A Brief Examination of The Mexican Debt Crisis

by

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As of January of 1989, Latin American debt was estimated at 420 billion U.S. dollars. Of this amount Mexico's share is approximately 107.4 billion or a little more than 25% of the total debt.[1] Nevertheless, debt in and of itself is not always harmful. It is generally recognized that a certain amount of deficit spending can be beneficial, particularly in troubled times, providing needed revenue for capital investment which in turn enhances employment, production and trade. However, while debt per se isn't always a troublesome issue, the ability to service the debt can be problematic. In 1982, during what is now recognized as the "Mexican Weekend," America's neighbor to the south announced that it was unable to continue to make payments on external loans. Since that time, although a number of debt crisis plans have been undertaken, Mexico's debt has actually increased from 80 billion to its present level of $ 107.4 billion dollars.

The effects of this inability to control the debt problem in both Mexico and the United States and possible solutions to this dilemma will be the subject of this study. Before examining these areas we will look at the causes of this seemingly intractable problem.

Crisis Causes

During the 1970's, prevalent economic conditions in Mexico were indeed much different than the current state. After the discovery of large oil deposits during the latter part of the 1960's, the government markedly increased its expenditures. Also, due to OPEC's petroleum supply restrictions and resulting boost in the prices of oil, an increase of about 400% from 1973-1974, Mexico, though not an OPEC member, was able to take advantage of high market prices. From 1970 to 1976 the number of state owned enterprises increased from 84 to 845.[2] Nevertheless, though Mexico, as the 4th largest oil producer in the world, received large amounts of petrodollars[3] during this time, expenditures

[1] John Yemma, "Latin Debtors Seek New Approaches," The Christian Science Monitor, 12 January 1989, p.9.

[2] Gabrial A. Almond and Bingham Powell, Jr., Comparative Politics Today A World View (USA : Foresman and Company, 1987), p. 478.

[3] Many oil producing nations require oil purchases to be made in $ U.S. Therefore,

outnumbered receipts. Not wishing to restrain domestic expansion, the Government borrowed heavily against the sale of future petroleum reserves. Hence, its combined foreign debt (public and private) increased from 12.1 billion dollars in 1970 to 82 billion in 1982.[4]

By 1982, due in part to falling oil prices, Mexico was unable to make its debt service payments. Relying to a large degree on continued petrodollars to cover expenditures, Mexico's income from oil was 5-7 billion dollars less than anticipated for that year, receiving 15 instead of the expected 20 to 22 billion. Considering the 16 billion annual debt service payment, the 15 billion revenue from oil sales left a gap of 1 billion dollars (by 1986, oil revenues had dropped to 6 billion).[5] Additionally, during the period from 1976 to 1982 as debt almost trebled, funds were borrowed at particularly high interest rates, 14 - 18%. Not only did this translate into higher debt servicing payments but henceforth as interest rates fell, Mexican officials were embittered at having to service their debt at the much higher rates and demanded lower rates more reflective of current market conditions.

Another problem which helped fuel Mexico's debt crisis is the phenomenon of "capital flight." Both private and public individuals alike transferred funds to dollars then sent them abroad, to U.S. banks for example, in order to avoid the instability of domestic markets where high inflation has traditionally occurred. Also, although attempts were made in 1964 and 1972 to modify Mexico's tax structure, officials failed; investment abroad is therefore desirable due to the lack of taxation on such funds. It is estimated that today Mexicans have approximately 84 billion dollars invested abroad.[6] Capital flight in short causes two major problems: it detracts from domestic investment, investment which provides a base for a nation's capital infrastructure, and it deprives the government of tax

this term generally refers to funds received from such transactions.

[4] Almond, p. 472.

[5] David R. Francis, "Needed Cash Flees Debtor Nations," The Christian Science Monitor, 13 February 1989, p. 9.

[6] Almond et al., p. 478.

revenues.

Also, adding to Mexico's woes was a depressed international economy during the 1970's. Although Mexico's domestic economy did benefit from the influx of petrodollars during this time, Gross Domestic Product increasing approximately threefold, a depressed First World economy resulted in a decrease in demand for Mexican goods.

Finally, over 70% of loan money after 1981 went to pay existing service on debt - borrowing to pay the interest on borrowed money.[7]

Effects on Mexico

The effects of Mexico's debt crisis on its populace tell a sad and tragic story. Additionally, the Mexican government has, no doubt, realized what a double edged sword a precious resource such as oil can be.

During the boom period of the 1970's, although Mexican officials were able to allocate petrodollars toward development of social and public works projects, investment in industry, agriculture and expansion of the bureaucracy, internal problems such as poor economic management and external forces like fluctuating oil prices and interest rates served to "bust" Mexico's economic miracle.

Spiraling inflation has been one of Mexico's chief economic ills. Generally, whenever an area experiences a large influx of capital funds in a relatively short period of time, as Mexico did during the 1970's, inflation will result. If allowed to develop unfettered without fiscal or monetary restraint inflation can turn into hyperinflation. Such was Mexico's condition during the 1970's and 1980's. During the 1960's, Mexico maintained a respectable 3% inflation rate. However, shortly after Mexico's discovery of oil and OPEC's subsequent price increase, inflation shot up in 1975 to 40%. Ten years later the inflation rate was 105.7% and presently stands at an impressive 150%.[8] During this time wage increases have not kept pace with inflation. For example, as the inflation rate stood at 90%, wages were only allowed to increase by 25%. This caused a substantial

[7] Nancy L. Hoepli, ed., Great Decisions (New York : Foreign Policy Association, 1989), p. 26.

[8] Hoepli, p. 29.

reduction in real purchasing power.[9]

Another effect of the crisis, precipitated to a large degree by imposed austerity programs, has been a significant reduction in domestic spending. This has in turn led to high levels of unemployment. In 1982 over a million governmental workers lost their jobs. Additionally, it is estimated that when Mexico finally recovers economic stability approximately 60% of the jobs created from 1977 - 1981 will have been lost.[10] Also, a reduction on social expenditures has caused special hardships. A UNICEF study for the period 1980 - 1984 revealed a drop in spending in both education and health care programs, areas vital to any nation's development.

As was mentioned, a large increase in the number of state-owned enterprises occurred during Mexico's boom period of the 1970's. State control of these enterprises entailed an expansion of the bureaucracy. Historically, Mexico has had problems with widespread corruption in the public sector. This large increase in the number of bureaucratic workers coupled with an abundance of capital revenue led to both corruption and inefficiency. Even the President of Mexico was not exempt from this phenomenon. It is estimated that from 1976 to 1982, former President Portillo drew over 3.5 billion dollars into his personal accounts![11]

Nevertheless, what may possibly be the most profound effect of this crisis is the feeling of frustration and despair instilled in the Mexican people. Since the Mexican weekend of 1982, the combined effects of high inflation, unemployment or under-employment, lack of social programs and the knowledge that Mexico must continue to function within the austerity framework has cast a pall of hopelessness over the countryside. Some fear that a continuance of this mood may lead to political instability. In Mexico's last election, an opposition PAN party presidential candidate who advocated canceling all debt garnered the largest percentage of vote to date against the dominant PRI

[9] Dostert, p.122.

[10] Ibid., pp. 121-122.

[11] Hoepli, p. 27.

party.[12]

Effects on the United States

One might easily consider Mexico's debt problem to be of little concern to the United States, particularly if one happens to be an American citizen who has experienced the general prosperity of the 1980's. However, the belief that Mexico's debt problem has little or no impact upon the United States is incorrect. In 1988 over 46 billion dollars worth of trade flowed between these two countries, making Mexico America's third largest trading partner. But, a weak Mexican economy strapped due to severe austerity measures is one which will be unable to buy U.S. products. In fact, exports to Mexico of U.S. goods declined from 1981 to 1988 by 30%. And, it is estimated that the loss of this trade has cost the United States over 1 million jobs.[13]

Also, approximately 50% of Mexican debt is held by U.S. banks. Pressed to the point of a refusal to service this debt, these banks would incur huge losses which would inevitably be passed on to the consumer.

Of equal importance and concern to the United States is Mexico's political condition. Economic woes can easily translate into governmental instability. For example, some analysts are concerned about the increasing emergence of populace candidates within Latin America. Many of these leaders are urged on by Cuban President Fidel Castro who has advocated to fellow Latin American states to refuse to pay outright all external debt to the United States. Upon taking office in 1985, Peru's President Alan Garcia announced that no more than 10% of Peru's total export income would be used to service debt, an amount far below its debt of 15 billion dollars. Also, Brazilian President Jose Sarney initiated a moratorium on all debt interest payments in 1987. Due to internal pressure, President Sarney did call off the moratorium a year later. Nevertheless, incidents such as these may

[12] PAN - Partido de Accion Nacional (National Action Party), PRI - Partido Revolucionario Institucional (Institutionalized Revolutionary Party).

[13] Hoepli, p. 27.

provide the people of other Latin American states such as Mexico with alternative paths to reduce or eliminate their debt with the risk of exacerbating relations with creditor states.

Possible Solutions

Since the Mexican weekend of 1982, U.S. officials have recognized the seriousness of Mexico's debt woes and their probable repercussions on the U.S. and Mexican economy. Almost immediately a number of emergency "stop gap" loans or bridge loans were granted in an attempt to solve what was then perceived as a serious but temporary problem. Yet by 1985 Mexico's debt continued to rise, increasing from 82 to 100 billion dollars. It was at this time that the U.S. policy toward Mexico took a somewhat different course. Breaking from conventional austerity recommendations,then Secretary of the Treasury James Baker offered a series of new loans to Mexico and other debt ridden Latin American states conditional,however, upon the adaptation of domestic economic reforms, programs intended to stimulate and sustain long term growth and stability, for example, privatization of government enterprises, incentives for local investment and reduction of tariffs.

Although Mexico did enact some of these reforms, e.g., the elimination of government subsidies for consumer goods, higher prices for domestic inputs caused further stagnation. To meet budget obligations in the face of falling tax revenues, the government elected to print more currency which resulted in higher levels of inflation.

While continuing to advocate the rescheduling of loans, extending payment periods, and lowering interest rates, Secretary Baker, in 1987, recommended other, somewhat unconventional methods in an attempt to tackle the debt problem, for example, debt holders converting loans to investments - property or bonds. Still, one year hence Mexico's debt ills continued to mount. In 1988, The United States again negotiated another set of bridge loans amounting to approximately 3.5 billion dollars.

Not surprisingly there have been many other alternative debt reduction plans. A plan by Dornbush and Modiglian of MIT would pay debt to banks in local currency, the banks then could purchase real estate or make investments within the debt country; the sale of property or interest on these investments going towards debt payments. Others have advocated the creation of an international agency to coordinate not only Mexico's but all Third World debt plans. This agency would be under United Nation supervision. Debt

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would be purchased at roughly half the listed amount, the savings passed on to debtor states. Another proposal has come from Venezuelan President Carlos Perez. President Perez advocates the formation of a Latin American pressure block, not to force cancellation of debt but to more effectively deal with the reduction and rescheduling of debt. He, too, would ultimately prefer to see a multilateral agency with power to purchase loans at market rather than list prices.

The most recent proposal from the U.S. administration, announced in March of 1989 by Secretary of the Treasury Nicolas Brady, differs markedly from previous policy. This latest initiative recognizes the need for debt reduction and recommends that creditors eliminate part of the debt principal; previously the Baker plans called for additional loans without debt forgiveness hoping that new injections would cause the economy to grow out of the debt predicament. Still, the Brady plan urges a continuance of borrowing and rewards those states that institute market oriented reform policies, provisions incorporated in earlier U.S. plans.

Multilateral Cooperation the Key

Clearly the impact of Mexican debt is widespread. It has affected Mexico's economic, social and political fabric, precipitating high levels of inflation, lowering spending for needed social programs and raising interest in alternative, sometimes politically radical approaches which some feel will solve the debt problem. These effects, too, reach beyond Mexico's internal structure. Her trading partners, e.g., the United States, have carried part of the debt burden in the form of declining trade, job loss and increased fears that economic instability might lead to political unrest.

It is apparent that unilateral action by any single party will not solve the dilemma; steps must be taken by Mexico, the United States and other trading partners and creditors and by supranational bodies such as the World Bank and the International Monetary Fund. The United States and other creditors must be willing to forgive a substantial percentage of the debt, restructuring all or part of the remainder. Also, short term loans at low or no interest rates must continue to be made available to assist with capital development and to meet current production costs. Too, unconventional methods such as converting loans to investment, property or bonds, should be encouraged. Mexico, too, must be willing to

cooperate. She must undertake measures to drastically reduce capital flight, alter current tax structures, reduce governmental control over key industries, stop the "peso presses" and provide increased incentives for domestic investment - these acts will help build a stronger economic infrastructure, something Mexico desperately needs. Paradoxically, however, such changes on the Mexican side are unlikely to occur as these measures would likely cause a reduction in profit for Mexican elite who, not surprisingly, control domestic economic policies. Still, these measures must be undertaken if the debt crisis is to be conquered.

Finally, international bodies such as the World Bank and International Monetary Fund must take action to cover part of the losses taken by creditors who forgive debt and to provide continued developmental aid to Mexico and other debt ridden nations to help spur growth. Member states of the World Band and IMF will ultimately bear the cost for these measures. However, such sacrifices must be made, otherwise Mexico's economic ills will continue to exert pressure on their leaders to find a solution, with none forthcoming the populace themselves are likely to attempt to solve the problem outside conventional political channels.

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