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A Strategy to Resolve
Mexico's Liquidity Crisis

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Yves Maroni*

A discussion of the strategy to resolve Mexico's liquidity crisis must start with an analysis of the origins of the crisis and a review of its principal phases. An understanding of what went wrong and of the emergency actions that followed and that are now history will shed valuable light on the problem and provide useful insight for the formulation of an appropriate strategy for the coming years.

The Origins of the Crisis

Mexico's financial crisis, which burst in full bloom in August 1982, had been brewing for nearly four years. It had its origins in the policies implemented by the Mexican authorities since 1978 and developments in the world economy following the second oil shock. It became inevitable when the Mexican authorities did not act forcefully to adjust these policies to the changed world economic circumstances.

Mexico's expansionary policies implemented since 1978 to promote employment yielded a real growth rate averaging over 8 percent in 1978-81 and lower unemployment, but these successes were achieved at the price of large public sector deficits, accelerating inflation, and rapid import growth. In spite of a persistent and growing differential between Mexican and U.S. inflation, the peso/dollar exchange rate was held virtually stable in 1978-80 and was allowed to depreciate only slowly in 1981. The result was a decline in Mexico's international competitiveness which further stimulated imports and held down non-oil exports, and contributed to a near quadrupling of the current

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account deficit from \$2 billion in 1977 to almost \$8 billion in 1980, in spite of a rise in oil export earnings from \$1 billion in 1977 to \$10 billion in 1980.

In 1981, weakness in the world oil market exacerbated by a miscalculation in Mexico's oil pricing policy in June and July, a recession in the industrial countries, and an accelerated rise in interest payments on the growing external debt as world interest rates reached new highs, worsened the situation still further and the current-account deficit rose to \$14 billion, more than 45 percent of total current-account earnings. Fears of a large peso devaluation and an outflow of capital developed in 1981 as awareness of the growing current-account deficit increased and as it became clear that only nominal reductions in public spending were being made in the face of the lower public revenues that the decline in world oil prices was bringing about. The fears and the capital outflow intensified as the realization spread that expansionary domestic policies would continue in 1982--an election year--and that the short-term outlook for exports was not encouraging. In February 1982, the Mexican authorities concluded that it would be too costly to continue supporting the exchange rate, and allowed the peso to depreciate by about 40 percent.

The Mexican government did not quickly adopt a meaningful stabilization program after the devaluation and instead took steps to alleviate its impact, including large wage increases and business tax concessions and benefits. On April 20, 1982, a stabilization plan was announced. But the Presidential election, only ten weeks away, constrained the capacity of the Mexican government to implement the plan forcefully.

Mexico had been able to borrow large sums on external financial markets since 1977, mainly on the strength of the potential expansion of its

oil exports, and indeed, in 1981, had succeeded in covering its \$14 billion current account deficit and the large capital outflow while adding to its reserves. But much of the 1981 borrowings were short-term, creating a heavy concentration of maturities in 1982. At the same time, a further increase in the current-account deficit was being forecast for 1982. Market realization of the magnitude of Mexico's 1982 external borrowing needs brought about a hardening of terms on syndicated loans, including higher spreads and shorter maturities. In May, the Mexican authorities negotiated a \$2.5 billion credit from a syndicate of banks, but the lead managers were able to sell only about \$350 million in participations to "second-tier" banks during the syndication period, in spite of two extensions, and the lead banks found themselves having to hold larger portions of this credit than they had planned. The poor reception of this credit forced postponement of other Mexican borrowings that had been under preparation and led to a growing reluctance of lenders to roll over maturing short-term credits. When sharp increases in the regulated prices of gasoline, electricity, tortillas and bread were announced on August 1, the public recalculated the prospective rate of inflation and concluded that another devaluation was inevitable. This caused a renewed outflow of capital, and, with reserves running low and access to external borrowings severely curtailed, the Bank of Mexico was forced once again to withdraw support of the peso.

The Crisis and Its Aftermath

On August 6, a dual exchange rate system was instituted. This raised fears of full-fledged exchange controls and triggered a large scale conversion of foreign-currency accounts at Mexican banks into foreign exchange. On August 13, these conversions were banned, the foreign-currency accounts at Mexican banks were ordered converted into pesos, and the foreign exchange

market was closed. With remarkable speed, on the understanding that Mexico would seek assistance from the International Monetary Fund, foreign banks agreed to roll over public sector principal payments owed to them pending a comprehensive debt restructuring and emergency official assistance to Mexico of more than \$4.5 billion was arranged.

However, once again, the Mexican government did not quickly adopt measures to strengthen its stabilization effort, and instead, on September 1, instituted comprehensive exchange controls and a fixed two-tiered exchange rate system, while lowering domestic interest rates. The nationalization of banks, also announced on September 1, dealt a further blow to the confidence of capital market participants in the policies and prospects of Mexico. Negotiations with the International Monetary Fund dragged on, although in the end they were successfully concluded in November.

The scarcity of foreign exchange, import and exchange restrictions, and the depreciation of the peso in real terms reduced the current-account deficit in 1982 to less than a third of the record 1981 level, mainly because of a 40 percent contraction in imports. But real GDP growth virtually ceased and inflation climbed to three-digit levels. The scarcity of foreign exchange after August 6 and the subsequent exchange controls also led to the widespread accumulation of private arrears on debts to banks and to suppliers, although even before August some private firms experiencing financial difficulties had already fallen behind in their debt servicing.

Short-run Strategy to Resolve the Crisis

Stabilization measures intended to carry out the IMF-approved program began to be implemented in December 1982, as soon as the new administration took office. They included an increase in the value-added tax and cuts in public spending--in particular reductions in public investment expen-

ditures and increases in public sector prices so as to reduce subsidies--a substantial increase in interest rates, and restraints on wage increases. In addition, the peso was devalued a third time and some flexibility was restored to the exchange rate system with a view to maintaining the country's international competitiveness. The program calls for a reduction of the public sector deficit/GDP ratio, which exceeded 18 percent in 1982, to 8.5 percent in 1983 and for further reductions in 1984 and 1985.

Adoption of these policies enabled Mexico to obtain IMF financial assistance (\$3.9 billion to be disbursed over three years) and, with the intervention of the IMF management, a \$5 billion foreign bank loan (linked to the IMF credit). Extraordinary export financing from Western governments expected to total \$2 billion in 1983 has also been arranged. In addition, Mexico has restructured about \$11.5 billion of public sector principal payments owed to foreign banks and falling due between August 1982 and December 1984,^{1/} and about \$1.5 billion in private sector debt owed to or guaranteed/insured by official agencies in the creditor countries. A number of mechanisms to pay private sector arrears on rescheduled terms have also been instituted.

The performance of the Mexican economy under these policies has been both encouraging and discouraging. On the one hand, Mexico has remained in compliance with the performance criteria specified in its agreement with the IMF and has been able to continue to avail itself of the financing that is conditioned on this compliance. As a result, it has repaid all of the emergency assistance obtained from foreign monetary authorities in August 1982. Performance has been especially encouraging on the fiscal side and on the external payments side, to the extent that Mexico has been able to delay drawings on the \$5 billion bank loan well beyond their original availability dates.

^{1/} The restructuring of another \$8.5 billion is still under negotiation.

On the fiscal side, public spending slowed sharply in the first half of the year and, although public sector revenues were less than expected (mainly because of the low rate of economic activity), the public sector deficit was significantly lower. The reduced need for financing by the public sector was reflected in slower money supply increases. On the external side, the current account, which shifted into surplus in the third quarter of 1982 as imports became increasingly depressed, has remained in surplus in the first half of 1983 in spite of some recovery in imports and in spite of the reduced earnings from oil exports that the lowering of oil prices in March brought about. In part, this reflects the impact of the decline in world interest rates after July 1982 and the effect of the peso depreciation on non-oil exports and services.

On the other hand, economic activity remains depressed and it is widely expected that real GDP in 1983 will be at least 4 percent lower than in 1982. While there are no statistics to prove this, it must be presumed that unemployment has increased. This probably has contributed to the willingness of organized labor to accept wage settlements this year that have been well below the twelve-month rate of increase in prices. While wage restraint is an important element in the adjustment strategy under way, there is no denying the fact that a reduction in real wages is painful and may be socially disruptive. At the same time, if the monthly rate of price increases, which has shown a tendency to ease somewhat in recent months, can be brought down significantly further, the reduction in real wages may be minimized.

Long-run Strategy

The short-run strategy to resolve the Mexican liquidity crisis has been based on (1) implementation of measures designed to adjust the Mexican economy to the changed world economic circumstances, (2) ensuring the

continued availability of external financing during the adjustment period, especially from banks, and (3) alleviating through debt restructuring the crushing burden of a heavy concentration of maturities falling due. Two important elements in this strategy have been the adoption of an IMF-approved stabilization program and the decision to continue paying promptly all interest due on the external public debt and to settle as soon as possible the arrears that accumulated before December 1982 on the interest payments on private sector debts. Lacking these steps, it would have been impossible to secure the agreement of the banks (a) to the rollover of principal payments that has now lasted more than a year, (b) to the increase in their exposure to Mexico represented by the \$5 billion loan of last March, and (c) to the public sector debt restructuring that is now nearing completion.

For the balance of the adjustment period and in the long run, it will be essential to strengthen the export sector and to bring about a revival of the voluntary flow of capital into Mexico. This is desirable not only to help resolve the liquidity crisis but also to provide the means of financing a recovery of imports and to help achieve a sustainable rate of real economic growth and the benefits of expanding trade. To revive the voluntary capital inflow, Mexico should aim to restore the confidence of foreign banks and other capital market participants in the policies and prospects of the country. This requires continued prompt payment of all interest falling due and the resumption of debt servicing by private Mexican debtors whose debt payments are overdue, either under debt restructuring agreements concluded with their private foreign creditors pursuant to one of the "FICORCA" plans or under any other mutually agreed arrangement. It also requires continued compliance with the performance criteria specified in the Mexican agreement with the IMF.

After the IMF agreement lapses at the end of 1985, assuming that there will be no need to renew it, an important element in nurturing international financial market confidence will be to follow the guidelines of what might be called a policy of reasonable borrowing.^{1/} One of these guidelines is to use external borrowings, either directly or indirectly, only for productive purposes, not for consumption or to pay interest on previous debts or to finance an outflow of capital, so as to generate the capacity to service the additional debt. Another guideline is to maintain a realistic exchange rate so as to prevent erosion of the country's international competitiveness. A third one is to maintain interest rates high enough to act as a disincentive to an outflow of domestic capital and as a magnet for foreign funds. A fourth one is to minimize the use of price controls and subsidies since they tend to encourage overconsumption and to distort the allocation of productive resources, thereby impairing the efficient functioning of the economy and hence its debt servicing capacity. A fifth one is to follow appropriate domestic fiscal and monetary policies and in particular to be willing to take fiscal and monetary policy steps in a timely fashion to mitigate adverse world or domestic economic and financial developments and to limit the current account deficit to a level corresponding to the amount that can reasonably be expected to be available from external sources of financing. Adherence to the first, second, and fourth guidelines will also contribute importantly to the strengthening of the export sector.

Beyond this, since the banks cannot be expected to provide all of the financing that Mexico may need if it is to resume a satisfactory rate of real GDP growth, and since the climate does not seem favorable for a large

^{1/} See my paper "How to Borrowing Reasonably", in Foreign Debt and Latin American Economic Development, (Antonio Jorge, Jorge Salazar Carrillo, and Rene P. Higonnet, editors), Pergamon Press, New York, 1983, pp. 77-84.

increase in the availability of official financing, either on a multilateral or a bilateral basis, it is likely to prove useful for Mexico to devise policies that will attract private foreign equity capital and that will stimulate the return of expatriated Mexican capital. This may require actions to minimize the risk of loss through devaluation or expropriation, a commitment to a vigorous private sector, a stable and predictable set of investment rules, and a reasonable degree of social peace.

The Responsibilities of the Creditors

The Mexican strategy outlined above has an important complement in the strategy that should evolve in the creditor countries to help resolve not only Mexico's liquidity crisis but also those of other countries experiencing external debt difficulties. Since world events over which Mexico had no control played a part in bringing about the Mexican liquidity crisis, it is only equitable to place some of the responsibility for resolving the crisis on the creditors. As noted earlier, the creditors have already done much to deal with the crisis in the short-run, but this is only a beginning.

In the long run, resolution of the crisis requires an expanding world economy that will absorb a growing volume of Mexican and other less developed country products and services at remunerative prices. The restoration of a steady and sustainable rate of real economic growth in the industrial countries is, of course, in their own interest on other grounds, so that one can rest assured that efforts to this end will be made. Conventional wisdom suggests that an economic recovery and expansion is more likely to extend over a long period if it proceeds at moderate rates that are sustainable than if it achieves high rates that generate inflation and lead to restrictive policies that interrupt it. However, cyclical fluctuations have not been abolished, and Mexico and other less developed countries must be prepared for

the next economic downturn which must surely come, even if its timing cannot be predicted. They should build up international reserves to provide a cushion that will give them time, after the downturn begins, to readjust their policies to the changed economic circumstances.

The industrial world must also be ready and willing to absorb an increase in imports from Mexico and other less developed countries. This implies that they will avoid an intensification of protectionist measures or, better still, that they will reduce trade barriers that impede imports from these countries. The world should remember the lesson of the 1930s when sharply increased tariffs and the use of quantitative restrictions made it impossible for indebted countries to earn through exports the means with which to pay their debts. It goes without saying that industrial country acceptance of increased imports from the less developed countries does not and should not amount to a license for the latter to engage in unfair competitive practices such as selling for export at lower prices than in the home market, or providing special subsidies or tax rebates for exporters. An export subsidy code has been developed within the GATT and they should adhere to such a code if they hope to find acceptance for their products in the industrial countries.

The United States has a further contribution to make, not only to the resolution of the debt difficulties of the less developed countries, but also to its own economic and financial future and that of the other industrial countries. If it will pursue policies that will substantially reduce its own fiscal deficit in coming years, this will considerably brighten the prospects that world interest rates will not rise significantly as the economic expansion proceeds, and there may even be a possibility that world interest rates might decline somewhat. Given the magnitude of the Mexican external debt--indeed, the external debt of many of the less developed countries--this could yield

immense benefits to these countries. Since approximately \$60 billion of Mexico's external debt is subject to floating interest rates, the savings associated with each percentage point decline in interest rates would amount to \$600 million per year.

An appropriate strategy for the creditor countries should include the avoidance of excessively restrictive bank regulatory measures which, while designed to promote the soundness of banks, will prevent a resumption of bank lending to the less developed countries on a voluntary basis. There is little doubt that many banks failed to exercise proper caution in extending loans to them in recent years and that some strengthening of the regulatory process and the enactment of some lending restraints are inevitable. However, if the result should be to discourage banks from making new loans to the less developed countries, it would make the task facing such countries as Mexico considerably more difficult. In the absence of a revival of voluntary bank lending, Mexico and other less developed countries would have to place greater reliance on other sources of capital and, failing this, would be forced to choose between making greater sacrifices or seeking ways to reduce their scheduled interest payments. The former would imply lower imports by them, the counterpart of which would be a loss of jobs in the supplying countries--and when it comes to supplying Mexico, this means chiefly the United States--whereas the latter would have incalculable consequences for the soundness of the banking system that the new regulatory measures were meant to enhance. Clearly, the effort to tighten the regulations governing foreign lending by U.S. banks is an exercise in tight-rope walking. If pushed too far, it has the potential of doing in its own way what the Smoot-Hawley tariff of 1930 did to world trade and, through it, to the economic and even the political fabric of the world in the 1930s.

Finally, the banks in the creditor countries should recognize that the maturity profile of Mexico's external debt still involves heavy concentrations of maturities in some of the years before the end of this decade. This suggests that they should structure new loans to Mexico in such a way as to minimize the repayments due in these years. Even if they do, they may be asked, in due course, to consider additional debt restructuring in the years of heavy concentration of maturities. There is plenty of time to think about this, but it is not too early for the banks to begin incorporating this possibility in their forward planning, so that no one will be surprised if and when it materializes.

Concluding Comments

The world of the 1980s is very different from that of the 1970s. Then, the industrial countries, and particularly the United States, placed more emphasis on maintaining output and employment and less emphasis on curbing inflation. Interest rates prevailing in world markets, and especially in the United States, were generally lower than the rate of inflation, and debtors were encouraged to borrow more, not only because real interest rates were negative, but also because principal repayments could be made in cheaper dollars--i.e., dollars that could be earned with a declining volume of exports, as export prices for the products of the debtor countries rose in dollar terms.

In such a world, the damage that debtor countries might suffer from having pursued ill-advised domestic policies could be overcome with relative ease with the help of the ongoing world inflation.

But in the 1980s, the industrial countries, and particularly the United States, have placed primary emphasis on the curbing of inflation and have accepted a sharp and prolonged recession. Interest rates in these countries were allowed to rise to unprecedented nominal levels that have generally

exceeded the rate of inflation by a rather wide margin. While U.S. economic activity is now expanding once again, and while nominal interest rates in world markets have fallen from their peaks, real interest rates continue to be positive and appear likely to remain so for the foreseeable future, although not necessarily at the current level. In this environment, borrowing is costly. Nominal interest rates cover not only an inflation premium, but also a positive real remuneration for the other risks involved and for the use of the funds. Moreover, with the reduced rates of inflation now prevailing in the industrial countries, it is no longer possible for debtor countries to contemplate the possibility of making principal repayments in much cheaper dollars on the assumption that the export prices for their products will continue to rise rapidly.

In such a world, the damage that debtor countries might suffer from pursuing ill-advised domestic policies is greater and more difficult to repair. This makes it all the more important for them (a) to avoid such policies, and (b) to recognize the need for prompt policy adjustments when world economic circumstances change. The borrowing strategy of the 1970s is no longer appropriate.

The Mexican experience of the past few years illustrates vividly what can happen when these conclusions are ignored. But the progress made in 1983 in rebuilding a viable Mexican economy shows that, with steadfastness and determination, there may be a way to overcome the crisis.