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MEXICO : WHAT WENT WRONG?

(Her Majesty's Ambassador at Mexico City to the Secretary of State for Foreign and Commonwealth Affairs)

SUMMARY

1. Three years ago Mexico was booming. Foreign banks competed fiercely to lend to a country with huge oil reserves, a large and growing industrial base and political stability. By 1982 the country was effectively bankrupt. The collapse of confidence and of the currency which occurred in 1976 was repeated, only more severely. (Paragraphs 1 – 2).

2. External factors played a part: high interest rates in the United States, the fall in price of oil and other export commodities, and the drying up of external credit. But it was the Government's policies which made the economy vulnerable. President Lopez Portillo wanted to be popular with all and did not take difficult but necessary decisions. (Paragraphs 3 – 4).

3. The Government's failure lay in four critical areas: it believed that the development of Mexico's massive oil resources had eliminated the balance of payments as a constraint on growth, and it failed to react in time to the down-turn in the market (paragraphs 5 – 6); in the cause of currency stability it allowed the peso to become greatly over-valued (paragraphs 7 – 8); in the cause of social justice it allowed an explosive growth in the cost of subsidies, and of the public sector deficit, while corruption reached unprecedented proportions (paragraphs 9 –10); above all it tried to tackle inflation by increasing production and jobs, long after the signs of overheating had become apparent (paragraphs 11 – 12).

4. Although a prominent member of the previous Administration, President de la Madrid has condemned past errors and seems genuinely bent on a new course which with IMF support would rid the economy of the deep ills which still afflict it. It remains to be seen if he has the political qualities to carry his good intentions into effect. (Paragraph 13).

Mexico City

18 April 1983

Sir,

1. Three years ago the Mexican economy was booming. Foreign banks were competing fiercely to provide loans and credits with ever more favourable spreads. Among all the countries of the world in need of capital, Mexico combined three characteristics which made it seem a uniquely desirable and secure borrower: huge oil reserves; a substantial and rapidly growing industrial base with a large and growing domestic market; and a tradition of political stability. In my despatch of

13 July 1982 I chronicled President Lopez Portillo's rake's progress towards massive foreign debt and huge public sector deficit. Now Mexico is effectively bankrupt, the economy is showing negative growth, and inflation has trebled. What went wrong?

2. In recent years the Mexican economy has shown a cyclical progression. The 1976 crisis was a comparatively mild pre-run of the present crisis. Then also government overspending led to a collapse of confidence and the currency, capital flight, and an appeal for rescue to the IMF. With this example before its eyes, the government might have been expected to avoid the same mistakes. In fact it failed to do so, and when disaster fell in 1982, disclaimed all responsibility.

3. Of course there were external factors which the Government could not have predicted: high interest rates in the United States, the fall in the price of oil and other export commodities (which are estimated to have cost Mexico US $10 billion in lost earnings in 1981), and the drying up of external credit. But it was the Government's policies which made the economy so vulnerable to external factors, and which proved so hard to change when the crisis broke. In October 1982 President-elect Miguel de la Madrid spoke unfamiliar truth when he said that Mexico's difficulties were due to excessive growth and decapitalisation brought about by internal as well as external factors.

4. Perhaps the key was the character of President Lopez Portillo. A man of charm who liked to be popular with all, he hoped to transform Mexican society without offending anyone. In his first year of office he was given contradictory advice by his Ministers of Finance and Planning. The first, Lic. Moctezuma Cid, was an orthodox classical economist who favoured cautious growth, control of inflation, flexible exchange rates, free movement of capital, less protection. The second, Lic. Carlos Tello, was a nationalist and dirigist in his views, and advocated high growth, fixed exchange rates, exchange controls, more protection and higher taxes. Each policy was consistent within itself, but the two could not be combined. President Lopez Portillo eventually dismissed both Ministers. He took the more popular options from both packages and rejected the difficult ones. For 3½ years the increase in oil revenues helped to obscure his Administration's failures in four critical areas: growing dependence on oil revenues, over-valuation of the currency, distortions caused by subsidies and corruption, and over all inflation.

5. On oil revenues, the Government knew, and Ministers seldom tired of saying, especially in the period before 1980, that Mexico must avoid becoming dependent on overseas revenue from this source. There was constant talk of the need for limits and ceilings for both production and exports. The queue of foreign governments pleading for more Mexican oil grew longer. At this time the unspoken but confident assumption was that if the balance of payments unexpectedly took a turn for the worse, the problem could always be overcome by turning on the oil tap. Many foreign bankers shared this assumption. Between 1979 and 1980 growing oil revenues caused improvement in many of the indicators commonly used to give warnings of balance of payments difficulties. Debt service payments fell from US $10.3 to US $7.7 billion; exports as a proportion of the official foreign debt grew from 28% to 43%; the debt service ratio fell from 67% to 33%; and the external public debt as a percentage of GDP declined from 22.1% to 18.5%.

6. When in the summer of 1981 the oil market suddenly turned soft, there were divided views within the government of how to react. The head of Pemex at the time, a self-made millionaire, favoured an aggressive marketing policy: he wanted to lower prices by whatever amount was needed to maintain the necessary volume of exports to achieve the desired revenues. But his colleagues in the government condemned this policy as disloyal to OPEC and unnecessarily submissive to pressures from the industrialised countries. He was overruled and disgraced. The President lent his prestige to the view that the market weakness would be short-lived, that Mexico should not damage its Third World credentials by under-cutting OPEC producers, and that the country's high credit

rating would enable it to increase borrowing to offset the short-fall in export income. The outcome was the worst of both worlds for Mexico. Pemex lost clients, and forfeited export revenue in trying to maintain high prices against the market. Within two months it was forced to reduce prices after all. From then on the self-imposed ceilings on production and exports became embarrassingly difficult to achieve. The shortfall was made up by foreign borrowing, much of it short term. As the general terms of trade for Mexico worsened, oil constituted an ever increasing proportion of export revenues. Earlier talk about the importance of avoiding the mistakes of Iran and Venezuela seemed ironically prophetic as the country slid deeper into oil dependence.

7. The next factor was overvaluation of the Mexican peso. The forced devaluation of 1976, after a long period of currency stability, had been a traumatic event for the Mexicans, who were used to assessing the value of things in dollars rather than in their own currency. President Lopez Portillo wanted to heal the wound. In theory the peso floated after 1976, but apart from a 10% drop in one day in 1977, it was in practice fixed. Ministers argued that control was necessary to restore internal and external confidence. Any devaluation would, they argued, increase the burden of servicing Mexico's foreign debt without in practice giving much help to exporters, as the booming internal market left little surplus capacity for exports. But the adverse impact on non-oil exports and tourism became more and more apparent. Given the degree of dependence of the Mexican on the US economy and the difference in inflation rates between the two countries, it was obvious that the fixed rate could not last much longer.

8. In late 1980 the Government at last changed course, and began a controlled downward movement of the peso. But as the rate of devaluation was less than the inflation differential, the peso continued to become more rather than less over-valued. The Government feared that speeding up the rate of devaluation would make people believe that a headlong slide was imminent and thereby precipitate a flight of capital. Again the outcome was that Mexico got the worst of both worlds. It exhausted its reserves in a prolonged but vain attempt to prop up the currency, giving plenty of time for small savers as well as speculators to move their capital out of the country, only to have the currency collapse at a most inopportune and damaging moment. President Lopez Portillo's famous phrase, the source of endless merriment, was that he would fight like a dog to defend the peso. He now lives in a house on what is known to all as the Cerro del Perro, the Hill of the Dog.

9. From 1976 onwards subsidies were an integral part of the Government's management of the economy. It is easy to see why. Mexico is a country with great inequality in the distribution of resources. Despite 60 years of government by a revolutionary party supposedly representing workers and peasants, contrasts of wealth and poverty are still enormous. Although the poor are used to their poverty, and have a tradition of stoic fatalism, the oil boom inevitably generated rising expectations. Every few weeks in the first years of the Lopez Portillo administration, there was fresh news of oil discoveries in Mexico, of rising prices in the international market, and of soaring export revenues. Everyone hoped to benefit from this sudden turn in the country's fortunes: but only some did. The private sector of industry mostly flourished. Officialdom, at federal, state and local level, benefitted more than was healthy: corruption, which is endemic in Mexico, reached unprecedented proportions as businessmen became used to giving, and officials to receiving, ever more lavish gifts for favours received or expected. But the peasants scraping a living from semi-barren land the slum-dwellers with no fixed employment benefitted scarcely at all.

10. In such circumstances the price of social stability was a system of subsidies designed to give the poor a share in the benefits of the new wealth and limit the worst effects of inflation through control of the prices of basic goods and services. The cost of this policy grew explosively during President Lopez Portillo's administration, reaching 15% of GDP in 1982: this was perhaps the main contributing factor to the growth of the public sector deficit which that year reached about 16% of

GDP. Naturally the Government took fright, but its eventual efforts to cut the cost made a bad situation worse: such efforts usually consisted of holding down the price paid to producers rather than raising the price to consumers. In this way certain vital economic activities, in particular agriculture, became unprofitable. The country's sugar refining industry was ruined. Dairy farms were abandoned. The pharmaceutical industry got into deep difficulties. Companies were forced to raise prices on other products to reduce losses on those that were controlled. The Government found itself obliged to import sugar, milk, eggs and other essential products at vast cost in cash and foreign exchange. It also held down the price of petrol, which was unchanged from 1974 to 1981. With the cheapest petrol in the world, Mexico became one of the most wasteful countries in terms of energy consumption.

11. Lastly I come to inflation. An influential group of Ministers in the Lopez Portillo Administration believed that in Mexico's case inflation reflected an imbalance between supply and demand, and that it could only be reduced by increasing supply, not by restraining demand. Such Ministers did not accept, even in 1981, that the economy had become over-heated. In this they received support from economists at Cambridge University where some had studied and with whom they had maintained contact. A Cambridge study in late 1981 concluded that "the planned rate of growth is not too high relative to the country's productive capacity and consequently it is not generating inflation".

12. Not all Ministers took this view. Lic de la Madrid, then Minister of Planning and a typical representative of the conservative financial establishment, was expressing concern as early as 1979 at the size of the budget deficit and at the inflationary impact of maintaining a growth rate of 8% at a time of world recession. But in the critical discussions in the cabinet the expansionists usually won the argument. President Lopez Portillo wanted to go down in history as the man who created 5 million jobs to match the relentless growth in the population (still running at over 2½% a year). He could not resist the arguments of those who said that the only alternative to his policies would bring recession and unemployment. In the end he had both, with inflation of about 100%.

13. President de la Madrid is well aware of the mistakes which led to Mexico's present plight. Although he was a prominent member of the Lopez Portillo Administration (a fact which he will not be allowed to forget), his inaugural speech on 1 December 1982 was in effect an indictment of the errors and follies of the previous six years. His own policies are designed to set the country on a new course, and with IMF support to rid the economy of the deep ills which still afflict it. As I have already reported, there is no doubt of his good intentions. But he has yet to show whether he has the political qualities and strength to carry them into effect.

14. I am sending copies of this despatch to HM Representatives at Washington, Brasilia, Caracas, Bogota, UKRep Brussels and UKDel IMF/IBRD, and to HM Treasury, the Department of Trade, Export Credits Guarantee Department and the Bank of England.

I am, Sir

Yours faithfully

Crispin Tickell