Mexico's Macroeconomic Adjustment and Growth Perspectives

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Over the last decade, the world economy has changed dramatically. Almost every nation on the planet is gearing its economy toward a market economy. They want to be more flexible, they want to be more open, and they want to be more efficient. They have to be.

Back in the eighteenth and nineteenth centuries, the assumptions of comparative factor advantage were more persuasive than they are today. Many industries were fragmented, production was more labor intensive and less skill intensive, and international trade patterns reflected differences in natural resource endowments and capital.

Today, economies of scale are widespread. Products are highly differentiated. We have seen explosive technological change, especially in widely applicable technologies such as microelectronics.

Advanced materials and information systems have rendered the traditional distinction between high and low technology industries obsolete. And now, it's not only the manufacturing industries that are facing more international competition—so are the service industries.

Many firms now compete with truly global strategies. They sell their products and services worldwide, and they can take advantage of more attractive factor costs and institutional conditions.

It is painfully obvious that those few countries that still subscribe to protectionist policies are only walking further down that primrose path to self-sufficiency—and poverty. Today, we have a much broader notion of what constitutes the wealth of nations. A wealthy nation is one where any legitimate business, started by anyone, has a chance to be successful, and one where the authorities work to foster, rather than hinder, the conditions which allow their country's entrepreneurs to develop and to compete in the international marketplace.

Policy has had to look economic reality square in the face. And now that it has, policy is going back to address the fundamentals of economic welfare. Now we know that a healthy economy is based on a few simple, but very often difficult to attain principles.

On the one hand, macroeconomic stability and consistent policies are critical. Without that, a country suffers a chaotic inflationary environment, and therefore, speculation and capital flight. And all the talk about privatization, deregulation, and trade liberalization will be nothing more than that: Just talk.

Confidence is a prerequisite for economic recovery and sustained growth. But confidence is not a gift. It must be earned through the adjustment effort--or rather, confidence is rented because it is never yours and because it can be taken away at any time. This means the adjustment effort is never over. The adjustment effort has to go on each and every day.

On the other hand, although fiscal and monetary prudence are crucial, it must also be recognized that permanent economic growth can only be achieved when such prudence is accompanied by the modernization of the economic structure. It is the? very important to combine the policies that foster a stable macroeconomic climate with actions leading to increases in productivity, a high national savings rate, a more progressive income distribution, and a more important role for the private sector.

The economic crisis of the 1980s showed us that stabilization and structural change must proceed together. That decade also taught us that, in a world where the globalization of markets is opening new frontiers, it is essential to have established the economic basis for each country's people to actively participate in the world economy.

The Salinas Administration, which began December 1, 1988, has worked together with the Mexican people to implement and follow through with a tough, wide-ranging program of economic adjustment and structural change, which started with the de la Madrid Administration. Our goal has been to consolidate the correction of monetary and fiscal imbalances, and to eliminate the distortions that inhibit economic growth. But this program is more than an attempt to "correct macroeconomic disequilibria." It also includes an ongoing social pact to attack price inertia, the systemic elimination of nontariff barriers to trade, the modernization of the financial sector, a sweeping fiscal reform, and a financially sound social spending program.

As for correcting the fiscal imbalance, Mexico's fiscal effort over the last eight years has no parallel in the postwar experience of the Western economies. The Mexican public sector's primary balance had been in deficit for several decades—and yet, since 1983, it has recorded a sizable surplus every year. The size of this adjustment from 1982 to 1990 amounts to 14 percent of gross domestic product (GDP). We're talking about the equivalent of almost three Gramm-Rudmans, fully enforced and with no waivers.

Over this period, in the face of both domestic and external financing constraints, public expenditures net of interest payments were reduced by 10 percent of GDP, while public revenues rose substantially as a result of the fiscal reform and public sector relative price corrections.

Nevertheless, the experience of one country after another proves that to achieve lower inflation and investor confidence, it is not enough to have spectacular, yet transitory, spending cuts. A successful adjustment program involves permanent adjustment, and it involves policies that address the expansion of the productive base. Thus, structural change must be an essential part of any successful strategy. In Mexico, we have tried to combine these two crucial aspects on several fronts: the fiscal system, social spending, the financial sector, our industrialization and development policies, privatization, and trade liberalization.

Let's consider the fiscal system first. Almost eighteen months ago, we launched a sweeping tax reform. Its main objectives: to promote economic efficiency by establishing adequate incentives for investment; to enhance Mexico's international competitiveness by bringing our domestic tax system more into line with that of our major trade partners, to promote domestic savings; and to improve income distribution.

The basic idea has been to increase fiscal revenues through lower tax rates, while at the same time broadening the tax base—both for corporate and personal income. Specifically, we have brought down the maximum tax rate for individuals from 52 percent in 1989 to 35 percent today, and we have brought down the corporate tax rate from 42 percent to 35 percent. In order to bring down tax rates and still achieve fiscal balance and macroeconomic stability, we have been fighting tax evasion and we have been treating formerly over-protected interest groups like the rest of the taxpayers.

It's now been a little more than a year and a half, and the results of this reform have been highly encouraging. In spite of the reduction in tax rates, last year total revenues increased at a real rate of 8 percent--compared to a 3.9 percent growth in GDP. We had a 4.5 percent real increase in income tax collection and we had more than 16 percent real growth on our value added tax revenues. As for enforcement, a few figures are revealing: Between 1930 and 1988—a period of fifty-eight years—the Fiscal Jury prosecuted and convicted only two cases for fiscal evasion. Now, in less than thirty months, more than 200 cases have been indicted.

According to the Mexican Constitution, the state must provide certain strategic and social services. But in the past, scarce resources had been put to use in a wide variety of activities that benefited few sectors, while essential services, such as education, infrastructure, health care, and justice administration, were left wanting. Back in 1983, the Mexican government began a major divestiture program as.part of the structural reform of public enterprises. To give you an idea of the progress that is being made, in 1982; there were more than 1,100 state-owned companies;,. To date, 770 have been privatized, merged, or liquidated; and 165 are in process. That means that out of 1,155 originally state-owned firms, there are now only 120. Of course, this has helped. improve the Mexican economy's overall productivity—but it has also been an important factor in improving the public finances on a permanent basis. This improvement has been key for increasing the state's effectiveness in providing strategic and social services.

Here I should stress that divestiture is not necessarily synonymous with privatization. It has been said that sometimes one bankruptcy is worth many sales. Not every government enterprise can be sold. Many of them simply are unviable—and recognizing this is an essential step. Many people think that the goal of the economic program should be to save it all—but often it is better to compensate the workers generously; once and for all, rather than to keep bleeding the public treasury. Besides, calling a bankruptcy by its name is a clear signal that the government knows what it is doing, and that it is committed to do .what must be done to permanently correct structural imbalances.

So far the Salinas Administration has successfully concluded sales of a number of large enterprises. For.example; we have privatized the two national airlines, Mexicana and Aeromexico, and one of the largest copper mines,in the' world, Compania Minera de Cananea. And in May of this year, we completed the privatization of Telefonos de Mexico.

With respect to social spending, our greatest challenge over the next year is to eradicate poverty and to correct the inequalities'among different segments of the population. Poverty and glaring inequality threaten not only the economic modernization efforts, but they also threaten the democratic process and even national sovereignty.

The National Solidarity Program is our effort to use the resources that are now available,after having.made corrections in the' public finances to strengthen social spending, but in such a way that we do not substitute or exclude citizen action. The National Solidarity Program convokes, aids, and coordinates the efforts of all of Mexican society. It recognizes the proposals of ethnic groups, of poor farmers, and of poor urban neighborhoods. These individuals and their interests are represented in decisionmaking.

The National Solidarity Program has made possible the electrification of 9,000 communities, which benefits 8 million people; it has also made possible the rehabilitation of 120,000 schools and the construction of 1,600 potable water and drainage systems in 224 cities. Furthermore, this program has also helped more than a million poor farmers improve their production. All of this has been achieved since 1989.

Our efforts in the financial sector have focused on making the domestic financial system more efficient. The most important step has been to initiate the reprivatization of the commercial banks.

We have introduced a number of new financial instruments to what was already a fairly advanced money market. Few people are aware that the foundations of a modem money market were laid down back in 1978 when the Mexican Treasury Bill, known as the "Cete," was introduced. In recent years we have created bonds indexed to the exchange rates and to the consumer price index, treasury bills with longer maturitiesand flexible interest rates, and a large market of bankers' acceptances and other instruments not subject to standard regulations and with flexible interest rates and maturities.

Also, in December 1989, Congress passed a legislative package which provides for the modernization of nonbank financial institutions such as brokerage houses and the stock exchange, insurance companies, leasing companies and warehouses, as well as the development of financial groups.

Another important part of the financial reform is that the central bank has cut back financing to the federal government. This is directly related to strengthening the public finances in that it means lower public sector borrowing requirements. But also, since it increases confidence, this directly translates into more attractive opportunities for noninflationary public sector borrowing. Specifically, during the first half of this year, the central bank slashed total net financing to the federal government by almost 30 percent in nominal terms. Meanwhile, nominal and real interest rates continue to drop.

Mexico has made another key effort with trade reform. Our sweeping trade liberalization has transformed a highly protected economy into an open economy. To give you an idea of how dramatic that transformation has been, in 1982, virtually all imports to Mexico were subject to nontariff barriers. Today, less than 20 percent of the value of our imports is subject to quantitative restrictions, in any form. And tariffs have plummeted. In 1982, they were at a maximum level of 100 percent. Today, maximum tariffs stand at only 20 percent.

As a result of these reforms, Mexico's trade structure is much more diversified. Back in 1982, crude oil exports accounted for 75 percent of Mexico's total exports. We have directly attacked that unhealthy dependence on crude oil. Manufactured exports now account for over half of all Mexican exports and oil exports account for less than 30 percent of total exports.

Another major element in our trade reform efforts is the Free Trade Agreement with the United States and Canada. The Salinas Administration has begun negotiations with its North American counterparts with the firm understanding that the agreement, which will grant a reciprocal and fair treatment to all parties, will make possible a better use of economies of scale and will generate new investment and employment opportunities.

When we look at the experiences of countries like Spain and Portugal, we see that a small and labor abundant country can join in a free trade area and reap enormous benefits, especially if it exploits the comparative advantages of its own and its larger and more industrialized counterparts.

But Mexico will not be the only winner in a Free Trade Agreement. The United States and Canada are both facing the challenge of the

European Economic Community's economic integration with the low labor cost countries of Eastern Europe, as well as less ballyhooed steps Japan is taking to integrate with Asia, and especially Southeast Asia. Together, the Mexican and the North American markets have enormous potential. To get an idea of how enormous that potential is, just look at the border area between Mexico and the United States. Although many people are surprised to hear this, it is a fact that, over the last ten years, the Mexico-U.S. border area has been the fastest growing region in the world.

For Mexico to join the world economy, we need foreign direct investment. We expect foreign direct investment to play an important role, complementing domestic direct investment, in promoting employment, in modernizing plant and equipment, and in opening new export markets. As per our new foreign investment rules, foreigners may now invest in sectors which used to be off-limits, only open to Mexican nationals. For example, foreign direct investment is now permitted in glass, cement, iron, steel, airlines, secondary petrochemicals, and cellulose. Also, via specially designed trusts, foreigners may now invest in the Mexican stock markets.

As the process of structural change advances, it has become increasingly clear that structural reform measures do indeed have a profound impact on macroeconomic performance—but they have also changed the way the public authorities should look at the aggregate data.

In economics, there is a more elegant way to say this:, 'The transmission mechanisms have changed." And this change in itself implies a change in the way fiscal and monetary policy should respond to external shocks.

Let me explain what this means for the case of Mexico: In the transition from a closed, overly regulated economy, suffering from hyperinflation to an open, stable economy, the same current account deficit can have totally different implications for exchange rate stability, inflation, and growth. For instance, in a closed, inefficient economy, a balance of payments deficit is usually the result of excessive public spending, which, to be financed, requires public sector external borrowing. This usually ends in a devaluation, a recession, and a jump in the inflation rate. Thus, here the causality runs from public spending to current account deficit, to borrowing, to an exchange rate collapse, hyperinflation and then fiscal adjustment to restore equilibrium.

On the other hand, let's look at an economy with a more active private sedtor. Let's suppose there is an autonomous improvement in the investment climate, such as might come from the prospect of joining a free trade area. Here the causality is precisely the reverse. Here the current account and the capital account are more closely linked because the current account balance is the result of new private sector projects. These projects are directly financed with capital repatriation or foreign direct investment. Thus, when there is a private sector current account deficit, there is, at the same time, a private sector capital account surplus. The excess of imports over exports is automatically financed, so there is no reason to expect a devaluation, or a recession, or hyperinflation.

In summary, whereas before the structural change a current account deficit is bad news, after the structural change a current account deficit is good news. It is a signal that foreign and domestic capital have confidence in the now more modem economy.

Thus in the future, our notion of what constitutes macroeconomic "normality" will have to be very different from what it used to be in the sixties, the seventies, and eighties. We should expect to see substantial primary government budget surpluses as a result of the commitment to fiscal discipline and from higher domestic savings rates. And as the economy offers more and increasingly attractive opportunities, and as higher productivity results in improved standards of living, we should also expect to see lower inflation and a sustainable real exchange rate appreciation—and we should expect to see relatively persistent private capital inflows. Current account deficits will be reduced to the extent that capital imports translate into higher levels of exports.

In the last ten years, Mexico has come a very long way in reshaping its development strategy. Our experiences over the phases of economic expansion, crisis, and adjustment have taught us that in promoting economic growth, government budget deficits and inflationary finance have a very limited role. These experiences have also taught us that instability has very uneven effects on income distribution. And these experiences have also taught us that sound macroeconomic policy is less a matter of ideology than it is a pledge to work for social justice.

Under President Carlos Salinas, Mexico is making the transition from hyperinflation to stability. But as Mexico makes that transition, Mexico also faces the challenge of joining a world economy that is undergoing dynamic transformation. Deregulation and a technological revolution that has fundamentally changed the way we organize ourselves to trade, produce, and finance are fueling the emergence of economic blocs and free trade areas.

On the fruits of our own efforts, we Mexicans have regained our self-confidence. But as authorities, we are fully aware that for Mexico to make a successful transition to stability—and for Mexico to fully participate in the world economy—we must have the support of all Mexicans. And we must create,,together with the international community, an environment of cooperation based not only on the recognition of' the enormous potential gains from exchanging materials, financial and technological resources, but also from the cultural and political interaction of our societies.