COPING WITH THE LATIN AMERICAN DEBT

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PREFACE

This volume is the result of a conference held at the Hoover Institution, Stanford University, September 17–19, 1987. Over 30 persons with expertise in the Latin American debt problem attended, including bankers, representatives of international financial agencies, government officials, academics, and Latin American economists.

Conferences (and books) on the Third World debt problem, which is largely Latin American, have been numerous. It was the aim of the Hoover Institution conference to give more emphasis than usual to the Latin American and political side of the problem, while taking into account the role of the financial actors, and to think as far as possible in terms of a solution, or at least an outcome, to the problem. This focus led to illuminating exchanges of information and ideas from different points of view.

Despite their different backgrounds, conferees seemed to be in more agreement than disagreement. However, there was vigorous debate on the merits of a strategy of "muddling through," or proposing incremental adjustments as opposed to a global restructuring of the international lending system, for example through an institution for the assumption of Third World obligations.

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LIMITATIONS OF MEXICAN DEBT-BASED GROWTH

Robert E. Looney

PHASES OF MEXICAN DEVELOPMENT

Many observers trace the current debt crisis back to the administration of Luís Echeverría, who was in office from 1970 to 1976. Basic dilemmas in his economic policy included the desire to use fiscal policy to reform the social structure without creating an adequate tax base; the desire to raise exports while maintaining a fixed exchange rate in the face of accelerating inflation; the desire to strengthen public sector enterprises while trying to maintain their prices at unrealistically low levels; and striving for greater industrial efficiency under a policy of protectionism.[1] The result was that the public sector deficit expanded to 9.5 percent in 1976, and by 1976 Mexico's public foreign debt was $20 billion. These alternative means of supporting Echeverría's policy of shared development proved unsustainable, however; in 1975 the development strategy collapsed.[2]

José López Portillo, who was in office from 1976 to 1982, began his administration with an IMF stabilization program and a promise of structural change. Once the petroleum revenues began surging, however, attempts at stabilization were abandoned as López Portillo decided to spend his way out of trouble through a massively expensive development program. As the oil revenues increased, foreign borrowing also accelerated, and control over spending became increasingly lax.[3] Instead of cutting back expenditures in the wake of the 1981 decline in oil revenues (which reached only $14.5 billion instead of the $20 billion projected in the budget), the government continued its spending by even heavier foreign borrowing, mainly of a short-term nature. By the end of 1981, the public sector foreign debt jumped to $53 billion, of which $14.5 billion was scheduled for repayment in 1982.[4]

DEALING WITH THE DEBT

During the 1983–85 period, there was significant progress in lowering the relative value of the public debt.[5] The domestic public debt, after having increased 60 percent in real terms during 1982, fell 30 percent between 1983 and 1985, and the public sector deficit decreased from 18 percent of the GDP to 9.9 percent. Also during this period, foreign public debt, in relation to the GDP, fell from 43.9 to 40.6 percent. This reflects a decline in the growth rate of net borrowing, which fell from levels surpassing 7 percent of the GDP in 1981 to 3.1 percent in 1983, 1.5 percent in 1984, and 0.4 percent in 1985.

The country has also made important improvements in public finances, in trimming the size of government and increasing efficiency in public enterprises.[6] The largest part of the reduction in the fiscal deficit came from cuts in government spending on goods and services before interest payments; spending has declined almost 8 percentage points of the GDP since 1981. The system of state subsidies was also completely revised. Between 1982 and 1985, government transfers to public companies in real terms declined by 40 percent. Also, an effort has been made to reduce the gap between the general price levels for consumer goods and the prices of public goods and services, especially in energy. Subsidies on gas, electricity, mass transportation, and basic foods are being phased out.

To stop capital flight, the government has set interest rates well above the inflation rate. The authorities have created incentives for export-oriented companies and companies generating new jobs. They are also divesting many state-run firms.

On another front, the government has enjoyed some success in its debt-capitalization program.[7] Launched in June 1986, this program allows debt to be converted into capital by foreign investors. Conversion is authorized if the applicant can persuade the government that it will create new jobs, increase exports, or introduce advanced technology with its investment. Depending on the nature of the project, the debt is exchanged for pesos at 76 to 100 percent of face value. By late 1986, some $200 million in external debt had been converted under this system.

Debt-for-equity agreements amounted to $850 million in foreign investment in the last nine months of 1986. Primarily because of fears of inflation, the program ceiling for 1987 has been set at $1.5 billion.[8] Optimists contend that this program could liquidate 8 percent of Mexico's external debt and that the country, by offering discounts of 5 to 25 percent to foreign investors wishing to purchase shares in 55 state-run firms that currently face indebtedness and liquidity problems, could get rid of a major source of federal budgetary deficits.[9] It is not at all clear, however, that the program will make more than a token dent in the country's external debt.[10] At most, foreign bankers and Finance Ministry officials estimate the debt swaps will retire about $3 or $4 billion of Mexican debt.

Finally, by joining the GATT, the country hopes to increase trade with the United States, which already accounts for 60 percent of its total trade, and to expand and diversify trade with Europe. Major measures under the GATT agreement include:[11] (1) a protection system that relies primarily on tariffs, in contrast to the previous structure that relied mainly on import licenses; and (2) cutting maximum import tariffs from 100 to 45 percent in 1986 and 30 percent in 1988.

THE 1986 RESCUE PACKAGE

The 1986 crisis initiated widespread debate about the causes, consequences, and costs of the debt. A popular public point of view was that Mexico could not and should not have to face more years of harsh austerity to satisfy the IMF and commercial bankers, but more conservative elements of the Mexican government felt that it was critical that Mexico meet the demands of the IMF and obtain the loans necessary to avoid a default. Others argued that, although the loans were necessary, concessions should be made by the IMF and the international banking community. This faction maintained that Mexico had attempted to restructure its economy and had imposed austerity; the unfortunate collapse of oil prices in 1986, they insisted, should be a responsibility shared by the commercial banks and the international financial institutions.[12]

The rescue package called for the commercial banks to generate approximately $6 billion of new loans. The IMF and World Bank loans were contingent on the commercial bank loans being secured. This package also contained some concessions for Mexico. The World Bank agreed to provide additional credit if real economic growth was less than 3.5 percent in 1987. The IMF loan of $1.6 billion guaranteed additional credit if oil prices fell below $9 billion. In exchange for this jumbo loan package, the IMF required Mexico to continue to sell off and reduce the number of state-owned enterprises, to liberalize trade, to attract more foreign investment, and to reduce its domestic deficit by 3 percent of the GDP.

Critics charge that this package will only address the short-run problem of servicing immediate debt obligations. It will possibly get Mexico through 1987, assuming that the economy generates strong real growth, that oil prices stiffen or even increase, that the global economy continues to grow, and that interest rates do not rise—all questionable assumptions.

Critics assert that adding another $12 billion to Mexico's debt will merely increase the nation's long-term debt service obligations. More importantly, they argue that this loan package will not reverse the transfer of capital from Mexico to the developed nations. Instead it will merely perpetuate this negative flow. The critics also warn that it will simply draw U.S. banks further into the debt quagmire. Moreover, they argue that the Mexican people should not have to suffer through more years of austerity and a further decline in their already low standard of living.

CONCLUSION

It is apparent that when the new president takes office in late 1988, he must tackle the fundamental problem that has confronted the present administration as well as its predecessors: how to regain the high rates of growth that characterized the Mexican economy over the 1955–70 period. Since the early 1970s, successive governments have attempted to solve this dilemma by either exporting oil or increasing the country's external debt. Although there has been some progress in transforming the structure of the Mexican economy, there is little reason to believe that simply decreasing government expenditures will return the country to a self-sustaining high growth plan. As Castañeda notes, whatever policies are chosen, Mexico's next president will need all the foreign reserves and breathing room that can be obtained.

In terms of longer-run policies for dealing with the varied issues surrounding the country's external debt, the options appear to be default, a further variant of the current Baker-type stabilization program agreed to in March 1987, or a combination of these two.[13] The default option can probably be rejected out of hand for political reasons, although it is not apparent that from a purely economic viewpoint there would be any great costs (to Mexico) involved.[14]

Pragmatic Mexicans[15] realized some time ago that political and economic reforms need to be enacted before the country will be able to return to any type of growth path resembling that achieved in the 1955–70 period. Controls on capital flight, privatization of inefficient and corrupt state-controlled industries, a lowering of trade barriers, tax reform, and price controls have been instituted or are being considered.[16] It will be politically impossible to fully implement these reforms without a significant reduction and eventual elimination of the debt burden.

NOTES

1. Travier Márquez, "La Economía Mexicana en 1977 y su Futuro," mimeographed (Madrid: 1977).

2. For a complete account of this period see: Robert E. Looney, *Mexico's Economy: A Policy Analysis with Forecasts to 1990* (Boulder: Westview Press, 1978).

3. Robert E. Looney, "The Mexican Oil Syndrome: Current Vulnerability and Longer Term Viability," *OPEC Review* 4, Winter 1985, pp. 369–88. See also: Robert E. Looney, "Scope for Policy in an Oil Based Economy: Mexican Stabilization Policies in the 1970s," *Socio-economic Planning Sciences* 21:3, 1987, pp. 167–76.

4. An analysis of the events leading up to the 1982 crisis is given in Robert E. Looney, *Economic Policymaking in Mexico: Factors Underlying the 1982 Crisis* (Durham: Duke University Press, 1985).

5. *Wall Street Journal*, August 8, 1987.

6. *Wall Street Journal*, August 8, 1987.

7. In the Mexican case, debt swaps work this way: a foreign company buys Mexican government debt on the secondary international market at the usual discount (in 1987 this was about 55 cents to the dollar) and redeems it within Mexico for pesos. For the highest priority investment projects, defined as the purchase of state-run enterprises, the government will supply pesos at the loan's full face value. In the lowest ranking of the nine investment categories defined under the plan, Mexico will hand over the peso equivalent of 75 percent of the loan's dollar value. Most transactions approved so far have fallen under the third category, which gives a 92 percent rate for projects oriented toward exports or high technology, or projects that will be located in designated industrial development zones. Also included in this category is foreign equity participation in existing Mexican-owned enterprises. The pesos must be used for approved capital investment and not for import financing, foreign debt payment, or as a cheap source of local working capital. The pesos are paid out directly to the foreign investor's local suppliers, creditors, and contractors. Compare with: "How Debt Swaps Work," *Journal of Commerce*, December 16, 1986.

8. "Heels Dragged on Local Debt Swap," *Latin America Weekly Report*, July 16, 1987, p. 4.

9. "Mexico," *Latin America Weekly Review*, October 2, 1986, p. 2.

10. William Orme, "Debt-Equity Swaps as a Passing Mexican Fancy," *Journal of Commerce*, December 16, 1986.

11. *Wall Street Journal*, August 8, 1987.

12. John C. Pool and Steve Stamos, *The ABC's of International Finance* (Lexington: Lexington Books, 1987), p. 113 (hereafter cited as *ABC's*).

13. The more traditional IMF stabilization programs are dealt with in the following: Robert E. Looney and P. C. Frederiksen, "Feasibility of Alternative IMF-Type Stabilization Programs in Mexico, 1983–1987," *Journal of Policy Modeling*, October 1983.

14. See Anatole Kaletsky, *The Costs of Default* (New York: The Twentieth Century Fund, 1985); Arthur MacEwan, "Latin America: Why Not Default?," *Monthly Review*, September 1986, pp. 1–13.

15. See Jorge Castañeda, "Mexico's Coming Challenges," *Foreign Policy*, Fall 1986, pp. 120–160; Carl Migdail, et al., "Mexico is Going to Make It," *Washington Quarterly*, Winter 1986, pp. 171–186.

16. Pool and Stamos, *ABC's*, p. 117.