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FICORCA debt is held by 13.4 percent of the firms. The fifty largest firms alone account for 57 percent of the total debt.

The FICORCA facility probably prevented a chain of bankruptcies in 1982. The major risk is that the facility will become a fiscal drain. If the domestic interest rate drops below its parity level, FICORCA grants a permanent subsidy to the indebted companies. So far, this has not happened. Between April 1983 and April 1987, FICORCA generated net revenues for the government.

Two large, well-known Mexican companies, Alfa and Moctezuma, defaulted and withdrew from FICORCA until they could work out a restructuring agreement with their creditors. In both cases, the banks took some losses. The Alfa group's debt was $2.6 billion, of which $900 million belonged to the holding company while the remainder represented liabilities of HYLSA, its steel company. A steering committee was formed by Bank of America, Chase Manhattan, Citibank, and Morgan Guaranty. The restructuring of the holding company's debt involved a cash payment of $25 million, conversion of $200 million into peso-denominated debt, and a swap of the remaining debt for equity. Mexican shareholders have a priority right to acquire any stock the banks sell.

Moctezuma, one of the nation's largest breweries, obtained an even better deal. Its $307 million debt was rescheduled to be repaid over fourteen years with a six-year grace period. The interest rate on half of the debt ($154 million) is fixed at 3 percent, while for the other half the rate is LIBOR + 0.25 percent. Interest accumulated during the two years of negotiations was also forgiven.

9 Future Prospects: Is There A Way Out?

At the time of this writing (early 1988), prospects for the Mexican economy appear very dim. After achieving small but positive per capita growth in 1984 and 1985, the economy was sent reeling by the sharp drop in world market oil prices in 1986. The De La Madrid administration reacted to the oil shock by dispensing a stronger dose of austerity. Real fiscal spending was reduced slightly, and real credit to the private sector cut 9.6 percent. To limit the deterioration in the payments balance, the rate of depreciation of the peso was raised substantially, culminating in a huge 32 percent real devaluation by the end of the year. These policies, in conjunction with the fall in oil prices, resulted in triple-digit inflation (105.7 percent) and a decline in real

output of 3.7 percent. In November 1986, the government announced in the *General Criteria for Economic Policy* that its goals were to reduce the inflation rate by 25–30 percentage points and to sustain a 3 percent growth rate over the next two years. Neither of these targets now seems attainable anytime soon. According to preliminary figures, in 1987 real output grew only 1.1 percent and the inflation rate accelerated to 159 percent.

Not only are the prospects for recovering an acceptable growth rate unpromising, but there is also a risk that, in the absence of policy reform, inflation will continue rising. The expenditure cuts and debt restructuring following the collapse in oil prices in the first half of 1986 have not proven sufficient to prevent a large increase in the fiscal deficit. The inflationary impetus created by the sharp deterioration in the fiscal balance is still working itself out. In chapter 7, it was demonstrated that the long-run inflation multiplier for a shock of this type can be extremely large after taking account of the mutually reinforcing nature of slow capital accumulation, financial disintermediation, and rising fiscal deficits. Mexico now seems to be caught up in this spiral and faces the threat that inflation will continue its relentless, upward march and soon reach (if it has not done so already) levels producing severe economic and social dislocations.[1]

Can Mexico pull out of its economic demise in the near future? Given the current schedule for debt service, the high growth rates enjoyed during most of the post–World War II period are probably out of reach. Policy reforms can, however, stimulate greater growth without intensifying inflationary pressures or causing the payments balance to deteriorate. The next two sections discuss in detail the implications of the study for fiscal, monetary, exchange rate, and trade policy.

9.1 The Mix of Fiscal and Monetary Policy

When the economy is operating at full capacity, an increase in debt service requires a reduction in domestic absorption. The De La Madrid administration chose to combine cuts in current and capital expenditures with an extremely restrictive monetary policy involving high marginal (and average) reserve requirements and bond financing of a large fraction of the fiscal deficit. These policies resulted in massive financial disintermediation and a virtual monopolization of new credit flows by the public sector. The extreme nature of recent monetary policy is apparent from table 9.1 and figure 9.1. Between 1981 and 1986, the real total shock of bank funds (M4 less currency held by the public) contracted 37 percent and total real credit to the private sector declined 33 percent. Financial disintermediation was so great that in 1986 the real stock of bank funds barely exceeded its 1972 value and, as a fraction of GDP, stood at its lowest level since 1966. By contrast, the credit share of the entire financial system (which includes Central Bank credit) rose from 42 to 57 percent of GDP during 1981–86.

Table 9.1 **Bank Funds and Total Credit of the Financial System, 1961–86**[a]

Year	Total Stock of Bank Funds[b]	Total Credit of the Financial System[c]
1961	13.2	24.7
1962	14.5	26.6
1963	15.8	27.5
1964	16.2	27.7
1965	17.8	30.5
1966	19.3	32.4
1967	21.6	34.6
1968	23.2	36.1
1969	25.1	38.4
1970	27.0	40.6
1971	28.7	42.2
1972	28.9	42.1
1973	27.0	40.4
1974	23.7	37.6
1975	23.8	38.7
1976	22.2	41.4
1977	20.2	41.9
1978	21.7	42.6
1979	22.6	41.4
1980	22.4	39.7
1981	23.8	42.1
1982	24.0	51.9
1983	21.9	50.3
1984	21.6	45.2
1985	20.8	47.8
1986	20.3	56.5

Sources: Indicadores Economicos (Bank of Mexico) and *Estadisticas Historicas de Mexico,* table 21.16 (Mexico, D.F.: INEGI).

[a]Average of beginning- and end-of-year stock divided by nominal GDP.

[b]M4 less currency held by the public.

[c]Sum of credit extended by the Central Bank, commercial banks, and development banks.

It was shown in chapter 7 that the various policies employed to divert credit from the private to the public sector have lowered growth by depressing the pace of private sector capital accumulation. Given that, in general, it is optimal to adjust to higher debt service by decreasing both present and future consumption, a reduction in investment is not necessarily cause for concern. For several reasons, however, the magnitude of the contraction in private sector investment seen in Mexico seems excessive. Numerous externalities cause the social return on investment to exceed its private return: (1) the social return on capital accumulation includes revenues accruing to the government from the corporate profits tax; (2) in a decentralized economy, the isolation paradox (see Sen 1967) is likely to result in undersaving; (3) on the plausible assumptions that capital and labor are gross complements and that the high-wage and capital-intensive sectors coincide, capital accumulation reduces underemployment, lessening the distortion in the labor market; and (4) if technological progress is partly embodied in capital goods, capital

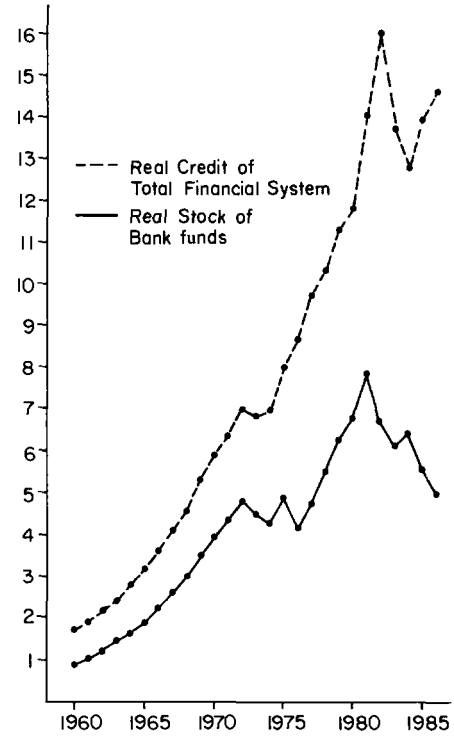

Fig. 9.1 Real credit of the total financial system and the real stock of bank funds, 1960–86

accumulation may be accompanied by a "demonstration effect," increasing the rate of technological transfer and productivity growth. It should be added as well that while a decrease in investment lowers inflation in the short run, the ensuing reduction in productive capacity tends to increase the inflation rate over the medium and long run; and though the welfare costs of inflation are not well understood, it is indisputable that they become nontrivial when inflation moves toward the triple-digit range.

A shift toward greater fiscal austerity and more expansive monetary policy is imperative to stimulate the recovery of private investment. One possible package is to combine further cuts in public sector consumption with a reduction in the reserve requirement (interpreted as the sum of the legal reserve ratio and mandatory credit to the government), maintenance of real deposit rates of 4–7 percent, and increased monetization of the fiscal deficit. The maintenance of high real deposit rates should help deter capital flight and maintain a healthy flow of funds into the banking system, while lower reserve requirements and increased monetization of the fiscal deficit would permit the share of credit to the private sector to be enlarged. Provided the

proper balance is maintained between monetary expansion and expenditure cuts, there should not be any adverse short-run repercussions on inflation or the current account balance, the stimulus to demand from higher private sector investment being offset by the reduction in the fiscal deficit. Some would argue as well (e.g. Dornbusch 1987) that a more hospitable investment climate will encourage a reversal of capital flight.

There is much to be said for lowering the fiscal deficit predominantly through further cuts in consumption expenditure (and less investment by inefficient branches of the parastatal sector). If the model of chapter 7 is an acceptable guide, this is the one expenditure item that can be cut without adversely affecting the growth rate. Cuts in other expenditure items and tax hikes are distinctly inferior alternatives. A reduction in public sector infrastructure investment depresses capital accumulation by lowering the productivity of private sector capital. Public sector layoffs and wage cuts reduce private sector income and lead to capital decumulation as deposit holdings decline and financial disintermediation takes place. Increases in the value-added tax or income taxes have highly uncertain effects upon financial intermediation and the incentives for private investment.[2] If tax increases are indispensable for lowering the fiscal deficit, they can be combined either with other fiscal measures enhancing the productivity of private sector capital (greater infrastructure investment, for example) or, at the very least, with a moderately expansionary monetary policy.

Two objections are commonly made against proposals for shifting toward tighter fiscal policy (but only of the right type) and looser monetary policy. The first is that further fiscal austerity is infeasible in view of the steep expenditure cuts that have already been made since 1982. This objection lacks force. Certainly, the De La Madrid administration reduced spending significantly and further cutbacks in some areas may have to be phased in gradually. Nonetheless, there is a solid case for lowering expenditures still more. Table 9.2 shows how nonwage current expenditures, inclusive and exclusive of interest payments, have evolved since 1965. The GDP share of current expenditure net of external debt service in 1986 was more than *triple* its 1970 value. Even if *all* interest payments (i.e., on both the internal and external debt) are excluded, "other" nonwage current expenditures in 1986 claimed 7 percent more of GDP than *total* nonwage current expenditures in 1970.

In this connection, it should also be pointed out that reductions in current expenditure today can pave the way for higher real expenditure (or smaller reductions than would otherwise be necessary) in the future. Expenditure cuts make it immediately possible to focus monetary policy on promoting private sector capital accumulation. As growth increases, it then becomes possible to reconcile a smaller expenditure share in GNP with a higher level of expenditure in real terms.

A second objection to this proposed alteration in the fiscal-monetary policy mix is that it does too little to combat inflation. But if the battle against inflation

Table 9.2 **Share of Nonwage Current Expenditure in GDP, 1965–86**

Year	Total	Less Interest Payments on the Foreign Debt	Less Total Interest Payments
1965	9.9	9.4	9.1
1966	9.5	9.0	8.7
1967	9.3	8.7	8.0
1968	9.1	8.4	8.0
1969	9.4	8.7	8.2
1970	9.6	8.8	7.6
1971	9.2	8.4	8.0
1972	10.2	9.5	8.3
1973	12.5	11.7	10.7
1974	14.3	13.2	12.3
1975	16.5	15.3	14.2
1976	16.0	14.5	12.6
1977	13.8	11.9	10.8
1978	14.3	12.3	11.2
1979	15.0	12.9	11.6
1980	17.6	15.5	14.0
1981	20.4	18.1	15.2
1982	27.4	22.3	18.9
1983	28.0	22.9	15.1
1984	26.9	23.9	14.7
1985	27.8	25.2	15.9
1986	33.5	29.1	16.8

Sources: Wage data for 1983–86 and all data for 1986 are from *Indicadores Economicos* (Bank of Mexico). All other data are from SHCP.

Notes: Total public sector wage payments are the sum of wage payments by the federal district, the federal government, the budget-controlled parastatal sector, and the nonbudget-controlled parastatal sector. For 1965–69, the peso value of interest payments on the foreign debt is estimated as the product of the period average controlled exchange rate and the dollar value of interest payments.

is fought with policies that lower the investment rate, any victories won are likely to prove ephemeral. For while a decrease in investment lowers inflation in the short run, the ensuing reduction in productive capacity and real output gives rise to powerful inflationary pressures beyond the short run (through lower demand for the monetary base, rising real bond rates, and falling tax revenues). As shown in chapter 7, for this reason, many anti-inflationary policies are largely or entirely self-defeating over the long run.

Which brings up a final issue. I have proposed that easier monetary policy be linked with tighter fiscal policy. If political constraints require that expenditure cuts be phased in only slowly, should more expansionary monetary policy be introduced on its own in an effort to accelerate the timetable for recovery of the targetted growth rate?

This notion has some appeal in view of the conclusion in chapter 7 that in the long run, expansionary credit policy succeeds in raising output and lowering the inflation rate.[3] Delinking monetary policy from the pace of fiscal reform, however, is a very dangerous step. The analysis of chapter 7 neglected problems associated with the adjustment process. While the current account remains in balance across stationary equilibria, in the short

run more expansionary monetary policy will drive up the inflation rate and worsen the trade balance if there is no compensating fiscal retrenchment. If the government lacks an ample supply of foreign exchange reserves or if inflation is already near socially unacceptable levels, a more expansionary credit policy is neither politically nor financially feasible unless supplemented by either temporary expenditure cuts or debt relief.[4]

9.2 Trade and Exchange Rate Policy

The experience of 1982–83 clearly convinced the Mexican government that import controls are not the best policy instrument for rectifying balance of payments problems (*Informe Anual 1986,* 21–22). The Central Bank is now committed to maintaining a heavily devalued currency in order to preserve payments equilibrium and allow trade liberalization to go forward uninterrupted.[5] Initially plans called for all import quotas to be replaced by a schedule of five tariffs ranging from zero to 30 percent, with the higher rates applying largely to consumer goods. These plans have since been scrapped in favor of a more ambitious liberalization program. As of early 1988, a flat 20 percent tariff applied to nearly all import categories and quantitative restrictions had been virtually eliminated. Since the value-added tax is 15 percent, it is almost correct to say that free trade prevails with respect to imports.

The De La Madrid administration's commitment to trade liberalization is generally commendable, but it is doubtful whether, overall, this commercial policy/exchange rate package delivers the right set of relative prices. In a second-best world where underinvestment and underemployment cannot be eliminated by appropriate wage and rental subsidies, trade policy should be structured so as to lower the prices of imported intermediates and capital goods relative to the prices of final goods since normally (i.e., when factors are gross complements) increased usage of these factors will raise the demand for domestic labor and stimulate capital accumulation. Optimal trade policy thus entails an escalated structure of protection in both the import and export sectors, a policy of *import substitution–cum–export promotion.* Recent theoretical work indicates that the optimal degree of escalation in the structure of protection is often quite pronounced when, as in the Mexican case, the labor market is highly distorted and a large fraction of exportable output is not consumed domestically.[6] Accordingly, while full trade liberalization for imported intermediates and capital goods seems desirable, consideration should be given to combining low (or zero) duties on these imports with tariffs on consumer imports and subsidies for nonoil exports substantially above 30 percent. This, it is interesting to note, is very similar to the trade policy followed by the successful, export-oriented LDCs (Taiwan, South Korea, Singapore, and Pakistan), where the import-competing sector has always been heavily protected. What has distinguished

there trade regime from those of many other LDCs is that the export sector is promoted to an equal extent so that the overall bias of trade policy is small.[7]

The same reasons for favoring a trade regime of import substitution–cum–export promotion militate against the policy of maintaining a heavily depreciated currency. A strongly depreciated peso promotes nonoil exports, but also induces import compression. As the analysis of chapters 6 and 7 suggests, and Mexican experience has repeatedly shown, import compression is invariably accompanied by a severe contraction in private sector investment and greater open unemployment or underemployment. An alternative method of dealing with a fundamental payments imbalance is to increase tariffs on consumer imports and nonoil export subsidies while following a neutral real exchange rate policy. This combination of policies make it possible to maintain the flow of critical imported inputs by generating a larger trade surplus in final goods and services, thereby avoiding the severe contractionary pressures produced by import compression.

A potential difficulty exists with this alternative to large, real devaluations in that the cost of export subsidies may exceed the revenues raised from higher tariffs on consumer imports. (Tariff revenue may fall, of course, if demand is elastic.) In this event, it is necessary that the revenue shortfall be covered by cuts in government expenditures. With money financing, the impact on inflation could be explosive.

9.3 Conclusion

Just how much improvement in the economy's performance can be expected from the policy reforms sketched in the preceding two sections? Even with a fully specified macroeconometric model, this question could not be answered with a great deal of accuracy. My own, tentative opinion is that better policy would enable the government to attain its target growth rate of 3 percent without suffering higher inflation or a worsening in the payments balance. But 3 percent growth is hardly a notable accomplishment in an economy where real GDP grew at an annual average rate of 6.8 percent between 1950 and 1981. Indeed, it should be remembered that only in recent years has it become normal to speak of 2–3 percent growth as representing "economic recovery"; in most of the post–World War II period, the economy was judged to be in a recession if growth dropped below 5 percent.

It is perhaps fitting to conclude by addressing a controversial normative issue I have studiously avoided. The prospect of continuing slow growth will inevitably lead to stronger demands for large-scale debt relief. A growth rate of 3 percent implies negligible growth per capita terms and steadily rising underemployment. Coming on the heels of a five-year period in which real per capita income has fallen 13.5 percent and real wages declined 30–40 percent, this is a very stiff price to pay.