

To the Graduate Council:

I am submitting herewith a thesis written by David Michael Dickson entitled "The Mexican Debt Crisis." I have examined the final copy of this thesis for form and content and recommend that it be accepted in partial fulfillment of the requirements for the degree of Master of Arts, with a major in Economics.

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THE MEXICAN DEBT CRISIS

A Thesis

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## DEDICATION

Without the unwavering support from my parents, Robert W. and Rose Marie Dickson, this thesis could never have been completed. Their relentless encouragement helped me to overcome roadblocks that I had placed in my path myself. To them I gratefully dedicate this thesis and express my eternal appreciation and thanks.

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## ABSTRACT

In 1976, Mexico suffered a serious economic downturn that was largely the result of failed domestic economic policy actions. However, the discovery of immense oil reserves and the tripling of international oil prices between 1979 and 1980 enabled Mexico to borrow vast sums of money in the international capital markets.

No sooner had Mexico incurred a foreign debt approaching \$80 billion when oil prices began to fall precipitously in 1981. An overdependency on oil for export revenues, an overvalued exchange rate, rising debt service costs, expansionary fiscal and monetary policies that produced increasing inflation, and the rapid decline in oil-related revenues simultaneously came together to generate a severe economic crisis that began with Mexico's de facto default in August 1982.

Efforts to address these economic dislocations and to re-invigorate the shattered economy have been undertaken by Mexican officials since 1982. Improvements have been made in some areas, but the short-term health of Mexico's economy remains inextricably tied to the international oil price. As long as the price of oil remains below \$20 per barrel (roughly half the level prevailing in early 1981), Mexico's prospects appear

quite bleak. Whether the efforts to restructure its export sector to emphasize manufactured goods sold to the United States will have significant long-term beneficial results remains to be seen.

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## CHAPTER I

### INTRODUCTION

The causes of the Mexican debt crisis are many and varied. Both external and internal disequilibria contributed to Mexico's unstable economic condition, which ultimately developed into a full-scale financial panic in August 1982.

The imminence of the problem, if not its magnitude, was predictable. This is particularly true in view of two factors: first, the severity of the 1981-82 recession that engulfed the developed countries had foretelling consequences for the developing nations; and second, the "petrolization" of the Mexican economy, whose overdependence upon oil brought with it an excessive degree of financial jeopardy during an oil glut, had adverse consequences that would be magnified during an economic downturn. Nonetheless, few economists and policy makers were prepared to deal with all of the adverse ramifications relating to Mexico's de facto default. While the Reagan administration focused upon the debt problems of Eastern Europe, paying particular attention to Poland, the Mexican financial crisis that was precipitated by massive capital flight and dwindling international reserves occurred with little official warning.

Not long after several crisis-alleviating measures were adopted to mitigate the consequences of Mexico's default, the economies of other Latin American nations (Brazil, Argentina, Venezuela, Peru, and Chile) collapsed from the weight of their own foreign debts. In all, Latin American countries owed external creditors more than \$320 billion when Mexico announced in August 1982 that it could no longer amortize its debt. The international debt crisis began when Mexico's debt bomb exploded.

Mexico, then, may be viewed as the first domino in a configuration of many dominoes. Its economic crisis represented the first of many Latin American economic emergencies, which, when combined with those of other Third World nations, collectively embodied an international debt problem that threatened to destroy the entire international economic system.

The purpose of this study is to investigate the underpinnings of Mexico's economic crisis, to review the corrective measures undertaken to address its economic problems, to assess the progress achieved through 1985 in that effort, and to prognosticate Mexico's economic future, both short-term and long-term, based upon its experience during the past several years.

While few economists recognized either the magnitude of the problem or its imminence (Emma Rothchild was one who recognized both), virtually no international

bank, whence Mexico and other developing nations borrowed at will, forecast the depth of the impending crisis, believing instead that Mexico's troubles were merely temporary. Operating under the often-stated belief of Citicorp's then-chairman Walter Wriston, who repeatedly asserted that sovereign nations do not go bankrupt, international bankers believed their loans to Mexico were as secure as its 72 billion barrels of oil in the ground.

Bankers and policy makers for far too long ignored the warning signs appearing for years in Mexico's deteriorating balance-of-payments accounts and its accelerating accumulation of external debt. Indeed, the pending crisis, once it was finally recognized, was viewed as a temporary economic problem! In May 1982, three months before Mexico defaulted, a syndicate of 75 banks had oversubscribed a \$2.5 billion Mexican credit. Half of these funds were needed to remit interest payments Mexico would otherwise have been unable to pay. When the loan was signed and finalized in July 1982, the banking syndicate declared, "The agreement signifies confidence in Mexico's recovery from severe economic crisis" ("Loan Signed for Mexico" 17). Bank of America, the syndicate's coordinator, defended Mexico's heavy borrowing, noting, "We are confident that Mexico's vast natural resources, its industrial labor force, its dynamic private initiative, as well as its efficient

public administration, will pull Mexico out of its current troubles" ("Loan Signed for Mexico" 17).

As always, hindsight provides a different, clearer picture. Indeed, no sooner had Mexico recovered from the severe economic setbacks it endured in 1976 and 1977 than the seeds were sown for the 1982 crisis. Moreover, the causes of the 1976-77 downturn, which reflected the worst economic conditions in Mexico since the Great Depression, were nearly identical to those precipitating the 1982 collapse. These quite similar circumstances included an overvalued exchange rate, an overdependence upon foreign capital to finance an ambitious, state-directed public sector investment program, and fiscal and monetary excesses that produced expanding federal deficits and accelerating inflation.

A confluence of factors--the size of the debt, Mexico's propensity to import more than it exports, double-digit inflation, fear of political instability--brought massive capital flight, a halt to private investment, and two devaluations of the once-vaunted peso in late 1976. (Grayson, "Mexico's Opportunity" 65)

Because these were the identical factors that brought about Mexico's even more serious crisis six years later, a sense of deja vu no doubt befell Mexico's newly elected president, Miguel de la Madrid Hurtado, when he entered office amidst economic chaos in December 1982. Just as President Jose Lopez Portillo had inherited in 1976 an economic crisis from his predecessor, Luis Echeverria, so

too had Lopez Portillo bequeathed a crisis to his successor, de la Madrid, in 1982.

To more fully understand the background of the 1982 crisis, it would be instructive to review what occurred during the Echeverria era before the 1976 downturn. First, however, a brief summary of Mexico's developmental process during the 1950s and 1960s is in order.

Table I on the next page presents a statistical summary of Mexico's economy between 1950 and 1978. In the two decades preceding 1970, the average annual real growth rate of Mexico's economy exceeded 6 percent. Gross domestic product (GDP) averaged annual increases of 6.4 percent (1950-65) and 6.9 percent (1965-70); and per capita income rose annually by more than 3 percent during these two decades (Cline and Weintraub 273). However, because the increasing income continued to be unevenly distributed, increases in per capita income did not fairly indicate how well most Mexicans shared in the growth.

During the same period, population nearly doubled, rising from 27.4 million in 1950 to 51.2 million in 1970 (World Bank, World Tables 122). Income distribution, however, continued to favor the wealthy. Table II on page summarizes the trend in income distribution between 1950 and 1969. Whereas the bottom 20 percent of households commanded 6.1 percent of total family income in 1950, their share in 1969 had fallen to 4 percent. The income group comprising 30

TABLE I

GROWTH OF MEXICAN GROSS DOMESTIC PRODUCT  
AND ITS COMPONENTS, 1950-78\*

| Component                                          | 1950-65 | 1965-70 | 1970-75 | 1976 | 1977 <sup>a</sup> | 1978 <sup>a</sup> |
|----------------------------------------------------|---------|---------|---------|------|-------------------|-------------------|
| Gross domestic product                             | 6.4     | 6.9     | 5.6     | 1.7  | 3.2               | 6.6               |
| GDP per capita                                     | 3.1     | 3.3     | 2.0     | -1.9 | -0.5              | 3.5               |
| Agriculture, livestock,<br>forestry, and fisheries | 4.6     | 2.3     | 2.0     | -2.8 | 2.7               | 3.1               |
| Mining                                             | 1.9     | 3.3     | 3.6     | 2.0  | 0.9               | -2.0              |
| Petroleum and petro-<br>chemicals                  | 9.3     | 9.6     | 7.5     | 10.6 | 15.9              | 15.5              |
| Manufacturing                                      | 7.1     | 8.6     | 5.9     | 2.7  | 3.6               | 8.5               |
| Construction                                       | 7.2     | 9.7     | 8.3     | -1.9 | -2.0              | 12.5              |
| Electricity                                        | 12.7    | 14.1    | 8.6     | 7.4  | 7.7               | 10.0              |
| Trade                                              | 6.6     | 7.0     | 5.2     | -1.0 | 2.0               | n.a.              |
| Transport and communi-<br>cations                  | 5.4     | 7.8     | 9.9     | 5.0  | 5.2               | n.a.              |
| Government                                         | 6.6     | 7.6     | 10.5    | 8.2  | 1.8               | n.a.              |
| Other services <sup>b</sup>                        | 5.4     | 5.4     | 3.7     | 2.2  | 2.3               | n.a.              |

\*Compound annual percentage rates of growth in constant prices (1960 = 100).

<sup>a</sup>Preliminary figures.<sup>b</sup>Contains adjustment for banking services.

n.a. = Not available.

Source: William R. Cline and Sidney Weintraub, eds., Economic Stabilization  
In Developing Countries (Washington, D.C.: The Brookings Institution, 1981), p. 273.

TABLE II

ESTIMATED DISTRIBUTION OF FAMILY INCOME IN MEXICO,  
SELECTED YEARS 1950-1969

| Income Group         | % of Family Income |       |       |       |
|----------------------|--------------------|-------|-------|-------|
|                      | 1950               | 1958  | 1963  | 1969  |
| Lowest 20%           | 6.1                | 5.0   | 4.2   | 4.0   |
| 30% below the median | 13.0               | 11.7  | 11.5  | 11.0  |
| 30% above the median | 21.1               | 20.4  | 21.7  | 21.0  |
| 15% below the top    | 19.8               | 24.3  | 24.3  | 28.0  |
| Top 5%               | 40.0               | 38.6  | 38.3  | 36.0  |
|                      | 100.0              | 100.0 | 100.0 | 100.0 |
| Top 20%              | 59.8               | 62.9  | 62.6  | 64.0  |

Source: David Gordon, "Mexico: A Survey," The Economist, 22 April, 1978, p. 16.

of the families below the median saw its share decline from 13 percent in 1950 to 11 percent in 1969. Meanwhile, the share accruing to the top 20 percent increased from 59.8 percent in 1950 to 64 percent in 1969. On the positive side, it must be noted that during this two-decade period, Mexico did develop an upper middle class (the 15 percent segment of families below the top 5 percent). Whereas the share of income received by the top 5 percent actually declined from 40 percent to 36 percent, the share captured by the new upper middle class increased significantly, rising from less than 20 in 1950 to nearly 30 percent in 1969 (Gordon 16).

Despite the welcomed emergence of an upper middle class and the decline in the share of income accruing to the top 5 percent, the proportion of income received by the top 10 percent compared to the bottom 40 percent of households increased during these two decades. In 1950 the average income of the top 5 percent of households was 22 times the average income of the poorest 40 percent of households. The average income of the next highest 5 percent was 5.2 times the poorest 40 percent. By 1969, the ratios had risen to 34 and 10.7, respectively (Felix 112).

Two decades of real growth averaging more than 6 percent per annum and an unbalanced income distribution produced "the classic dual economy with a modern sector small in numbers but rich in money and power, and a

traditional sector large in numbers but poor and weak" (Gordon 16).

Postwar governments encouraged industry by subsidizing the industrialists at the expense of the peasants. The government borrowed to pay for the infrastructure demanded by industry, manipulated corrupt trade unions into accepting wage increases smaller than inflation, maintained food prices below the level needed to encourage sufficient production and to provide for agricultural capitalization, and, in effect, condemned the peasants in the country to a life of poverty and bare subsistence.

The coddling of industry distorted the pattern of the economy and created a bias against agriculture, while capital-intensive industry failed to provide jobs for those driven off undercapitalized land. This coddling of industrialists distorted the distribution of income so that demand encouraged the supply of luxury goods for which the bulk of the people had neither the money nor the need (Gordon 16).

Echeverria sought to reform the dual economy he inherited when he became president in 1970. "Shared development" became the watchword. His goals were income redistribution favoring peasants and labor, expansion of employment opportunities, decentralization of industry, improvement in the balance of payments, and a reduction in

Mexico's dependence upon foreign capital and technology (Blair 125). Though his goals were laudatory, his achievements were not.

In terms of income redistribution (Table III), the results were mixed. While the shares of income accruing to the top 5 and top 20 percent of households had declined, so too had the share of the lowest 20 percent, compared to 1969 (Cline and Weintraub 275; Gordon 16). (See Table III.)

On the unemployment front, the results were equally mixed. Because of the subtle distinctions among unemployment, underemployment, and the underground economy, employment statistics are somewhat unreliable. Nevertheless, the increasing labor force and the decreasing economic growth rates combine to suggest that Echeverria's goals in employment were not reached.

Under Echeverria, the public sector, which includes current expenditures and investment expenditures, grew enormously. In the six years before his administration, public sector current expenditures averaged 6 percent of GDP. During the last two years of the Echeverria regime, they averaged more than 17 percent. Public sector investment expenditures doubled between 1971 and 1976, increasing from 6 percent of GDP to 12 percent. Thus, the public sector embracing both current and investment expenditures increased from 12 percent of GDP before Echeverria assumed the

TABLE III  
ESTIMATED DISTRIBUTION OF FAMILY INCOME IN  
MEXICO, 1975 AND 1977

| House Holds        | Total Income Received (Percent) |      |
|--------------------|---------------------------------|------|
|                    | 1975                            | 1977 |
| Lowest 20 percent  | 1.9                             | 3.3  |
| Lowest 40 percent  | 8.1                             | 10.9 |
| Highest 20 percent | 60.4                            | 55.1 |
| Highest 5 percent  | 30.7                            | 25.5 |

Source: William R. Cline and Sidney Weintraub, eds.,  
Economic Stabilization in Developing Countries (Washington, D.C.:  
The Brookings Institution, 1981), p. 275.

presidency to 29 percent at the end of his six-year term (Cline and Weintraub 276).

Early in his administration Echeverria failed to raise taxes sufficiently to finance the rising public expenditures. As a result, the overall public sector deficit increased significantly. Averaging 2.5 percent of GDP between 1965 and 1970, the public sector deficit more than doubled between 1971 and 1976, during which time it averaged 5.7 percent of GDP. By 1976, the public sector deficit reached 9.5 percent of GDP (Cline and Weintraub 276).

To be sure, much of the money was well spent, including expenditures for oil exploration, railroad construction, airports, roads, and education.

Yet the critical destabilizing factor of the Echeverria administration was the decision to expand the public sector and to use it as the main vehicle for stimulating economic growth and rectifying social inequalities--but then doing so on an inadequate tax base and revenue-generating base (Cline and Weintraub 276).

Initially, the fiscal stimulus accelerated the growth rate of real GDP, increasing it from 3.4 percent in 1971 (which approximated the growth rate of population) to 7.3 percent in 1972 and 7.6 percent in 1973 (Gordon 18). Inflation, as measured by the implicit GDP deflator, rose from 5.7 percent in 1971 to 6.3 percent in 1972 and 12.8

percent in 1973 (World Bank, World Tables 122), clearly not out of line with world trends.

However, Mexico did not acknowledge the world recession that followed the global expansion of the early 1970s. Its public sector deficit, manifesting the expansionary fiscal policies pursued by the government, grew in tandem with increased government expenditures. Mexico financed the expanding deficit by increasing the money supply and by borrowing externally. Inflation increased to 22.7 percent in 1974 and averaged nearly 20 percent during the final three years of the Echeverria administration (World Bank, World Tables 122). Real GDP growth decelerated and fell below 2 percent in 1976, when real per capita output actually declined by 1.9 percent--the first time such a decline had occurred in decades (Cline and Weintraub 285).

Although deficits approaching double digits were universally viewed as destabilizing, not all economists agreed that government spending had been "excessive."

Given the massive unemployment and underemployment in Mexico and the pressures to create jobs of any sort, the social costs of a real recession would include an increase in unrest and political protest, perhaps more violence, increased pressures for illegal migration to the United States, and increased land invasions by campesinos without employment alternatives. (Blair 126)

While disagreement exists among economists regarding the merits of the size of Mexico's fiscal expenditures, there exists little disagreement with the conclusion that Echeverria's conduct of international

economic policy was a major failure. Compounding the destabilizing effect of expanding federal budget deficits was a significantly overvalued peso that produced a large imbalance in the external accounts.

Variously described as an "article of faith" or a "Mexican fetish," the government's insistence upon maintaining a fixed exchange rate of 12.50 pesos to the U.S. dollar, irrespective of Mexico's relatively high inflation rate, finally resulted in a major crisis in August 1976. During the previous three years, Mexico registered large increases in its inflation rate relative to the experience of its major trading partner, the United States. In Mexico, the compounded increase in the GDP deflator between 1973 and 1976 was 91.7 percent, compared to 32.3 percent in the United States. Declining to acknowledge the obvious, Mexico stubbornly maintained its exchange rate fixed at 12.50 pesos to the dollar. The results were predictable. As Mexican products became increasingly uncompetitive, its exports, measured in constant prices, remained unchanged in 1974 and actually declined by 8.5 percent in 1975 (International Monetary Fund, International Financial Statistics 25, 75-77).

Meanwhile, imports surged, and the merchandise balance of trade worsened, moving from a deficit of \$728 million in 1972 to \$2.3 billion in 1974 and \$2.8 billion in 1975. The current account deficit increased from \$916

million (1972) to \$1.4 billion (1973), \$2.9 billion (1974), and \$4.0 billion (1975). Measured as a percentage of GDP, the annual current account deficit averaged 2.4 percent (1965-70) and 3.7 percent (1971-76). In 1975 and 1976, the current account deficit was 5.1 percent and 4.3 percent, respectively (Cline and Weintraub 282-83).

Fearful of an imminent devaluation and taking advantage of the absence of exchange controls, wealthy Mexicans converted their large peso savings into dollars. Peso deposits at private banks, measured as a percentage of GDP, declined from 31 percent in 1972 to 21 percent in 1976; and dollar deposits at private banks surged by 350 percent during the same period (Gordon 19).

Capital fled the country. A rough estimate of capital flight can be gleaned from the "errors and omissions" item of the balance-of-payments accounts. As recently as 1971, "errors and omissions" had totaled a mere \$34 million. In 1974, 1975, and 1976, when capital flight was evident, the "errors and omissions" totaled \$845 million, \$1.2 billion, and \$3 billion, respectively (Cline and Weintraub 283). Added to the "internal capital flight" resulting from the conversion of peso deposits into dollar deposits, the incidence of capital flight reached epidemic proportions.

Nonetheless, until August 1976, Mexico insisted on maintaining its exchange rate fixed at 12.50 pesos to the

dollar, preferring to finance the current account deficits and the capital flight by borrowing extensively from abroad. According to the Inter-American Development Bank's extensive study, External Debt and Economic Development in Latin America: Background and Prospects, Mexico's external debt increased more than five-fold under Echeverria, rising to \$21.8 billion by 1976 (93).

Finally, the pressures from the overvalued exchange rate became unbearable, and Echeverria severed the peso from its fixed position against the dollar on August 31, 1976. The peso immediately depreciated 40 percent and, following an unsuccessful government effort to manage the float at two different levels, "The central bank withdrew its support, the foreign exchange market was reorganized, Lopez Portillo was inaugurated, and the peso settled down at very close to 20 to the dollar" (Blair 126).

The peso had been held to 12.50 per dollar since it was pegged at that rate in 1954. By 1970, the wholesale price index for Mexico City (a national index is not available) had risen about 38 percent faster than the U.S. wholesale price index, which is known today as the producer price index. Thus, the purchasing power parity theory would suggest that the peso had become overvalued even before Echeverria became president in 1970. Echeverria's inflationary policies merely exacerbated the peso's overvaluation. When the exchange rate ultimately settled at

20 pesos to the dollar in late 1976 after Mexican intervention had ceased, it could be argued that this market-determined rate was "about right." Strict adherence to the purchasing power parity theory would have produced an exchange rate of 21.25 pesos, not significantly different from the market-determined rate. This point is emphasized here because the forthcoming analysis of the peso's performance under the Lopez Portillo regime will begin with the (reasonable) assumption that purchasing power parity had been closely approximated in late 1976 at 20 pesos.

In summary then, the 1976 crisis can be said to have resulted from the following factors:

1.) Increased government spending was not accompanied by a proportionate increase in revenues. The resulting federal deficit, financed largely by increases in the money supply, aggravated inflation.

2.) The government's failure to adjust the increasingly overvalued exchange rate to account for relative changes in inflation increased the external deficits in the trade balance and in the current account. Massive capital flight represented a second consequence of the overvalued peso.

3.) The 1974-75 world recession, which reduced the demand for Mexico's exports, further complicated its current account problems. Significantly, Mexico's 1976 crisis could not be traced to the quadrupling of world oil prices. In

1974 its net energy imports amounted to only \$250 million, and by 1975 Mexico had become a net exporter of petroleum (Cline and Weintraub 284).

4.) A quintupling of the external debt was undertaken largely in response to the deteriorating current account and the capital flight. Incurring the debt did not in itself produce the economic problems, but the inability to service the debt (due to the decline in foreign exchange reserves) and the rising debt service ratio discouraged Mexico's creditors from increasing their exposure further.

To deal with the economic crisis, Echeverria was ultimately forced to negotiate with the International Monetary Fund and to acquiesce in the requisite austerity measures that would be implemented by his successor. The IMF provided Mexico with resources totaling SDR 837.15, about \$1 billion. In return, Mexico agreed to adopt several measures to supplement the new exchange rate regime, including:

Some export taxes designed to mitigate the impact on domestic prices of the exchange rate adjustment and to increase government revenue; the suspension, with a few exceptions, of the tax rebate regime; and the progressive dismantling of unnecessary import controls and tariff reductions for import products required for domestic production. Moreover, price controls for essential consumer goods and raw materials are being continued and widened to avoid undue domestic price increases. . . . In addition, the program includes other fiscal and monetary measures to provide for an increase in the revenue of the public sector, combined with tight control in current public expenditure, thus reducing the need for financing from abroad (emphasis added).  
(International Monetary Fund, IMF Survey 333)

The monetary measures mandated by the IMF included targets for money supply expansion and international reserves. The fiscal measures required Mexico to reduce its public sector (federal) deficit as a percentage of GDP over the three-year period of the IMF program. The deficit, which had reached 9.5 percent of GDP in 1976, was to fall to 6 percent in 1977, 4 percent in 1978, and 2.5 percent in 1979 (Looney, Mexico's Economy 128).

Of particular interest was the IMF condition requiring a reduction in the rate of growth of external debt. As noted previously, public sector external debt (including publicly guaranteed private debt) increased from \$4 billion in 1970 to \$16 billion in 1976. (Total external debt, including \$5 billion of non-publicly guaranteed private debt, amounted to \$21 billion in 1976.) In the final three years of Echeverria's administration, public external debt had been increasing by nearly \$4 billion per year. Thus, the IMF-imposed limitation of net external borrowing of \$3 billion per year for 1977 and 1978 represented a major deceleration in external debt accumulation (Cline and Weintraub 286).

When Lopez Portillo assumed the presidency in December 1976, he inherited a crisis-convulsed economy growing so slowly that per capita income was declining. Moreover, his first order of business required him to implement an IMF-imposed austerity plan intended to purge

the economy of its inflationary bias while simultaneously limiting its growth in the short run.

Even as Mexico was recovering from the crisis of 1976 and implementing painful corrective measures, the future was filled with opportunity. For Mexico had billions of barrels of oil and gas reserves, and it was preparing to embark upon a major exploitation effort. Mexico's wild card was oil, and it was about to play it.

## CHAPTER II

### MEXICO'S OIL

One major achievement of the Echeverria regime involved the planting of the seeds from which a re-invigorated oil industry later sprouted. "The heavy investments made in Pemex (the nationalized oil company) during the 1970-1976 period, combined with a degree of Mexican technological competence and dynamic ability, produced breakthrough discoveries" (Velasco-S. 68). Indeed, proved reserves of crude oil (i.e., oil and condensates) increased from 3.29 billion barrels in 1970 to 7.28 billion in 1976. Natural gas reserves rose from the equivalent of 2.28 billion barrels to 3.88 billion during the same period (Velasco-S. 61).

As the scope of the discoveries became apparent and as more discoveries were made, Mexico's reserves soared. Proved hydrocarbon (crude oil and natural gas) reserves increased by nearly 50 percent in 1977 alone to reach more than 16 billion barrels. In 1978 they jumped to 40.2 billion barrels, and by 1981 proved hydrocarbon reserves were reported to be 72 billion barrels, of which nearly 57 billion were crude oil reserves and 15 billion were natural gas (Velasco-S. 61). As of December 1984, proved hydrocarbon

reserves were listed at 71.75 billion barrels ("84 Oil Output up in Mexico").

As proved hydrocarbon reserves increased, so too did estimates of probable and potential reserves. By 1981 an additional 58 billion barrels of hydrocarbons were believed to be "probable" reserves, and Mexico's "potential" reserves, including proved and probable, reached 250 billion (Velasco-S. 62).

According to Oil and Gas Journal, only Saudia Arabia (164 billion), Kuwait (64.5 billion), the Soviet Union (63 billion), and Iran (57 billion) had higher proved crude oil reserves than did Mexico (56.99 billion) at the end of 1981. The United States had 29.8 billion barrels of proved reserves ("Annual Survey").

With an increase in reserves came an increase in production, and Mexico quickly moved from a net importer of energy (\$250 million) in 1974 to a net exporter in 1975 (Cline and Weintraub 284). Production of crude oil increased from 429,000 barrels per day (bpd) in 1970 to 803,000 bpd in 1976, 1.94 million bpd in 1980, and 2.7 million bpd in 1982-84 (Velasco-S. 69; Inter-American Development Bank, Economic and Social Progress 469).

Exports of crude oil expanded from slightly less than 100,000 bpd in 1975 to 200,000 bpd in 1977, 830,000 bpd in 1980, and 1.5 million bpd in 1982, at which level they roughly remained through 1984 (Cline and Weintraub 279;

IADB, Economic and Social Progress 469; "Mexico Trims Oil Exports").

Not only did the discovery, production level, and export rate of Mexican oil increase significantly between 1970 and 1984, but so too did its price, and, consequently, Mexico's export revenues. Indeed, Lopez Portillo entered office with the intention of drastically expanding Mexico's oil sector as the major strategy for dealing with the economic crisis he inherited. At the same time, he made oil the cornerstone of Mexico's development.

Given the relatively low level of Mexico's proved crude oil reserves in 1976 (7.28 billion barrels), the ultimate production and export levels attained by 1982 substantively exceeded even Lopez Portillo's ambitious plans outlined in 1976. His announced goal upon entering office was to achieve oil-export revenues of \$5.5 billion by 1982 (Gordon 23). In fact, Mexico earned nearly three times that level, \$15.6 billion, from its oil exports in 1982 (Foreign Economic Trends, October 1983 2). Beyond all mid-1970s expectations, the value of oil exports increased nearly nine-fold between 1976 and 1982, rising from less than \$2 billion in 1976 to nearly \$16 billion in 1982 ("Mexico--Progress and Prospects" 2). Figure 1 on the following page summarizes the role oil played in Mexico's economy during the late 1970s and the early 1980s.

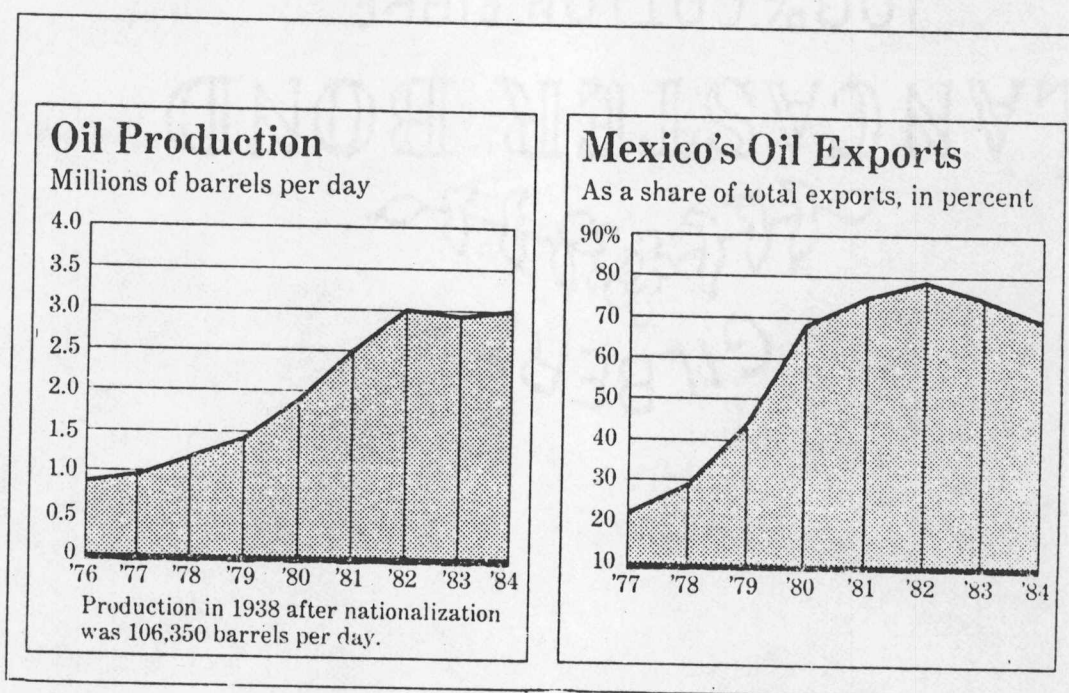


FIGURE 1

## THE ROLE OF OIL IN MEXICO'S ECONOMY

Source: The Wall Street Journal, October 5, 1985, p. 26.

Given such an immense windfall in oil revenues, how could Mexico find itself on the brink of financial collapse in the summer of 1982? What occurred during the intervening years between the 1976 IMF austerity program and the 1982 panic that led Mexico into the financial abyss?

It was largely a matter of expanded, and unfulfilled, expectations. Between 1976 and 1982, as the extent of the oil resources became known and appreciated and as world oil prices soared during 1979 and 1980, expectations of oil income increased significantly from the levels forecasted when Lopez Portillo entered office. Development of the oil industry, massive though it was to have been, accelerated beyond the wildest imaginations of both Pemex and Lopez Portillo.

Thus, while 1981 and 1982 oil export revenues were nearly triple the levels predicted five years earlier in 1976, they fell significantly below the revised forecasts of the early 1980s that called for \$20 billion annually. In 1980 the \$14 billion derived from oil exports was more than 40 percent below the revised forecast (Looney, "Mexican Policy Dilemmas" 33). Oil revenue realized in 1982 was \$4 billion below projections made the year before (Street 411).

Meanwhile, Mexico's oil industry developmental investments soared:

As soon as President Lopez Portillo took office, he authorized a massive expansion plan for Pemex. This has been revised upwards twice and planned investment by Pemex in 1977-82 now (April 1978)

stands at about \$17 billion, about three times its investment in the previous six years. . . . In 1978 Pemex's capital expenditures will account for over half the public sector's investment of \$8.2 billion, and its total expenditure will be nearly 30 percent of the whole public sector budget. (Gordon 23)

Oil industry expenditures eventually increased well beyond even these expanded projections. During 1981, Pemex received 35.6 percent of a growing public sector budget (Velasco-S. 88). Much of Pemex's budget financed its capital imports, which included oil-drilling equipment, oil technology, and the industrial components it needed to find and extract its oil. "The Pemex share of total imports increased from 5.5 percent in 1970 to 9.8 percent in 1975, and climbed to almost 15 percent in 1978. . . . Pemex's imports almost tripled from \$3.45 billion in 1979 to \$9.64 billion in 1980 (Velasco-S. 189).

Moreover, Pemex's share of the rapidly rising foreign debt increased over time as well. In 1970 the Pemex share of total public sector foreign debt was a modest 10.3 percent, and by 1976 the total was only 11.3 percent. But in 1978 the percentage increased to 16.5 percent, in 1979 to 19.7 percent, and in 1980 to 21.6 percent (Velasco-S. 88).

By 1982 Pemex owed \$24.8 billion of the \$60.8 billion public debt. Not all of these borrowed funds were properly used to develop Mexico's immense oil reserves. Billions and billions, quite literally, were squandered through massive corruption and ill-conceived projects, including, for example, the construction of a \$1.5 billion

gas pipeline when enlargement and extentions of existing pipelines could have accomplished the same result at a fraction of the cost. In 1982 alone, Pemex's budget exceeded \$9 billion, \$2 billion of which was needed to drill new wells in all major production fields merely to maintain its 2.7 million bpd output (Grayson, "Oil Politics" 417).

Paradoxically, then, the very resource that was universally perceived to be Mexico's salvation contributed in part to its financial demise. Mexico had, in effect, become "petrolized," despite the warnings evident in the boom-and-bust experiences of Venezuela, Iran, and Nigeria. Mexico became exceedingly reliant upon its oil export revenues, whose proportion of total exports increased from a mere 16 percent in 1976 to 75 percent by 1981 (Grayson, "Oil Politics" 417). To the detriment of other potential export sectors of its economy, Mexico increasingly depended upon its oil industry. Combined with its historical emphasis upon a stable exchange rate, irrespective of its accelerating inflation rate relative to that of its trading partners, Mexico's oil wealth contributed to an overvalued currency, the effect of which made its non-oil trade less competitive. Thus, even as its oil revenues increased in 1981, its non-oil export earnings actually declined by 11 percent in real terms (Caplan 40).

William Cline of the Institute for International Economics has concluded:

Mexico's large build-up of debt was almost certainly accelerated rather than deterred by higher oil prices. Mexico first borrowed heavily to develop oil production, and subsequently the promise of oil exports was the main basis for its ability to borrow large amounts more generally in pursuit of a high growth strategy. (Cline, International Debt 22)

Unlike other developing countries that borrowed to pay for their oil imports, Mexico used its oil resources as collateral to borrow at will from international commercial banks in order to finance the continued expansion of the oil industry and to service the debt to which its earlier oil sector expansion had contributed.

### CHAPTER III

#### THE GROWTH OF EXTERNAL DEBT

To describe Mexico's accumulation of external debt in the years immediately preceding its 1982 collapse requires no hyperbole. In a word, it was staggering. Figure 2 on the next page illustrates the growth of Mexico's external debt from 1970 through the early 1980s.

In 1976, when Lopez Portillo entered office, Mexico's external debt, both public and private, totaled \$21.8 billion. This amount was initially considered large and potentially burdensome, but after the extent of Mexico's oil wealth became known, its debts were seen as easily manageable.

By August 1982, when Mexico announced it was no longer able to service its debt because its foreign reserves were exhausted, total external debt exceeded \$82 billion. During Lopez Portillo's administration, Mexico's external debt increased by nearly 300 percent. What is most astonishing about this feat is that it occurred during and after IMF-imposed limitations were placed upon Mexico's capacity to increase its external debt precisely because debt had accelerated during the latter half of the Echeverria administration. To be sure, much debt incurred between 1977 and 1982 related to the exploitation of

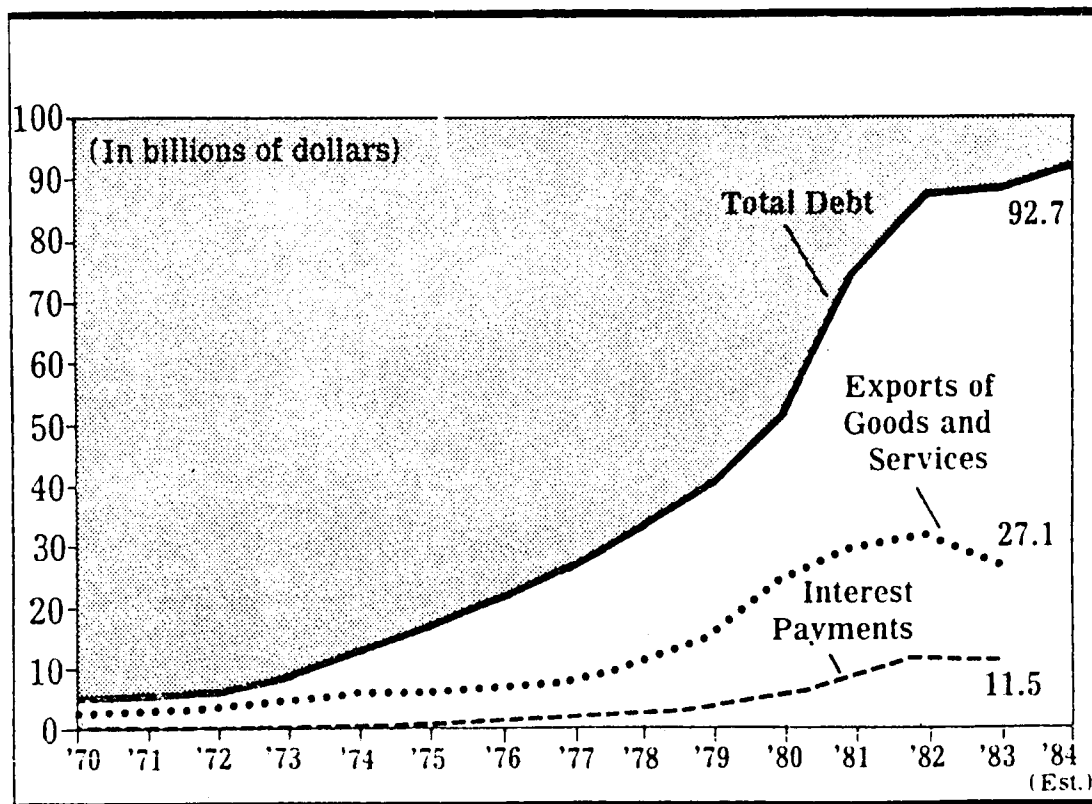


FIGURE 2

## MEXICO'S GROWING DEBT

Source: The Wall Street Journal, May 15, 1984, p. 32.

Mexico's oil resources, but a disproportionate amount of the new debt replaced capital flight and sustained the peso at an untenable level, about which more will be said later.

Not only did Mexican debt substantially increase in the aggregate, but between the beginning of 1980 and the summer of 1982 (when credits temporarily ceased), Mexico's total external debt accelerated at an unprecedented rate, rising from \$40.8 billion at year-end 1979 to \$82.5 billion (Inter-American Development Bank, "External Debt" 93). This \$41.7 billion increase resulted in the expansion of long- and medium-term credits and, most important, short-term credits.

Total long- and medium-term credits (i.e., loans with original maturities of one year or more) increased by \$23 billion during this three-year period. More than \$16 billion of this amount came from private creditors (suppliers, banks, and bonds), whose portion increased from \$25.5 billion in 1979 to \$41.7 billion in 1982. Long- and medium-term debt owed to official creditors (i.e., multilateral institutions and governments) rose from less than \$4 billion in 1979 to more than \$10 billion in 1982. The debt owed to these private and official creditors was either a part of Mexico's public external debt, or it was private debt that was publicly guaranteed. Long- and medium-term credits extended to private borrowers whose debts were not publicly guaranteed remained unchanged at

about \$8 billion between 1979 and 1982 (IADB, "External Debt" 93).

Unquestionably, the most unstable component of Mexico's debt portfolio involved its short-term credits, which increased by 600 percent between 1979 and 1982, rising from \$3.2 billion to \$22.4 billion. As recently as 1977, Mexico's short-term debt had been only \$376 million (IADB, "External Debt" 93). Thus, short-term external debt alone in 1982 (\$22.4 billion) exceeded Mexico's entire external debt of \$21.8 billion six years earlier (1976), 98.5 percent of which was then medium- and long-term debt (IADB, "External Debt" 93). By 1982, short-term debt accounted for more than 25 percent of total external debt. Short-term debt is unstable because creditors become reluctant to renew it when a nation's economy deteriorates.

Not only did Mexico's total debt increase substantially, but the portion held by international commercial banks rose as well. Banks held most of the public and publicly guaranteed medium- and long-term debt Mexico incurred from private sources. A large share of the \$8 billion in medium- and long-term private loans with no public guarantees was also extended by banks. Moreover, virtually all of the short-term credits were obtained from commercial banks (IADB, "External Debt" 15). This is significant because most of the banks' loans, unlike bond financings or official credits, were based on floating

interest rates. By 1982, the proportion of Mexican debt with variable interest rates had increased to 77 percent (IADB, "External Debt" 93).

Mexico's external debt increased by \$12 billion in 1980, \$23 billion in 1981, and \$7 billion in 1982. Nearly all of 1982's increase was incurred during the first six months. Short-term credits increased by \$8.6 billion in 1980 and \$11 billion in 1981. Indeed, 56 percent of the increase in Mexico's total external debt between 1979 and 1981 was financed with short term credits (IADB, "External Debt" 93).

Its borrowing in the Eurocurrency markets, where much of its international commercial bank credits were obtained, increased at a rapid pace. In 1981, for example, Mexico borrowed \$7.5 billion there, and during the first six months of 1982, its Eurocurrency credits increased at an annual rate of \$14.6 billion ("International Lending" 2).

Much of the short-term credit, which traditionally finances import transactions, was instead used to finance balance-of-payments deficits exacerbated in large part by capital flight. Mexico, in effect, violated the cardinal rule of external borrowing:

The fundamental purpose of external borrowing is to ensure a net inflow of external resources that supplements and expands domestic savings and allows economic development to accelerate. These resources make an effective economic contribution when they are absorbed in productive investment and facilitate technological advancement. (IADB, "External Debt" 18)

In the heady days preceding its de facto default in August 1982, Mexico was borrowing at a pace of \$500 million per week in the short-term market alone (Caplan 33). Its seemingly insatiable appetite for external funds in 1982 was a mere continuation of a process that had begun in 1979. Commenting on Mexico's successful, though clumsy, amelioration of its 1981 financial crisis caused by a precipitate decline in oil exports, Institutional Investor presciently observed that Mexico's problems were just beginning:

This summer's brief short-term borrowing binge was only the tip of the iceberg, the latest manifestation of a whole-hearted enthusiasm with which (the Mexicans) have been sacking the international capital markets for the better part of two years. It reflects a well-considered judgment on the part of the official hierarchy in Mexico City to "take advantage of market situations" while the going is good. And the opportunity, at least to date, has been clear: The combination of the creditability of oil reserves and the huge liquidity, and therefore low spreads, of the international and U.S. banking systems. (Ashehov, "The Mexican Petrotrauma" 297)

The Economist echoed these observations several months following Mexico's de facto default in August 1982. While non-oil developing countries borrowed to pay their oil-import bills, oil-producing nations, Mexico in particular, borrowed because the "the money was there for the asking and, what the hell, they had oil, the best of securities, to borrow against anyhow" ("Latin America: The Breaking of a Continent" 18).

International commercial bankers, to be sure, encouraged oil-wealthy nations to feed at the trough of international liquidity. Indeed, they intensely competed with one another to gain the opportunity to extend credit to developing countries. In his book, The Money Lenders, Anthony Sampson recounts a conversation he overheard at an annual convention of the World Bank and the International Monetary Fund in the late 1970s. One Third World contact told a group of American bankers, "I've got good news for you. I think they'll be able to take your money" (15).

Perhaps more so than any other country, the experience of Peru illustrates the blind faith bankers exhibited in lending their money to questionable clients. Peru, a country that in the mid-1970s seemed broke, was metamorphosed in the eyes of the bankers, who believed that an oil pipeline shuttling oil across the Andes would transform its balance of payments. "I can hardly face going back to the hotel," Peru's prime minister was heard to complain at the same convention. "There are six different banks waiting for me" (Sampson 19). By 1985, Peru, having incurred a \$14 billion external debt, unilaterally declared that interest payments and debt amortization would be limited to 10 percent of its annual export income. At the time of its declaration, Peru owed \$3.1 billion in unpaid interest and principal, with an additional \$2.6 billion maturing within 12 months. The 10 percent self-imposed

limitation amounted to \$320 million, barely 10 percent of its delinquent obligations. Moreover, the bulk of the \$320 million, \$265 million, would be used to repay debts owed to multilateral agencies. Most of the balance would be paid against "soft" loans extended by governments. In effect, the bankers would receive very little (Riding, "Foreign Banks Eager"). Whereas six years ago six banks were camped outside the hotel room of Peru's prime minister, seeking the privilege of sharing their funds with his country, today these same banks prepare to write off the loans they so eagerly extended.

As banks increased their exposure to Mexico and other developing countries, the banks' futures became inextricably linked to the solvency of Third World debtors.

By June 1982, Mexico owed \$64.4 billion to the international commercial banks. U.S. banks were particularly exposed. At year-end 1982, Citicorp had invested 54.6 percent of its primary capital (shareholders' equity, subordinated notes, and reserves against possible loan losses) in loans to Mexico. Comparable percentage figures for the next nine largest U.S. banks were: Bank of America (52.1); Chase Manhattan (40.0); Morgan Guaranty (34.8); Manufacturers Hanover (66.7); Chemical (60.0); Continental Illinois (32.4); Bankers Trust (46.2); First Chicago National (50.1); and Security Pacific (31.2). Loans to Mexico from the 10 largest U.S. banks totaled \$14.7 billion

by the end of 1982 and amounted to 48 percent of their collective capital (Cline, International Debt 34).

When exposure of the 10 largest U.S. banks to other Latin American debtors (Argentina, Brazil, Venezuela, and Chile) is considered, what emerges is the ominous finding that each of the banks has loaned monies amounting to more than 100 percent of its primary capital (Cline, International Debt 34). Table IV summarizes the exposure of U.S. banks to Latin American debtors in relation to the banks' capital.

Bankers were mesmerized by what they perceived to be the financial genius of Mexican technocrats, who were recognized to be the most sophisticated borrowers in the Third World:

Where the Mexicans really showed their smarts was in playing the game of slicing away at borrowing costs of all kinds. This was a sophisticated campaign . . . using a dizzying array of stratagems for getting the most out of the market. As (Angel) Gurria (the federal borrowing chief at Mexico's finance ministry) coyly puts it: "You've got to give the bankers something new all the time. You've got to keep them entertained." (Ashehov, "Let's Hope the Mexicans Know What They're Doing" 165-66)

The herd instinct that dominates international banking merely reinforced the bankers' actions. They simply couldn't afford NOT to have a piece of Mexico. After all, the sharpest minds employed by America's largest banks couldn't all be wrong, could they?

Mexico's growing debt was as much a response to its voracious, uncontrollable appetite (demand) for funds as it

TABLE IV  
EXPOSURE TO LATIN AMERICAN DEBTORS AS PERCENTAGE OF CAPITAL,  
MAJOR BANKS, END 1982

| Category                  | Argentina | Brazil | Mexico | Venezuela | Chile | Total | Capital <sup>a</sup><br>(Million Dollars) |
|---------------------------|-----------|--------|--------|-----------|-------|-------|-------------------------------------------|
| Citibank                  | 18.2      | 73.5   | 54.6   | 18.2      | 10.0  | 174.5 | 5,989                                     |
| Bank of America           | 10.2      | 47.9   | 52.1   | 41.7      | 6.3   | 158.2 | 4,799                                     |
| Chase Manhattan           | 21.3      | 56.9   | 40.0   | 24.0      | 11.8  | 154.0 | 4,221                                     |
| Morgan Guaranty           | 24.4      | 54.3   | 34.8   | 17.5      | 9.7   | 140.7 | 3,107                                     |
| Manufacturers<br>Handover | 47.5      | 77.7   | 66.7   | 42.4      | 28.4  | 262.8 | 2,592                                     |
| Chemical                  | 14.9      | 52.0   | 60.0   | 28.0      | 14.8  | 169.7 | 2,499                                     |
| Continental<br>Illinois   | 17.8      | 22.9   | 32.4   | 21.6      | 12.8  | 107.5 | 2,143                                     |
| Bankers Trust             | 13.2      | 46.2   | 46.2   | 25.1      | 10.6  | 141.2 | 1,895                                     |
| First National<br>Chicago | 14.5      | 40.6   | 50.1   | 17.4      | 11.6  | 134.2 | 1,725                                     |
| Security Pacific          | 10.4      | 29.1   | 31.2   | 4.5       | 7.4   | 82.5  | 1,684                                     |
| Wells Fargo               | 8.3       | 40.7   | 51.0   | 20.4      | 6.2   | 126.6 | 1,201                                     |
| Crocker National          | 38.1      | 57.3   | 51.2   | 22.8      | 26.5  | 196.0 | 1,151                                     |
| First Interstate          | 6.5       | 43.9   | 63.0   | 18.5      | 3.7   | 136.0 | 1,080                                     |
| Marine Midland            | n.a.      | 47.8   | 28.3   | 29.2      | n.a.  | n.a.  | 1,074                                     |
| Mellon                    | n.a.      | 35.3   | 41.1   | 17.6      | n.a.  | n.a.  | 1,024                                     |
| Irving Trust              | 21.6      | 38.7   | 34.1   | 50.2      | n.a.  | n.a.  | 996                                       |
| First National<br>Boston  | n.a.      | 23.1   | 28.1   | n.a.      | n.a.  | n.a.  | 800                                       |
| Interfirst Dallas         | 5.1       | 10.2   | 30.1   | 1.3       | 2.5   | 49.2  | 787                                       |

<sup>a</sup>Bank capital includes shareholders equity, subordinates notes, and reserves against possible loan losses.

n.a. = Not available.

Source: William R. Cline, International Debt and the Stability of the World Economy (Washington, D.C.: Institute for International Economics, 1983), p. 34.

was to the bankers' seemingly endless supply of money and their unfaltering willingness to part with it. The second oil shock of 1979-81 brought with it a petrodollar recycling problem that dwarfed its predecessor of 1974-75. Not only did OPEC's average price increase by \$20 per barrel from \$15 in early 1979 to \$35 in early 1981 (compared to the \$8 to \$9 per barrel increase experienced during the first oil shock); but OPEC's all-time production peak of 31 million barrels per day was also attained in 1979, the year the second oil shock commenced. The combination of peak production levels and leap-frogging prices produced unprecedented OPEC current account surpluses. Between 1979 and 1981, OPEC registered current account surpluses totaling \$220 billion (Central Intelligence Agency 10-11).

Much of these funds were deposited in banks whose purpose it was to recycle them. Where better to lend than to a developing oil power such as Mexico? The near consensus forecast during the heady days of 1979 and 1980 projected the price of oil to continue climbing by at least the rate of inflation. Bankers and international risk assessors viewed Mexico's proliferating oil reserves as locked-in wealth that would either retain its purchasing power or appreciate.

Despite the fact that Mexico's borrowings had been increasing in volume faster than its oil exports, bankers seemed undeterred. And why not? By their own estimates,

Mexico was considered the most creditworthy country in Latin America and among the 25 most creditworthy nations in the world. Together with oil-endowed Venezuela, Mexico was rated far above its Latin American neighbors as late as March 1981, according to Institutional Investor's compilation of bankers' perceptions. The following analysis describes the common view about Mexico's prospects:

The international community is looking forward to quiet development between now (July 1981) and the election in December 1982. . . . Bankers are looking for rates for Mexican borrowers to harden, and according to another lender, "They (the Mexicans) are conceding a higher spread because they realize they have to do it to get money." But in "two or three years," he concludes, "they will still be big borrowers. I'm not worried about the risk." (Stewart 210-11)

## CHAPTER IV

### EXTERNAL CAUSES OF MEXICO'S DEBT CRISIS

One of the leading external shocks commonly cited as a major factor precipitating the world-wide debt crisis is the increase in world oil prices during 1973-74 and 1979-80. Oil-importing developing countries saw the price of oil increase from \$3 per barrel in 1973 to as high as \$41 per barrel in 1980.

Mexico, which emerged as a major oil exporter in the mid-1970s, is viewed as having benefited from the rapid rise in oil prices--though Mexico's oil proved to be a mixed blessing, as explained earlier. The vagaries of the oil market dealt Mexico its first severe blow in early 1981, when oil prices began to collapse. Up to that point, production, exports, and oil prices had risen in concert for nearly a decade. Oil production had increased from 500,000 bpd between 1970 and 1973 to 1 million bpd in 1977 and nearly 2 million bpd in 1980. Meanwhile, exports had risen from 16,000 bpd in 1974 to 830,000 bpd in 1980 (Velasco-S. 79).

The price per barrel of Mexican Isthmus-34 light oil had increased from \$10.40 in 1974 to \$12.18 in 1975, \$14.10 in January 1979, \$24.60 in October 1979, \$32 in January 1980, and \$38.50 in January 1981. The price per

barrel of Mexican Maya-23 heavy oil, which first became available in 1979, had increased from \$21.50 in October of that year to \$34.50 in January 1981 (Velasco-S. 113).

The fortunate combination of a rising export volume and an increasing export price produced expanding export revenues. Mexico's oil export receipts increased from \$123 million in 1974 to \$1.8 billion in 1978, \$4 billion in 1979, and \$10.4 billion in 1980 (Velasco-S. 115).

According to its long-range plan, Mexico expected to increase production in 1981 by 750,000 bpd to 2.75 million bpd. Exports were to rise in tandem to 1.5 million bpd, at which level they were to remain. The plan did not allow for any price reductions from the record levels obtained in early 1981 ("Pemex Agonistes" 65).

In February 1981, however, Pemex diverted from its long-range plan and proposed increasing production to 4 million bpd by 1982 (Riding, "Mexico at Odds on Oil Output"). A political firestorm ensued. Because most of Mexico's oil was purchased by the United States (and in view of what it considered to be an unfavorable experience with its northern neighbor before the oil industry was nationalized in 1938), Mexico's oil production level and its destination had always been a political football. Politicians were keenly sensitive to being perceived as running the oil industry in accordance with the needs of the United States. Pressure to limit production to a level that

would conserve its oil resources, while simultaneously maximizing the benefits derived from the revenue its oil generated, caused Mexican officials to balance the monetary benefits against the perceived exploitation by its northern colossus.

Before a final decision on Pemex's proposal to increase production to 4 million bpd could be made, the international oil market made it for Mexico. Two months after Pemex began to consider an increase in output, an oversupply of oil developed in the world oil market. Estimated to be between 2 and 3 million bpd, the glut negatively impacted the price of oil. In April, Mexico reduced the price of its Maya heavy crude from \$34.50 to \$32, while maintaining the price of its Isthmus crude at \$38.50 (Velasco-S. 113). Having increased its 1981 production level by 500,000 bpd to 2.5 million bpd and its export volume from a 1980 average of 830,000 bpd to 1.1 million bpd in 1981's first quarter, Mexico itself had significantly contributed to the oil glut that was intensifying downward pressure on price (Martin).

In an abrupt move, on June 2, 1981, Pemex director Jorge Diaz Serrano announced price reductions of \$4 per barrel, which applied to both grades of crude. Four days later, Diaz Serrano resigned after being severely criticized by the cabinet for his unilateral decision to reduce oil prices. Two weeks following Diaz Serrano's price cuts, which

were followed by comparable reductions by Britain, Norway, and Ecuador, Mexico announced that its prices would rise by \$2 per barrel in July, warning that "buyers unwilling to pay the new price might permanently forfeit Mexico as an energy source" (Riding, "Mexico, in Switch, Will Lift Oil Price").

Most of Mexico's oil clients responded by canceling contracts. Compagnie Francaises des Petroles, the government-controlled oil company in France, canceled its 100,000 bpd purchases for three months. Mexico reacted by suspending construction contracts held by French companies ("Mexico's Rift Grows").

Other buyers, reportedly from the United States, India, and Yugoslavia, according to Mexican newspapers, canceled contracts for an additional 450,000 bpd (Riding, "Oil Glut"). Having risen to 2.7 million bpd by the end of the second quarter, oil production was reduced by 700,000 bpd in July in response to the canceled contracts (Riding, "Mexico Cuts Back").

Following years of uninterrupted growth in production, exports, prices, and revenues, Mexico faced simultaneous declines in all four categories during the summer months of 1981:

In June, oil receipts fell by a quarter to \$1.1 billion from a composite average of the previous three months' income of \$1.5 billion. During July and part of August, Pemex's exports dropped to around 40 percent of their previous levels, at one point falling to as low as 20 percent. (Ashehov, "The Mexican Petrotrauma" 290)

As Mexico's oil revenues plummeted, financial chaos ensued. One long-time Mexican observer noted: "This began the biggest and fastest fundraising operation in Mexico since the Aztecs handed over the keys of the strongroom to Cortes" (Ashehov, "The Mexican Petrotrauma" 293). So severe was the oil-induced cash shortfall that the foreign borrowing chief of Mexico's finance ministry, Angel Gurria, observed, "In July (1981), we couldn't have told you whether the shortfall was going to be \$10 billion or \$20 billion. What we knew was that we had the devil's own problem on our hands. What we didn't know was how long it was going to go on" (Ashehov, "The Mexican Petrotrauma" 293).

The finance ministry estimated that its July-August foreign borrowings, which were needed to cover the oil revenue shortfall, amounted to \$3.9 billion, much of it lent not at the customary London inter-bank offer rate (Libor) plus 1/8 but at rates based upon the U.S. prime rate, which at the time was 2 percent above Libor (Ashehov, "The Mexican Petrotrauma" 293).

Mexico finally regained its lost oil exports during late August and early September by lowering its oil price to a level that was barely different from the level Diaz Serrano set in June--before he was forced to resign. Particularly helpful was the agreement by which the U.S. Strategic Petroleum Reserve would purchase 400,000 bpd (Ashehov, "The Mexican Petrotrauma" 297). The short term

crisis was over, but its fallout, especially among international bankers, was widespread.

The summer of 1981 highlighted Mexico's overdependence upon its oil sector. When the oil industry caught a cold, Mexico caught pneumonia. Prior to the short-term liquidity crisis that was caused by a shortfall in oil revenue, Mexico had long been considered a premier credit risk because of its oil wealth. The 72 billion barrels of proved hydrocarbon reserves represented ideal collateral. That real oil prices would continue their upward trend through the balance of the century was an article of faith among bankers, sheiks, Mexican policy makers, and industry analysts. But the bubble burst in 1981, and harsh reality set in.

By 1981 Mexico was selling far less oil in international markets at far lower prices than its revised forecasts had projected. The old constraints that had plagued the Mexican economy re-emerged with a vengeance. A balance-of-payments disequilibrium undermined confidence in Mexican loans, threatening to cut off Mexican access to foreign credit. Lower levels of oil revenues required sharp cutbacks in government spending for welfare and development programs (Mallah et al. 25).

Notwithstanding the temporary contraction of oil exports in 1981, Mexico's oil revenues nonetheless increased over 1980 levels. For the year, oil exports rose by nearly

one-third, averaging 1.1 million bpd. Compared to the expected export level of 1.5 million bpd, however, the actual export level fell below its target by more than 25 percent.

In 1982 Mexico's oil exports increased to an average of 1.53 million bpd (Inter-American Development Bank, External Debt 471). Prices, however, continued to fall. On March 1, 1982, the price of the light Isthmus-34 crude, which had peaked 14 months earlier at \$38.50 per barrel, fell another \$2.50 to \$32.50. Having peaked at \$34.50 per barrel in January 1981, the price of Mexico's heavy Maya-23 crude was reduced by \$3.50 to \$25 on the same day. For the balance of the year, these prices remained unchanged (Velasco-S. 113). Thus, the increase in oil exports of 400,000 bpd was negated by price deterioration, and oil export revenues for the year totaled \$14.62 billion, only 5.7 percent above 1981's level and well below official projections ("1983 Economic Review of Mexico, No. 1" 14).

Compounding the negative impact of falling world oil prices upon Mexico's "petrolized" economy were several other external developments. These factors, which exacerbated Mexico's precarious financial situation, included: rising world interest rates, which markedly increased Mexico's debt service obligations and contributed to its deteriorating balance-of-payments situation; increased protectionism in the developed countries, which

reduced the demand for Mexico's non-oil exports; and the severity of the 1980 and 1981-82 industrial countries' recessions, which further reduced the demand for Mexico's exports.

Unlike other major Latin American debtors (Brazil, Argentina, and Chile), Mexico's terms of trade did not deteriorate in the three years immediately preceding the debt crisis. Because Mexico's oil exports, which are priced in dollars, rose in both absolute and relative terms, Mexico experienced an improvement in its terms of trade. In a study for the Brookings Institution, Thomas Enders estimated that Mexico's oil-induced improvement in its terms of trade resulted in a "favorable trade shock" of \$22.5 billion between 1979 and 1982. Other Latin American debtors, which either imported much of their oil requirements or relied on exports whose commodity prices plunged (or both), experienced marked deterioration in their terms of trade. According to Enders' estimates, "unfavorable trade shocks" relating to the changing terms of trade negatively impacted trading patterns by \$31.7 billion (Brazil), \$1.9 billion (Chile), and \$6.2 billion (Argentina) during the same period (19).

If Mexico was somewhat unique in its avoidance of the declining terms-of-trade imbroglio, such was not the case for the deleterious effects of rising world interest rates, both nominal and real. The multiplication of Mexico's

debt, particularly during the Lopez Portillo administration, has already been examined. Not only did the external debt virtually quadruple during this period, but the debt service obligations in the form of interest payments and debt repayments rose substantially as well. The increase in interest payments resulted primarily from two factors: an increasing base of debt and rising interest rates.

Higher nominal interest rates normally reflect a higher inflation rate. Thus, to the extent that the debt is tied to floating interest rates, inflation in the currency in which the debt is denominated causes debt service to rise. The converse of increased interest payments resulting from inflation is the concomitant reduction in the real value of the debt as a result of increased inflation. "Accordingly, high interest rates caused primarily by high inflation have the effect of causing a greater present cash flow burden in return for eroding the real value of outstanding debt. In effect, they cause accelerated amortization of the debt in real terms" (Cline, International Debt 16).

Figure 3 compares changes in the London Interbank Offer Rate with changes in the U.S. GNP deflator throughout the 1970s and early 1980s. Throughout the 1970s, when real interest rates were very low and oftentimes negative, high inflation-induced nominal interest rates proved to be less burdensome than initially perceived.

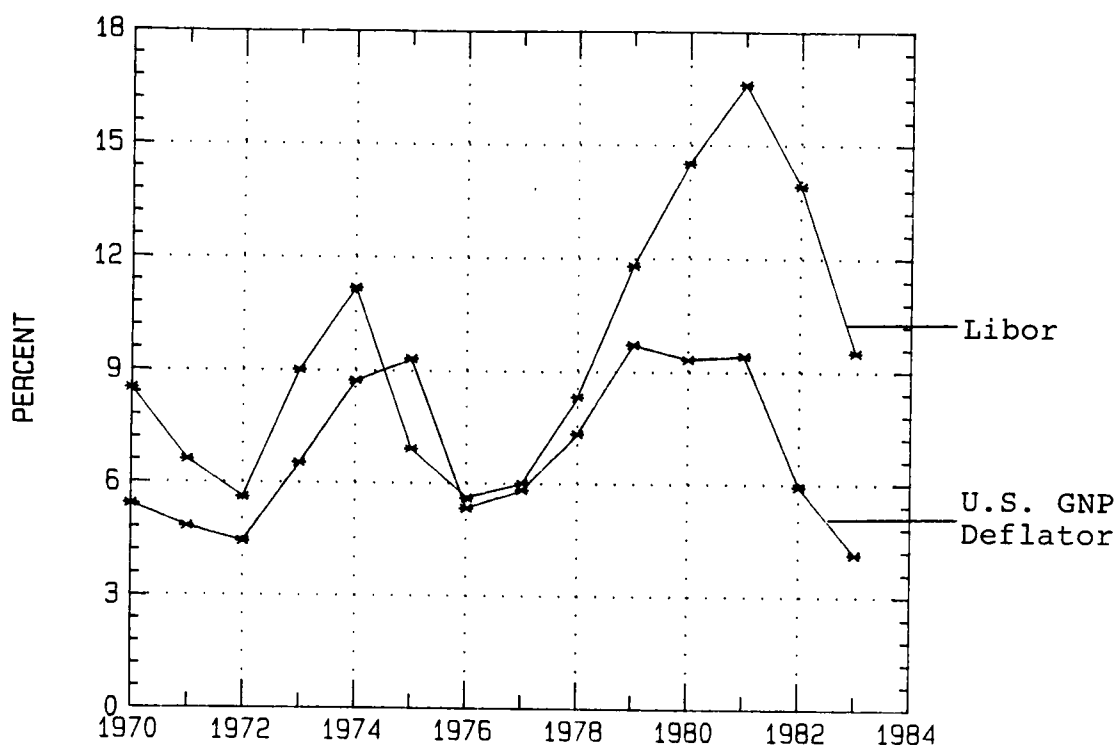


FIGURE 3

LONDON INTERBANK OFFER RATE (LIBOR) AND U.S. GNP  
DEFLATOR, 1970-1983 (in percentages)

Source: External Debt and Economic Development  
In Latin America, 1984, p. 41.

From 1973 to 1979, Eurodollar rates in London, which set the basis for most international lending, averaged 8.5 percent, while U.S. wholesale prices rose at an average annual rate of 9.8 percent. Even allowing for the fact that most third-world borrowers paid small spreads over the Euromarket rate, the real interest rates they paid were still negative (Council of Economic Advisers, Economic Report 1983 23).

Moreover, Mexico's booming exports, which increased by an annual average of 23.5 percent (Cline, International Debt 18-19) during this period (1973-79), provided the funds needed to service the debt. And when cash-flow problems did appear, excessive international liquidity made available loans to remit debt service obligations.

Such a pattern, however, markedly changed in 1981. Inflation fell sharply in the industrial world, in general, and in the United States, in particular. Meanwhile, real interest rates rose because nominal rates fell much more slowly than did inflation.

Mexico was now compelled to service a much larger debt at real interest rates that far exceeded historical experience. Worse, the interest rate spread, i.e., the premium above Libor, increased simultaneously, further raising Mexico's debt service requirements. Moreover, as was noted earlier, the proportion of Mexico's debt in the form

of short-term loans bearing floating rates was also increasing.

The susceptibility of short-term debt to sudden disruption in normal renewal, once creditor confidence erodes, makes its rising share a source of instability. And short-term borrowing is an especially unreliable form of financing for long-term development. Ideally, loan maturities should match those of investment projects. (Cline, International Debt 16)

In Mexico's case, short-term debt increased from \$1.07 billion in 1978 (about 3 percent of total external debt) to \$22.4 billion in 1982 (27 percent of total external debt) (IADB, External Debt 78).

The external debt service paid by Mexico increased from \$2.5 billion in 1975 to \$11.8 billion in 1982 (OECD, External Debt 163). Were it not for the temporary cessation of debt payments in August 1982, Mexico's total debt service obligations for 1982, including retirement of some short-term debt, would have exceeded \$19 billion (IADB, External Debt 78).

Although Mexico's exports had been increasing substantially as a result of the increase in both the volume and the price of its oil exports, its debt service/exports ratio nearly doubled since it became an oil exporter. Figure 4 shows how Mexico's debt service ratio changed since the mid-1970s until its debt crisis occurred in 1982. In 1975 its debt service/exports ratio was 30.3 percent. In 1982 it was 58.5 percent. Indeed, had Mexico paid all the debt service it owed in 1982 (\$19.05 billion), its debt

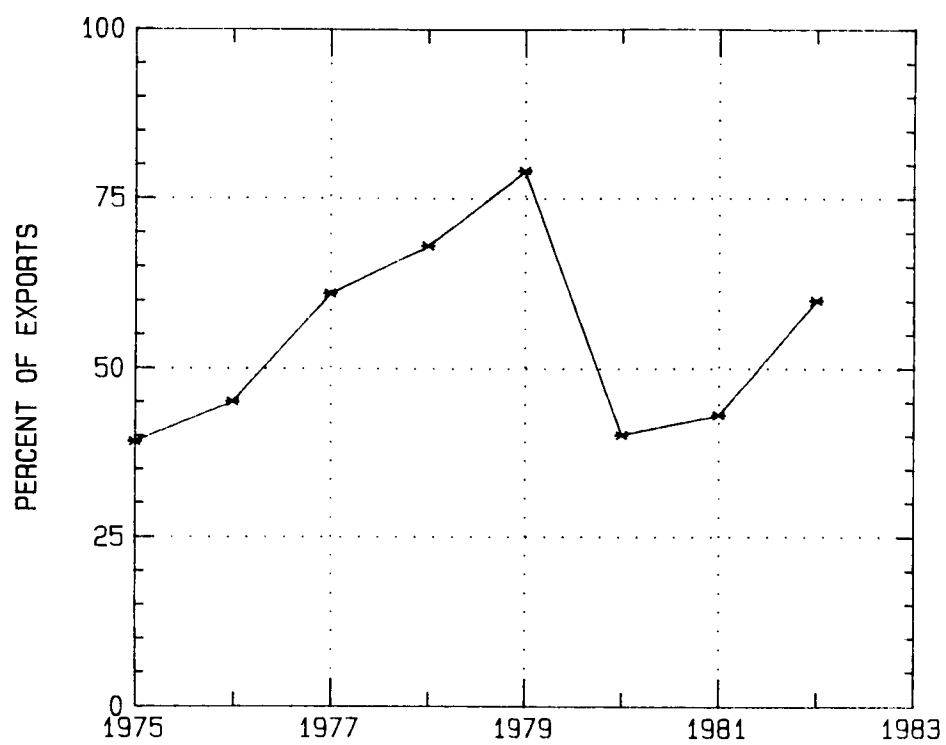


FIGURE 4

## DEBT SERVICE RATIO

Source: External Debt and Economic Development  
In Latin America, 1984, p. 94.

service/exports ratio would have exceeded 90 percent, three times the level experienced in 1975. Interest payments alone (\$11.3 billion) amounted to 54 percent of Mexico's 1982 exports, having risen from 23.3 percent in 1978 (IADB, External Debt 78; "Mexico--Progress and Prospects" 3). To fully appreciate the burden of rising interest payments expressed as a percentage of exports, it must be noted that Mexico's exports more than tripled in value between 1978 and 1982, increasing from \$6.06 billion to \$21 billion (IADB, External Debt 35).

Most of Mexico's debt was indexed to the Libor, the nominal average of which was 6.8 percent from 1975 to 1978. During the next four years, the nominal Libor averaged 14 percent (Cline, International Debt 18-19). Adjusted for U.S. inflation measured by the Producer Price Index for Finished Goods, the real (i.e., inflation-adjusted) Libor was 7.3 percent in 1981 and 9.1 percent in 1982. In 1977 and 1978, by way of comparison, the real Libor was -.5 percent and +.8 percent, respectively. Exacerbating the reversal in the real Libor were the increasing premiums Mexico was required to pay in 1981 and 1982 compared to the smaller increments required in earlier years. Whereas Mexico's rate in the late 1970s was customarily Libor+1/4, by 1982 it had become Libor+2.

As noted previously, Mexico's terms of trade on-average improved between 1979 and 1982, resulting in an

oil-induced "favorable trade shock" of \$22.5 billion (see earlier reference to the Enders study). But all of this improvement occurred in 1979 and 1980, as the price of oil increased rapidly and substantially. During the latter two years, 1981 and 1982, however, the softening of the world oil market caused Mexico's terms of trade to deteriorate, though not sufficient to offset the massive gains achieved during 1979 and 1980. According to a study performed by the U.N. Commission for Latin America, Mexico's terms of trade deteriorated by 1.2 percent in 1981 and 17.9 percent in 1982 after having improved by 17.6 percent and 23.6 percent in 1979 and 1980, respectively (Diaz-Alejandro 353). Thus, as Mexico's external finances were being adversely affected by rising real interest rates in 1981 and 1982, its terms of trade were simultaneously deteriorating, further compounding its precarious financial situation.

The two simultaneous developments of rising interest rates and falling oil prices were compounded by an overvalued exchange rate, which increased imports and discouraged non-oil exports. All three factors contributed to a generate a deteriorating current account balance. As the deficit in the current account grew, so too did the need to finance the deficit by importing capital and, thereby, incurring additional external debt. After averaging \$4 billion per year during the last two years of the Echeverria administration, Mexico's current account deficit declined to

\$1.6 billion in 1977. Thereafter, however, it expanded annually through 1981: \$2.7 billion (1978); \$4.9 billion (1979); \$7.2 billion (1980); \$12.5 billion (1981) (IADB, External Debt 34-35).

In addition to rising debt service obligations, Mexico's current account deficit was augmented by a worsening performance in the merchandise trade balance--despite rising oil exports. Figure 5 illustrates the changes in these two balances.

From a deficit of \$1 billion in 1977, Mexico's trade deficit grew to \$3.2 billion in 1979 and \$4.5 billion in 1981. Mexico's rapidly deteriorating international position produced unusually high external deficits relative to exports. For example, the current account deficit of \$12.5 billion for 1981 compared to \$19.4 billion in total exports for that year.

Mexico's deteriorating current account balance was further compounded by the 1980 U.S. recession and the 1981-82 global recession, which afflicted the industrial countries unlike any other economic downturn since the Great Depression. As a direct consequence, the importation of Mexican products was adversely affected. U.S. imports from Mexico, after having increased by \$2.7 billion in 1979 (44 percent) and by an additional \$3.8 billion in 1980 (43 percent), virtually stagnated in 1981, rising only \$1.2 billion (9 percent). In 1982, U.S. imports from Mexico

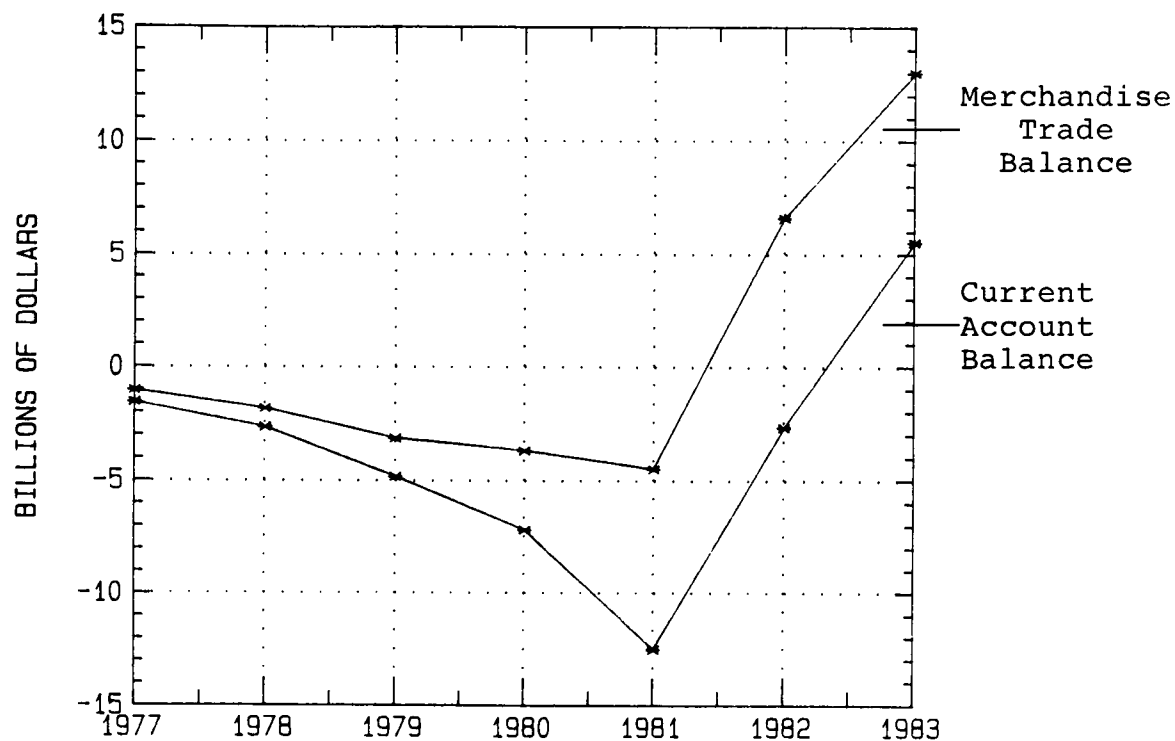


FIGURE 5

MERCHANDISE TRADE BALANCE AND CURRENT ACCOUNT BALANCE,  
MEXICO: 1977-1983

Source: External Debt and Economic Development in Latin America, 1984, pp. 34-35.

increased a mere 13 percent to \$15.5 billion (Survey of Current Business 48).

It must be noted that oil comprises by far the largest portion of U.S. imports from Mexico, which now serves as the United States' chief foreign oil supplier. In effect, much of the increased imports replaced other foreign oil supplies. There is little likelihood that the U.S. market could continue to absorb ever increasing amounts of Mexican oil in the future. Moreover, the current worldwide oil glut further discounts the possibility that Mexico could markedly expand its market share.

The downturn in the U.S. economy prevented the importation of other Mexican products, and Mexico's increasingly overvalued currency merely made a bad situation worse. Protectionism played a role as well:

The weakening of demand for Latin American exports caused by the reduced economic activity in the industrial countries was exacerbated by the effect of the protectionist measures that many of these countries have been adopting in recent years to deal with balance-of-payments problems, or to protect lines of production affected by reconversion programs, or whose survival has been threatened by the domestic recession itself and by competition from Latin American products enjoying comparative advantages. The export sectors most seriously affected by these measures include clothing and footwear, leather, textiles, iron and steel, and most agricultural products. (IADB, External Debt 38)

To be sure, the external shocks manifested in the form of the precipitous decline in the price of oil, rising world interest rates, increasing protectionism in the industrial countries, and the worldwide recession did

significantly contribute to Mexico's debt crisis. On the other hand, misguided internal policies reminiscent of the mistakes of earlier regimes just as certainly contributed to the crisis. These internal causes will be examined in the next chapter.

## CHAPTER V

### INTERNAL CAUSES OF MEXICO'S DEBT CRISIS

Apart from becoming "petrolized" despite their pledges to avoid such a trap, Mexico's policy makers pursued several other misguided policies. Chief among these were: domestic demand expansion beyond the long-term capacity of the economy to grow; an excessively expansionary fiscal policy producing unsustainable budgetary deficits; and the stubborn maintenance of an overvalued exchange rate. These policies, it should be repeated, were quite similar to those pursued by the Echeverria administration, precipitating the crisis of 1975 and 1976.

The overexpansion of demand and the overvaluation of the peso generated substantial trade deficits. In order to finance these growing trade deficits, the Mexican government embarked on a spree of foreign borrowings. The linkage was succinctly described in the 1984 Economic Report of the (U.S.) President:

The government sector expanded too quickly, especially in the form of credit to inefficient state enterprises. Often government deficits were monetized, and the currency was not devalued fast enough to keep up with the inflation; then the loss of competitiveness of the export industries led to trade deficits that were financed by borrowing from abroad. The end result was the same as when the government financed its deficits by borrowing from abroad directly. Though much of the money was used

for profitable investment, some went to unwise projects, to consumption, and to capital flight out of the country. (Council of Economic Advisers 74)

The realization of Mexico's oil wealth brought with it enormous sums of imported capital to exploit the reserves. Despite the favorable developments relating to Mexico's emerging oil wealth, such a rapid inflow of capital enhanced inflationary pressures, and "the loss in price competitiveness had an adverse effect on the exports of other industries, especially in the manufacturing sector on which previous hopes for growth had been pinned"(Council of Economic Advisers, Economic Report of the President 1984 74).

Compared to the rapidly expanding oil exports, Mexico's merchandise imports rose even faster, largely to develop the oil industry and to satisfy the wealthy class's nearly insatiable appetite for consumer luxury goods. In addition, Mexico was also in the initial stages of developing its nuclear power industry, which required capital imports. Figure 6 depicts the pattern on all Mexican imports, in general, and its capital imports, in particular, during the period between 1978 and 1983. Importation of capital goods, it can be seen, increased from \$2 billion in 1978 to \$7.6 billion in 1981. Imported intermediate goods increased from \$5.3 billion to \$13.5 billion during the same period. Meanwhile, imported consumer goods increased by \$2.2 billion. In all, merchandise imports rose from less than \$8

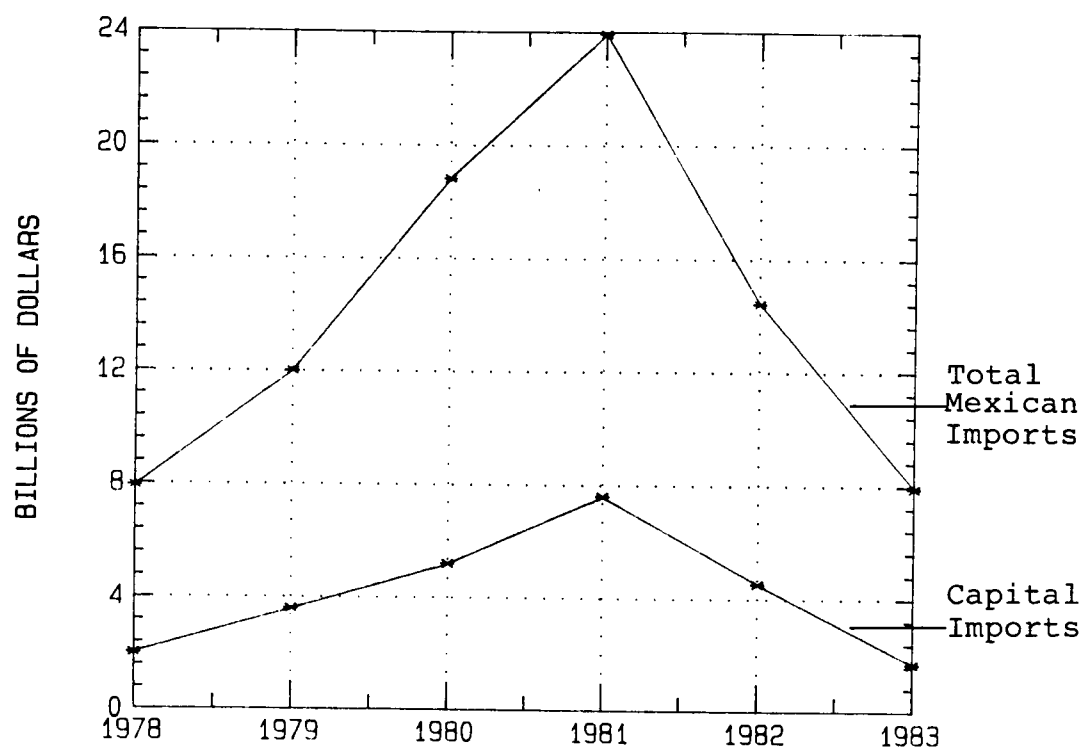


FIGURE 6

TOTAL IMPORTS AND CAPITAL IMPORTS, MEXICO: 1978-1983

Source: External Debt and Economic Development In Latin America, 1984, p. 43.

billion to nearly \$24 billion between 1978 and 1981 (Inter-American Development Bank, External Debt 43).

At the same time, Mexico's oil export revenues increased from \$2 billion to \$14.5 billion ("Why Pemex Can't Pay" 60). Total exports increased from \$6.1 billion in 1978 to \$19.4 billion in 1981. Thus, Mexico's merchandise trade deficit expanded from \$1.9 billion in 1978 to \$4.5 billion in 1981. Adding the rising deficit in services (interest payments, mostly) to the trade deficit increased the current account deficit, which rose from \$2.7 billion to \$12.5 billion between 1978 and 1981 (IADB, External Debt 35).

Mexico was thus caught in a vice: Unable to ameliorate its growing demand for imports, which was caused in large part by an overvalued currency; forced to reduce the price of its primary export (oil), which accounted for three-fourths of its export revenue; required to pay ever increasing interest charges to service its rapidly expanding external debt; and barred from continued unbridled access to the international credit markets to secure the funds needed to bridge the widening gulf, Mexico finally acknowledged its inability to meet its obligations. The result was its de facto default in August 1982.

What domestic policies did Mexico pursue to produce such a cataclysmic result? Primarily, the Lopez Portillo administration expanded the government (public) sector at an unprecedented rate to an unprecedented degree. Figure 7

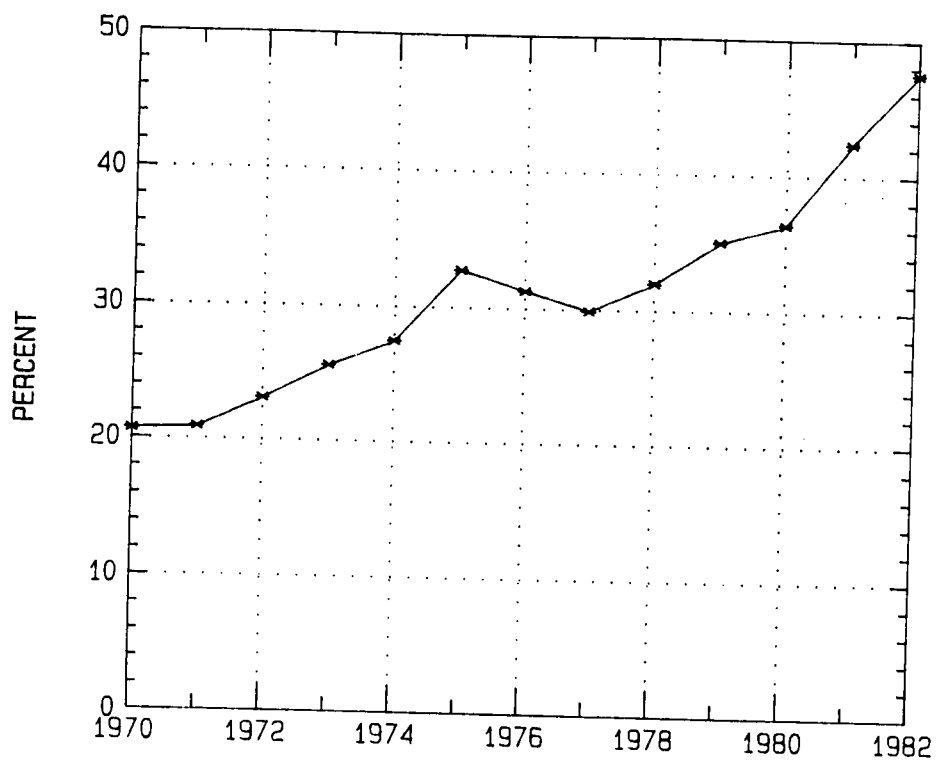


FIGURE 7

PUBLIC SECTOR EXPENDITURES, MEXICO: 1970-1982  
(percentage of DF GDP)

Source: External Debt and Economic Development  
In Latin America, 1984, p. 208.

illustrates the rising public sector expenditures as a percentage of Gross Domestic Product throughout the 1970s and early 1980s. Despite committing his administration to follow policies different from those enacted by his predecessor, Echeverria, Lopez Portillo in fact repeated the same mistakes. Whereas Echeverria increased the public sector (measured in terms of its percent of gross domestic product) from 20.6 percent in 1970 to 31.2 percent in 1976, Lopez Portillo annually increased the public sector's share of GDP until it reached 47.5 percent in 1982 (IADB, External Debt 177).

Moreover, just as Echeverria's rising public sector expenditures generated increasing public deficits, so too did Lopez Portillo's--following a temporary decline resulting from IMF-imposed austerity measures. Figure 8 provides the record of public sector deficits from 1970 until 1982. Echeverria's public deficits increased from 1.9 percent of GDP in 1970 to 9.1 percent in 1975 before falling to 7.5 percent in 1976. In Lopez Portillo's first year, he reduced the deficit further to 5.2 percent of GDP, after which his policies produced ever increasing deficits. Indeed, the public deficit expanded to 7.5 percent of GDP in 1979, 7.9 percent in 1980, 14.5 percent in 1981, and 16.5 percent in 1982 (IADB, External Debt 177).

The public sector was expanding beyond control. To be sure, much of the increase was attributable to Pemex, but

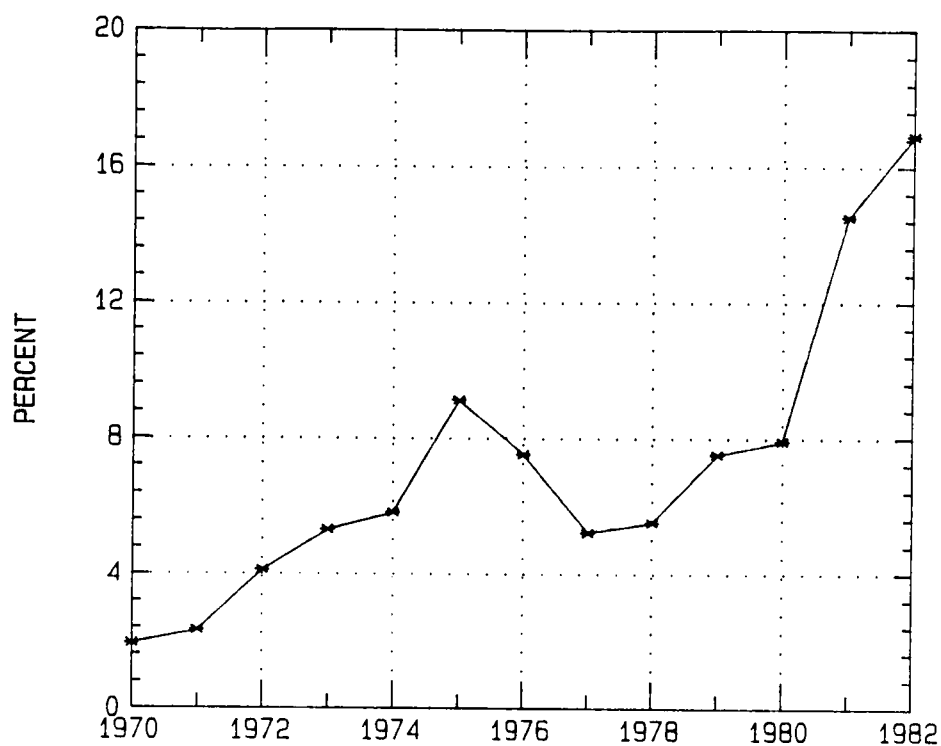


FIGURE 8

PUBLIC SECTOR DEFICIT, MEXICO: 1970-1982  
(percentage of GDP)

Source: External Debt and Economic Development  
In Latin America, 1984, p. 208.

therein lies the problem. Notorious for pervasive corruption and wasteful expenditures, Pemex squandered billions of its annual appropriations. In 1981, for example, Pemex reported a meager net profit of \$16 million against sales of \$19.2 billion, less than one-tenth of 1 percent ("Why Mexico Can't Pay" 61).

Until Mexico defaulted in August 1982, an increasing percentage of the growing public sector debt was financed by borrowing externally. Between 1970 and 1974, when Mexico's public sector deficit averaged 3.9 percent of GDP, 2.2 percent was financed externally. Between 1975 and 1979, the public sector deficit averaged 7 percent of GDP, and a portion representing 4 percent of GDP was financed by borrowing from abroad. By 1981, when the public sector deficit reached 14.5 percent of GDP, fully 8.3 percent (of GDP) was financed by increasing Mexico's external debt. In 1981, Mexico's total external debt increased by nearly \$23 billion, of which \$19.2 billion represented a rise in public external debt, nearly half of which was raised in the short-term market (Jorge et al. 62).

The expansionary demand policies that concentrated on the public sector are evident in the growth rates achieved therein. Between 1978 and 1981, public sector consumption increased by an average annual real growth rate of 9.5 percent. Public sector investment increased at an average annual real growth rate of 20.4 percent. Together,

the investment and consumption components of the public sector generated an average annual real growth rate of 14.9 percent for the public sector itself. During the same four-year period (1978-81), private consumption and private investment grew at average annual real rates of 8.2 percent and 13.6 percent, respectively (Jorge et al. 63).

The upshot of government policy promoting a much faster growth rate for the public sector than for the private sector between 1978 and 1981 was the significant increase in the public sector's share of GDP, which rose from 29.8 percent in 1977 to 42.3 percent in 1981 (IADB, External Debt 177).

The impressive growth rates achieved in both the public and private sectors enabled the economy as a whole to grow at rapid rates. Table V provides a summary of the growth rates achieved by sector between 1978 and 1982. Following the stabilization program Lopez Portillo enacted during 1977, the first year of his term, the Mexican economy expanded by an average of 8.5 percent in constant dollars between 1978 and 1981 (International Monetary Fund, International Financial Statistics No. 8 17). This average growth rate markedly exceeded the long-term growth capacity of the Mexican economy, which, according to estimates by William Cline, was about 6 percent ("Mexico's Crisis" 108).

In contrast to the slow growth experienced by the developed countries in response to the second oil crisis,

TABLE V  
AGGREGATE DEMAND AND SUPPLY IN MEXICO REAL GROWTH RATES

| Category                 | 1978 | 1979 | 1980 | 1981 | 1978-81 | 1982  |
|--------------------------|------|------|------|------|---------|-------|
| Aggregate Demand         |      |      |      |      |         |       |
| Internal Demand (1)      | 9.2  | 10.9 | 11.2 | 9.7  | 10.3    | -5.0  |
| Private                  |      |      |      |      |         |       |
| Consumption              | 7.7  | 10.8 | 8.5  | 9.0  | 9.0     | -3.8  |
| Investment               | 8.1  | 8.8  | 7.5  | 8.1  | 8.2     | 0.6   |
| Public                   |      |      |      |      |         |       |
| Consumption              | 5.1  | 22.7 | 13.7 | 13.7 | 13.6    | -25.3 |
| Investment               | 19.8 | 13.3 | 13.2 | 13.3 | 14.9    | -6.6  |
| External: Exports        | 9.9  | 9.6  | 9.5  | 9.1  | 9.5     | -0.4  |
| Imports                  | 31.6 | 17.1 | 16.7 | 17.0 | 20.4    | -11.7 |
| Aggregate Supply         |      |      |      |      |         |       |
| Internal Supply (GDP)    | 11.6 | 12.1 | 6.1  | 5.7  | 8.8     | -10.4 |
| External Supply: Imports | 8.2  | 9.2  | 8.3  | 8.1  | 8.5     | -0.7  |
| Exports                  | 21.9 | 29.9 | 31.9 | 18.5 | 25.4    | -35.5 |

(1) Includes changes in inventories.

Source: Antonio Jorge, Jorge Salazar-Carrillo, and Enrique P. Sanchez, Trade, Debt, and Growth in Latin America (New York: Pegamon Press, 1984), p. 63.

developed countries in response to the second oil crisis, which tripled world oil prices between 1979 and 1981, Mexico's oil-driven, overheated economy moved relentlessly, and recklessly, forward. Not surprisingly, accompanying the rapidly expanding economy was an accelerating rate on inflation.

Having cut the inflation rate in half in 1978, when the IMF-imposed stabilization program brought it down to 16.7 percent from 30.4 percent the previous year, Lopez Portillo's fiscal and monetary policies embarked on their expansionary phases. The results were predictable: During the next three years, inflation averaged more than 25 percent per year (IMF, International Financial Statistics 1984 No. 8 77). The money supply, augmented by the external borrowings and enhanced by the monetization of the portion of the expanding public sector deficit that was not financed externally, increased by an average of 33 percent between 1978 and 1981 (Jorge et al. 61).

The current account deficit increased and inflation accelerated, but efforts to maintain the peso at its relatively fixed rate caused it to become increasingly overvalued. In what had come to be a matter of intense Mexican national pride, policy makers would not permit the peso to deviate from its relatively fixed position, literally spending billions to prevent it from falling. The underlying economic conditions, particularly the widening

difference between Mexico's inflation rate and that of its principal trading partner, the United States, were disregarded by Mexican officials for years. Only when left with no other choice did policy makers very reluctantly agree to devalue the peso.

Apart from the misguided pride, the stable exchange rate policy was believed to be essential in moderating inflation. Yet the Mexican development policy, which emphasized import substitution and substantial protection, precluded effective competition that would have otherwise acted as an inflation deterrent. Moreover, the expansionary policies pursued by the government made inflation inevitable in any event.

Following the requisite devaluation made in 1976, when the peso fell from 12.50 per dollar to 22 per dollar, purchasing power parity had been achieved; and the peso was believed to be fairly valued. Table VI illustrates what happened to the purchasing-power-parity exchange rate (pesos/dollar) between January 1977 and December 1982. By January 1977, the peso rested at 22.18 per dollar. Thereafter, the government resumed its strict control of the peso's exchange rate, preventing it from maintaining its purchasing power parity rate. The peso became increasingly overvalued during the next four years (Jorge et al. 64).

What, then, were the consequences of the overvalued peso? As described earlier, these consequences manifested

TABLE VI  
PURCHASING-POWER-PARITY (P-P-P) EXCHANGE RATE (Pesos/Dollar)

| Month         | Prices <sup>1</sup><br>Mexico | Prices<br>U.S. <sup>2</sup> | P-P-P<br>Exchange Rate <sup>3</sup> | Ordinary<br>Exchange Rate<br>(controlled) | Ratio P-P-P<br>to Ordinary<br>Exchange Rates |
|---------------|-------------------------------|-----------------------------|-------------------------------------|-------------------------------------------|----------------------------------------------|
| January 1977  | 100.00                        | 100.00                      | 22.18                               | 22.18                                     | 100.00                                       |
| December 1977 | 115.46                        | 105.45                      | 24.28                               | 22.74                                     | 106.77                                       |
| December 1978 | 133.71                        | 115.57                      | 25.66                               | 22.72                                     | 112.94                                       |
| December 1979 | 160.33                        | 132.59                      | 26.82                               | 22.87                                     | 117.27                                       |
| December 1980 | 202.66                        | 149.28                      | 30.11                               | 23.26                                     | 129.45                                       |
| December 1981 | 257.79                        | 157.17                      | 36.38                               | 26.23                                     | 138.70                                       |
| February 1982 | 281.88                        | 158.73                      | 39.39                               | 44.64                                     | 88.24                                        |
| June 1982     | 339.67                        | 159.07                      | 47.36                               | 48.04                                     | 98.59                                        |
| August 1982   | 398.99                        | 159.62                      | 55.44                               | 49.81                                     | 111.30                                       |
| December 1982 | 496.83                        | 162.83                      | 67.68                               | 96.48                                     | 70.15                                        |

<sup>1</sup>Wholesale Price Index for Mexico City. January 1977 = 100.00.

<sup>2</sup>Wholesale Price Index, "All Commodities." January 1977 = 100.00.

<sup>3</sup>Assumes that the prevailing exchange rate in January 1977 was the P-P-P exchange rate.

Source: Antonio Jorge, Jorge Salazar-Carrillo, and Enrique P. Sanchez, Trade, debt and growth in Latin America (New York, Pergamon Press, 1984), p. 64.

themselves in the form of an insatiable appetite for imports and a stagnation in non-oil exports, particularly manufactured and agricultural products. In addition, the protectionist nature of the Mexican economy, which until recently greatly restricted the importation of lower-cost inputs, generated uncompetitive products, the foreign demand for which was further reduced by the overvalued peso. The tourist industry was also devastated. Even without the unfavorable effects of the overvalued peso, the tourist industry would still have been hampered by the world recession. Having been the principal contributor to Mexico's annual \$1 billion-plus surplus in its non-financial services account of the balance of payments, tourism suffered its worst season in 15 years during the winter of 1981 (Riding, "Mexico's Economic Imbalance"). After averaging an annual surplus of \$1.28 billion during the previous four years, Mexico's non-financial services account recorded a deficit of \$776 million in 1981 (IADB, External Debt 35).

Not only did the overvalued peso contribute to a deficit in the merchandise trade account and the tourism sector, but it also encouraged capital flight. Faced with the prospect of earning negative real interest rates from their savings in the domestic market, Mexicans transferred literally tens of billions of dollars from Mexico. The vast majority of these funds were used either to purchase high-yielding U.S. banks' certificates of deposit or to

invest in real estate in Miami, Houston, or other U.S. metropolitan areas. Capital flight to the United States was not a problem unique to Mexico. The existence of high real interest rates in the United States attracted capital from all over the world. These high real interest rates were necessary in order for the United States to finance its burgeoning federal budget deficits. The Mexicans who transferred their capital to the United States were rationally reacting to real economic incentives. |

Much of the (capital) drain from (Mexico) in the past three years (1980-82) was caused by an artificially high exchange rate and domestic interest rates below the rate of inflation. Mexico maintained an overvalued currency and negative real interest rates, hoping that these policies would promote domestic development and foster political calm. These measures worked as long as investors, both local and foreign, had faith in the domestic economy's prospects. By building up huge balance-of-payments deficits, funded with growing sums borrowed in the Eurodollar market at floating rates, Mexico rapidly lost that confidence. ("An Exodus of Capital" 132)

Aware that the peso had become increasingly overvalued, as it had six years earlier, Mexican residents feared an imminent devaluation, the effect of which would have raised the peso-price of dollars. In the absence of capital controls and under a policy of full convertibility, capital flight proved to be a simple task.

Estimates of capital flight are always difficult to make. Nevertheless, between 1980 and 1982, according to Business Week, as much as \$26 billion may have fled Mexico in the form of capital flight ("An Exodus of Capital" 132).

Morgan Guaranty, offering an estimate that approaches Business Week's figure but not its rate, calculated that "capital outflows exceeded \$9 billion in 1982, for a cumulative total of more than \$25 billion for 1978-82" ("Mexico--Progress and Prospects" 3). For 1981 and 1982 alone, the Bank of Mexico estimated capital flight to be \$17 billion (Cline, International Debt 27). Toward the end of 1981:

A flight of capital began to take place on an increasing scale, eventually reaching \$1 billion a month, and the government had to make large short-term borrowings to shore up the reserves. Purchases of real estate in the United States (including one tactless deal by a cabinet minister) were becoming the in-thing. (Caplan 35)

Even as capital flight accelerated, Mexican authorities only permitted relatively infinitesimal adjustments in the peso, allowing it to fall 2.4 percent in 1980 (from 22.80 pesos per dollar to 23.35) and 10 percent in 1981 (to 26 pesos per dollar). Finally, in a desperate effort to stem capital flight, Lopez Portillo belatedly agreed to the necessary devaluation in February 1982, when the peso dropped 28 percent the day the government permitted it to float. Within weeks the peso fell to 46 per dollar from its pre-float level of 26 per dollar, reflecting a depreciation of about 45 percent. Even this action, however, couldn't halt the momentum that had given rise to massive capital flight, and Mexican authorities were unable to restore a semblance of public confidence in their handling

of the economy. After all, inflation was accelerating from 27 percent in 1981 to 61 percent in 1982 (IMF, International Financial Statistics 77). And by year end, the annual rate of inflation exceeded 90 percent.

In addition to attempting to stem capital flight, another goal of the devaluation was to rectify Mexico's deteriorating position in its merchandise trade account. In terms of the prices of tradable goods, a devaluation will make imports more expensive in the home currency (i.e., pesos) by raising the home currency price of foreign exchange. As imported goods become relatively more expensive following the devaluation, fewer of them will be purchased. On the other hand, a devaluation will make the exports of the devaluating country cheaper in terms of foreign currency, since a given amount of foreign currency can now purchase more home currency. In Mexico's case, however, the second effect of a devaluation (i.e., making its exports relatively cheaper) has a minimal impact on its merchandise exports. This is due to the fact that Mexico's oil exports, which account for about three-fourths of its total exports, are priced in dollars. Thus, devaluation does not significantly increase Mexico's foreign exchange "inpayments." In short, because Mexico's major export is priced in dollars, devaluation doesn't work as well for Mexico as it does for other countries.

In April 1982 Mexico's largest conglomerate, Group Alfa, told its 130 foreign banks that it had to suspend principal payments on its \$2.3 billion foreign debt (Delamaide 102). Mexican firms holding foreign debt were especially adversely affected by devaluations, which required them to earn more pesos to pay their dollar debts.

Also in April, President Lopez Portillo announced an austerity program, the centerpiece of which was the proposed reduction of the government deficit by 8 percent. The government declared that growth for the next 12 months would be 0.

A second major devaluation, which pushed the peso to 70 per dollar, occurred in early August. At that time, a dual exchange rate regime was established. A preferential rate of 49.50 pesos per dollar applied to crucial imports such as food and some capital goods, to interest payments on public and private foreign debt arranged after August 5, and to principal payments on public debt incurred before then.

On August 12 Mexico drove another nail into its currency coffin. It froze \$12 billion in U.S. dollar accounts held in Mexican banks. By the stroke of a pen, these dollars became pesos at the rate of 70 to the dollar. By the time the pesos could be withdrawn, they were worth half that in dollar terms, and a one-fifth of the value the dollars had when they were deposited (Delamaide 103).

The Mexican economy was in a free fall. Following the presidential elections in July, Lopez Portillo announced new austerity measures aimed at reducing the widening government deficit exacerbated by subsidies. He decreed increases of 100 percent in bread and tortilla prices and 50 percent in gasoline prices. William Cline, an economist at the Institute of International Economics, described what happened next as an "old-fashioned panic":

Anti-inflationary in the long-run, these measures meant short-run corrective inflation. More significantly, they provoked the public--already shocked by a 60 percent annual inflation rate--frantically to convert pesos to dollars. With sharply declining foreign exchange reserves, the government declared domestic dollar deposits in banks redeemable only in pesos, instituted a dual exchange rate, and (one week later) temporarily closed the exchange markets. When the markets reopened, the peso soared from 70 to 120 per dollar. The financial panic was at full gale. ("Mexico's Crisis" 109)

On the day the exchange markets reopened, August 19, Mexico's Treasury Secretary Jesus Silva Herzog paid several "courtesy calls" to New York City banks, informing his creditors of Mexico's intention to suspend principal payments pending a major debt rescheduling. For all practical purposes, Mexico had defaulted.

The final straw that broke Mexico's back could be traced to the refusal of several European banks to refinance a portion of Mexico's short-term credits. At the time Mexico suspended principal payments, its total external debt, public and private, slightly exceeded \$80 billion, about 20

percent of which was due in 12 months or less. Moreover, another \$8 billion of medium-term credit fell due before year-end. Annual interest payments totaled \$11.5 billion. In effect, at the time of its de facto default, Mexico faced during the next 12 months payment obligations approaching \$35 billion in interest and amortization (Bennett, "Mexico Seeking Postponement").

Thus, a combination of factors, both internal and external, precipitated Mexico's financial crisis. These factors include: a shortfall of oil-export revenues (\$6 billion per year and 400,000 barrels per day); historically high interest rates that markedly increased the cost of servicing an expanding external debt; rising protectionism and the deep worldwide recession that reduced the demand for Mexico's non-oil exports; the accumulation of a disproportionately high share of short-term debt as a percent of its total foreign obligations; excessively expansionary demand policies that overheated the economy; misguided foreign exchange policies that caused an overvalued peso, which, in turn, exacerbated the stagnating demand for Mexico's non-oil exports, encouraged an explosion of imports, and engendered capital flight; fiscal and monetary policies that promoted large budget deficits, which were financed by external borrowing and domestic monetization; over-centralization, corruption, inefficiency, and government ownership of assets.

In the end, with its foreign exchange cupboard bare, Mexico had no choice but to suspend principal payments. Though the climactic decision was the inevitable result of the overlapping and compounding of all of the factors outlined above, the decision nonetheless did evoke surprise:

Mexico's decision to suspend payments on its foreign debt shocked the world. Morgan Guaranty economist Rimmer de Vries, a sober Dutchman not given to hyperbole, said: "It was like an atom bomb dropped on the world financial system . . . ." The waves of debt shock sent tremors around the world. First Mexico, then Argentina, Brazil, Venezuela, and practically every other country in Latin America sought relief from their debt burdens. (Delamaide 10-11)

## CHAPTER VI

### ECONOMIC ADJUSTMENT 1982-1983

Having suspended principal payments in August 1982, Mexico muddled its way through the balance of the year, negotiating an austerity program with the IMF and seeking refinancing and additional funds from the 1,400 international banks to which it owed approximately \$67.5 billion of its \$82 billion external debt.

The immediate task in August, however, was to replenish Mexico's empty treasury with a modicum of reserves needed to transact daily business. To this end, an unprecedented weekend refinancing rescue effort took place in Washington, D.C.

The \$3 billion (Mexico) requested was made available in time to meet Mexico's immediate commitments. . . . The \$3 billion package included \$1 billion from the Commodity Credit Corporation, a \$1 billion advance payment by the Department of Energy for Mexican oil to go into the United States strategic reserve, \$700 million directly from the Federal Reserve, and \$300 million from the Treasury under existing pre-arranged ("swap") lines of credit that had been set up between central banks. In addition to the \$3 billion directly from the United States, Mexico sought and later received a \$1.85 billion line of credit from the Bank of International Settlements. (Makin 13)

Following negotiations at the U.S. Treasury, Mr. Silva Herzog traveled to the IMF, where he sought a \$3.92 billion extended credit facility. Negotiations with the IMF commenced forthwith.

In September, while capital was still fleeing the country, retiring President Lopez Portillo nationalized the private banks and imposed exchange controls banning the import and export of currency. "The looney intention behind the second measure was to trap private capital from leaving Mexico. But capital continued to soak out of Mexico, while domestic savings collapsed because of the negative real interest rates" ("Latin America: The Breaking of a Continent" 22).

Lopez Portillo accused the nationalized banks of "looting" the country. In his final state of the union address, he charged: "I can affirm that in recent years a group of Mexicans, led, counseled, and supported by private banks, have taken more money out of the country than all the empires that have exploited us since the beginning of our history" (Riding, "Mexico Seizing Banks"). Citing capital flight totaling \$22 billion over the previous two to three years alone, Lopez Portillo maintained that Mexicans had deposited \$14 billion in the United States and invested \$25 billion in real estate there (Delamaide 104). U.S. banks, which had refused to deposit money in private Mexican banks, fearing the Mexican government would not stand behind their debts, greeted the nationalization with relief (Bennett, "Takeover Pleases U.S. Banks").

IMF negotiations concluded in November 1982, and Mexico and its creditor banks came to terms in December. The arrangements included these provisions:<sup>1</sup>

- Mexico would receive \$3.96 billion worth of credit over three years from the IMF.

- To qualify for these IMF funds, the Mexican government committed itself to increase taxes and curb imports. In addition, Mexico agreed to adopt additional fiscal measures that would reduce the public sector deficit from 16.5 percent of GDP in 1982 to 8.5 percent in 1983, 5.5 percent in 1984, and 3.5 percent in 1985. To accomplish such drastic reductions, public expenditures would have to fall sharply over a prolonged period.

- Mexico promised to achieve a trade surplus of \$8-\$10 billion and to reduce inflation annually from the current rate that was approaching 100 percent per year. Annual inflation targets were established at 55-60 percent (1983), 35 percent (1984), and 18 percent (1985). The double-tiered exchange rate system was to be phased out, and domestic interest rates were to rise to realistic levels.

- Banks assured the IMF that they would provide Mexico with an additional \$5 billion in new financing in 1983 to keep the country afloat. In exchange, the banks were guaranteed no less than 2 1/4 percent above Libor or 2 1/8 percent above the U.S. prime rate for the new \$5 billion, which would be repaid within six years with the first

principal payments due in three years. The \$23 billion in short-term and medium-term credit due between August 1982 and December 1984 was rescheduled over an eight-year period with a four-year grace period. The applicable floating interest rate for this rescheduled debt was  $1 \frac{7}{8}$  percent above Libor or  $1 \frac{3}{4}$  percent above the U.S. prime rate. In addition, the banks were to receive a  $1 \frac{3}{4}$  percentage-point fee for the new \$5 billion loan and a 1 percentage-point fee for the \$23 billion in rescheduled loans.

- Another \$2 billion in agricultural credits and export financing would be provided by government donors.

- Mexico committed itself to borrow no more in 1983 than the \$5 billion in new bank credits and to continue to reduce its debt as a proportion of GNP in 1984 and 1985.

- Mexico agreed to continue to pay interest on its debt. In 1982 interest charges totaled \$11.3 billion, and for 1983 they were expected to be between \$10 and \$12 billion.

Having completed negotiations with the IMF, the new Mexican president, Miguel de la Madrid Hurtado, three months after entering office, permitted the peso to float once again. It immediately fell 53 percent, falling from the non-preferential rate of 70 pesos to the dollar to 148.50 pesos per dollar. The new rate closely approximated the free market rate along the U.S.-Mexican border. The government also devalued the "preferential" rate, setting it at 95

pesos to the dollar compared to the 50 pesos-per-dollar rate that had been in effect since exchange controls were established in September 1982. The "preferential" rate, it will be recalled, applied to import and export transactions involving essential items.

At the close of 1982, the new administration began to implement the IMF-mandated austerity program that would, at least in the short run, shrink the already pathetic living standards of the overwhelming majority of Mexicans:

On the earning side, the government is planning across-the-board increases in the prices of all goods and services provided by the state, which include gasoline, electricity, telephones, rail and road transportation, steel, and basic petrochemicals. The local value-added tax is to be doubled for most items, while a 10 percent income tax surcharge will be applied in 1983. Even civil servants are to pay an income tax for the first time.

On the spending side, the government plans to slash a wide range of subsidies, including those that applied to basic food items, such as beans and tortillas. And with 40 percent of the budget assigned to debt servicing and seven million tons of food to be imported next year, all major construction projects have been canceled or suspended. (Riding, "Mexico Uses Austerity")

In addition, the government closed 106 state companies and agencies. Although inflation at year-end was running at an annual rate of 100 percent, wage increases were held to 25 percent (Delamaide 113). The price of oil remained precarious in a glutted oil market that was extremely volatile. The other exports--textiles, shoes, and automobile parts--faced rising protectionism in an

international market beset by deep recession. The Economist bleakly assessed Mexico's situation as follows:

The Mexican economic and social landscape meanwhile looks as though a hurricane had swept through it. Hundreds of firms are going bankrupt every month. Private investment declined some 15 percent in 1982. Unemployment is reckoned to have jumped from 8 percent to around 13 percent in the space of a few months, in an economy in which underemployment anyway probably stands at around 45 percent. This, in a country where a motor mechanic earning \$12 a month is considered employed. Real industrial wages...are falling fast. ("Latin America: The Breaking of a Continent" 22)

The economic figures for 1982 verified the wrenching experience Mexico endured during the year. For the first time in several decades, Mexico's real GDP declined. When the negative growth rate of -.2 percent is compared to the 3 percent annual growth rate of population, it is evident that per capita income plunged. Moreover, because the income is so inequitably distributed, it was no surprise that the brunt of the country's economic plight was borne by the impoverished masses, whose food subsidies were slashed and whose underemployment intensified.

Gross capital formation fell from 29.0 percent of GDP to 21.3 percent, the lowest level since 1973. Gross domestic investment fell from \$49.5 billion in 1981 to \$35.3 billion in 1982 (Inter-American Development Bank, Economic and Social Progress 421). Virtually all areas of the economy were adversely affected:

The performance of the manufacturing sector reflected an especially sharp decline in the production of capital goods and consumer durables.

The 13.6 percent decline in the production of capital goods resulted from the sharp drop in public and private investment. The production of consumer durables dropped 10.1 percent. Production by the automotive sector fell 25.7 percent . . . .

Output in the construction sector declined 4.2 percent compared to an increase in output of 11.8 percent in 1981. (Foreign Economic Trends--Mexico, October 1983 8)

In an inevitable adjustment to the weakening of the capital account (in the latter part of 1982, capital inflows virtually ceased), the current account deficit declined sharply in 1982. Compared to the 1981 current account deficit of \$12.5 billion, 1982's deficit fell to \$4.9 billion. Imports fell 40 percent from \$23.9 billion in 1981 to \$14.4 billion in 1982. This development was largely attributable to the dramatic, albeit overdue, depreciation of the peso and to the scarcity of dollars after the imposition of exchange controls. In all, the value of the peso depreciated by 82.7 percent in nominal dollar terms and 37 percent in real terms. However, exports only marginally increased by 9 percent, rising from \$19.4 billion in 1981 to \$21.2 billion in 1982. Though the average price of oil in 1982 was \$4.51 per barrel less than the 1981 average price, a 36 percent volume increase generated a 17 percent increase in value. Despite the real depreciation in the exchange rate, Mexico's non-oil exports declined 6.5 percent in value (Foreign Economic Trends--Mexico October 1983 10; "Mexico--Progress and Prospects" 3).

An economic report prepared by the American embassy in Mexico City attributes the decline in non-oil exports to the lower volume of imports, "which has severely affected the country's productive capacity. Shortages of imported goods are forcing slowdowns or stoppages in many industries. The lack of spare parts is particularly acute. These shortages are aggravating the unemployment problem" (Foreign Economic Trends--Mexico, October 1983 10).

Thus, compared to 1981, when Mexico registered a \$4.5 billion merchandise trade deficit, in 1982 the trade balance reflected a \$6.8 billion surplus, the first in 39 years.

As devastating as 1982 was, 1983 proved to be much worse--to no one's surprise because the austerity programs and the economic retrenchment they mandated were implemented shortly after de la Madrid became president on Dec. 1, 1982. Indeed, in his inaugural address, de la Madrid outlined a 10-point economic program, which included budget cuts, tax increases, price increases, postponement of public works, an increase in interest rates, and a relaxation of foreign exchange controls. From de la Madrid's inaugural address:

We live in an emergency situation. The situation is intolerable. I will not allow the nation to disintegrate in our hands. We are going to act with decision and firmness . . . All Mexicans must participate in this national effort, which no foreign aid and magic solution can substitute. The recovery will take time, at least two years. The first months of the government will be arduous and difficult. The situation requires it. The austerity is obligatory. ("Mexico's President Taking Office")

Whereas real growth in the economy declined by  $-.2$  percent in 1982, it fell by an unprecedented 4.7 percent in 1983. Population, meanwhile, continued its inexorable rise, increasing by 2.5 percent (2 million) in 1983.

Living standards continued their decline. In August 1983 The Economist estimated a 30 percent fall in living standards since 1981 ("Mexico Under the IMF" 20). The real minimum wage, having fallen 12 percent in 1982, declined by another 16 percent in 1983. In the manufacturing sector, average real wages, which declined little in 1982, plunged more than 25 percent in 1983. The public sector wage bill dropped 20 percent in real terms, the equivalent of nearly 2 percentage points of GDP ("Mexico--Progress and Prospects" 3-4).

During 1983, Mexico largely achieved the goals to which it had been committed by virtue of its IMF agreement:

- The 1982 public sector deficit of 16.5 percent of GDP was reduced to 8.7 percent in 1983,  $.2$  percent above its target. The small deviation was attributed to the fact that 1983's GDP was considerably lower than the level originally projected. Public sector expenditures declined by 5 percent of GDP, while public sector revenues increased by 4 percent of GDP. Interest payments, which accounted for nearly one-third of public sector expenditures, increased more than 40 percent in real terms. (Recall that one facet of the IMF program required Mexico to move from negative real interest

rates to positive ones.) However, virtually all other spending categories were subjected to major budgetary reductions, including subsidies, which were lowered by 40 percent in real terms through price increases in electricity, petroleum products, and foodstuffs. Public-sector capital outlays fell 30 percent in real terms.

- Net international reserves of the central bank, which were targeted to reach \$1.5 billion by 1983's fourth quarter, ended the year at \$5 billion.

- Public sector external debt by the end of the year was below its permissible level.

- The most striking results were achieved in Mexico's balance-of-payments accounts. The IMF program called for Mexico to achieve a \$3.4 billion deficit in its current account for 1983, which would have resulted in a 30 percent improvement. Yet Mexico's current account actually blossomed into a surplus of \$5.5 billion in 1983. Merchandise imports continued to plummet, falling to \$7.7 billion, 46 percent below 1982's level and fully 68 percent under 1981's record level of \$23.9 billion. Merchandise exports, \$21.4 billion, increased at a disappointing rate of less than 1 percent--although reported exports were probably understated due to the continued dual exchange rate system and to the existence of a more favorable exchange rate outside Mexico. Even with under-invoicing of exports, Mexico still managed to double its surplus in its trade balance to

\$13.7 billion. As impressive as the trade-account turnaround appears, it is tempered by the fact that it was achieved not by substantively expanding exports but by slashing imports. Thus, imports of parts for machinery and transport equipment were one-quarter of the 1981 rate. As a result, production lines, lacking spare parts, were forced to shut down, further exacerbating the decline in industrial production and reducing the availability of manufactured products for export.

On the services side, interest payments on its external debt declined from \$11.3 billion in 1982 to \$9.9 billion in 1983. And an increase in tourism contributed to the generation of a \$1.7 billion surplus in "other services and transfers." The 90 percent expansion of tourism revenues was primarily brought about by the marked depreciation of the peso.

Despite the fact that the Mexican economy was starved for funds, its capital account in 1983 reflected a deficit of \$2.3 billion. Thus, we have the spectacle of capital-short Mexico, in effect, exporting capital to the capital-rich United States.

●Not as much progress was made in 1983 on the inflation front. On a December 1981 to December 1982 basis, inflation increased by 98.8 percent. The IMF target for 1983 was 55-60 percent. However, due to the rapid peso devaluation during the latter part of 1982 and the price

increases imposed when de la Madrid entered office, inflationary momentum in the early part of 1983 pushed the rate significantly higher before inflationary pressures abated during the last two quarters of 1983. On a month-to-month basis, prices rose 7 percent per month during the first half, 4.8 percent per month during the third quarter, and 4 percent per month during the fourth quarter. In 1983 the CPI increased 80.8 percent on a December-to-December basis, 20 to 25 percentage points above target.

●The monetary base increased by only 55.6 percent in 1983 on a December-to-December basis (compared to 95.6 percent in 1982). In real terms, the monetary base actually shrank by 13.9 percent in 1983.

●Contributing to Mexico's lackluster export performance in 1983 was a real appreciation of the peso. Because Mexico's inflation rate continued to outpace that of its trading partners, the peso required constant devaluation. However, it was not devalued sufficiently to compensate for the inflationary differential. As a result, the real effective peso exchange rate appreciated in 1983, giving up more than half the 1982 gain in international price competitiveness. The dual exchange rate regime continued in 1983, although the difference between the controlled rate and the "market" rate narrowed to 12 percent by year-end. Then, the market rate was 161 pesos to the

dollar, and the controlled rate was 144 per dollar, up from January's levels of 148.50 pesos and 96 pesos, respectively (Foreign Economic Trends--Mexico, November 1984 10; "Mexico--Progress and Prospects" 6; Bogdanowicz-Bindert).

The 4.7 percent reduction in Mexico's 1983 GDP was generally diffused throughout the economy--except for slight increases in the production of agricultural commodities and electricity. General commerce (wholesale and retail trade) declined 8.6 percent, construction fell 15.1 percent, and industrial production (a category that embraces industry manufacturing, mining, construction, and electricity) declined 8.2 percent--although each quarterly decline, when compared to the previous year's level, became successively smaller (-13.1, -10.6, -6.4, -3.2) (Foreign Economic Trends--Mexico, November 1984 5).

Mexico's wild card, of course, is oil. And in 1983, both petroleum export revenues and total production declined. Crude oil production fell by 2.9 percent from 2.75 million bpd to 2.67 million bpd. Though Mexico's crude oil exports marginally increased in volume from 1.53 million bpd in 1982 to 1.54 million bpd in 1983, price reductions caused a 5 percent decline in total export value. The price of Mexico's Isthmus light fell \$3.50 per barrel early in the year, declining from \$32.50 to \$29, where it remained for the balance of the year. At the same time Mexico reduced the price of its Isthmus light crude, the price of its Maya

heavy oil fell by \$2 per barrel from \$25 to \$23, although it returned to \$25 before year's end. Mexico's oil exports are divided evenly between light and heavy crudes. For the year, Mexico's oil export revenue fell by \$500 million from \$16.5 billion to \$16 billion (The Economist's Economic Review of Mexico, May 10, 1983 13; "Mexico: Bad business as Usual" 56).

The two most important international variables over which Mexico exercises little or no control are the world oil price and the base interest rates (Libor and the U.S. prime rate) to which its external debt is tied. The general rule of thumb is that a \$1 change in the price of oil causes a \$550 million annual change in Mexico's oil export revenues, based upon daily crude exports of 1.5 million barrels. On the other hand, a 1 percentage point change in the dollar's interest rate causes Mexico's annual interest payments to change by \$750 million. Thus, increases in U.S. interest rates (or Libor) increase Mexico's debt service requirements, and decreases reduce its debt burden (Rowe).

During 1983, Mexico benefited from a relatively stable prime rate. At the beginning of the year, the prime rate, to which much of Mexico's debt is indexed, stood at 11.50 percent, fell to 10.50, and ended the year at 11.00, having averaged 10.79 percent throughout the year. The average 1983 rate was about 4 percentage points below 1982's average (14.86 percent) and 8 points below its 1981 average

(18.87 percent) (Council of Economic Advisers, Economic Report of the President 1984 298-99).

Notwithstanding the decline in world nominal interest rates, the real (i.e., inflation-adjusted) interest rate Mexico encountered remained well above historical levels. This was due to two facts. First, inflation, as measured by the U.S. GNP implicit price deflator, declined precipitously (1981, 9.4 percent; 1982, 6.0 percent; 1983, 4.2 percent). Second, as a result of its 1982 debt re-negotiations, Mexico was obligated to pay a higher premium above the prime rate than previously. Loans initially bearing a premium of 1/8 percent were rescheduled at rates carrying premiums as high as 2 1/4 percent.

Moreover, although average base rates in 1983 were substantially below those prevailing in 1982, and although Mexico's total external debt increased by only \$3.5 billion in 1983, the increase in premiums meant that Mexico's interest payments declined by only \$1.4 billion, from \$11.3 billion to \$9.9 billion ("Mexico--Progress and Prospects" 6).

In addition to the progress the Mexican government made in 1983 by moderating inflation, reducing budget deficits, and improving its balance of payments, among other things, progress was also made in alleviating the burden of external debt held by the private sector. In particular, Mexico reached agreement with foreign bankers to reschedule

most of its \$14 billion in private debt. The debt was rescheduled over an eight-year period and longer, with a grace period of four years before principal payments were to begin. The private debt repayment program, known as Ficorca (its Spanish acronym), was welcomed by the borrowers because:

It meant the government would help them repay loans they otherwise could not manage themselves. Bankers, for their part, were receptive because the Ficorca program meant the Mexican government had become the guarantor of debt that might have been otherwise difficult to collect. (Frazier, "Mexican Companies Enthusiastic")

Despite its falling real GDP, Mexico's 1983 performance was hailed for the turnaround it had achieved, particularly in its external accounts. One typical analysis follows:

In no other country in modern times, not even post-Weimar Germany, has so radical a program been instituted so rapidly, so free from hesitation--or with such sudden success. Within months of accepting the IMF's rescue, and installing a technocratic banking and financing team in his cabinet which shares the IMF's views, Mr. de la Madrid is able to look the world's bankers in the eye. ("Mexico Under the IMF" 19)

For all the laurels international bankers and economists heaped upon Mexico's policy makers, the vast majority of Mexico's 75 million citizens experienced devastating reductions in their already pathetic living standards. "Over all, real income fell 25 percent during 1983. Living standards of the middle class, long used to

imported goods, dropped by some 40 percent. Unemployment soared" ("Hard Times in Mexico").

## CHAPTER VII

### ECONOMIC ADJUSTMENT 1984-1985

In exchange for its demonstrated willingness to undergo the IMF-mandated austerity measures, Mexico received commitments from its bankers for \$4 billion in new loans for 1984 on extremely favorable terms. Not only was the repayment period longer than normal, but the premium (1.13 percent above the U.S. prime rate) was one percentage point below earlier spreads. Initiation fees were lower as well. Mexican officials estimated that the interest rate concession would amount to an annual savings of \$38 million (Witcher, "Mexico's New Lower-rate Loans").

Gaining even more kudos from the bankers, in April 1984 Mexico organized a last-minute bail-out of Argentina, which had fallen far behind in its interest payments. To prevent a formal Argentinian default and all the attendant adverse ramifications for the balance sheets of the U.S. banks, Mexico contributed \$100 million to a \$500 million fund it had arranged to pay Argentina's delinquent interest.

Mexico by now had become the example bankers wanted other Latin debtors to emulate. Having implemented the draconian austerity measures mandated by the IMF, Mexico managed to generate a sufficient trade surplus to enable it to remit nearly \$10 billion in interest payments in 1983.

Because its additional financing for the year fell far below its interest payments, Mexico had, in effect, become a capital exporter. One result was a dramatic decline in living standards.

Mexico's ruling party, the Institutional Revolutionary Party, was able to exact such sacrifice from labor because the country's largest union, the five-million member Mexican Workers' Confederation, is an affiliate of the party itself. Moreover, the Mexican labor leader, 86-year-old Fidel Velazquez, has single-handedly ruled his confederation for 40 years during the terms of seven presidents. Whether such stability in the Mexican labor movement, in the face of falling living standards, will remain after Velazquez's mortal demise is an open question.

However, no sooner had the Mexicans and their bankers reached a rapprochement than did it begin to unravel in response to rising interest rates. Both the U.S. prime rate and the London interbank offer rate (Libor) increased 1 percentage point in April 1984--effectively canceling the savings Mexico had expected to realize from its \$4 billion loan bearing a 1.13 premium rather than the customary 2.13 premium. Worse, Mexico's other debts indexed to floating rates were affected as well. As noted earlier, each percentage point rise in interest rates costs Mexico about \$750 million per year in additional interest costs.

In May the prime rate increased by another .50 percent to 12.50 percent. Two weeks later, President de la Madrid met in Buenos Aires, Argentina, with the presidents of three other Latin American debtors: Argentina, Colombia, and Brazil. Citing rising international interest rates, the four presidents warned that they would not permit their increasing debt service requirements to force them into insolvency. Their joint communique said: "We do not accept seeing ourselves forced into a situation of insolvency and continuous economic crisis. Our nations cannot indefinitely accept these hazards" (Schumacher). Among their demands were "lower interest rates on loans, longer grace periods for repayment, fewer bank commission charges, and greater allowances for their exports to industrialized countries" (Schumacher). The four chief executives announced that they would convene a meeting of Latin American debtors "to obtain satisfactory solutions for all nations involved."

Not since the debt crisis erupted in August 1982 had it become so precarious and volatile. The prospects of a debtors' cartel loomed on the horizon.

In response to the implied threat of open rebellion, policy makers from creditor countries proposed several schemes for capping interest rates. One plan would reduce payable interest rates to 2 percent and would capitalize the unpaid difference by adding it to the principal. Thus, Mexico would be required to pay interest

costs of \$1.8 billion in the first year (2 percent of \$90 billion), but the unpaid interest of about \$10 billion would be added to its external debt. These capitalized, unpaid annual interest charges of \$10 billion would be payable, according to one plan, 10 to 15 years later. While alleviating short-term liquidity problems, such a plan would surely aggravate the long-term debt problem when the capitalized portion, itself subject to interest accumulation, became due. (Such are the wonders of compound interest, \$10 billion in principal bearing an interest rate of 12 percent would require a payment of \$31 billion after 10 years and \$55 billion after 15 years.) Understandably, debtors showed little enthusiasm for this proposal.

Another plan, advocated by Federal Reserve Chairman Paul Volcker, would ease terms for those countries, Mexico in particular, that had reined in their economies.

The Fed wants to reward the countries by giving them generous repayment terms if they follow strict economic austerity plans and stay current on bank payments. That way, the Fed figures, the countries adjust their economies, and banks and their shareholders pay some of the price for troubled international debts. (Witcher, "Mexico, Volcker Allied")

While such a plan might appeal to Mexico, which had already undergone wrenching austerity measures, it was unlikely that other debtors would want to pay the sizable price Mexico had paid for the privilege of "generous repayment terms."

Still another scheme called for the establishment of an interest rate below the market rate, such as 7 percent, with the difference forgiven. The banks, for obvious reasons, strongly opposed this option.

Shortly after 11 Latin American debtors met in Cartagena, Colombia, in June to discuss their increasing debt burdens, U.S. banks again raised the prime rate by another .50 percent to 13 percent, more than two points above its average for the previous year. Given the rule of thumb that each percentage point increase in interest rates costs Mexico an additional \$750 million a year in debt service payments, the increase of 2 percentage points during the first half of 1984 raised Mexico's annual debt burden by about \$1.5 billion. These additional costs, moreover, negated the progress Mexico had finally made in achieving a trade surplus in non-oil products ("Mexico: Debt Payments Swallow an Export Surplus").

Meanwhile, Mexico was negotiating with its bankers to reschedule the nearly \$50 billion of debt falling due between 1985 and 1990. In 1985 alone, \$10 billion in principal was due, rising to \$14 billion by 1987. Shortly before the second meeting of the Cartagena Group, Mexico managed to extract most of the concessions it had sought from its bankers, who, understandably, were anxious to come to terms with Mexico before the evolving debtors' cartel met again. The agreement allowed Mexico to spread out over 14

years the principal payments that were due during the next six years. Among the provisions of the \$48.7 billion public-sector debt rescheduling, which represented the largest sovereign rescheduling ever, were these:

- Debt in the amount of \$20.1 billion, mainly dating from the 1977-82 lending spree and maturing between 1985 and 1990, was refinanced over 14 years with a one-year grace period.

- A further \$23.6 billion, which was the subject of the August 1982-December 1984 rescheduling agreements, had its repayment deadline extended from 1990 to 1998 with no grace period.

- Repayment of the \$5 billion in emergency loans that were extended in 1983 was spread out to 1998.

- The spread charged above Libor was reduced to an average of 1.10 percent. This was a major achievement. Recall that when Mexico obtained its \$5 billion emergency loan from the banks in 1983, the spread it was forced to accept was 2.25 percent above Libor. And for the \$23.6 billion rescheduled at the same time, the premium above Libor was 1.88.

- Principal payments on the rescheduled debt for the next four years were negotiated downward to zero in 1985, \$250 million in 1986, \$500 million in 1987, and \$1 billion in 1988. These downsized principal repayments are in addition to the principal repayments that will be due on the

portion of the debt that was not part of the rescheduling agreement. However, when all debt is considered, annual principal payments between 1985 and 1988 will average no more than \$2 billion--compared to the \$12 billion per annum that would have been due prior to the rescheduling. Figure 9 compares the difference in principal repayments between those required before rescheduling and those mandated afterwards ("Mexican Debt: Tequila with Salt"; Riding, "Latin Debt: Postponing the Burden"; Meislin, "Mexico Reports Accord").

One noteworthy feature of the agreement was the absence of any authoritative monitoring agent. Mexico's IMF-mandated austerity program is scheduled to expire in December 1985, after which the IMF will continue to issue a report every six months to Mexican authorities. However, it will then be Mexico's decision to determine what information, if any, will be made available to the banks.

This procedure is far less restrictive than recent IMF programs, where the fund and the Mexican government jointly set very specific economic targets, and where banks as a group agreed that the attainment of such goals was a requirement for rolling over existing debt and providing new money. Without the assured support of the banks, the fund will now have less leverage over Mexico's policies (Garten).

Mexico's 1984 performance registered positive real growth (3.50 percent) for the first time since 1981. And by

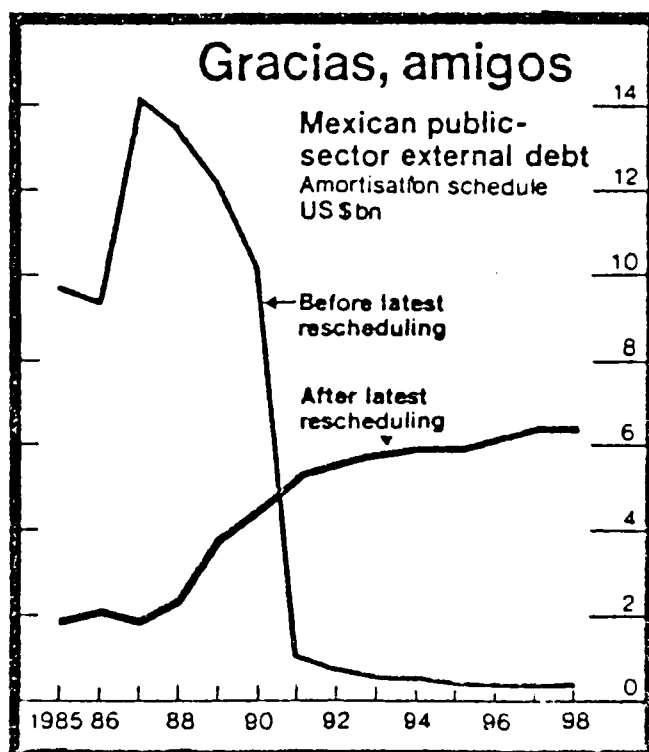


FIGURE 9

MEXICO'S PUBLIC SECTOR EXTERNAL DEBT,  
BEFORE AND AFTER RESCHEDULING

Source: The Economist, September 15,  
1984, p. 86.

year's end the economy began to surge at a 6 percent annual rate. Investment for the year reversed the downward trend experienced in 1982 and 1983. Private investment increased 8.8 percent and public investment rose .06 percent "Mexico Grew 3.50 Percent").

Although non-oil exports increased by nearly \$3 billion and Mexico's oil revenues remained constant, its trade surplus slightly decreased from \$13.7 billion in 1983 to \$12.8 billion in 1984, largely because imports increased almost 30 percent. To appreciate the progress Mexico had achieved in its external accounts, recall that its trade deficit registered a deficit three years before. The current account for 1984 remained in surplus at \$4 billion, about \$1.5 billion below its 1983 level but much improved over its \$12.5 billion deficit recorded in 1981 ("Latin America's Trade Policies").

Petroleum production and exports remained virtually unchanged in 1984 compared to 1983 and 1982. Oil export revenue was \$16.5 billion, and export volume averaged about 1.53 million bpd. Proved oil reserves, having increased slightly in 1983 to 72.5 billion barrels, remained unchanged in 1984 (Foreign Economic Trends--Mexico, March 1985 9-10).

The price of Mexico's Isthmus light oil, which accounted for about 41 percent of its 1984 oil exports, remained unchanged in 1984 at \$29 per barrel, a price in effect since early 1983. The price for Mexico's Maya heavy

oil, which accounted for 59 percent of 1984 oil exports, improved moderately, rising from \$25 per barrel to \$25.50 ("Mexico: Bad Business as Usual").

In 1984 Mexico again experienced more inflation than permissible under its IMF agreement. In 1983 inflation averaged 81 percent compared to the targeted level of 55-60 percent. In 1984 inflation measured by the consumer price index decelerated to 59 percent, which significantly exceeded its target of 35 percent. At year-end, inflation began to re-accelerate.

The most important target, the public-sector deficit as a percent of GDP, was also exceeded. Scheduled to fall to 5.50 percent in 1984, the actual public-sector deficit was at least 7.60 percent of GDP. Mexico reported a deficit of only 6.20 percent, but in doing so it excluded additional expenditures amounting to 1.40 percent of GDP that are normally included in deficit calculations. To further compound the deficit picture:

Mexico pushed some of its 1984 spending into 1985, meaning Mexico starts out with holdover spending. This makes it even harder to believe that Mexico can substantively reduce the (1985) budget deficit. A special contingency fund in the 1985 budget, similar to one that the IMF opposed in last year's budget, could push the deficit even steeper. (Frazier and Witcher; Frazier, "Mexico Pledges Spending Curbs")

Mexico's debt service requirements were substantively reduced in the second half of 1984 as the prime rate fell nearly 3 percentage points to its lowest

level in seven years. Nonetheless, real rates remained high relative to historical standards.

On the currency front, the government by the end of the year had sufficiently devalued the controlled rate to 192.5 pesos per dollar so that it did not deviate as much from the market rate of 209.2 pesos (Foreign Economic Trends--Mexico, March 1985 2). Because inflation had been higher than expected, in early December the government increased the peso's daily devaluation from 13 centavos, the rate that had been in effect since September 1983, to 17 centavos (there are 100 centavos per peso). Indeed, despite the daily devaluation, the peso had become increasingly overvalued during the year, losing still more of the gains it had recouped in 1982. For the 12 months ended in October, inflation had been 63 percent while the peso had been devalued only 31 percent ("Mexico's Shift in Devaluation"). According to Morgan Guaranty Trust Co., Mexico's real effective exchange rate had been increasing throughout 1984. Using 1980-82 as a base period, Mexico's real effective exchange rate had increased from a 1983 average of 85.3 (reflecting the impact of Mexico's devaluation program, which had reduced the index from 112.4 in 1981) to a 1984 average of 103.5. By December 1984 the index had increased by nearly 30 percent over its 1983 average ("The Bonn Summit").

At the end of the year, Mexico's central bank announced that it had nearly \$8 billion in foreign reserves ("Mexico's Shift in Devaluation"). Inasmuch as its coffers had less than \$2 billion two years before, such an accumulation of reserves marked a major improvement. Through June, however, capital flight, to the extent it could be gauged through the "errors and omissions" in the balance of payments, began to rise from its level during a comparable period in 1983. And Mexico's acceleration of its daily devaluation in December 1984 suggests that capital flight continued to rise during the second half of the year.

At the end of 1984, Mexico's total external debt approximated \$95 billion, and its interest payments for the year amounted to \$11 billion.

Despite the general euphoria that accompanied Mexico's massive rescheduling, several developments toward the latter part of 1984 presaged major problems for 1985, notwithstanding the decline in interest rates.

First, the peso had become increasingly overvalued. Although Mexico's non-oil exports had increased by about \$3 billion in 1984, largely in response to the lagged effect of earlier real devaluations, the increase in Mexico's real exchange rate during 1984 projected a decline in non-oil exports in the future. Second, for all its earlier progress in reducing its public-sector deficit, it appeared that Mexico was approaching the limit of its improvement in this

area. Indeed, the government revised its 1985 deficit target to 5.10 percent of GDP from the initial IMF goal of 3.50 percent. However, bankers expressed strong doubts that even the looser 5.10 percent target could be met (Frazier and Witcher). Third, inflation had re-accelerated during the fourth quarter despite its overall improvement for the year. On the inflation front, Mexico was regressing, not improving, and the government's promise to increase real wages by 30 percent in 1985 would further complicate the government's efforts to reduce inflation (Taylor).

Fourth, in response to the oil glut that was becoming increasingly severe, Mexico reduced its oil exports by 100,000 bpd in November in a cooperative gesture to OPEC. This reduction cost it about \$83 million per month (\$1 billion a year) in hard currency. Although this November reduction negligibly affected its 1984 oil-sector performance, the trend for 1985 was moving in the wrong direction. Moreover, as rampant cheating among OPEC members made it clear that oil producers could not forever deal with the glut merely by reducing "official" output levels, sooner or later (and probably sooner) prices would fall. For two years, Mexico's price for its Isthmus light oil held steady at \$29 per barrel, and the price of its Maya heavy oil actually improved by \$2.50 per barrel since mid-1983. Because 1984 oil export receipts accounted for 71 percent of Mexico's total export revenue (down from 79 percent in

1982), a softening of the market in terms of either volume or price would significantly affect Mexico's ability to service its debt. Even though principal payments would amount to less than \$2 billion in 1985, interest payments would still require at least \$10 billion. If oil exports and non-oil exports were to fall, Mexico's debt service ratio would rise markedly. "If (oil) prices were to drop by \$5 per barrel, Mexico fears it could not service its \$96 billion of foreign debt ("OPEC's Fellow Travelers Fall by the Wayside").

Fifth, the negative impact of the increasingly overvalued peso upon Mexico's non-oil exports would likely be further exacerbated in 1985 by two other factors: rising protectionism and a reduction of growth in the United States, which purchased 59 percent of Mexico's global merchandise exports in 1984. Non-oil exports to the United States increased 26 percent in 1984 (Taylor). Yet the United States was being overwhelmed by protectionist sentiment against low-wage countries accused of causing havoc in industries running the gamut from shoes and textiles to steel and semiconductors. In addition, U.S. economic growth sharply decelerated in the second half of 1984, falling from an annual rate of 8.60 percent in the first half to 2.90 percent in the second.

Finally, Mexico's policy makers and the ruling Institutional Revolutionary Party had to be concerned about

how much longer its ever-increasing population could continue to absorb such drastic reductions in their already pathetic living standards. Slashing subsidies and raising prices in order to reduce the public-sector deficit clearly aggravates social harmony in the short run. No doubt this thinking was behind the government's stated commitment to increase real wages by 30 percent in 1985. In 1984, for the third year in a row, the real minimum wage had fallen, albeit at a slower rate than in either 1982 or 1983.

On the positive side, the significant decline in interest rates during the second half of 1984 was most welcome in Mexico City. Nevertheless, it was the single bright spot in a situation that had a far greater chance of deteriorating very rapidly as 1985 began.

It didn't take long to happen. Early in February 1985, in the face of an intensifying world oil glut causing Mexico's oil exports to fall an additional 13 percent to 1.3 million bpd, Mexico broke ranks with OPEC. Only three months before, Mexico had reached an accord with the oil cartel by agreeing to reduce exports by 100,000 bpd, but it was in no position to sacrifice any more volume to the rampant cheating throughout OPEC. Though maintaining the price of its Maya heavy crude at \$25.50 per barrel, Mexico reduced the price of its Isthmus light oil from \$29 per barrel to \$27.75. Since the Isthmus grade accounts for about 40 percent of its oil exports, the pricing move figured to

reduce Mexico's annual revenues by about \$275 million, provided, of course, that it regained the the shipments it had lost by delaying its price cut (Frazier, "Mexico to Cut Outlays").

Inflation continued to rise, and in the face of a widening public-sector deficit, President de la Madrid announced further austerity measures in February, including reductions in subsidies and investments. In all, the austerity program was aimed at reducing the federal budget by \$465 million. The plan included closing, liquidating, or transferring 236 of the more than 500 state-owned enterprises. The president had been promising since he entered office to sell off "non-essential" state-owned enterprises, many of which are inefficient and the source of huge losses; but prior to his newly announced austerity program, few had been sold. And the firms selected to be sold were mostly small companies that in the aggregate represented a small part of the state's holdings. Indeed, the fact that public-sector spending amounted to more than 40 percent of GDP has often been cited by Mexico's critics as a major factor contributing to its hugely inefficient and wasteful economy. In fact, the public sector's external debt of \$67.5 billion represents more than 70 percent of Mexico's total external debt of \$96 billion.

In addition to the new austerity measures, de la Madrid announced plans to gradually increase imports in

order to reduce the cost of goods that are made in part from imported products. And he promised to provide within 30 days a plan to increase Mexico's non-oil exports ("Mexico Fails").

Within days of announcing the new austerity measures, January's inflation rate of 7.40 percent (153 percent at an annual rate and the highest monthly rate in nearly two years) was reported, prompting the government to more than double its federal budget cuts from \$465 million to \$1.2 billion, which represented 1.50 percent of the 1985 budget (Frazier, "Mexico to Cut Budget").

Indicative of accelerating inflation and falling non-oil exports and three months after Mexico had raised the daily peso devaluation from 13 centavos to 17 centavos, it was compelled to increase the daily change by another 4 centavos to 21 centavos per day. At the same time, the government outlined its plan to permit the increased importation of new materials used in the production of exportable goods. The goal was to substantially open Mexico's protected domestic market and to compel manufacturers to become more efficient. The plan, known as Dimex, would permit manufacturers to import up to 40 percent of the value of their export sales free of duty or import permits. A government official noted: "Since the 1940s, there has never been a thorough, long-standing attempt to open the economy and make our industry more competitive.

This is the first solid step to change all that" (Frazier, "Mexican Peso to Be Devalued More Quickly").

However, fierce lobbying by Mexican industry delayed implementation of the Dimex program. Finally, a watered-down version of the original program was unveiled in early June. Rather than the original figure of 40 percent, businesses will be permitted to import 30 percent of the value of their export earnings without having to pay duties or obtain import permits.

The (initial) plan was designed to make Mexican manufacturers more competitive by giving them access to imported components--and by forcing manufacturers who won't export to compete with imported goods, which are often cheaper than Mexican products. Officials hoped the plan will convince manufacturers to make long-term decisions to become export-oriented instead of just looking to export excess stock when the domestic economy weakens (Frazier, "Mexico Acts").

Not only did Mexican industries force the government to reduce the portion of unrestricted imports to 30 percent, but they also convinced the government to prohibit exporters to resell the goods they import under the program. Moreover, the government expanded the list of products that could not be imported under the program to include "30 percent of Mexico's total imports. And several industries covered by the import substitution programs were

excluded, such as the pharmaceutical and auto industries (Frazier, "Mexico Acts").

Even without the Dimex plan, Mexican imports surged, though they were not the production inputs for export-based industries. During 1985's first quarter, Mexico's imports were 38.9 percent higher than their 1984 levels. Meanwhile, exports had declined 11.1 percent overall, and non-oil exports had fallen 16 percent from the levels achieved during the first quarter of 1984. Mexico's trade surplus for the first quarter of 1985 narrowed to \$2.3 billion, 42 percent below 1984's first quarter surplus. At a seasonally adjusted annual rate, Morgan Guaranty estimated that Mexico's trade surplus would fall from \$12.8 billion in 1984 to \$8.4 billion in 1985--assuming oil prices and shipments would decline no further. Under the same assumption, the current account surplus was projected to fall from \$4 billion in 1984 to \$1.1 billion in 1985 ("Mexico Fails").

If Mexico's rapidly deteriorating trade situation did not indicate a country moving back toward the abyss, its 82 percent annual rate of inflation during 1985's first quarter certainly did ("Latin America's Trade Policies"). It became clear that Mexico would substantially exceed its 1985 inflation target of 35 percent, itself an upward revision of the initial IMF target of 18 percent.

Predictably, Mexico's accelerating inflation rate and its inadequate daily devaluation of 21 centavos per dollar combined to increase the overvaluation of the peso. By February the peso's real effective exchange rate calculated by the Morgan Guaranty index (1980-82=100) reached 113.6, higher than the 1981 average level of 112.4 (when all observers recognized its extensive overvaluation) and fully 35 percent higher than the index's 1982 level of 83.9 ("The Bonn Summit"). Accompanying the overvaluation problem, as it always does, was the resumption of capital flight (Bartlett).

Simultaneously, Mexico was rapidly losing oil customers as it became apparent that its February price reduction was inadequate. Repeating the 1981 dread experience of neglecting to sufficiently adjust its prices in the face of declining oil exports, Mexico saw its shipments in early June fall by 200,000 to 300,000 barrels per day. In mid-June Mexico belatedly reduced the price of its Maya heavy oil by \$1.50 per barrel to \$24, but it maintained the price of its Isthmus light crude at \$27.75. The oil still remained overpriced relative to the steep discounts offered by OPEC members and the spot market. (Prior to the \$1.50 cut in Maya crude, both grades sold for \$2 to \$4 above the spot market.) Predictions by oil industry analysts that Mexico's loss of market would widen because of its price rigidity were fulfilled in the latter half of

June, when Mexico's oil exports fell to 800,000 bpd, barely one-half of its export target of 1.5 million bpd. Mexico finally reacted on July 10, nicely timed to follow its July 7 elections. Mexico further reduced the prices, retroactive to July 1, of both its crudes by an average of \$1.24 per barrel. For the first time, Mexico established different f.o.b. prices (to which the appropriate freight is added) for different destinations (Meislin; Ibrahim; "Mexico: Bad Business as Usual").

The oil price deterioration Mexico realized during the first half of 1985 is summarized in Table VII (Ibrahim).

Mexico's 1984 oil exports were divided as follows: United States (49 percent); Japan (11); United Kingdom (7); Spain (7); France (6); 18 other countries (20) (Foreign Economic Trends--Mexico, March 1985 10).

Compared to the peak prices commanded in the first quarter of 1981 (Isthmus at \$38.50 and Maya at \$34.50), Mexico's average oil prices in effect on July 1, 1985, reflected declines of nearly \$12 per barrel (31 percent) for Isthmus and \$11.20 (32 percent) for Maya.

Based upon the rule-of-thumb estimate of a \$550 million loss of revenue for each \$1 decline in the price of oil, the price reductions during the first half of 1985 alone would amount to an annual oil revenue shortfall of \$1.25 billion. Such an income loss would absorb two-thirds of the \$1.8 billion savings Mexico says it achieved as a

TABLE VII  
1985 CHANGES IN MEXICO'S OIL PRICES

| For Shipment To | Isthmus Light |                  | Maya Heavy |                  |
|-----------------|---------------|------------------|------------|------------------|
|                 | 1/1/85        | 7/1/85 Change    | 1/1/85     | 7/1/85 Change    |
| United States   | \$29.00       | \$26.75 - \$2.25 | \$25.50    | \$23.50 - \$2.00 |
| Europe          | 29.00         | 26.25 - 2.75     | 25.50      | 22.50 - 3.00     |
| Asia            | 29.00         | 26.50 - 2.50     | 25.50      | 23.00 - 2.50     |
| Average*        | 29.00         | 26.51 - 2.49     | 25.50      | 23.33 - 2.17     |

\*Based on Weighted-Purchases.

Source: Youssef Ibrahim, "Mexico Cuts Heavy Crude Price to \$24, Raising Pressure on Mexico," The Wall Street Journal, 18 June 1985, p. 4.

result of world interest rates falling nearly 4 percentage points between July 1984 and July 1985 ("Mexico Tallies Debt Savings").

Moreover, because the peso's acute overvaluation was (again) causing capital flight, currency speculation, and a dwindling of peso savings accounts, Mexican policy makers were compelled to raise domestic interest rates to discourage people from converting their peso savings into dollars. The resulting increase in government expenditures (the banks are nationalized) "would cost the government slightly more than \$2 billion this year, wiping out the savings from lower international rates," according to one Mexican official (Frazier, "Mexico Acts").

In a veiled effort to reduce the relative value of the peso without declaring an official devaluation immediately before July elections, Mexican authorities established a "super free" rate in late June. From the prevailing official "free" rate of 245 pesos per dollar, a rate at which it was almost impossible to obtain dollars from banks, the "super free" rate immediately soared to the black market rate of 335 pesos per dollar, representing a de facto devaluation of 27 percent (Frazier, "Mexico Lets Banks Devalue Peso"). The controlled rate of 227 pesos, which was adjusted by 21 centavos per day, remained in effect, but dollars at that rate could only be obtained by direct

authorization of the government to purchase necessary imports and to remit interest.

In any event, the huge difference between the "super free" rate (the "free" rate disappeared) and the controlled rate invited Mexican businessmen to "make an easy killing by the well-known tactic of under-reporting export earnings or overstating import bills and depositing the difference in New York bank accounts. Some estimates suggest this dodge cost the central bank around \$4 billion a year" ("Mexico: Bad Business as Usual"). To discourage such a practice, the controlled rate was finally devalued on July 25 by 17 percent, reaching 280 pesos per dollar. By then the "super free" rate had fallen to 370 pesos.

Jorge G. Castaneda, a graduate professor of political science at the National Autonomous University of Mexico and a political commentator for the Mexican weekly *Proceso*, summarized Mexico's plight as follows:

The July devaluation has shattered whatever confidence Mexicans may have had in their government's efforts to adjust the economy. Inflation, capital flight, imports, and the domestic deficit are up once again. Growth, exports, investment, and savings are rapidly declining after brief improvements. Worst of all, the price of oil, which accounts for 75 percent of our exports, is down and tumbling. ("Mexico: Once Again at the Brink")

Inflation decelerated somewhat in 1985's second quarter, but that appears to have been a short-lived development. The growing public-sector deficit, which is caused by a fall in oil revenue and a rise in domestic

interest payments, will inevitably be monetized because domestic savings is falling and capital inflow is limited. In addition, the belated peso devaluation in the second quarter further enhanced inflationary momentum, which had earlier been stoked by pre-election expansionary policies pursued by the government. Since 1984's fourth quarter and through the second quarter of 1985, real GDP grew by 7 percent, more than double the government's planned target for 1985.

In an effort to moderate the growth rate, the government announced in late July still new budget cuts amounting to a relatively insignificant \$410 million. Such cuts are insignificant because domestic interest rates have become so high that "economists now say the year's interest payments on government spending will top interest obligations on the country's \$96 billion foreign debt" (Walsh, "Mexico Feeling Grip of New Recession"). Even after consideration is given to the nearly \$2 billion in savings in foreign interest payments attributable to the decline in international rates, Mexico still expects 1985's interest on its external debt to exceed \$10 billion.

Other austerity measures announced in July by President de la Madrid, who said the government would pursue "radical structural changes that would demand still greater efforts from society," included:

- the removal of the application process intended to protect against imports, replacing it with a tariff-based system. Import restrictions would be stripped from 37 percent of the goods that enter Mexico.

- the revision of the foreign exchange system to give additional advantage to non-petroleum exports and to protect foreign reserves. In effect, the government would allow the controlled-rate peso to float against the dollar.

- the imposition of new actions to cut the evasion of taxes and duties.

- the reduction of capital flight (Walsh, "Mexico Hopes").

Concomitant with Mexico's deteriorating, precarious financial condition came the desire to discuss its mutual interests with other Latin debtors. Heretofore, Mexico had been considered the "model student" by U.S. bankers, the IMF, and the U.S. Federal Reserve for its implementation of stiff austerity measures. While Mexico had been a member of the so-called Cartagena Group, named for the June 1983 meeting of Latin debtors in that Colombian city, it had always exhibited a moderating influence, encouraging other debtors to embark on the austerity courses mandated by the IMF. For its role in discouraging Peru, Argentina, and others from pursuing a radical course that would include unilateral interest payment reductions and in recognition of the austerity it underwent, Mexico was rewarded with lower

interest rates and a generous rescheduling agreement. Indeed, the unprecedented \$48 billion rescheduling arrangement was reached days before the Cartagena group was to meet a second time in September 1983.

In mid-July 1985, however, as its economy began to unravel and as the price of oil seemed about to tumble, Mexico reversed its gears and hosted its own debtors' meeting at the resort town of Oaxtepec. No communique was issued from the unannounced weeklong meeting. According to a Wall Street Journal report, one Latin American finance official familiar with the meeting said it signaled "a change in (Mexico's) approach" to the foreign debt crisis. During June, the month before the Oaxtepec meeting, Mexico's oil prices declined twice and export volume was barely half its target level of 1.5 million bpd. The official noted that Mexican authorities have been "re-analyzing and making a new diagnosis of the global (debt) problem" (Witcher, "Mexico Hosts Latin American Meeting").

Participants at the Oaxtepec meeting said Mexico's role as host showed that "Mexico, once cool to the idea of a debtors' cartel to push for better terms, has changed its mind and that debtor nations are preparing to turn their rhetoric into concrete mechanisms of debt relief" (Witcher, "Latin American Debtors Step up Efforts").

The broad-based plan reportedly under development, according to The Wall Street Journal, addressed several concerns of the debtor countries:

Industrialized countries (should) provide more funds through such multilateral agencies as the World Bank. (There should be a) reduction in debtors' interest bills, much of which is owed to international commercial banks . . . . The problem is that without more funds from abroad, debtor states can't pay the interest on their debt and fuel economic growth at the same time. To facilitate future bank lending, the debtors are looking to multilateral agencies to guarantee at least part of any new bank loans . . . . Furthermore, the debtors want bank regulators, particularly in the United States, to make it easier for banks to capitalize, or defer, interest payments; those payments would be added to existing loans. (Witcher, "Latin American Debtors Step up Efforts")

A review of credit activity during 1983 and 1984 reveals why the Latin debtors have expressed such concerns. To be sure, bankers have been extremely reluctant to increase their exposure since Mexico's de facto default in August 1982. Indeed, the outstanding claims of U.S. banks against all less-developed countries actually declined by 3 percent in 1984. For Latin America the net claims of U.S. banks increased only marginally during 1983 and 1984, rising by \$200 million (.20 percent) in 1983 and by \$2.1 billion (2.5 percent) in 1984, when year-end claims against Latin American debtors totaled \$86.2 billion. From all banks, including U.S. banks and others, net claims against Latin America increased by only \$7.6 billion (3.90 percent) in 1983 and \$1.6 billion (.70 percent) in 1984. By the end of 1984, outstanding bank loans to Latin American countries

from all banking sources totaled \$242.6 billion, reflecting a two-year increase of less than 5 percent ("International Bank Lending Trends"). Compared to the excessive liquidity that characterized international credit markets throughout the 1970s and early 1980s, Latin debtors and other less-developed countries have encountered tight-fisted bankers since the debt crisis erupted.

For Mexico, in particular, exposure of U.S. banks has increased by only \$1.5 billion over the last two years--\$1.1 billion in 1983 and \$400 million in 1984. Total Mexican exposure of U.S. banks at the end of 1984 was \$25.8 billion. From all banks, including U.S. banks and others, Mexico received increased financing of \$4.1 billion in 1983 and \$700 million in 1984. Outstanding bank claims against Mexican debtors, both public and private, totaled \$72.8 billion at year-end 1984, reflecting a two-year increase of 7 percent ("International Bank Lending Trends").

As noted previously, Latin American debtors had actually become capital exporters during 1983 and 1984, when interest and principal payments exceeded new credits from banks, governments, and multilateral agencies. When capital flight is included, the amount of capital exported from Latin America, in general, and from Mexico, in particular, becomes much larger. In Mexico's case, interest payments alone amounted to more than \$20 billion during 1983 and 1984. Its net external debt, meanwhile, only increased by

\$13.5 billion, rising from \$82.5 billion at the end of 1982 to \$96 billion at the end of 1984. Largely facilitating Mexico's ability to remain current with its interest payment obligations without receiving comparable infusions of new capital were the impressive trade surpluses totaling \$26.5 billion it had accumulated during 1983 and 1984. Because Mexico's trade surplus for the first seven months of 1985 declined by 47 percent from 1984 levels, projecting an annual reduction of \$6 billion, the likelihood that Mexico could continue indefinitely to generate sufficient hard currency to purchase necessary imports and to remit interest payments seemed increasingly remote. Hence, its change in attitude toward the prospective debtors' cartel was not so surprising. Nor, of course, was the open-armed welcome Mexico received from its Latin neighbors.

Not all the trial balloons floated by Latin debtors appealed to U.S. bankers. Capitalization of interest, according to U.S. banking regulations, "would cut bank earnings and result in non-performing loans, weakening a bank's balance sheet" (Witcher, "Latin American Debtors Step up Efforts"). Moreover, since 1982 the banks had made significant progress in reducing the ratio of Latin loans to capital by curtailing their Latin lending and by increasing their primary capital ("International Bank Lending Trends").

Just as the details of the Oaxpetec meeting became public, bankers were presented with their first direct

challenge as the debtors' strategy began to unfold. Peru's newly inaugurated populist president, Alan Garcia Perez, announced that his country would limit debt payments, including interest and amortization, to 10 percent of its export earnings during the next 12 months. Peru declared it would re-negotiate its \$14 billion external debt directly with its creditors without the involvement of the IMF. In his inaugural address delivered on 28 July 1985, Garcia urged a regional approach, saying Latin American countries should act in unison to obtain lower interest rates, longer repayment periods, and new trading opportunities from developed nations (Riding, "Peru's New Chief to Limit Payments").

Two days later in Lima, 20 Latin debtors, including Mexico, signed a declaration calling for the linkage of repayments on their collective external debt of \$360 billion to growth in their export earnings ("Latins Link Debt, Exports").

U.S. bankers were not enthused. One bank analyst, noting that the 1984 interest payments of Argentina, Brazil, and Mexico consumed an average of 40 percent of their export earnings, observed that if these countries had limited their interest payments to 20 percent (double the level Peru unilaterally imposed), the after-tax profits of eight U.S. money-center banks would have been reduced by 22 percent to 67 percent (Lowenstein and Witcher).

In Mexico's case, its 1984 exports totaled \$23 billion. Its interest payments were \$11.7 billion. Had it limited its interest remittances to 10 percent, it would have saved \$9.4 billion. If its interest savings were capitalized (i.e., added to its debt), then its total external debt would have increased nearly 10 percent by \$9.4 billion. Annual interest charges accruing against the unpaid, capitalized interest savings would amount to about \$1 billion. So long as international interest rates (i.e., U.S. prime rate and Libor) approximate 10 percent and Mexico's oil and non-oil exports do not decline (two optimistic assumptions in view of the world oil glut, Mexico's erratic non-oil export performance, and the U.S. federal deficit projections), limiting interest and principal payments to 10 percent (or 20 percent) of export income would necessarily balloon Mexico's external debt, increase applicable annual interest charges, and result in rising annual capitalization amounts.

Limiting debt service payments to a fixed percentage of export earnings and capitalizing the difference will not solve Mexico's debt crisis. Such actions will merely postpone the day of reckoning, much as the 1984 rescheduling did. Though annual amortization payments on the public-sector debt remain small through 1988, they escalate thereafter, reaching \$6 billion per year by 1991 and remaining near that level throughout the next decade.

Bleak as Mexico's future appeared to be in the summer of 1985, the approach of fall brought with it a devastating earthquake that ravaged Mexico City, killing more than 5,500 people and destroying more than \$4 billion in property (Stockton). Nature's onslaught compounded Mexico's precarious financial position. As it once again approaches the abyss, what are its prospects for the near and distant future?

## CHAPTER VIII

### MEXICO AND THE FUTURE

What are Mexico's prospects? Will the current economic crisis prove to be temporary aberration from a long-term strategy that will inevitably result in the resumption of adequate economic growth? Or is the present crisis merely the beginning of a process that will eventually produce deeper, more profound turmoil transcending the economic sphere and enveloping the political and social arenas as well?

Were one to know what the future holds for the world oil price two and ten years hence, or the nature of world interest rates during the same period, the answers to these questions would be more easily discernible.

Surely, however, the underlying forces do not bode well for oil in the near future. Apart from a short-term blip during the winter months, the price of oil is expected to decline further next spring. OPEC nations, which extracted 31 million barrels per day as recently as 1979, are now producing at about half that rate. Iran and Iraq alone are producing barely a third of their combined output (nine million bpd) achieved in the late 1970. Each will need to markedly increase its

production to finance postwar reconstruction. Nigeria will almost certainly find it necessary to increase its oil revenues to deal with its own severe economic problems. The rampant cheating among OPEC members seems to have become institutionalized and will likely continue unabated in the foreseeable future. Indeed, the notion that the market price could fall to \$15 per barrel has received widespread consideration by the rulers of oil-rich, under-producing Kuwait and Saudi Arabia. Because each dollar change in the world oil price causes Mexico's annual oil revenue to change by \$550 million, a \$10-per-barrel price decline would cause a shortfall in excess of \$5 billion per year, about one-half the funds Mexico needs to pay the annual interest costs of its foreign debt.

On the international interest rate front, the likelihood that the London interbank offer rate (Libor) will fall much below its current rate (November 1985) near 8 percent seems remote. Moreover, as burdensome as Mexico's external debt-servicing costs are, the funds required to service its growing domestic debt have been increasing at an increasing rate. As domestic rates rise in order to procure the funds to roll-over domestic debt, servicing costs rise in tandem.

Shortly before Mexico City was devastated by the recent earthquake, the International Monetary Fund was about to declare Mexico in default and thus deprive Mexico of its final installment. At the same time, President de la Madrid had been flirting with the idea of joining forces with other Latin debtors to present a united front against the bankers of the developed countries.

Shortly after the September earthquake, however, the IMF reversed its decision to penalize Mexico and instead sought to renegotiate a new agreement with Mexican officials. Mexico immediately made it known that it would be seeking substantial new loans from both the IMF and foreign banks in 1986. Following the earthquake, the Mexican government also expropriated 5,000 privately owned buildings and vacant lots covering 625 acres of Mexico City, promising to compensate the former owners over a 10-year period. Not long thereafter, the government instituted restrictions on foreign banks operating in Mexico. Predictably, Mexico's actions caused an acceleration of capital flight and another precipitous decline in the peso, whose "free" exchange rate fell from 370 per dollar before the earthquake to more than 500 afterwards.

Within two weeks of Mexico's earthquake, U.S. Treasury Secretary James Baker unveiled a new

international debt plan at the annual IMF-World Bank meeting. In addition to the \$11 billion in net new loans that were already expected to be granted by official multilateral agencies (e.g., the IMF and the Inter-American Development Bank) to 15 debtor nations during the next three years, Baker proposed another \$9 billion from these sources. Commercial banks were asked by Baker to "pledge" \$20 billion in new loans to these same nations over the next three years. Bankers reacted warily to Baker's plan. But they will probably comply when Fed chairman Paul Volcker seeks their "participation," given their extensive exposure to date. In effect, the bankers will be cajoled into throwing good money after bad, fearing that the alternative of default or repudiation would be worse. The real question is whether such a \$40 billion, three-year infusion will be adequate. Mexico alone will need at least \$10 billion in new bank loans during the next three years.

Another important variable affecting Mexico's future is the growth of the U.S. economy. Should a recession occur in the next few years, Mexico's ability to obtain hard currency from non-oil exports would be adversely affected. Rising U.S. protectionism will no doubt have a similar impact against Mexico's manufactured exports.

But the factor that most hurts Mexico's export opportunities is its own overly statist, vastly inefficient, exceedingly corrupt economy.

Given the thirst of its northern neighbor for imports from every corner of the world, Mexico's failure to use its own cheap labor to sell things (apart from illegal drugs) across the Rio Grande illustrates how incontinent its domestic industrial economy still is. Taiwan's 18 million people, 5,400 miles away from the United States, sell more than twice as many manufactured goods to America as do Mexico's 75 million people next door. Why? Mexico is one of those countries to which the outside world seems a hostile place. It is the tenth biggest economy in the non-communist world, but it has refused to join the free-traders club, the Gatt; it is by far the largest abstainer outside the communist block. Success in Mexico's business world is not a matter of being a new entrepreneur seeking out export opportunities, but of being an established business maintaining the status quo, the local monopoly, the restricting tariff. ("Mexico Fails" 71)

In addition to the obvious problems inherent in Mexico's grossly inefficient, state-dominated, crisis-oriented economy, its political structure was also undergoing severe stress before the earthquake, which merely accentuated the problem. The National Action Party (PAN) represented the first-ever serious challenge to the Institutional Revolutionary Party (PRI). But the July 1985 mid-term elections proved to be as dishonest as earlier contests. Indeed, riots broke out in some areas to protest the ruling party's brazen and unapologetic behavior during the election ("Mexican Debacle").

A historically unprecedented challenge to the PRI's hegemony by the PAN held the prospect of giving birth to a two-party system, or at least some serious political competition, in Mexico. For that reason, observers and friends of Mexico were watching with extraordinary interest. President Miguel de la Madrid failed to redeem his promise to hold honest elections. They were instead a travesty.

The internal policies the PRI pursues to maintain its monopoly on the domestic body politic are matched in intensity only by the paranoia it exhibits in the foreign investment arena. the barriers the Mexican government has erected to discourage foreign investment need to be dismantled if Mexico can ever expect to attract the necessary foreign investment to supplement foreign lending.

It was not the purpose of this thesis to assess the political system of Mexico. But in projecting Mexico's economic future, attention must be given to the question of whether Mexico's political system can continue to withstand the pressures caused by economic stress. Can an economic system so pervasively corrupt be reformed in a way that would provide a more equitable distribution of economic benefits? Today the poorest 40 percent of Mexico's population shares only 9 percent of all income (Huey). More than likely, the answer is no.

Another important variable in the equation of Mexico's future is its population growth rate. Its present annual growth rate of about 2.50 percent projects a doubling of population in less than 30 years. How can Mexico absorb another 75 million people by 2015? By the turn of the century, Mexico City alone will have a population of 26 million, more people than presently inhabit all of Canada. Immigration to the United States, which has served as an unofficial safety valve during the last two decades, may be drastically restricted as political forces in the United States seek to stem the human wave transgressing its borders.

So unfavorable do all the variables affecting Mexico seem to be that one could construct a near limitless array of scenarios involving disaster. By all standards--economic, political, and social--Mexico's present state must be viewed as being extremely precarious. Three years of wrenching austerity have exacted their toll without providing any light at the end of the dark tunnel that is Mexico's future.

On its overextended shoulders rests its unquestioned ability to wreak havoc throughout the international and the United States' banking systems, which are inextricably linked to the ultimate health of Mexico and its Latin neighbors. If Mexico's future is truly as bleak as all the evidence suggests, it would appear that the international debt bomb is still ticking.

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