the Southwest ECONOMY

THE FEDERAL RESERVE BANK OF DALLAS JULY 1990

Mexico Is Making Economic Progress Despite Problems

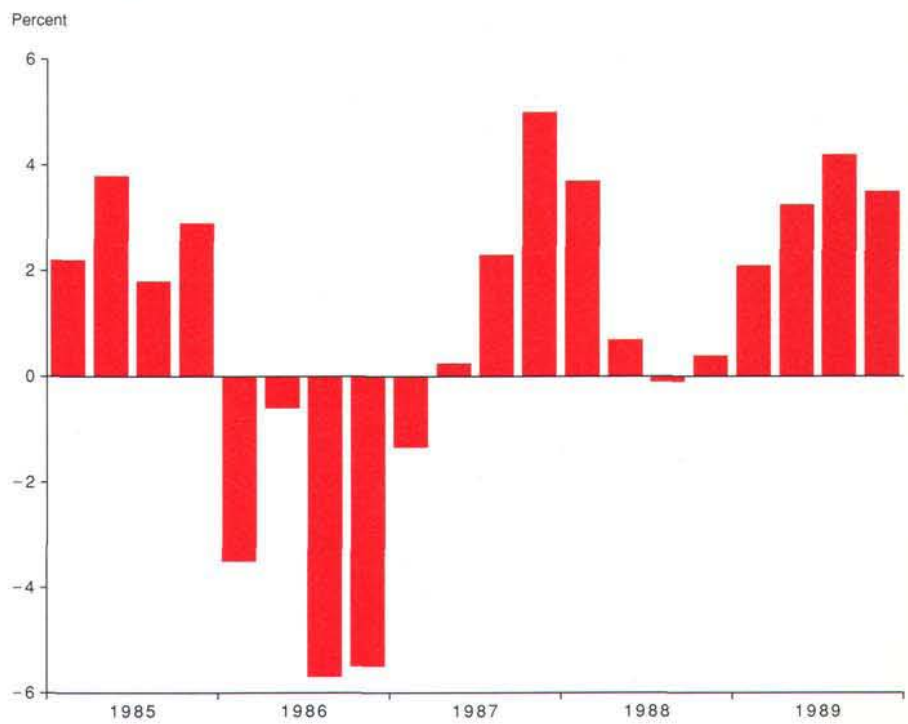
The Mexican economy shows many signs of having turned the corner from its serious difficulties of the early and late 1980s, but the country still faces problems. Although Mexico's aggregate economic expansion is well established, problems of insufficient credit, inadequate public and private investment and renewed inflationary pressures continue to impede the resurgence. Moreover, additional problems have appeared in recent months.

Investment, Consumption and Exports Rise

The evidence that Mexico's economy is growing has become very clear. Mexican production of both capital and consumer goods has increased. As the changes in Mexican gross domestic product show (*Chart 1*), overall output has expanded, and the rate of growth has accelerated.

Mexico's overall exports have

Chart 1
Gross Domestic Product



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grown. Some of this strength results from increased demand and prices for Mexican oil. The manufacturing sector has also been an important contributor to export growth (*Chart 2*). This sector helped offset declining energy exports during the late 1980s.

Mexico has been expanding capacity as well. Chart 3 shows rates of change in investment in Mexico. The chart suggests that expectations of further growth have become more optimistic in recent years, after serious problems during the mid-1980s. After a major decline in 1986, investment began to grow in 1987 and has continued to expand since then.

Changes in Government–Private Sector Relations

To attract still more investment and to create more jobs, Mexico is now taking additional steps to facilitate foreign investment. Aside from the *maquiladoras*—the in-bond export factories for which 100-percent foreign ownership is permitted, Mexico has traditionally required many types of manufacturing and other firms to have Mexican-majority ownership. Mexico has been liberalizing its ownership requirements and has opened 100-percent foreign ownership of firms in many formerly Mexican-only industries. Moreover, the Mexican government has opened preliminary talks with the United States to negotiate a free-trade agreement that would create jobs and stimulate investment.

Mexico has also taken steps to make the country more economically efficient. The Mexican government has sold or closed hundreds of state-owned enterprises including airlines, steel mills and hotels. These money-losing enterprises were a significant drain on the government's scarce resources. The government owned more than 1,100 of these enterprises in 1982, but it had reduced the number to less than 400 by the end of 1989. The Mexican government has recently begun to take steps toward the privatization of its banking system, which it nationalized in 1982. In another move toward efficiency, Mexico liberalized its import policies, partly as an attempt to introduce sufficient competition to hold down domestic prices.

Mexico has also pursued an austerity program. The government imposed wage and price controls and, in an effort to provide a sense of stability and to hold back any inflationary impact of a major devaluation, Mexico has instituted a controlled exchange-rate slide of one peso per day against the dollar.

Mexico has worked hard to bring down its inflation rate. The country has restricted expansion in its monetary base. It has liberalized import policies, reducing its maximum tariff from 100 percent to 20 percent. As Chart 4 shows, the result has been a dramatic decline in the nation's rate of price increase.

Chart 2
Foreign Currency Revenues from Exports

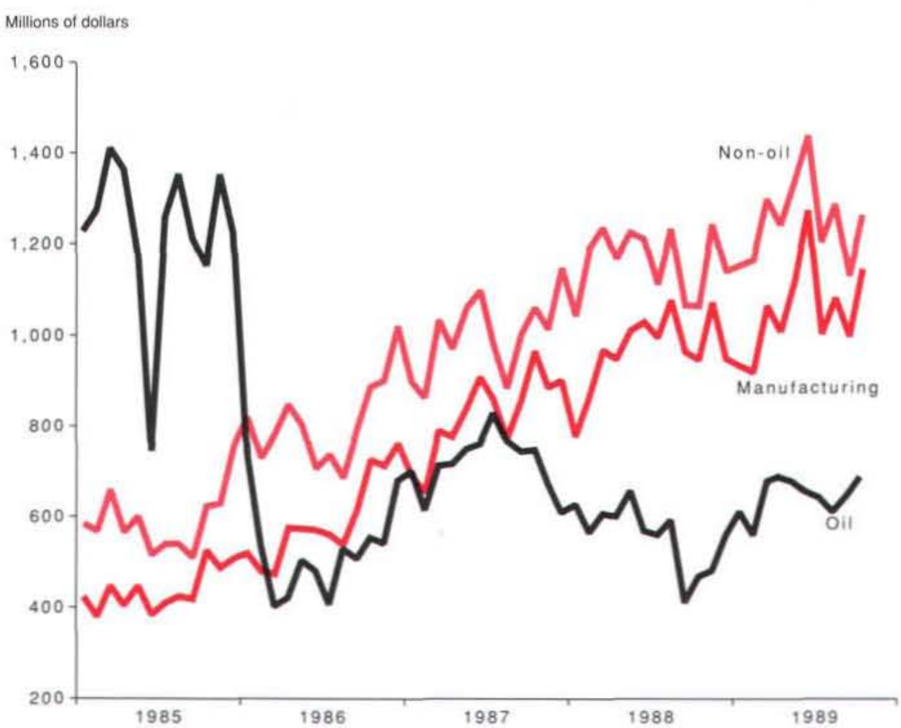
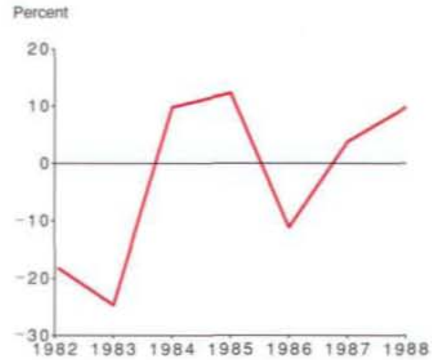
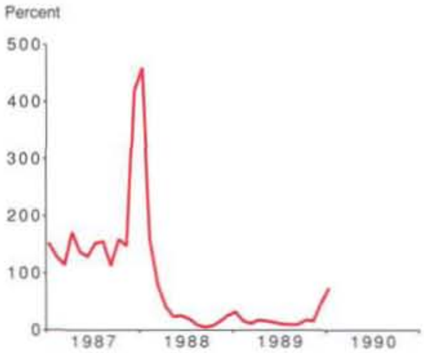


Chart 3
Growth in Real Private-Sector Investment



"Mexico's external public debt is a little less than $100 billion, which poses a serious problem."

Chart 4
Mexican Annualized Rate of Inflation



In sum, there are positive signs in Mexico. Output is growing. Inflation has declined far below its peaks. Investment is gaining momentum. The Mexican government has taken steps to liberalize its relation to the private sector. But problems exist as well.

High Debt and Insufficient Investment

Mexico's most well-known current problem is its foreign debt. Mexico's external public debt is a little less than $100 billion, which poses a serious problem. The Mexican government's total foreign debt has lately equaled a little less than half the nation's gross domestic product. As a portion of gross domestic product, the debt has fallen from almost 80 percent in 1986. Moreover, Mexico exchanged more than $40 billion of its commercial bank debt for new bonds as part of a recent agreement that offers reductions in the nation's interest payments. Nevertheless, payments on Mexico's foreign debt represent a major financial drain on the nation's economy.

Foreign debt is only one of Mexico's financial constraints. Mexico's government deficits have resulted in a significant run-up in its domestic debt. Chart 5 depicts the dollar value of Mexico's public domestic debt, the proceeds from which have been used to fund both internal deficits and hard-currency liabilities.

One problem with these levels of debt is that the Mexican public sector has absorbed savings that are needed to expand both private and public productive capacity. Together, Mexico's public and private investment as a percentage of gross domestic product have remained below 20 percent, compared with about 30 percent in some of the rapidly growing, newly industrialized Pacific nations. Mexico is not acquiring enough capital to make the investment efforts the nation needs to stay competitive with these countries.

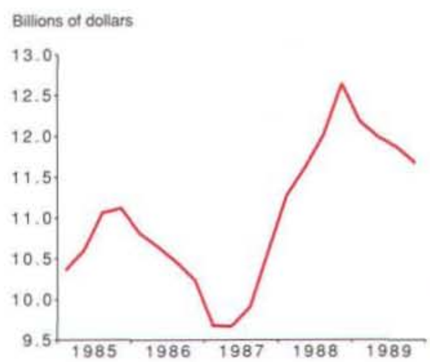
Evidence suggests that some of Mexico's public infrastructure is deteriorating. Mexico City's water system, for example, loses about 30 percent of its water through leaky pipes and other weaknesses in the system. This rate compares with about 15 percent in the United States and 12 percent in Europe. Because of past low levels of investment, Mexico has a great deal of catching up to do.

Mexico Tries to Diminish Problems

Because Mexico faces problems, the country's programs to make its economy more efficient and its public sector less burdensome, such as selling inefficient state-owned government enterprises, are very important. The same is true of Mexico's attempt to provide the stability that results from low inflation rates. Mexico hopes that these stabilizing measures will attract expatriated capital back to the country, which would facilitate further investment. To some extent, this strategy appears to have begun to work. Chart 6 shows the levels of total Mexican private—or nongovernmental—deposits in U.S. banks. These deposits have begun to fall, suggesting that some repatriation of Mexican capital is taking place.

Chart 5
Mexican Public-Sector Domestic Debt

Chart 6
Mexican Private Deposits in the United States



Nevertheless, capital shortages continue. One sign of this problem is the interest rate the Mexican government must pay on its short-term domestic debt. With the dramatic decline in Mexico's inflation, Mexican interest rates have fallen markedly. Between January 1988 and September 1989, the annualized rate of interest on Mexican one-month treasury bills (*cetes*) fell from 154 percent to 34 percent. Since then, however, both inflation and interest rates have risen. While inflation-adjusted interest rates have fallen since 1989, they remain

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well into double digits and far above inflation-adjusted rates for U.S. treasury bills.

Inflation and the Peso

The reacceleration in Mexico's inflation rate, together with the austerity program's one-peso-per-day slide against the dollar and comparatively low U.S. inflation rates, suggests that Mexico's currency is overvalued and that pressures against it may be increasing. Chart 7 compares the actual peso–dollar exchange rate with what would occur if the exchange rate adjusted perfectly for differences between Mexican and U.S. increases in their consumer price indexes.

When such adjustment does not take place, Mexican prices in pesos rise more rapidly than peso-denominated U.S. prices. These changes make U.S. goods increasingly attractive to Mexican buyers, and Mexican goods become less attractive.

To reach an inflation-adjusted peso–dollar exchange rate comparable to that of the fourth quarter of 1987, the number of pesos per dollar would currently have to increase by more than 30 percent. If the Mexican inflation rate suddenly began to equal the U.S. rate today, and continued in tandem, Mexico's current controlled peso-per-day exchange-rate slide would produce the appropriate exchange rate late in 1992. However, there is little evidence that Mexico's inflation rate will fall to that of the United States in the near future.

The value of the peso may help to explain why Mexico's trade balance has been in deficit since the third quarter of 1989. Both rising imports and slowing export growth contributed to this shift, which compares with a trade surplus of $1.7 billion for 1988.

Despite its benefits so far, Mexico's austerity program may also have created a potential for future inflationary problems. So far, the austerity program has contributed significantly to the reductions in inflation, which is one of the most dramatic aspects of recent changes in the Mexican economy. However, the removal of the program's wage and price controls is likely to pose a more delicate problem than instituting them did. Removing these controls may not only result in a surge of price increases, but in the self-fulfilling expectation of further increases in inflation.

Conclusion

In sum, the Mexican government's attempts to liberalize its relations with the private sector and with foreign investors suggest a positive outlook for the country, and Mexico has, indeed, recently been posting strong rates of growth. But, while Mexico has markedly reduced inflation, inflationary pressures remain strong by U.S. standards. Moreover, shortages of credit, a darkening Mexican trade picture and the related high value of the peso are problems that must be dealt with to facilitate long-run growth. Furthermore, the wage and price controls that constitute a portion of Mexico's austerity program have aided in bringing down inflation, but questions remain as to their ultimate inflationary impact when they are repealed.

— William C. Gruben

Chart 7
Actual and Theoretical Peso–Dollar Exchange Rates