

A Multi-Country Evaluation of Trade Imbalances Mexico

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I. Introduction

Between 1979 to 1997, Mexico experienced varied trends in its current and capital accounts. From 1979 to 1997, Mexico was a net debtor with a current account deficit in all but 1983 to 1985, 1987 to 1988, and 1995. Mexico was a net debtor with a current account surplus only in 1984, and was a net creditor with a current account deficit in 1988 and 1995. Finally, Mexico was a net creditor with a current account surplus in 1983, 1985, and 1987. It is very important to note that Mexico is a net creditor by terminology, but in actuality, Mexico was not lending this money to other countries. When Mexico had a capital account deficit, this money was being used to pay off its international debt. This chapter examines Mexico's current and capital account status from 1979 to 1997 by examining Mexico's macroeconomic variables, which describe the country's pattern of trade imbalances. This chapter will identify whether Mexico's pattern of trade imbalance was good, bad or benign.

The Mexican economy is one of significant size compared to the rest of the developing countries. From 1970 to 1999, Mexico went through a volatile economic period. "By 1970 the Mexican economy seemed well on its way to becoming another of the postwar economic miracles. And the miracle seemed all the greater since this was a genuine example of development, rather than construction, as was the case in Germany, Italy, and Japan."¹ This prediction has not come true. Mexico has had many economic crises since the 1970s. Most often, these economic crises have occurred at the start of new administrations.

II. Analysis

1979 to 1982: A Downward Spiral into The Debt Crisis

From 1970 to 1976, Mexico's economy can be divided into three periods. 1971 to 1973 is a period of austerity and inflationary growth. 1974-1975 is a period of international crisis and deterioration, and 1976 is the year of the devaluation and collapse into crisis.² In 1976, the government was forced to devalue the peso because investors were skeptical about investing in Mexico due to the political and economic instability about the future of the country.

¹ Looney, Robert. "Mexico's Economy: A Policy Analysis with Forecasts to 1990". Westview Press: Boulder, Colorado. 1978. p.3.

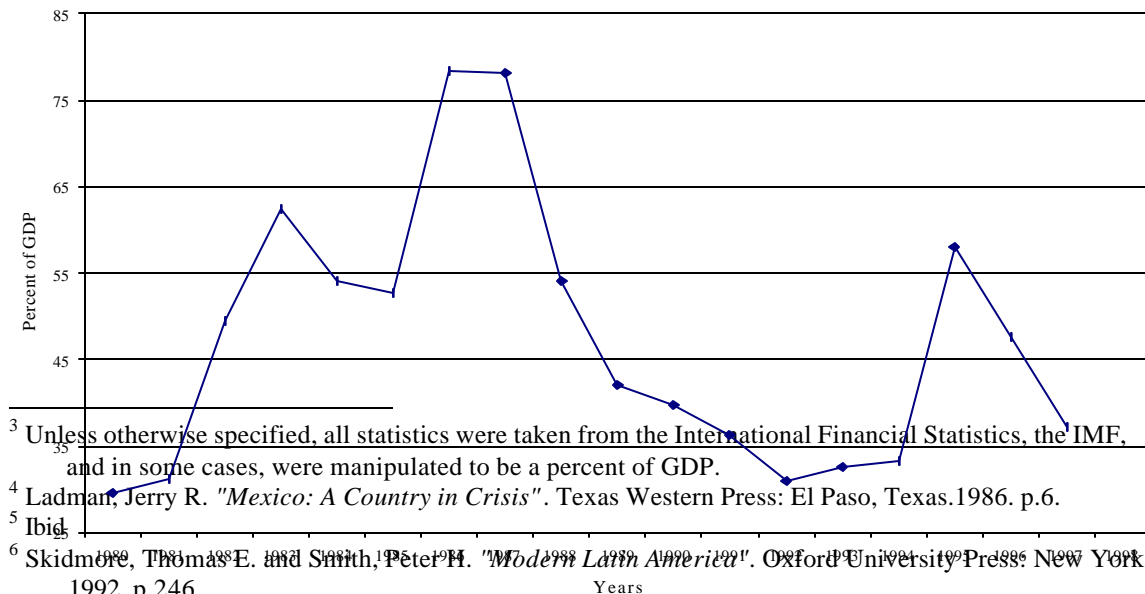
² Ibid., p.64.

This devaluation of 1976 was part of the reason Mexico was a net debtor with a current account deficit in the early 1980s. The current account deficit from 1979 to 1982 was caused by large amounts of interest payments on Mexico's foreign borrowings. The amount of these interest payments was a larger portion of GDP than the trade balance and so determined the current account balance. This was the first negative point of Mexico's position. Also, the current account deficit was greater than 5 percent³ in 1980 and 1981, which can be potentially problematic. This negative current account was due to the fact that Mexico had an oil boom in the late 1970s and early 1980s.

Mexico began the 1980s asking the International Monetary Fund for financing. IMF funds of course come with heavy strings attached. They are conditional, austerity measures which tend to produce a strong tightening in a country's finances. However, oil reserves were discovered which eliminated Mexico's need for these funds. These oil reserves brought much needed hard currency to Mexico. Mexico discovered major oil deposits between 1976 and 1982. Proven reserves expanded nearly seven-fold and potential reserves about twenty-four times.⁴ Production of crude and natural gas tripled and doubled in value, and their combined values of export sales increased some four thousand percent, the latter benefiting from the decision of OPEC nations (of which Mexico was a member) to raise prices.⁵ The following quote by President Portillo illustrates Mexico's confidence when oil was discovered in Mexico: "There are two kinds of countries in this world today-those that don't have oil and those that do. We have it."⁶ Mexico was hoping that the discovery of this oil would be the key for economic prosperity, restructuring, and stability in Mexico.

Mexico had a large and increasing external debt from 1979 to 1982. External debt rose from 30 percent of GDP in 1980 to almost 50 percent of GDP in 1982. Figure 7.1 illustrates Mexico's external debt as a percent of GDP from 1979 to 1997:

Figure 7.1
External Debt



The debt service ratio also illustrates that Mexico's debt was becoming increasingly unsustainable. The debt service ratio⁷ increased from approximately 60 in 1980 to 65 in 1982. The Mexican government decided to rely on foreign sources of borrowing to finance the oil boom. "The ready availability of foreign loans during the period of soft international financial market, combined with the reluctance on the part of the government to capture domestic savings through tax reform and monetary policy, caused Mexico to look outside its borders for financing."⁸ This became a dangerous economic move for Mexico.

The capital account surplus during these years rose to a large percent of GDP. In 1979, the capital account surplus was 3.8 percent of GDP and was 10.6 percent of GDP in 1981, but then the capital surplus decreased to only 1 percent of GDP. The capital account was not due to an increase in foreign direct investment or portfolio investment in Mexico, but rather to Mexico borrowing abroad. The "other capitals" part of the current account consisted of the Mexican government and other sectors borrowing "petrodollars" from European and American commercial banks. The "other capitals" was nearly 9 percent of GDP in 1981, but then was once again negative in 1982 when borrowing from abroad stopped because Mexico's debt was unsustainable.

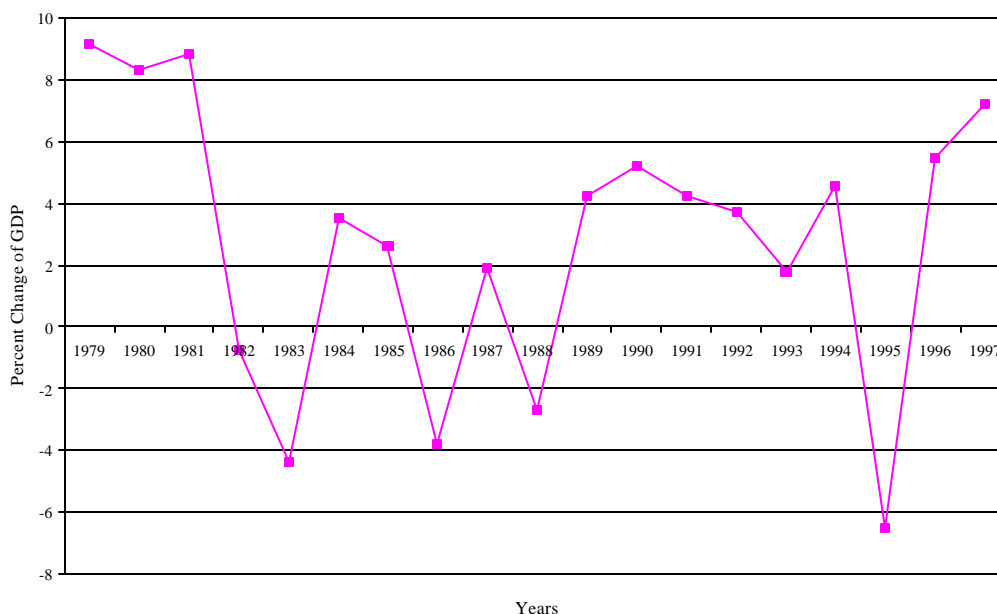
Three other events influenced Mexico economically during this time period, and made Mexico's debt unsustainable. Exports were affected in two ways. In 1981, there was a decrease in the price of oil. This caused Mexico's revenues from oil to decrease, which the government relied heavily upon for financing the debt. Also in 1981, world interest rates increased, most noticeably in the United States, and thus increased the amount of interest that Mexico had to pay for its debt to the U.S. because Mexico's interest rates on its foreign loans were variable rates. Finally, the Mexican peso was devalued more than 50 percent nominally from 1981 to 1982. This devaluation led to a trade surplus in 1982.

Another negative point for Mexico was that its rising external debt was preceded by slower GDP growth, which was the case in 1982. The percent change in real GDP growth was 9.2 percent for 1979, 8.3 percent for 1980, and 8.9 percent for 1981 before the Debt Crisis of 1982. Figure 7.2 illustrates Real GDP Growth as a percent change of GDP from 1979 to 1997:

⁷ The debt service ratio is a country's capacity to service the debt: (principal + interest) / exports of goods and services.

⁸ Ladman, Jerry R. *"Mexico: A Country in Crisis"*. Texas Western Press: El Paso, Texas.1986. p.7.

Figure 7.2
Real GDP Growth



Source: IMF Statistics

Mexico

The 1982 Debt Crisis was based on foreign borrowing, and not simply government overspending with domestic borrowing. The Peso was devalued in 1982 by over 57 percent from the previous year's level. This devaluation decreased Mexico's export prices and increased the prices of imports and non-tradable goods, which produced a positive balance of goods and services. However, even though the current account remained negative because of the payment of interest on foreign loans, the current account was only 3.4 percent of GDP. In September of 1982, exchange controls were used to stop the continued capital flight and speculative attacks on the Mexican peso. Mexico also expended large amounts of its international monetary reserves in trying to stabilize the peso and pay-off its external debt. Mexico had to resort to more international funding to stabilize the economy. The International Monetary Fund provided assistance and many international Mexican debts were written off.

According to the criteria mentioned in the introduction, some of these characteristics were noticeable in Mexico, which led to Mexico's unsustainable debt. There was an increase in Mexico's net debt position, and Mexico's current account deficit was greater than 5 percent of GDP in 1980 and 1981. There was also a large capital account led by heavy foreign borrowing and a decrease in domestic investment from 1980 to 1981. This position as a net debtor with a current account deficit was acquired by Mexico, and the way Mexico acquired its debt position was not sustainable.

1983 to 1989: A Period of Stabilization After the Crisis

In December 1982, Miguel De La Madrid was elected president of Mexico. The policies of this administration were very important because they were the basis for

Mexico's recovery from the Debt Crisis. This administration stressed price and financial stability in the short-run. In the distant horizon, this administration was also trying to increase "the competitiveness of the Mexican economy, relying more on internal than on external savings, and promoting the deregulation and decentralization of economic life."⁹ These goals proved to be far more challenging than was expected.

Between the years of 1983 and 1989, Mexico was forced to undergo enormous structural and economic changes. The recovery from the "Debt Crisis" was very slow for Mexico. From 1983 to 1988, Mexico tried to keep inflation in check while also maintaining a stable balance of reserves. Miguel De La Madrid announced his first stabilization program in December 1982, called the Programa Inmediato de Reordenación Económica, (Program of Immediate Economic Reorganization), PIRE. The "shock treatment" began with a large devaluation, a decrease in public expenditures, and an increase in tax revenues. There was also an increase in public savings from 1983 to 1988, which illustrates that there was not full confidence in Mexico's economic recovery by Mexico's citizens. Madrid's program received the support of the IMF, and the government signed an extended fund facility with the IMF in late 1982.

This first program was a failure, and Mexico faced a smaller balance of payments crisis in 1985, which led to harsh stabilization measures. These years were difficult for Mexico because IMF funding stopped in mid-1985 when Mexico did not comply with the IMF standards. There was also an earthquake in September of 1985, which devastated Mexico. Oil prices fell enormously in 1986 from \$25.5 per barrel in 1985 to \$12 per barrel in 1986.¹⁰ Mexico lost a lot of foreign exchange reserves in 1986 due to a lack of external funding, and in early 1986, there were rumors that Mexico was going to have a "unilateral moratorium" on its debt to the world. This did not happen because of some U.S. convincing. In September of 1986, Mexico signed another "standby" agreement with the IMF. Finally, in 1987, with the external funding in place, macroeconomic policy could finally concentrate on price stability and recovery rather than the protection of the balance-of-payments. Even though Mexican authorities were heading in the correct direction economically, there was still a run on the peso.

By 1988, inflation was reasonable, but the percent change in real GDP growth had reached was no more than 4 percent in any of the years from 1982 to 1988, and was even negative in 1986 and 1988. "Only a combination of more decisive external support and a shift in Mexico's development strategy managed to produce a turnaround."¹¹ Private savings also increased steadily from 25 percent in 1980 to approximately 34 percent in 1986, a sign that the people of Mexico did not believe that the Mexican economy was going to be prosperous. The Mexican government also sought to reduce government intervention and regulation, which would in effect, open up investment markets.

⁹ Lustig, Nora. *Mexico, The Remaking of an Economy*. The Brookings Institution: Washington, D.C. 1992. p.28.

¹⁰ Ibid., p.39.

¹¹ Ibid., p.2.

From 1983 to 1989, Mexico was a net creditor with a trade surplus in 1983, 1985, and 1987. Although, as was stated before, Mexico was not lending money to the rest of the world, rather, Mexico was paying its debt. In 1984, Mexico was a net debtor with a current account surplus. In 1983, 1984, and 1985 "net income" or payments of interest on foreign loans were greater than 5 percent in each year. GDP growth was very slow from 1983 to 1985. GDP growth was (-4.3) percent in 1983, and growth was limited to 2.6 percent in 1984 and 1.9 percent in 1984. External debt was 62.4 percent in 1983, decreased in 1984 and 1985, and then increased again to nearly 80 percent in 1986.

1984's position as a net debtor with a current account surplus was more problematic than the other years' status. Investment in Mexico was either negative or decreasing in terms of foreign portfolio and direct investment. The current account surpluses of 1983 through 1985 also followed the default of the Debt Crisis. The net debtor with a current account surplus position of 1984 was more problematic or worrisome than the net creditor and current account surplus of 1983, 1985, and 1987. Even though Mexico was a net creditor in 1983, 1985, and 1987, Mexico was reducing its debt in the first two years. In 1987, out of all the years examined, Mexico can be considered a net creditor by its definition.

The situation in 1986 was once again worrisome for Mexico. Mexico was a net debtor with a current account deficit in 1986. External debt was 78 percent of GDP, but fortunately, the current account deficit was only 1 percent of GDP. There was also little investment by foreigners in the form of portfolio and direct investments. The exchange rate also depreciated during this time, and then was changed after 1985. The change in real GDP growth was also negative in 1986, (-3.8 percent).

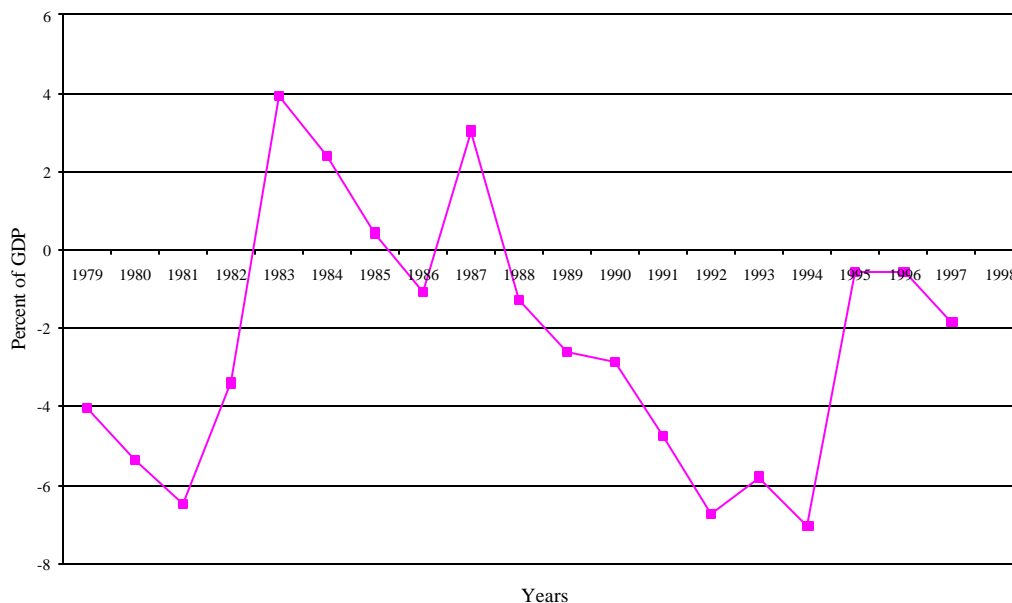
By 1988, there was more consumption and an increase in imports in the Mexican economy, both signs of stability and confidence in future growth. There was also a return of FDI, and domestic investment levels increased to pre-1982 Debt Crisis levels. A decrease in the trade balance, a further increase in FDI, and a positive capital account showed that while Mexico was decreasing its debt position; Mexico was also receiving investment from abroad, which helped Mexico pay back its debt quicker.

In December of 1988, Carlos Salinas de Gortari took office, and announced a new pact called the "Pact for Economic Stability and Growth" (PECE). By early 1990, trade and public reforms were proceeding at a good pace. To further these reforms, the government announced a plan to reprivatize the banks in May 1990. Capital inflows increased with this decision. Salinas also announced in August 1990 that the North American Free Trade Agreement with the U.S. was definitely going to be signed. This second decision also increased capital flows. By 1991, the world thought that Mexico was finally entering a new, stable economic chapter.

1990 to 1994: The Period Leading to the Peso Crisis

Mexico experienced another severe economic crisis at the end of 1994. This crisis, referred to as the Peso Crisis, initially stemmed from Mexico's policy combination of excessively expansionary fiscal and monetary policies, along with its fixed exchange rate. Investors were also concerned about the large and increasing current account deficit. Figure 7.3 illustrates Mexico's current account as a percent of GDP from 1979 to 1997:

Figure 7.3
Current Account Balance



Source: IMF Statistics

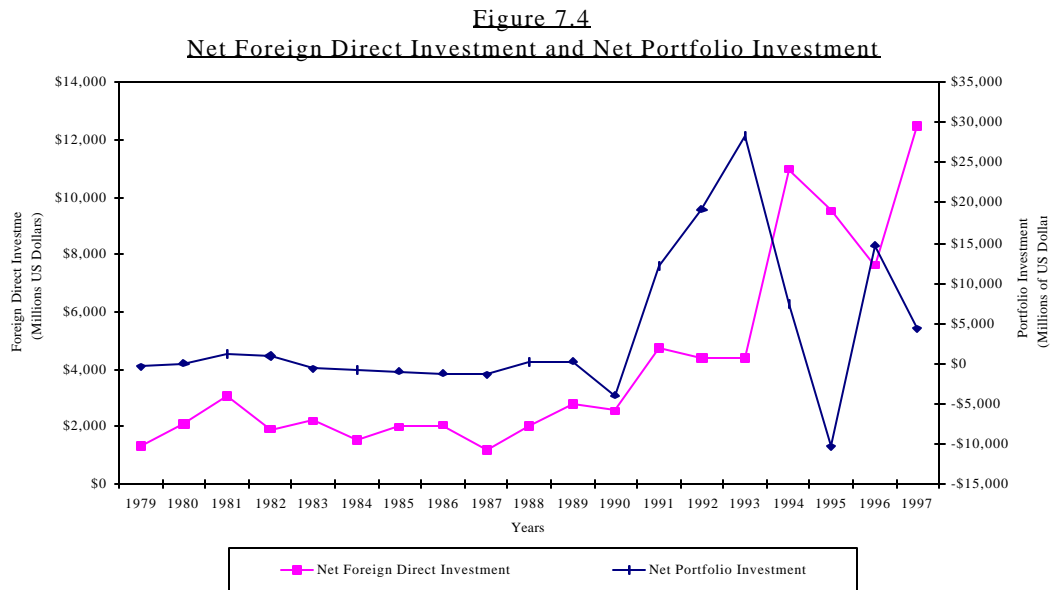
Mexico

The Mexican government was aware of this, but believed that a stable peso was of greater importance for attracting capital inflows, and therefore decided not to allow the peso to depreciate. The percent change in real GDP growth decreased from 3.7 percent in 1992 to 1.8 percent in 1993. Even though growth was 4.6 percent in 1994, this figure was a very strong negative number in 1995 (-6.49%).

From 1990 to 1994, Mexico was a net debtor with a current account deficit. Mexico's external debt was nearly 40 percent of GDP in 1990, but decreased to 33.3 percent. The debt/service ratio reached its peak in these years at approximately 47 in 1993. This illustrates that Mexico's Peso Crisis, which was building during this time, was not because of international borrowing. Mexico, on the other hand, had a current account deficit that was above 5 percent from 1991 to 1994, and it reached nearly 7 percent for

two of those years. The trade deficit was the source of the current account deficit, rather than net income as was the case during the Debt Crisis in the early 1980s.

The capital account was a very large surplus beginning in 1991, 8 percent of GDP. It reached 8.2 percent of GDP in 1993. An increasing percentage of portfolio investment created part of this large positive balance. At its highest, portfolio investment was 7 percent of GDP. Foreign direct investment was also positive, and even through the Peso Crisis, continued to flow into Mexico regularly. Figure 7.4 illustrates the amount of net foreign direct investment and net portfolio investment in Mexico from 1979 to 1997:



Source: IMF Statistics

Mexico

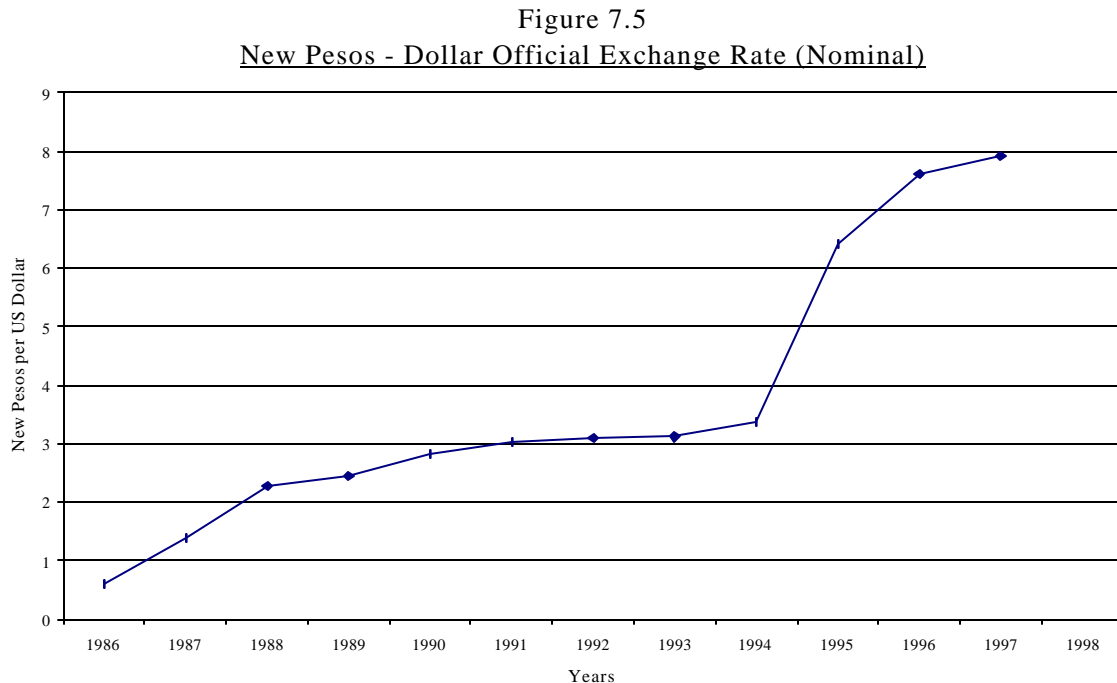
This is attributed to NAFTA, and its opening of the Mexican/U.S. borders to investment. The exchange rate remained steady during this time, but became a source of instability in 1995.

There were other reasons for the crisis. Though not economic, the political instability in Mexico was important in assessing the causes of the crisis, and why the crisis persisted. 1994 was a particularly rocky year for Mexico, politically and economically. Even before May of 1994, there were guerrilla revolts, a political assassination (Luis Donaldo Colosio, the candidate of the ruling party), kidnappings, a devaluation of the peso, and an outflow of capital. To stop the fall of the currency, ward off a stock market slump, and soothe foreign investors, interest rates were increased in May of 1994.

Investors' confidence further decreased after the presidential election of 1994. President Carlos Salinas' administration was replaced by the administration of Ernesto Zedillo. Investors' confidence further decreased when the newly elected president of Mexico, Ernesto Zedillo, received news that the rebels from the Chiapas were on the

offense. To compound capital outflows, rational investors and their money followed higher world interest rates, especially in the United States.

The capital flight caused by the possible political instability in Mexico and of the higher world interest rates, caused a serious decrease in foreign exchange reserves in Mexico. The large decrease in foreign exchange reserves forced the Mexican government to allow the peso to float on December 20, 1994. Figure 7.5, illustrates Mexico's nominal exchange rate in New Pesos from 1986 to 1997:



Source: IMF Statistics

Mexico

1995 to 1999: The Peak of the Crisis and the Step Toward Stabilization and Growth

1995 was the peak of the Peso Crisis, and 1996 and 1997 were years of stabilization for Mexico. The net debtor and current account deficit positions of 1996 and 1997 were more periods of stabilization and slow growth rather than periods possibly leading to a crisis. Mexico's external debt reached 58 percent of GDP in 1995, and the debt service ratio 36.3. Mexico was a net creditor with a current account deficit in 1995, but it even though it was a net creditor, this was not because Mexico was lending to the world but rather Mexico was paying its debt. The current account deficit was below 2 percent, and so was not dangerously high. Exports increased tremendously due to the strong devaluation of the peso, and were 27 percent of GDP. The United States was also buying a lot of Mexico's exports due to NAFTA, which helped increase Mexican exports. Mexico's net income or interest payments to the rest of the world were at 4.4 percent of GDP in 1995.

Regarding the capital account, Mexico lost a lot of its portfolio investment that it had gained from 1991. Foreign direct investment remained steady. Borrowing increased to 3.4 percent of GDP. Real GDP growth was (-6.5 percent) in 1995. This crisis was not as bad for Mexico as the Debt Crisis. The U.S. and the IMF both took an active role in bailing out Mexico.

Mexico's recovery has been very slow from the Peso Crisis. This can be explained by several economic indicators and world events. Private savings in Mexico, as was the case during the mid-1980s, increased steadily from 12.2 percent in 1994 to almost 21 percent in 1997. This is an indicator that Mexicans still do not believe that the economy has fully recovered enough to take a gamble and spend their money rather than save money to cushion future economic problems. The current account deficits are well below 5 percent, but the external debt was 47 percent in 1996, and slightly lower at 37 percent in 1997. The debt service ratio increased from 50 to 53 in 1997. The exchange rate has stabilized, and will keep attracting exports to the U.S. because of the dollar's strength relative to the peso's. Real GDP growth was also positive at 5.5 percent in 1996 and 7.2 percent in 1997.

Investment in the form of portfolio and foreign direct investment have both increased, showing international confidence in Mexico's recovery. This investment has also protected Mexico from some of the external shocks of 1997 and 1998, like the Asian Crisis and a drop in world oil prices. The Asian Crisis has made it more difficult for Mexico to export to Asia due to a lack of demand for goods, and the decrease in the world price of oil also due in part to the excess supply of oil and lack of Asian demand gas affected Mexico. Mexico has diversified its exports, but the Mexican government still depends on oil exports for a part of its revenues. The Mexican government has acted responsibly by cutting its spending to match the decrease in revenues from the decrease in the price of oil.

An article from the Wall Street Journal¹² says that Mexicans are currently struggling to maintain their buying power from before the large devaluation and abandonment of the fixed exchange rate during the Peso Crisis. Mexico is viewed as an example of how a country should get out of an economic crisis. Using Mexico as an example is not completely fair since Mexico survived the Peso Crisis in large part because of a huge bailout from the U.S. and the IMF. Mexico's close trade relationship and border with the U.S. has established a special relationship that does not exist between the U.S. and any other developing country.

2000 and Beyond: Another Crisis?

Mexico has a distinguished pattern of falling into economic crisis with a change of administrations. The current Mexican administration is trying to prevent a crisis in 2000 by planning ahead. The Zedillo administration is looking beyond economic recovery and into sustained growth. In 1997, the Zedillo Administration released a plan

¹² Millman, Joel. "The Outlook: Is the Mexican Model Worth the Pain?". The Wall Street Journal. March 9, 1999.

called the National Program for Development Finance (PRONAFIDE). This plan outlines the government's economic policy and projections for the period 1997-2000. This project predicts 5 percent average annual growth and the creation of one million formal sector jobs by 2000. This program will be supported by a growth in domestic savings, a high level of foreign direct investment, and responsible fiscal and monetary policy. "A key objective of the government is to convince the public, now, that when President Zedillo's term ends in the year 2000, the measures currently being taken will succeed in avoiding the type of financial crisis that has come at the end of the last several six-year presidential terms"¹³ Mexico's current economic indicators are not nearly at the danger level as they were before the Debt Crisis and the Peso Crisis. No financial crisis is predicted if there is a smooth transition of power, and if Mexico continues to practice fiscal responsibility.

III. Conclusion

Mexico's net debtor and current account deficit positions from 1979 to 1982 were indeed problematic for Mexico. Mexico's capital account deficit position in 1983 and 1985 were both caused by Mexico's government reducing its debt, which made Mexico's position benign. Mexico's net creditor position in 1987 was beneficial because Mexico could lend abroad, something that it could not do in any other year from 1979 to 1999. Mexico was also paying its debt in 1988. From 1990 to 1994, Mexico was leading into the Peso Crisis with its net debtor and current account deficit positions, and so these years are considered to be worrisome or problematic, as was the case in 1995, when Mexico was in the Peso Crisis. From 1996 to 1999, Mexico has been in a benign state. Mexico is still experiencing a recovery from the Peso Crisis, but it has paid a lot of its debt from the crisis, and has acted fiscally responsible amid two large external shocks: the Asian Crisis and the decrease in world oil prices.

¹³ "Mexico: Economic Trends and Outlook". Country Commercial Guides. U.S. Department of Commerce, International Trade Administration. 1998.

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Appendix

Trade Balance

