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THE MEXICAN ECONOMY ON THE WAY TO RECOVERY?

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INTRODUCTION

During the last ten years the institutional framework of the Mexican economy has experienced significant changes, ranging from constitutional reforms, to new laws governing the way markets operate and the opening of the economy. The modifications that have been introduced in the past years have the objective of achieving higher rates of economic growth as well as higher levels of welfare. At the same time, the government tried to achieve a permanent macroeconomic stabilization of the economy, a process that went afoul during 1994 and 1995. The rate of inflation, that was as low as 7% in 1994, increased during 1995 to 52%. As a result, the government has recently implemented another stabilization program to reduce inflation. Elimination of inflation has been considered by the government—and correctly so—as a necessary condition for the structural reforms to continue and moreover, for them to be successful.

The purpose of this essay is to analyze the significant changes that have been taking place in the Mexican economy, and the effects that these will have in the short and the medium term. The first section analyses the results of the new stabilization program and the short-term challenges the Mexican economy faces if is to recover sustained growth. The second section deals with the reform of the state, especially the macroeconomic and microeconomic effects of the privatization program. The third section analyses the changes in the legal framework of the economy, or the "deregulation" of the economy, and the effects this will have on the allocative efficiency of resources and economic growth. Finally, the fourth section presents some conclusions on the future processes of privatization and deregulation.

I. THE SHORT-TERM SITUATION

The year 1994 was traumatic for Mexico. In January a guerrilla movement began an uprising in southern Mexico. In March the leading, and government supported, candidate for the presidency was assassinated. In November the leader of the government party was also assassinated, and finally, in December the government misjudged the current account deficit and decided that a devaluation was needed to correct the imbalance.

The increase in the exchange rate, even though it could have corrected the current account deficit, effectively made the economy unable to service the debt that was indexed to the exchange rate and which was issued during 1993 and 1994 to retain short-term foreign capital in Mexico. Facing an insolvency situation, the Mexican government had two options. The first was to pay off this debt in pesos and generate hyperinflation, with all the implicit costs associated. The second option, which was the one the government opted for, was to get new financial resources from the U.S. government and the I.M.F. and pay off the debt in U.S. dollars.

However, the delay in getting these resources until the end of March of 1995 had a profoundly negative effect on the Mexican economy. Interest rates rose from 15% in December of 1994 to 80% in March, while the exchange rate rose from 3.4 pesos to a dollar before the devaluation to 8 pesos to a dollar by March. The instability that prevailed during the first quarter resulted in a 6.5% drop in real GDP and a 8.5% fall in per capita GDP, while private consumption fell by 12%, and investment fell by more than 35%. The main element that explains such a huge drop is the combination of a restrictive monetary and fiscal policy together with the crisis of the Mexican banking system.

We cannot explain the deep recession of 1995 by solely looking at the restrictive monetary and fiscal policy the government implemented. The answer also lies within the banking system and, in particular, the increase in non-performing loans, which by the end of 1995 represented 20% of all outstanding bank credit. The non-performing loans problem has its origins in a distorting set of regulations dating back to 1941 (which has made the banking system very inefficient), and an attitude on the part of the banks which aggravated their situation.

The number of non-performing loans began to rise during 1993 due to slowing growth. Banks responded by increasing the spread between lending and deposit rates, giving rise to an adverse selection problem where good debtors paid off their debt while bad debtors stayed. The devaluation of 1994, and the resulting increase in interest rates as well as the fall in economic activity aggravated this adverse selection phenomenon. As a result, banks began to experience a lack of capital, while at the same time they needed to increase their reserves. The consequence was a decrease in real outstanding credit, which fell on average, between April of 1995 and June of 1996, by 25%. This huge contraction in banking credit send the economy to its worst recession in more than 60 years, with GDP falling by almost 10% in the second quarter of 1995.

The government reacted to the rising probability of the banking system going bankrupt with support programs for the debtors. This helped them service their debt but did not solve the problem of the huge stock of non-performing loans. Since this problem remains, the inability of the banking system to grant new credit inhibits the economic recovery, at least for the short term.

The fall in GDP during 1995, even though huge, would have been worse without rising exports. The opening of the economy in 1985 complemented with the North American Free Trade Agreement (NAFTA), allowed firms to take advantage of the exchange rate subsidy. Non-oil exports rose during 1995 at a rate of 33%, becoming the main force of the economic recovery.

After the 6.5% fall in real GDP last year, growth of 4% is expected during this year. However, this rate of growth is not enough to recover the level we had during 1994, and it will not be reached until the second quarter of 1997. As for the stabilization program, much has depended on the central bank's monetary policy which features a floating exchange rate. Although inflation is still very high, it has dropped from a monthly high of 8% in April of 1995, to 1.3% in August of this year, and is expected to fall further in the coming months. Inflation is estimated to be about 25% this year, half of what it was in 1995, and is expected to be around 15% in 1997.

The macroeconomic crisis and the urgency to avoid an even larger drop in economic activity, has practically stopped the implementation of structural change in the economy, a process that began in 1985, and to which I will refer to next.

II. THE REFORM OF THE STATE.

One of the main elements that made possible the fiscal adjustment necessary to stabilize the economy, at least up to 1994, has been the reform of the Mexican public sector. At the end of 1982, the government owned 1,155 firms and organisations, a significant increase over the 272 national firms that existed at the end of 1970, the year in which government intervention in the economy began to increase significantly. These firms and organisations included PEMEX, the state owned oil firm, the railroads, sugar mills, steel firms, a whole range of manufacturing firms, restaurants, hotels, cabarets, etc.

The expansion in the number of state-owned firms and organizations distracted resources that could help satisfy the basic social needs of the population and became the main source of fiscal deficit, inflationary pressure, and external indebtedness the government incurred during the 1970s and the first year of the 1980s. By 1982, the transfers received by state-owned firms were equivalent to 75% of the fiscal deficit, and represented 12.7% of GDP. From 1983 onwards the transfers and subsidies received by these firms (as a percentage of GDP) have been decreasing. This is a result of the smaller number of state-owned firms and organizations as well as an increase in the real prices of the goods and services produced by those firms that have remained government property.

The reduction in the number of the public sector companies from 1155 in 1982 to around 220 in 1995, has been accomplished by the sale, transfer or liquidation of those firms not considered strategic by the government. The reduction has had important macroeconomic and microeconomic effects.

On the macroeconomic side, a decline in transfers and subsidies has contributed significantly to reducing the fiscal deficit and stabilizing the economy. In addition, the government obtained important resources from the sale of firms, which has also had an important macroeconomic impact. Proceeds from the sale of state-owned firms were considered once and for all revenues and therefore, could not be used to finance current spending.

The government decided to use these resources to pay off domestic debt. This will have two effects in the years to come. First, as the amount of outstanding debt is lower, the resources the government will have to divert for interest payments will also be lower. Secondly, by having to rollover a smaller debt, the interest rate at which the government borrows (as well as the rest of the agents of the economy) will also be lower, and so will be the interest payments. This will free-up resources that could be assigned for other uses (infrastructure and basic social needs, for example), a phenomenon that has already been observed in the past few years.

Another macroeconomic effect of the sale of state firms has been its impact on the financial system, a result springing from the redirection of funds and because one of the areas recently privatized has been the commercial banking system. Due to the adjustment in public sector finance, and its smaller demand for financial resources, a growing percentage of these resources have been channeled to the private sector and the financing of its investment projects, growing from a low of 25% in 1986 to almost 90% in 1995.

Another aspect directly related to the privatization process is the moderate stimulation it has provided the stock market. Contrary to the privatization processes in other countries (i.e. England and Chile) which used the stock market to privatize state firms, the Mexican government sold the firms directly to specific buyers using a system of "one round" auctions, trying mostly to maximize the proceeds from the sale, and not to democratize the capital. Even though this method tends to concentrate wealth, it gives the necessary incentives for the owner of the firm to allocate efficiently the resources so as to maximize profits. In the case of Mexico, the stock market has not been used to privatize firms, but some firms that were privatized have issued new stocks to finance investment projects.

On the microeconomic effects of the privatization process, three variables are especially relevant: investment, employment, and market structure. All of these variables are closely related with the efficiency in the allocation of resources. One conclusion derived from the "principal-agent" theory is that, given the same conditions (regulations, market prices, etc.), the allocation of resources in state firms is inefficient when compared with the private sector. Another source of inefficiency in state firms is that the administrator of a state firm will tend to maximize the expenditures of the firm in an attempt to maximize political power. This is contrary to the objective of a private sector administrator who, in principle, will try to maximize profits by allocating resources efficiently.

With respect to investment, capital formation was the component of aggregate demand that was most affected by the macroeconomic crisis. After 1982, when Mexico announced that it was impossible to continue making payments on its external debt, the flow of credits from the international financial system practically stopped. For much of the remainder of the 1980s, the Mexican economy made a continuos transfer of real resources toward the interest payments of the external debt, leaving less resources to be invested internally.

The need for a fiscal adjustment also resulted in public spending on capital accumulation decreasing significantly. At the same time, the absorption of almost all financial resources to finance the deficit left the private sector with few resources and so its investment also fell. During the seventies the Mexican economy was a user of external savings, and from 1983 to 1988 the debt crisis meant that the amount of external savings used by the economy was relatively small. This resulted in less resources available to invest, both by the public and the private sector.

With the last administration, things began to change. First of all, the outstanding public external debt was renegotiated, resulting in a significant reduction in the amount of the debt as well as in the interest payments. Secondly, the actions taken by the government to stabilize the economy, and the resulting perceptions of a stable environment, together with the privatization of state firms and first steps in the deregulation process, created the conditions for a significant increase in private investment.

An important aspect of the relationship between privatization and private investment, is that the transfer of state firms to the private sector can constitute an incentive for additional private investment, which results from new investment opportunities that were not present when the firms were owned by the government. From a theoretical point of view, private savings depend on investment opportunities. The argument is based on the hypothesis that inter temporal consumption maximization depends on inter temporal income streams, which is a function of savings decisions, the resources available and, investment opportunities. The privatization of state firms obviously opens new opportunities for private sector investment. To finance these, the private sector can use external financing or crowd-out other investments projects. However, as the privatization process advances, its is expected that new investment is going to be financed by increments in domestic savings. Another aspect of this relationship is that by transferring state firms to the private sector, they can explore new lines of business. This was not possible when the firms were government-owned, as their sphere of action was limited.

Although the privatization process will, in the long run, have the effect of increasing factor productivity, employment, and the real return to these factors (labor and capital), in the short-run, privatization has had a detrimental effect on labor employment. When a firm is government-owned and subject to special treatment (like subsidies and protection from competitors), the firm tends to have higher levels of employment.

There are three possible arguments of why this happens. The first is that a public firm values labor at its social price, while the private firm does it at its market value, inducing public firms to have a labor force above its optimum level. A second argument is that public firms are used to "artificially" reduce unemployment, especially in a situation were the economy is not growing and unemployment is relatively high. A third argument, and one mentioned earlier, uses theories of property rights and public choice to advance the hypothesis that the utility function of a public firm administrator has as a principal argument the maximization of political power. This is achieved primarily by maximizing the spending of the firm. One way to do this is to hire a work force above the optimum. This type of maximization of spending is made possible by the fact that there is no clear definition of property rights over a public firm. Obviously, when a public firm is privatized, the new owner will adjust employment levels by removing excess personnel.

As to the rates of return of both factors of production, if the state firm had privileges that were not available to the private sector (and assuming that the administrator tries to maximize its political power by way of spending), payment to labor in these firms will be above its marginal productivity. In addition, the wages paid will be higher than the private sector, profits will be smaller and, in most cases, the firm will have losses that require subsidies from the Federal Government. When the firms are privatized, labor contracts are revised, implying that wages will decline and profits will rise. As the firm becomes more efficient and uses new technologies of production which reflect the comparative advantages of the economy, wages and profits will rise in response to an increase in productivity. This process is already at work in Mexico, where real labor productivity has been growing by almost 7% per year.

There is not, however, a clear relationship between privatization and the market structure in Mexico. Evidence shows that except for a few cases, the market structure of the Mexican economy is not monopolistic or oligopolistic, and privatization has not had an effect on market structure. The element that really affects the market structure is the opening of the economy. This induces more competitive markets, even if the internal market structure are not competitive.

One final effect of the privatization process and the fiscal adjustment that is worth mentioning is the impact it has had on welfare. Privatization can improve welfare from four different sources:

a) Democratization of the firm stock;
b) Increased employment and labor productivity;
c) Improved quality of goods and services through increased competition;
d) Liberalization of public funds and its reallocation to social spending.

a) The effect that privatization can have on the concentration of wealth and capital depends on the mechanism that is used to privatize firms and the source of funds to acquire these firms. If the stock market is used to privatize, this will divide ownership across a large segment of the population and attain a more equitative distribution of wealth. If on the contrary, state-owned firms are sold using the mechanism of auctions, only those who already have a privileged position in terms of a relatively high level of wealth can participate in the process, generating an even more unequal distribution of wealth.

In deciding upon the appropriate mechanism to privatize, the government has consider democratization of capital (selling the firm through the stock market), and the effect this can have on efficiency once it is privately owned. When the stock of the firm is divided among many investors, resource allocation may not be optimal, (ie. profit-maximizing). In this situation, the administrator of the firm can have different objectives than the stockholders, and profits can be lower. If by dividing the firm's capital the optimum resource allocation is not achieved, welfare will no be maximized. The Mexican government chose to privatize by way of auctions, and although this tends to concentrate wealth, it also sets the conditions to achieve a more efficient allocation of resources, and higher rates of growth in the future.

There are three sources of funding that can be used to buy state-owned firms:

a) domestic financing
b) external financing
c) association with foreign investors.

If all the financial resources are obtained in the domestic financial system, this will have the effect of crowding-out other investment projects, which could have a higher rate of return than the investment being made in a privatized firm. If this is the case, the well-being of the economy will suffer. If even a fraction of the resources are obtained in the international financial system, or from the association with foreign investors, then the general health of the economy will improve.

b) Privatization can also enhance the health of the economy by increasing employment and labor productivity. As was mentioned above, in the first stage after privatization, it is expected that employment in privatized firms will decrease due to more efficient resource allocation and, consequently, productivity will increase. In the short-run the net effect on welfare is ambiguous, although in the long-run it will increase.

c) Increased competition results in a higher quality of goods and services which will, by itself, enhance economic well-being. This is not just a result of privatization, but also from other elements of structural change.

d) Finally, another element that helps the economy is the reduction in the fiscal deficit and the resulting lower inflation and real interest rates, as well as the liberalization of government resources that can be used to satisfy the basic social needs of the population. In addition, government expenditures on social needs such as health, education, urban infrastructure, etc., results in a more equal access to opportunities and, in the long-run, a more equitable distribution of wealth and income.

The reform of the State has had very important macro and microeconomic effects. On the macroeconomic side, the reduction in the size of the public sector and in transfers and subsidies to the state-owned firms, has been crucial in reducing the fiscal deficit. On the microeconomic side, the privatization of state-owned firms will result in higher factor productivity, increased competition and efficiency, and higher rates of economic growth.

Even though much has been done during the privatization process, the government still owns more than 200 firms and organizations that require continuos transfers and subsidies. Almost all of these firms, including PEMEX, cannot be considered strategic for economic development, and therefore should be sold or liquidated. It is not the role of the government to own firms that produce goods, if those goods can be produced more efficiently by the private sector. Even if the market remains monopolistic, it is more efficient to have a regulated private monopoly, than a state-owned monopoly.

The government's role should be to concentrate its resources on a development policy that satisfies the minimum social needs of the population, creates the conditions for more equal opportunities, and provides the economy with a clear set of rules that promotes efficiency and competitive markets. However, as a result of the macroeconomic crisis that the Mexican economy has been going through since December of 1994, the government has practically stopped the privatization process, and almost nothing is expected to happen in the near future, except for a few sectors like natural gas and railroads.

III. DEREGULATION

In developing countries, institutional problems can constitute a significant barrier to development. Therefore, one task of development policy is to improve the regulatory framework and the quality of the institutions. With these in mind, one of the main elements of the structural reform of the Mexican economy has been, together with the reform of the State, a significant overhaul of regulations that affect the way markets function and allocate resources. The changes in the regulatory framework range from Constitutional reforms to new laws and regulations. These changes are important since economic institutions constitute a key element in determining the level of output of the economy and the welfare of the population.

The economic institutions with which the economy operates play an important role in providing the environment in which transactions take place. Such institutions are crucial in the development of markets and, by reducing transaction costs, help promote specialization. The main element defining economic institutions is the legal framework that affects the efficiency of factors of production. The legal framework determines this in three ways. First, it defines property rights that enable economic agents to appropriate net flows from their economic activity. Second, they determine the conditions of market entry and competition within the economy. Finally, they contribute to the creation and development of markets.

In Mexico, the deregulation process was conceived as a way to improve the quality of regulations and business. Included in this program was the elimination of regulations that inhibited competition, created monopolies or oligopolies, prevented private participation or generated unnecessary transaction costs. The overall objective of deregulation was to achieve a more efficient allocation of resources and promote economic growth.

Before the deregulation process began in 1989, the regulatory framework was characterized by:

a) Substantial barriers to market entry and competition.
b) Obsolescence or inconsistency of a large number of regulations within the new context of trade liberalization and accelerated technological change.
c) Its inhibiting effect on the efficient division of labor across production sectors and between the public and the private sectors.

As a result of these regulations, transaction costs were extremely high, inhibiting the exploitation of economies of scale, and creating, in some sectors of the economy, an oligopolistic structure. This regulatory framework inevitably led to an inefficient allocation of resources, and a lower rate of economic growth. Conversely, deregulation works against these tendencies and enhances growth to the extent that new opportunities are open for private investors that allows the most efficient allocation of resources. Costly regulations that were needed to correct market failures in a closed economy are no longer necessary when the economy is an open, and the risks associated with regulation by bureaucratic discretion are eliminated.

During the last administration, many regulations were changed to enhance efficiency and create a better environment for private sector participation and more competitive markets. For example, modifications were made to the constitution regarding private sector participation in agriculture, the trucking industry, maritime and air transportation, technology transfers, electrical utilities, petrochemical production, custom brokers, the packaging of consumer products, the automobile industry, fishing, the textile industry. The best known and most dramatic modification, however, was the unilateral opening of the economy, which has reduced the average import tariff to 6% and has eliminated almost all quantitative restrictions to foreign trade, a process complemented by the 1992 North American Free Trade Agreement (NAFTA) as well as similar agreements with Chile, Colombia and Venezuela.

NAFTA was especially important, given the unilateral opening of the economy that Mexico had implemented in 1988. While allocative efficiencies (a result of facing world prices) had already been achieved by opening the economy in 1988, NAFTA was still extremely important. It effected how the public perceived the structural changes that the economy was experiencing as a result of the elimination of barriers to trade, deregulation and the privatization of state-owned firms. NAFTA gives the private sector the signal that all these changes are permanent, there is not going to be a reversal or return to the government intervention and high trade barriers of the 1970's. This reduces uncertainty and lowers the premium that has to be obtained on investment in Mexico. By itself, this creates incentives for investment projects and, as a consequence, higher rates of economic growth.

In 1993, and in line with the objectives of deregulation and the promotion of competitive market and trade liberalization, the Congress approved the Law of Competition and the Commission of Competition. The aim of these policy decisions was to eliminate all distortions, legal or otherwise, that inhibits competition and free access to markets.

Even though the Mexican government has achieved a great deal by way of deregulation, we are still very far away of being a free society, economically and politically. There still exist almost a thousand set of regulations that firms have to comply with to open and/or to operate. These regulations increase transaction costs, make the production process inefficient, and inhibit the rights of individuals to make a free decisions.

Two sets of regulations that are crucial to development and improved welfare, regulations of the labor market and the regulations of the educational system, have not even been touched. Labor market regulations undoubtedly distort resource allocation. They protect workers while punishing employers. In addition, labor regulations discriminate against human capital accumulation; make it too costly for firms to introduce technological change, inhibit the mobility of resources from one sector to another; and finally, make labor a quasi-fixed factor of production. Given the changes that have been taking place in the Mexican economy that dictate a reallocation of resources to those activities in which the economy has comparative advantage in the international markets, the distortions introduced by these laws constitute a significant barrier to achieving an efficient allocation of resources. It is imperative that labor regulations be changed so the Mexican economy can fully exploit the advantages of having an open economy.

With respect to the public educational system, it has also proven to be extremely inefficient and offers educational services of a very poor quality. The system is dominated by the Teacher's Union, whose leaders are rent-seekers and look for political power without a sense of responsibility — it is a system which is destined to fail. In addition, the lack of definition of property rights in public schools, from basic education to universities, results in low quality education, low wages for teachers and low productivity. Obviously, if the quality of education is poor and the rate at which the economy accumulates human capital is slow, its rate of growth will be low and sustained economic development will be difficult to achieve. Furthermore, in a world in which competition between countries and between industries is increasing, if the population does not have a minimum education, the country will experience, in the long-run, a decrease in its share of world income. Therefore, to increase the quality of education, property rights have to be defined, and to do this, it is necessary that all education be privately supplied.

The road of deregulation is still a long one, and the macroeconomic crisis has stopped this process. As long as property rights are illdefined and doing business is costly, economic development will be inhibited.

IV. CONCLUSIONS.

During the past ten years the Mexican economy has gone through a profound structural change. The fiscal adjustment, the privatization of state-owned firms, and the deregulation process have made the Mexican economy very different from what it was ten years ago. The reforms introduced have set-up conditions for a more efficient allocation of resources, higher rates of economic growth and advanced economic development.

However, much more has to be done in order to make the Mexican economy an efficient one. First a rapid macroeconomic stabilization in called for. An economy that operates in an inflationary context does so inefficiently. Second, the privatization of government-owned firms needs to be resumed, as the private sector can produce the same goods more efficiently. Because of the macroeconomic crisis the Mexican economy has been experiencing, the support the government has to proceed with the privatization process is relatively weak, especially in those sectors where a "nationalistic" sentiment is obvious (ie. the petrochemical industry). In other sectors, such as natural gas distribution, railroads, maritime ports and airports, the privatization process is continuing but it is moving at a very slow pace.

Finally, although a lot was done in the recent past to deregulate markets, the Mexican economy is still overregulated. Expensive processes of production and high transaction costs inhibit domestic and foreign investment which, in turn, ultimately results in lower rates of economic growth. It is imperative that the Mexican government move along a path of liberty, granting firms and individuals the freedom to choose within an efficient set of regulations. Without freedom, and in spite of all the resources and the potential for accelerated growth, it would be very difficult to achieve and to sustain economic growth.

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