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WHAT REAGAN SHOULD KNOW AS HE HEADS FOR MEXICO

(Updating *Backgrounder* No. 588, "Deja Vu of Policy Failure: The New $14 Billion Mexican Debt Bailout," June 25, 1987.)

On Ronald Reagan's February 13 visit to Mexico City to meet with Mexican President Miguel de la Madrid Hurtado, that country's economic difficulties will be a principal topic of discussion. A recent, much publicized plan devised by Mexico and Morgan Guaranty Trust Company, that could retire as much as $20 billion of Mexico's $110 billion foreign debt, is raising hopes that Mexico's debt problems are nearing resolution. Hope too springs from recent decisions by Mexico to liberalize its trade and investment regulations. Reagan should congratulate de la Madrid on these reforms. But he should also emphasize that Mexican economic growth requires much more substantial reforms--cutting the size of the public payroll, privatizing state-owned industries, and trimming government regulations much further.

Breaking the Cycle. The debt crisis, caused by Mexico's mismanagement of its economy, has created a vicious cycle of new borrowing to meet interest payments on past loans, which then generates additional debt and requires even more new loans in the future. The new initiative, worked out by Mexico with the assistance of Morgan Guaranty, helps break this cycle. Under the Morgan plan, Mexico will spend about $2 billion of its dollar reserves to purchase U.S. Treasury bonds worth $10 billion at maturity in twenty years. These will be used as collateral for new Mexican government bonds that Mexico will give to creditor banks. In exchange for these new bonds with their hard currency backing, the banks will forgive part of the old debt owed them by Mexico. Mexico hopes to arrange this "debt-for-debt swap" at a 50 percent discount, thus retiring about $20 billion of its existing debt for the $10 billion in new bonds.

Mexico's creditors so far are responding cautiously to the Morgan Plan. While the new bonds, which represent $10 billion owed by Mexico, are secured by U.S. government bonds as collateral, the periodic interest that Mexico must pay to holders of these bonds until their maturity is unsecured. These interest payments represent 85 percent of the total funds creditors are to receive under this arrangement. Many bankers also believe that Mexico's economy will grow stronger.

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If so, then the debt now held by the bankers is worth more than 50 cents on the dollar. And some banks simply do not want to take a 50 percent loss on their loans at this time.

Flirting with the Free Market. Despite the hesitation, the Morgan Plan is a creative means to take some financial pressure off Mexico. Much more crucial, of course, will be what Mexico does to move its heavily regulated economy in a free-market direction. Some recent developments are promising. In 1986, Mexico entered the General Agreement on Tariffs and Trade (GATT) to bring its trade practices in line with those of most other countries. Restrictive import quotas have been replaced with less restrictive tariffs. Then last November, the U.S. and Mexico agreed to a framework for negotiating freer trade in textiles, steel, agriculture, and other areas. And some exceptions have been granted to Mexico's law limiting foreign investors to no more than 49 percent ownership of an enterprise in Mexico. Several foreign firms, including Ford Motor Company, IBM Corporation, and Nissan Motor Corporation, have been allowed 100 percent ownership.

Though these moves are welcome, government domination of the economy remains the major cause of Mexico's economic stagnation. The Mexican budget deficit climbed from 16 percent of gross domestic product (GDP) in 1986 to 18.5 percent in 1987 due to high government spending. The U.S. budget deficit for fiscal 1987 was 3.6 percent of GDP. Mexican government expenditures as a percent of GDP rose from 46 percent in 1985 to 54 percent last year. Government employees now number some 4.35 million, up from 3.71 million in 1982.

Voting Fraud. Privatization of state-owned firms has been extremely slow, even though the Mexican government claims that it has halved the number of such firms since 1982. Only a few significant state enterprises have been divested or dissolved. The biggest state companies remain untouched. Among them are Conasupo, the agricultural marketing board; CFE, the federal electric company; Fertimex, the state fertilizer monopoly; the government railway system; and the Mexico City underground transit system. These enterprises annually lose large amounts of money, requiring huge fiscal subsidies. The 1987 bank privatization involved only a third of the banks nationalized in 1982, and this was done through vastly underpriced shares offered privately to friends of the government.

The Mexican presidential election scheduled for this July also threatens to stall economic reforms. The ruling Institutional Revolutionary Party (PRI), for years the only legal party, has not lost a presidential election since it took power in 1929. Another problem is that mounting anger over voting fraud by the PRI is undermining the regime's legitimacy. Fraud in this year's election could threaten political instability, which would frighten businessmen away from economic activity in Mexico.

Congratulating Mexico. Reagan should congratulate the Mexicans on their recent debt initiative and trade reforms. He also should raise the possibility of a Free Trade Area between the two countries, which would remove all tariffs and many non-tariff barriers. Such an arrangement would promote strong economic growth in both countries. Finally, Reagan should make clear that only by freeing the creative energies of Mexican workers and businessmen can Mexico attract back the tens of billions of dollars its citizens have sent abroad.

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