GDP (Annual Growth Rate)**



serious cases has displaced domestic production

- Physical and financial infrastructure bottlenecks, which have impeded restructuring efforts of some industries, especially small and medium-sized ones
- The prolonged NAFTA approval process in 1993, which caused some companies to adopt a wait-and-see attitude toward investing in Mexico.

In fact, in the closing months of 1993, the widespread expectation was that, with NAFTA approval out of the way, the trade agreement's 1994 implementation would be a clear opportunity for growth to resume its upward trend.

Also, the authorities had announced somewhat more relaxed fiscal policy objectives for 1994, including initiatives that would enhance the purchasing power of the lower income groups. The hope was that such a policy, combined with

lower interest rates, would stimulate growth in 1994 without, however, compromising gains on the inflation front.

### **1994: The Start of a New Phase**

Unfortunately, coincident with NAFTA's implementation came the armed uprising in the southeastern state of Chiapas. On January 1, the world learned of a new movement in Mexico—the EZLN,<sup>1</sup> or Zapatist National Liberation Army—that was protesting social and political injustice in the country. Negotiations between the rebels and authorities are ongoing, but the conflict remains unresolved.

Mexico was dealt another blow on March 23 when Luis Donaldo Colosio, the presidential candidate of the PRI<sup>2</sup> and expected winner in the August elections, was assassinated—the first such event for Mexico in decades. Just two weeks earlier, yet another example of unrest had taken the country by surprise—the kidnapping of the president of Mexico's largest bank, Banamex.

Thus, despite optimistic expectations for Mexico's outlook at the beginning of 1994—indeed, in the first two months Mexico attracted

over \$4 billion in capital flows—March and April were characterized by turbulence in the financial markets and allegedly even some capital flight as confidence in the country was shaken by unexpected developments in the sociopolitical sphere.

The changing expectations for Mexico this year can be appreciated by looking at the country's growth and inflation outlook in January relative to April. In January, private-sector forecasts showed real GDP growth in Mexico at above the official target of 3 percent, with estimates ranging between 3.2 percent and 3.5 percent; the story for inflation was similar in that a rate higher than the official 5-percent goal was also expected: estimates ranged between 6 percent and 7.5 percent.

The uneasy sociopolitical climate that has pervaded the country, especially since the Colosio assassination, has had a negative impact on this outlook. Private-sector estimates in April placed growth at half the official target, 1.5 percent, and only as high as 2.5 percent; inflation estimates, on the other hand, were higher, between 7 percent and 7.8 percent.

Many observers safely assumed

***T**he expected positive effects of NAFTA on the economy in 1994 have been counteracted by unexpected sociopolitical developments.*

<sup>1</sup> *Ejército Zapatista de Liberación Nacional.*

<sup>2</sup> *Partido Revolucionario Institucional*, or the Institutional Revolutionary Party, which has been the ruling party in Mexico since 1929.



***“Many observers safely assumed that 1994 would be a political year because of presidential elections in August, but no one anticipated the extent to which this is turning out to be true, nor did anyone foresee the consequent deeper repercussions on the economy.”***

that 1994 would be a political year because of presidential elections in August, but no one anticipated the extent to which this is turning out to be true, nor did anyone foresee the consequent deeper repercussions on the economy. Since the beginning of the year, Mexico has been forced to grapple with a set of sociopolitical conditions that received far less attention during the country’s push to stabilize the economy. Indeed, Mexico has discovered that it can no longer neglect the sociopolitical dimension in the formulation of economic policy.

Yet it was precisely the emphatic approach to economic reform for more than a decade—the profound economic transformation—that gave the country the resiliency to sustain the current difficult situation. In other words, had it not been for Mexico’s strong foundation of macroeconomic stability now, the events in the first quarter would have produced a much more negative, if not chaotic, outcome for the country. One need only recall the

economy’s vulnerable conditions during the 1980s—negative growth, massive devaluations and triple-digit inflation—to appreciate the economy’s resiliency today.

And so, Mexico has reinforced economic continuity in the midst of new sociopolitical realities by moving forward with additional reforms and measures. For instance:

- After the Chiapas incident, the authorities reratified the terms under the latest phase of the Pact for Stability, Competitiveness, and Employment to signal that the economic reform program remained viable.
- Also in January, a new foreign investment law became effective, giving Mexico a greater institutional framework to abide by the new NAFTA provisions for a more open trade and investment scenario.
- In March, Mexico approached U.S. financial authorities on

	<b>Official Target</b>	<b>Forecast* (January)</b>	<b>Forecast* (April)</b>
<b>Real GDP (%)</b> :	<b>3.0</b>	<b>3.2 – 3.5</b>	<b>1.5 – 2.5</b>
<b>Inflation (%)</b> :	<b>5.0</b>	<b>6.0 – 7.5</b>	<b>7.0 – 7.8</b>

\* Range derived from individual private-sector forecasts.

securing a \$6 billion line of credit in case these extraordinary funds were needed to maintain stability in the exchange rate market. Given Mexico's substantial international reserves, however, this move was taken more as a measure to add confidence in the country through U.S. support rather than as an emergency loan.

- In April, Canada, Mexico, and the United States formed the North American Financial Group, an alliance established to guard the stability of member countries' currencies through swap arrangements.
- Also in April, the autonomy of the central bank became effective. This reform, initiated in 1993, should be a significant step forward in building the institutional framework necessary for long-term price stability.
- May brought Mexico's first-ever debate of presidential candidates, which became the country's first televised coverage of opposition candidates. Also, Mexico's congress approved important electoral reforms. Both events are signs of greater political opening.
- Mexico's entry into the Organization of Economic Cooperation and Development (OECD) became effective in May. The

significance of this event is the vote of confidence it represents from a group of the world's most industrialized and developed economies.

- Throughout the first six months of this year, Mexico has been directing greater expenditures to social areas, such as housing, education, and rural development. For example, in May, the authorities announced the availability of some \$1.2 billion to finance the purchase of 42,000 low-income homes.

The mixture of these events points to a new phase for Mexico in policy-making. While authorities continue to pursue economic continuity and are unflinching in their commitment to price stability, they are also introducing elements of social and political development in their reforms.

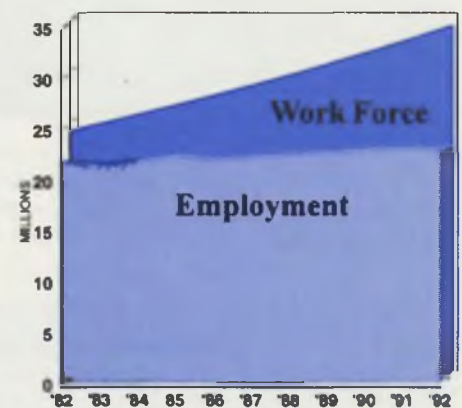
It seems this would be the natural trend for a developing economy—to move toward higher stages of development once a stable, growing economy has been secured. Mexico, in a way, was forced to accelerate this process because of the determining sociopolitical events of the first quarter of the year.

## The Challenges of a Growth-With-Equity Policy

So far in 1994, Mexico's economy is showing signs of a recovery. First-quarter growth, though a low 0.5 percent, was positive, reversing the negative growth registered in the last two quarters of 1993. Inflation has continued to report single-digit rates and remains slightly below 7 percent in annual terms.

However, it is no longer enough to check for the sign and the magnitude of GDP growth, nor to applaud inflation's single-digit performance. The challenge now is to point to what's behind the numbers: look at the gains in per capita GDP, review the nation's income distribution, look at the country's ability to absorb all its excess labor, count the poor.

### LABOR MARKET



The new sociopolitical realities that have surfaced in Mexico since the beginning of the year shed light



on what the economic reforms have not yet produced: widespread benefits for the entire population. It is true that some of the reform's benefits are expected to accrue only in the long term as the country's standard of living rises. However, Mexico now has to face the demands of a society no longer willing to wait for policies that have been in place for over a decade to take their full effect. It is no surprise, then, that the presidential candidates of the three main political parties—the PRI, PAN,<sup>3</sup> and PRD<sup>4</sup>—are very prominently, and foremostly, addressing sociopolitical themes even as they call for economic continuity.

The series of pervasive policy themes today, as opposed to those that were prevalent a decade ago can be summarized as follows:

Last Decade's Agenda	Next Decade's Agenda
• stabilization	• income distribution
• debt burden	• poverty
• structural change	• rural development
• privatization	• housing
• trade liberalization	• health
• deregulation	• education
• sustained growth	• regional growth
• competitiveness	• small/mid-size industry
• productivity	• inequality
• modernization	• marginalization
• economic opening	• political opening

<sup>3</sup> *Partido de Acción Nacional*, or the National Action Party.

<sup>4</sup> *Partido de la Revolución Democrática*, or the Democratic Revolution Party.

Mexico must reconcile the issues on both lists, which translates into building a new growth-with-equity policy for the country. Mexico is halfway there: one could not even begin to consider the issues under the second list unless those under the first list had first been addressed and were firmly in place. In other words, the sociopolitical issues of today are much more addressable now because of the economic transformation the country has experienced over the past decade. Imagine, for example, trying to deal effectively with housing, health, and education deficiencies under the budget deficits and high inflation of the 1980s.

More than likely, Mexico will indeed be able to meet the challenge at hand: social needs will be addressed with the appropriate spending programs but not at the cost of fiscal discipline. Also, with a strong, independent central bank, Mexico is poised to attain long-term price stability even as the country addresses the new issues that surface along its evolution toward a more developed society.

— Lucinda Vargas  
Economist

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The views expressed are those of the author and do not necessarily reflect the positions of the Federal Reserve Bank of Dallas or the Federal Reserve System.

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