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ECONOMIC PROSPECTS AND POLICIES IN MEXICO

Bela Balassa

May 1986

* This is a revised version of a paper originally presented at the Conference on "Industrial Organization, Trade and Investment in North America: U.S.A., Canada and Mexico," held in Merida, Mexico on December 16-18, 1985. The author is indebted to Conference participants for helpful discussions and to Javier Alejo, Gerardo Bueno, and Clark Reynolds for their valuable comments on the paper. The author alone is responsible, however, for its contents that should not be interpreted to reflect the views of the World Bank.
Abstract

This paper was originally presented at the Conference on "Industrial Organization, Trade and Investment in North America: U.S.A., Canada, and Mexico," held in Merida, Mexico on December 14-18, 1985. It was subsequently revised to take account of the implications of the precipitous fall of oil prices.

The paper proposes the adoption of an aggressive exchange rate policy, accompanied by import liberalization for Mexico. It also recommends reducing the public sector deficit; liberalizing financial markets; denationalizing public firms outside basic industries and improving the operation of others; reforming existing regulations to conform to the needs of a modern economy; and taking measures to increase Mexico's attractiveness to foreign investment. It is further suggested that current inflation rates cannot be maintained for a protracted period, eventually necessitating monetary reform.
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The paper set out to examine Mexico's possibilities in the world economy in general and in the North American area in particular, and to consider the choice of policies that may be applied to exploit its possibilities to best advantage. This is of especial interest today as the precipitous decline in oil prices has aggravated the problems associated with Mexico's large external debt. At the same time, these problems cannot be separated from the country's overall development strategy and the paper will consider them in this context.

As an introduction to the discussion, Section I will review the policies applied in Mexico during the 1973-83 decade of external shocks. In turn, Section II will examine the extent to which Mexico has exploited its comparative advantage in trade in manufactured goods. Finally, Section III will focus on policies that may permit Mexico to cope with its debt problem and to ensure rapid and sustained economic growth in the future.


The author has estimated the balance-of-payments effects of external shocks, and of the policies applied, for the 1973-78 and the 1978-83 periods (Balassa, 1981 and 1986a). External shocks have been defined as large, unanticipated changes in world economic conditions. They include shifts in the terms of trade, associated to a large extent with changes in oil prices, and the slowdown in the growth of world export demand, associated with world recessions. In the second period, increases in interest rates in world financial markets also come under this heading.
The methodology applied involves estimating the balance-of-payments effects of external shocks, including terms of trade and export volume effects and, in the second period, interest rate effects, as well as those of the policies applied, including additional net external financing, export promotion, import substitution, and deflationary measures. The base year for the calculations pertaining to the 1973-78 period is the average for the years 1971-1973; it is the average for the years 1976-78 for the 1978-83 period.

The balance-of-payments effects of external shocks have been derived by postulating a situation that would have existed in the absence of such shocks. Terms of trade effects have been estimated as the difference between the current price values of exports and imports and their constant price values, estimated in the prices of the relevant base period. They have further been decomposed into a 'pure terms of trade effect,' and an unbalanced trade effect. The former has been calculated on the assumption that the balance of trade expressed in base year prices was in equilibrium; it thus abstracts from the impact of price changes on the deficit (surplus) in the balance of trade that comes after the latter heading.

The balance-of-payments effects of the slowdown of foreign demand on the exports of the less developed countries, or export volume effects, have been estimated as the difference between the trend value of exports and hypothetical exports. The trend value of exports has been derived on the assumption that the growth rate of foreign demand for the country's traditional export products and for the exports of fuels, non-traditional primary commodities, and manufactured goods remained the same as in the 1963-73 period and that the country concerned maintained its base year share in these exports. In turn, hypothetical exports have been derived on the
assumption that the country maintained its base year share in the actual
exports of these products and product groups during the period under
consideration.

Finally, the balance-of-payments effects of increases in interest
rates have been estimated as the difference between actual net interest
payments and the payments that would have been made if interest rates remained
at the average 1976-78 level. The calculation has been made by utilizing
London Eurodollar rates for one year deposits.

In estimating the balance-of-payments effects of the policies
applied, additional net external financing has been derived as the difference
between the actual merchandise trade balance and the trade balance that would
have obtained if trends in imports and exports observed in the 1963-73 period
continued and the prices of exports and imports remained at their base year
level. Similar calculations have not been made for services and private
transfers, except that interest payments have been included in the estimates
in the 1978-83 period. 1/

The effects of export promotion have been calculated as changes in
exports resulting from changes in the country's base year export market
shares. In turn, import substitution has been defined as savings in imports
associated with a decrease in the income elasticity of import demand for fuel
and non-fuel imports of the country concerned, compared with the 1963-73
period. Finally, the effects of macroeconomic policies on imports have been

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1/ It would be of interest to make such calculations in the future, so as to
indicate the effects of external shocks, and policy responses to these
shocks, on tourism, border trade, and the maquila industries in Mexico.


Table 1

Balance of Payments Effects of External Shocks and of the Policies Applied: Mexico

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<tbody>
<tr>
<td>External shocks (as percent of GNP)</td>
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<td></td>
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<tr>
<td>Terms of trade effects</td>
<td>-1.1</td>
<td>1.9</td>
<td>0.8</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.7</td>
<td>0.8</td>
<td>-0.9</td>
<td>-2.5</td>
<td>-5.7</td>
<td>-5.8</td>
<td>-2.9</td>
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<tr>
<td>Pure</td>
<td>-0.7</td>
<td>-0.5</td>
<td>-1.2</td>
<td>-1.8</td>
<td>-2.4</td>
<td>-1.4</td>
<td>-0.1</td>
<td>-3.5</td>
<td>-5.4</td>
<td>-5.8</td>
<td>-0.9</td>
<td>-3.2</td>
</tr>
<tr>
<td>Unbalanced</td>
<td>1.9</td>
<td>2.4</td>
<td>2.0</td>
<td>1.7</td>
<td>2.4</td>
<td>2.1</td>
<td>0.9</td>
<td>2.4</td>
<td>2.9</td>
<td>0.1</td>
<td>-4.9</td>
<td>0.3</td>
</tr>
<tr>
<td>Export volume effects</td>
<td>0.2</td>
<td>0.5</td>
<td>0.3</td>
<td>0.7</td>
<td>0.7</td>
<td>0.5</td>
<td>0.1</td>
<td>0.5</td>
<td>0.8</td>
<td>1.1</td>
<td>1.5</td>
<td>0.8</td>
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<tr>
<td>Interest rate effects</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1.3</td>
<td>2.1</td>
<td>3.5</td>
<td>4.6</td>
<td>2.4</td>
<td>2.8</td>
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<tr>
<td>Total</td>
<td>1.3</td>
<td>2.4</td>
<td>1.2</td>
<td>0.6</td>
<td>0.6</td>
<td>1.2</td>
<td>2.1</td>
<td>1.7</td>
<td>1.7</td>
<td>-0.1</td>
<td>-2.0</td>
<td>0.7</td>
</tr>
<tr>
<td>Total less unbalanced terms of trade effects</td>
<td>-0.5</td>
<td>0.1</td>
<td>-0.9</td>
<td>-1.1</td>
<td>-1.7</td>
<td>-0.9</td>
<td>1.2</td>
<td>-0.7</td>
<td>-1.2</td>
<td>-0.1</td>
<td>-2.9</td>
<td>0.4</td>
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</table>

The policies applied (as percent of external shocks)

| Additional net external financing | 240.2 | 151.5 | 140.5 | -94.7 | -16.9 | 123.1    | 127.4 | 222.3 | 313.2 | -4413.9 | -646.3 | -129.2  |
| Export promotion                | -47.1 | -28.1 | -112.3 | -206.3 | -66.7 | -70.4    | -61.0 | 131.1 | 171.9 | 4860.7 | 274.2 | 467.4   |
| Import substitution             | -84.3 | -21.4 | 55.6  | 322.6 | 137.3 | 33.5     | -76.9 | -231.6 | -361.7 | -1028.7 | 186.8 | -269.1  |
| Effects of deflationary policies| -8.8  | -1.9  | 16.2  | 78.5  | 46.3  | 13.8     | -11.4 | -21.8 | -23.4 | 481.9 | 85.2 | 31.0    |
| Additional net external financing/GNP | 3.2  | 3.7  | 1.6  | -0.5 | -0.1 | 1.5      | 2.7  | 3.7  | 5.3  | -3.4 | -12.7 | -0.9    |
| Export promotion/exports        | -17.7 | -21.1 | -42.0 | -38.1 | -10.4 | -24.7    | 19.8  | 31.4 | 38.9 | 44.2 | 50.2 | 38.9    |
| Import substitution/imports     | -13.4 | -6.6  | 9.6   | 33.4  | 12.6  | 5.7      | -17.3 | -33.0 | -43.6 | -9.1 | 88.7 | -18.7   |
| Lower GNP growth effects/imports| -1.4  | -0.6  | 2.8   | 8.1   | 4.3   | 2.4      | -2.5  | -3.1 | -2.8 | 4.3  | 40.5 | 2.2     |


Note: Interest rate effects were assumed to be zero in the 1974-78 period.
estimated by taking the difference between actual GNP growth rates and the
growth rate of the 1963–73 period and assuming unchanged income elasticities
of import demand.

This paper reports the estimates made for Mexico. Table 1 shows the
balance-of-payments effects of external shocks, and of the policies, applied
on an annual basis. The annual data are of particular interest because of the
changes that occurred in Mexico's petroleum exports. In the following
discussion, the two periods of external shocks will be separately considered.

1973–1978

With its trade balance in petroleum turning positive, pure terms of
trade effects became increasingly favorable for Mexico during the first period
of external shocks. Towards the end of the period, they came to offset the
adverse unbalanced terms of trade effects that find their origin in Mexico's
large deficit in merchandise trade more than compensating for increases in the
adverse volume effects owing to the world recession and the subsequent slow
growth of the world economy. Correspondingly, after rising from 1.3 percent
in 1974 to 2.4 percent in 1975, the negative balance-of-payments effects of
external shocks decreased to 0.6 percent of the gross national product in 1978
(the results become favorable if unbalanced terms of trade effects are
excluded from the calculations, with a gain of 1.7 percent).

In view of the small magnitude of external shocks during the first
period, it may not be appropriate to speak of policy responses to these shocks
in Mexico. In fact, the policies applied were largely autonomous, with the
expansionary measures applied by President Echevarria until 1976 followed by
deflationary policies in 1977 and expansionary measures again taken in 1978
under President López Portillo. Nevertheless, the methodology applied retains
its usefulness in the present case of Mexico as it permits examining quantitatively the effects of the policies applied in a consistent framework.

The expansionary measures applied by President Echevarría involved increasing the share of public expenditure in the gross domestic product from 17 percent in '1972' to 28 percent in 1976. With the lack of a commensurate rise in revenues, the deficit of the public sector reached 9 percent of GDP in 1976, compared with 2 percent in '1972.' 1/ The deficit was increasingly financed by foreign borrowing that provided more than one-half of the net financial requirements of the public sector in 1976.

Foreign borrowing made it possible for Mexico to maintain the exchange rate at 12.50 pesos to the U.S. dollar until September 1976, even though domestic prices rose more rapidly than foreign prices (Table 2). The resulting deterioration in Mexico's competitive position led to declines in export market shares that came to represent a loss of 28 percent in export value in 1977. The loss was even larger, 35 percent, if one excludes the exports of petroleum from newly-found deposits. It declined to 22 percent (excluding petroleum) in 1978, reflecting the effects of the devaluations of the peso undertaken in September 1976 and in the course of 1977 (Table 3).

In the 1974-78 period, taken as a whole, a decline of 20 percent occurred in Mexico's average export market share, excluding petroleum. In particular, its market share in the manufactured exports of the developing countries fell by one-half between "1972" and 1977 and rebounded only slightly

1/ The data represent a revision compared with Balassa, 1983. The following discussion relies on this paper as well as on Balassa, 1981.
Table 2

Changes in Real Exchange Rates in Mexico
(1976-78 = 100)

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<td>Exchange rate</td>
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<td>Peso/US$ Index</td>
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<td>Wholesale price index</td>
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<td>U.S. wholesale price index</td>
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<td>Index of relative price vis-à-vis U.S.</td>
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<tr>
<td>Real exchange rate vis-à-vis U.S.</td>
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<td>Real effective exchange rate</td>
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Note: The real effective exchange rate has been calculated by weighting with the composition of Mexico's trade in 1976-78. The estimates are averages of monthly estimates, so that there are some small discrepancies if one wishes to translate one row into another in the table.
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<tr>
<td>Exchange rate</td>
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<td>Peso/US$ Index</td>
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<td></td>
<td>102.0</td>
<td>114.2</td>
<td>126.1</td>
<td>138.0</td>
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<td>503.7</td>
<td>563.8</td>
<td>622.6</td>
<td>681.5</td>
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<tr>
<td>Wholesale price index</td>
<td>563.5</td>
<td>683.7</td>
<td>771.7</td>
<td>856.6</td>
</tr>
<tr>
<td>U.S. wholesale price index</td>
<td>153.7</td>
<td>154.2</td>
<td>155.7</td>
<td>156.5</td>
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<tr>
<td>Index of relative price vis-à-vis U.S.</td>
<td>369.6</td>
<td>446.9</td>
<td>499.6</td>
<td>551.9</td>
</tr>
<tr>
<td>Real exchange rate vis-à-vis U.S.</td>
<td>127.3</td>
<td>127.3</td>
<td>125.5</td>
<td>124.5</td>
</tr>
<tr>
<td>Real effective exchange rate</td>
<td>130.8</td>
<td>120.4</td>
<td>117.8</td>
<td>116.9</td>
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in 1978. Mexico further experienced losses in primary exports, especially in cattle, meat, and sugar.

The appreciation of the real exchange rate also gave rise to negative import substitution in Mexico, represented by an increase in the income elasticity of import demand. Import substitution turned positive in 1976 in response to the tightening of import controls and increases in tariffs, with the devaluation of the exchange rate providing further incentives to the replacement of imports by domestic production.

Finally, the application of expansionary measures contributed to the acceleration of the growth of imports in the early part of the period, followed by a deceleration as deflationary measures were applied. However, the effects of these measures were partially undone in 1978, when expansionary policies were again adopted under President López Portillo.

All in all, the policies applied discriminated against exports, owing both to the overvaluation of the exchange rate and increased import protection. The adverse effects of the resulting losses in export market shares on Mexico's balance of payments were only partially offset by import substitution. At the same time, notwithstanding the virtual absence of external shocks, Mexico accumulated foreign debt that came to attain 33 percent of the gross national product in 1978, compared with 9 percent in 1971-73, on the average.

1978-1983

Favorable pure balance-of-payments effects increased further after 1979, exceeding the adverse unbalanced terms-of-trade effects by widening margins. As a result, despite the rise of the unfavorable export volume effects, the balance-of-payments impact of external shocks other than interest
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</thead>
<tbody>
<tr>
<td>Fuel exports</td>
<td>+10.8</td>
<td>+347.6</td>
<td>+348.5</td>
<td>+578.0</td>
<td>+1277.9</td>
<td>+509.0</td>
<td>+137.2</td>
<td>+330.7</td>
<td>+543.4</td>
<td>+762.4</td>
<td>+864.3</td>
<td>+476.1</td>
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<tr>
<td>Non-fuel primary exports</td>
<td>-7.3</td>
<td>-9.4</td>
<td>-17.5</td>
<td>-17.9</td>
<td>2.6</td>
<td>-9.8</td>
<td>-1.1</td>
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<td>2.5</td>
<td>-8.6</td>
<td>-2.0</td>
<td>-2.3</td>
</tr>
<tr>
<td>Manufacturing exports</td>
<td>-24.5</td>
<td>-36.3</td>
<td>-49.7</td>
<td>-50.0</td>
<td>-43.6</td>
<td>-41.9</td>
<td>-8.4</td>
<td>-30.1</td>
<td>-41.1</td>
<td>-27.0</td>
<td>18.3</td>
<td>-16.3</td>
</tr>
<tr>
<td>Total exports</td>
<td>-15.1</td>
<td>-17.5</td>
<td>-29.6</td>
<td>-27.6</td>
<td>-9.5</td>
<td>-19.8</td>
<td>24.7</td>
<td>45.7</td>
<td>63.7</td>
<td>79.1</td>
<td>100.7</td>
<td>63.8</td>
</tr>
<tr>
<td>Total exports other than fuels</td>
<td>-15.4</td>
<td>-21.8</td>
<td>-33.9</td>
<td>-34.5</td>
<td>-22.2</td>
<td>-25.9</td>
<td>-3.9</td>
<td>-13.6</td>
<td>-16.4</td>
<td>-16.4</td>
<td>7.3</td>
<td>-8.3</td>
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rate effects became increasingly positive, reaching 4.6 percent in 1982. (Unbalanced terms-of-trade-effects were practically nil in that year.)

Petroleum prices declined in 1983 but this was compensated by the fact that unbalanced terms-of-trade effects turned favorable as Mexico drastically cut its imports in response to the debt crisis. At the same time, given its high and rising indebtedness, Mexico experienced large adverse interest rate effects as world interest rates rose.

Increases in oil revenues fueled the expansionary policies adopted by President López Portillo. These revenues did not suffice, however, to finance the rising public expenditures, in particular public investment, and transfer payments. By 1981, the share of public expenditures in the gross domestic product reached 47 percent and the public sector deficit came to amount to 13 percent of GDP.

The financing of the large public sector deficit, in turn, required foreign borrowing. This borrowing permitted maintaining the exchange rate in the range of 22.5 to 24.5 pesos to the dollar between 1977 and 1981, notwithstanding the acceleration of inflation resulting from the application of expansionary policies. As a result, by the fourth quarter of 1981, the exchange rate appreciated in real terms by 35 percent vis-à-vis the currencies of Mexico's trading partners, compared with the 1976-78 average.

Borrowing abroad reinforced the adverse effects of increased petroleum exports on the non-oil tradeable goods sector. Even in the absence of foreign borrowing, the balance of payments would have been equilibrated at an exchange rate unfavorable for non-oil exports and import substitution. The foreign financing of the current deficit, amounting to 5 percent of the gross
domestic product in 1983, thus further aggravated the situation for the non-oil tradable sector.

As a result, Mexico suffered a 16 percent loss in export market shares between 1976–78 and 1981, excluding fuels. The losses were concentrated in manufactured goods, where Mexico experienced a 41 percent decline in export market shares. In turn, the slight gain of 3 percent in nonfuel primary exports is explained by the United States while Mexico suffered considerable losses in the exports of cattle, meat, and tomatoes.

Mexico further experienced negative import substitution, reflecting in part the overvaluation of the exchange rate and in part the spillover effects of rapid economic expansion. Also, the expansionary fiscal policies applied also contributed directly to the rise of imports as shown by the negative macroeconomic effects in Table 1.

The situation changed in August 1982, when Mexico ceased to be creditworthy for commercial bank lending. Additional net external financing turned strongly negative and imports were reduced to a considerable extent. Substantial declines in imports occurred as a result of the direct and indirect effects of deflationary policies, the application of import controls, and a large devaluation of the exchange rate.

The large devaluations undertaken in the course of 1982 and 1983 contributed to the expansion of exports and, in 1983, Mexico had a gain in its market shares for non-fuel exports. This was the result of an increase of 18 percent, compared with the 1976–78 average, in the exports of manufactured goods, and a 2 percent loss in nonfuel primary exports. Increases in export market shares contributed to the financing of interest payments on the foreign debt without, however, appreciably affecting Mexico's external debt.
Thus, Mexico remained saddled with a large foreign debt that was the result of the excessively expansionary policies applied during much of the period under consideration. Nor did this policy bring the expected gains in terms of economic growth. According to calculations made by the World Bank, between 1972 and 1982, annual increases in industrial output of 7.5 percent necessitated increases of 13.5 percent in the capital stock and 3.3 percent in labor, representing a decline of 0.7 percent a year in total factor productivity, and per capita agricultural output declined. Furthermore, the gross domestic product fell by 5.3 percent in 1983.

II. Exploiting Mexico's Comparative Advantage in Manufactured Goods

Having reviewed the policies applied during the 1973-83 decade, and the effects of these policies, the paper will next analyse the pattern of Mexico's comparative advantage in manufactured goods. This will be done by utilizing a two-stage procedure, described in Balassa, 1979.

In the first stage, indices of revealed comparative advantage, calculated as the ratio of a country's share in the world exports of individual commodity categories to its share in the world exports of all manufactured goods, were regressed on variables representing the capital intensity of the individual commodity categories. The calculations have been
made for 38 developed and developing countries by using a stock as well as a
flow concept of capital, both of which include physical and human capital. 1/
The estimating equation is shown in (1), where $x_{ij}$ is the index of
revealed comparative advantage of country j in commodity category i, $k_i$ is
the ratio of capital to labor (capital intensity) for commodity category i,
and the $\beta$ -coefficient for country j indicates the percentage change in the
country's comparative advantage index associated with a one percentage change
in capital intensity. A positive (negative) $\beta$ -coefficient thus shows that a
country has a comparative advantage in capital (labor) intensive commodities,
while the numerical magnitude of the $\beta$ -coefficient indicates the extent of
the country's comparative advantage in capital (labor) intensive commodities.

\begin{equation}
\log x_{ij} = \log \alpha_j + \beta_j \log k_i
\end{equation}

Next, the hypothesis was tested that intercountry differences in the
$\beta$ -coefficients can be explained by differences in country characteristics
that determine the pattern of comparative advantage. This test was performed
by regressing the $\beta$ -coefficients estimated for the individual countries on
variables representing their physical (CDICAP) and human (HMIND) endowments in
an intercountry framework.

1/ The stock measure has been derived by adding to the value of the physical
capital stock, established as the depreciated value of investments
undertaken over the past fifteen years, the present value of the
difference between average and unskilled wages, taken to represent
investment in human capital. In turn, the flow measure of capital has
been defined as value added less the unskilled wage. In all cases, the
ratio of capital to worker has been used in the calculations. The data
derive from U.S. statistics.
\( \beta_j = f (G\text{DICAP}_j, H\text{MIND}_j) \)

The estimates made for 1971 show that intercountry differences in the structure of exports are in large part explained by differences in physical and human capital endowments, both of which are highly significant statistically. These results were reconfirmed by estimates for the year 1979 (Balassa, 1986b).

In the present case, however, the focus of interest is Mexico. In both 1971 and 1979, the \( \beta \)-coefficients for Mexico had the expected negative sign. For 1971, the coefficients, estimated by utilizing equation (1), were \(-0.47\) and \(-0.29\) using the stock and the flow measures of capital, respectively. Coefficient values increased between 1971 and 1979; they reached \(-0.19\) using the stock measure and \(-0.09\) using the flow measure of capital. These changes may be explained by the fact that the accumulation of physical and human capital in Mexico between 1971 and 1979 much exceeded the average; it was surpassed by only four countries during the period.

Considerable differences remained, however, in Mexico's relative position in terms of physical as compared to human capital. In 1971, Mexico was in 26th place in regard to the former and 33rd place in regard to the latter, whereas the corresponding rankings were 22nd and 31st in 1979. The results indicate the existence of a bias in Mexico's capital endowment inasmuch as the accumulated physical capital was not accompanied by corresponding changes in human capital. This fact reflects a weaker educational effort in Mexico compared with other countries, in particular those of the Far East. Thus, in 1979, Mexico was ahead of Korea and Taiwan in
terms of physical capital but it was considerably behind them in terms of human capital.

At the same time, the $\beta$-coefficients derived in the first stage equation (or the actual coefficients) are considerably higher than those obtained in the second stage equation (or the expected coefficients), indicating that Mexico's manufactured exports were much more capital-intensive than expected on the basis of its physical and human capital endowment relative to other countries. Nor did this relationship change appreciably between 1971 and 1979. In 1971, the expected $\beta$ coefficient, estimated from equation (2), was -0.93 using the stock measure, and -0.84 using the flow measure, of capital; the corresponding coefficients were -0.98 and -0.88 in 1979.

The explanation for this persistent deviation appears to lie in the policies applied, which did not permit exploiting Mexico's comparative advantage in manufactured goods indicated by the expected $\beta$-coefficient derived in cross-country relationships. High import protection, low duties on capital equipment, the repeated overvaluation of the peso, and distortions in factor prices, with low interest rates, and social legislation favoring capital-intensive activities, contributed to the exportation of commodities that were substantially more capital intensive than warranted by Mexico's physical and human capital endowment. It is apparent that these policies have imposed a considerable cost on the Mexican economy by distorting production and trade patterns.

The observed large deviation between the actual and the expected values of the $\beta$-coefficients for Mexico makes it difficult to make projections for the future. Two possible alternatives present themselves;
postulating that Mexico will asymptotically approach the cross-country relationship between capital endowments and the relative capital intensity of exports or assuming that the observed deviations from the cross-country pattern will persist over time. In the first case, one may utilize equation (2) to estimate the $\beta$ -coefficients corresponding to Mexico's physical and human capital endowment for some future year; in the second case, the estimate is adjusted for deviations between actual and expected values of the $\beta$ -coefficients in the base year, 1979.

Projections were made for the year 2000 by postulating that Mexico would reach Spain's 1979 physical capital endowment, representing an increase by nine-tenths compared with 1979 values in Mexico, and Argentina's 1979 human capital endowment, representing an approximate doubling compared with 1979 values in Mexico. These projections reflect the assumption that Mexico would reduce, but not eliminate, its lag in the accumulation of human capital.

Utilizing equation (2), Mexico's expected $\beta$ -coefficients in the year 2000 would reach -0.61 using the stock and -0.53 using the flow measure of capital. 1/ While these expected values are considerably lower than those estimated for 1979 from the same equation, they continue to exceed the actual values of the $\beta$ -coefficients for 1979, estimated from equation (1). The projected values would be 0.18 and 0.27 if one assumed that the differences between the values of the actual and the expected $\beta$ -coefficients observed in 1979 would persist until 2000.

1/ These projections pertain to a situation that would be obtain if Mexico's physical and human capital endowments would increase without changes in other countries.
The latter alternative has little to commend it, however, as it would mean maintaining the present, excessively capital-intensive, structure of Mexican exports. In fact, reaching Spain's 1979 physical capital endowment, and Argentina's human capital endowment, should not lead to a positive $\beta$- coefficient for Mexico, representing the preponderance of capital-intensive exports.

These conclusions are strengthened once we admit the fact that other countries, and not only Mexico, accumulate physical and human capital. Also, with rapid wage increases in Far Eastern countries and the decline of Mexican wages in terms of dollars following the recent devaluations, wages are now higher in the Far East than in Mexico, thereby improving Mexico's competitive position in labor-intensive activities. Such is the case, in particular, in the North American area where much of Mexico's exports are sold and where it enjoys the benefits of geographical proximity.

At the same time, it should not be assumed that labor intensity is synonymous with the textile, clothing, and shoes industries, which the U.N. Economic Commission for Latin America called 'vegetative industries.' While Mexico has possibilities for expanding its clothing and shoe exports, textiles have increasingly become a capital-intensive industry and there are other labor-intensive activities that hold considerable promise for Mexico.

These activities include, first of all, agriculture that was once a net exporting sector but, with an increased bias of the incentive system against exports and against agriculture in general, became a net importer. With appropriate incentives, Mexico can exploit its comparative advantages in agriculture that is a highly labor-intensive sector.
Agriculture, in turn, can provide the basis for the expansion of agro-industry, including traditional processed foods as well as new products derived from agriculture. Examples are dehydrated fruits and vegetables, prepared food, and feed supplements, involving the extraction of protein from sugar cane and other low-valued products.

Mexico also has considerable potential in tourism, in border trade, and in maquila industries. The last point, in turn, leads to the question of Mexico's comparative advantages in labor-intensive products. Apart from products using largely unskilled labor, such as leather goods, sisal products, toys, and sporting goods, Mexico has a potential in products using semi-skilled labor, such as machinery and transport equipment, where it can participate in the international division of the production process by manufacturing labor-intensive parts and components as well as undertaking assembly activities. This would, however, require a far-reaching policy reform in the short and medium run and an increased educational effort in the medium and longer run. The next section of the paper will deal with the requirements of such a policy reform.

III. Policy Reforms for Structural Adjustment and Economic Growth

Economic policies in Mexico would have to serve the double objectives of coping with the debt situation, which was aggravated by the precipitous decline in oil prices, and promoting economic growth. The former requires generating sufficient foreign exchange to pay interest on Mexico's large external debt. The latter necessitates a reorientation of Mexico's development strategy as neither import substitution nor oil can provide an adequate impetus for economic growth. Import substitution-orientation brought diminishing returns and increasingly smaller net foreign exchange earnings in
highly protected domestic markets from the mid-sixties onwards while the
deterioration of markets does not augur well for the oil sector.

This is not to say that the opportunities for efficient import
substitution would have been exhausted in Mexico. In the manufacturing
sector, such possibilities exist in conjunction with exports through the
exploitation of economies of scale and through participation in the
international division of the production process. In agriculture, Mexico's
natural advantages would permit the reversal of its unfavorable trade balance
through exports and import substitution if appropriate policies are followed.

The precondition for economic growth through exports and efficient
import substitution is a shift towards an outward-oriented development
strategy that provides similar incentives to exports and to import
substitution as well as to manufactured and to primary activities, with
exceptions made for infant industries. The change in development strategy, in
turn, needs to be linked to appropriate policies for servicing the foreign
debt.

Two broad alternatives present themselves: an expenditure-reducing,
or deflationary, policy and an expenditure-switching, or output-increasing,
policy. The choice between these alternatives is exemplified by the recent
experiences of Hungary and Turkey, both of which encountered debt problems as
early as 1979.

Hungary adopted a deflationary policy that bore heavily on
investment, reinforced price and import controls, and let its exchange rate
appreciate in real terms, leading to losses in export market shares, with the
slow growth of the economy (about 2 percent a year) being threatened by
increases in imports as structural adjustment has not occurred. In turn,
output-increasing policies in the form of a large devaluation, the provision of export subsidies, and the liberalization of prices and imports have contributed to structural adjustment in Turkey, with exports doubling between 1980 and 1983 under difficult world market conditions, economic growth rates averaging 4-5 percent, and the country again becoming creditworthy for lending on commercial terms (Balassa, 1985).

Exchange Rate Policy

Structural adjustment through the adoption of output-increasing policies would thus permit simultaneously to deal with the debt problem and to promote economic growth in Mexico. The cornerstone of such a policy is the adoption of an appropriate exchange rate policy.

As noted in Section I, several years of overvaluation of the Mexican peso were followed by substantial devaluations in 1982 and 1983. These devaluations brought the real exchange rate vis-à-vis Mexico's principal trading partners above its 1978 level. 1/ The real exchange rate appreciated again in 1984 and the first half of 1985, however, as Mexico failed to devalue sufficiently to compensate for domestic inflation. Thus, in the second quarter of 1985, the peso showed a 13 percent appreciation in real terms compared to 1978 (Table 2).

These changes in exchange rates had a considerable effect on Mexico's exports. While the dollar value of non-fuel exports rose by 36 percent

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1/ For purposes of the following discussion, comparisons are made with 1978, in part to allow for the effects of the 1977 devaluation on domestic prices and in part because this was the first year of substantial petroleum production in Mexico. -- Note that, in accordance with the method of calculation of Table 2, an increase in the real exchange rate represents a devaluation.
between the first half of 1982 and the first half of 1984 as the exchange rate depreciated, this increase was followed by a 11 percent decline over the next twelve month period as the peso appreciated again in real terms.

Substantial devaluations were again undertaken after June 1985. By the end of the year, Mexico’s real exchange rate stood 11 percent above its 1978 level and preliminary data show a depreciation of 20 percent by March 1985. At the same time, the difference between the free market and the official exchange rate declined to 5 percent from over 60 percent in mid-1985.

The devaluation of the peso compared with its 1978 level has been necessary because of the changes that have occurred since. To begin with, there has been a shift from large external borrowing to the payment of substantial interest charges. Also, Mexico having accepted the obligation to abolish export subsidies under a bilateral agreement with the United States in early 1985, the exchange rate becomes the principal instrument of export promotion. Finally, in order to encourage exports, Mexico would have to reduce the existing anti-export bias of the system of incentives that can be accomplished by lowering import protection pari passu with the devaluation of the exchange rate.

It would further be desirable to unify the free and the official exchange rates. While the difference between the two rates has decreased to a considerable extent in the course of 1985, this is largely explained by extreme tightening of monetary policy that has led to the repatriation of funds held abroad. Under a less restrictive policy, the difference in the rates would increase again, inviting evasion through the underinvoicing of exports and the overinvoicing of imports, providing inducement for capital flight in expectation of a further devaluation of the official exchange rate,
and favoring sectors that can utilize the free exchange rate (tourism) over sectors utilizing the official rate (domestic manufacturing).

There would further be need for maintaining stability and predictability in the real exchange rate, thereby reducing uncertainty that has discouraged exports in recent years. Stability and predictability would be served by setting automatic rules, so as to avoid that the exchange rate would get out of line again in the future.

In this connection, reference may be made to the experience of Brazil, where the application of automatic rules in adjusting the exchange rate for the difference between domestic and foreign inflation rates has importantly contributed to rapid export expansion over the last two decades. In turn, despite the very favorable exchange rate for nontraditional exports in Venezuela, firms are reluctant to undertake the investment necessary to enter foreign markets because they are uncertain as to the continuation of the present exchange rate policy.

B. Trade Policy

The Programa Nacional de Fomento Industrial y Comercio Exterior (PRONAFICE) for 1984-88 states the need "to favor efficient import substitution and to promote exports in Mexico" (p. 119). The programme suggests that these objectives may be attained by rationalizing protection, promoting exports in a sustained manner, developing the border areas and free trade zones, and entering into international negotiations in order to consolidate existing markets and to open new ones.

The decision to enter GATT is an important step towards the fulfilment of the last-mentioned objective. It would have to be followed by further steps, with Mexico taking an active role in the new round of
multilateral trade negotiations. This is necessary both because the participation of the newly-industrializing countries, such as Mexico, is a precondition of the success of the negotiations and because joint action by these countries may ensure favorable treatment for them.

The further development of border zones and free trade areas is also desirable. Mexico may promote these arrangements while simultaneously pursuing the objectives of industrial decentralization and the geographical diversification by providing infrastructure for port-based regional development oriented towards Western Europe, the Far East, and Latin America.

At the same time, efforts would need to be made to increase links between these areas and the rest of the national economy. This should not be done not by imposing domestic content requirements on producers in border zones and free trade areas, but by providing the suppliers of domestic products with the same privileges as if they were exporting directly and permitting producers in border zones and free trade areas to sell in domestic markets on the payment of duties on imported components.

Under the bilateral agreement signed with the United States, Mexico cannot provide direct export subsidies. Reducing the anti-export bias of the system of incentives, then, would necessitate lowering import protection. This would also provide incentives to reduce costs and to improve technology in import-competition industries. As stated in PRONAFICE, "excessive and permanent protection cannot be the norm of the policy applied as it gives rise to a super-protected industry that in many cases is hardly efficient" (p. 119).

While Mexico's precarious balance-of-payments situation does not permit precipitated action, additional measures will need to be taken to
eliminate excessive protection and to reduce the bias against manufactured and primary exports and against primary production in general. This will be necessary in order to meet PROFINACE's target of 15-18 percent annual increases in non-oil exports in the 1985-88 period and to carry out its recommendation "to favor agricultural and mineral production which create more employment per invested capital and could limit migration from the country to the cities" (p. 122).

The stated objectives would be served by liberalizing imports pari passu with the devaluation of the exchange rate. This would amount to a compensated devaluation, under which exports receive the full benefits of the change in the exchange rate while the resulting increases in import prices are offset by reductions in protection. In particular, it would be desirable to abolish the import prohibitions that provide powerful incentives for the domestic production of luxury goods; to further reduce the scope of quantitative import restrictions that adversely affect domestic production; to eliminate the use of official import reference prices that have in practice similar effects as import restrictions; and to reduce all the tariff rates in excess of 40 percent that unduly raise domestic prices.

The described measures would need to be followed by the further reduction and rationalization of import protection. This should be done according to a timetable determined in advance, so as to prepare domestic producers for the changes and to provide incentives for adjustment. The timetable would include eliminating the remaining quantitative import restrictions, lowering tariffs to a maximum of 15-20 percent, and reducing tariff disparities. In fact, as shown in PROFINACE (Table 6.1.3), effective
protection on value added now varies between negative rates for agriculture and minerals to up to 3500 percent in some manufactured goods.

Additional incentives may be provided to new activities on a temporary basis and on a degressive scale. Such incentives should preferably take the form of production subsidies, so as to simultaneously encourage exports and import substitution. They should be available to all new activities, with the selection is made by the market rather than by bureaucrats who can have only limited knowledge of the opportunities available.

Further questions arise about the appropriateness of sectoral programs, of which two are in operation at present and six more are envisaged. The implementation of sectoral programs runs counter to the effort at reducing protection. National content requirements increase protection while the fulfilment of export targets may substantially raise costs for the domestic user.

These considerations may explain that Brazil has eliminated export targets for domestic as well as for foreign enterprises operating in its territory. In fact, Brazil has done well in exporting manufactured goods, including automobiles, while Mexico has not succeeded to do so, despite the proximity of the United States. Mexico may profitably follow the Brazilian example by foregoing the establishment of new sectoral programs and phasing out the existing ones.

Once tariff barriers have been reduced, the provisions of GATT may be invoked in taking anti-dumping action under appropriate conditions. However, the law in preparation would need to be revised both to conform to GATT rules and to avoid its uses for protectionist purposes. This would necessitate
clarifying the meaning of unfair trade practices, establishing a clear and transparent procedure for granting relief, with possibility for appeal on the part of the importer, and limiting relief action to temporary tariff surcharges.

The Roles of the Public and Private Sectors

Under the Echeverria (1972-76) and the López Portillo (1977-82) presidencies, the role of the public sector increased greatly in Mexico. The public sector enlarged the scope of its regulatory activities; raised the extent of its participation in the productive sphere; increased the amount of budgetary transfers; and augmented its claims on financial resources.

Increases in regulations took various forms. Labor legislation limited the scope of the enterprise to reduce its work force; the procedures involved in establishing new enterprises became more onerous; after an interlude of trade liberalization, import restrictions were tightened again; and the scope of price control increased to a considerable extent.

The extent of public participation in the production process also rose substantially. Public enterprises assumed importance in the steel and chemical industries, as well as in the production of trucks, buses, tractors, railway cars, agricultural machinery, paper, and sugar. The government established a large number of enterprises and took over private firms threatened by bankruptcy. As a result, the number of public enterprises grew from 84 in 1970 to 964 in 1982.

Also, the government greatly enlarged the activities of CONASUPO. While the original purpose was to provide basic staples at relatively low prices, CONASUPO was subsequently transformed into a vast retail trade network
operating at a high cost. Finally, in late 1982, the commercial banks were nationalized.

The growing importance of public enterprises and of the public sector in general is apparent, first of all, in the rise of the share of public investment from 7.2 percent of the gross domestic product in 1973 to 10.9 percent in 1982. The increase was even larger in investments by public enterprises that came to account for two-thirds of public investment in 1982.

Furthermore, the share of current expenditures by the public sector rose from 17.9 to 36.3 percent of GDP between 1973 and 1982 (Inter-American Development Bank, 1984) Much of the increase in current expenditures involved transfers including consumer subsidies, the financing of the losses of public enterprises, and allocations to state and local governments, rising from 2.2 percent of GDP in 1973 to 11.3 percent in 1982 (International Monetary Fund, 1986). Administrative expenditures also increased rapidly as the bureaucracy proliferated.

Notwithstanding increases in oil revenue, the rise in public expenditures led to a large public sector deficit. The deficit in the budget of the central government rose from 4.0 percent of GDP in 1973 to 15.4 percent in 1982 and the deficit of the entire public sector exceeded 18 percent in that year. The figures include interest charges that rose rapidly as the public debt accumulated.

For a time, the public sector deficit was financed in large part by foreign loans. With the exhaustion of borrowing possibilities abroad and the increased budgetary cost of servicing the debt, domestic financial resources were increasingly drawn upon. As a result, the share of financial resources made available to the private sector has declined over time. At present, the
services. Apart from budgetary savings, such improvements would benefit productive activities in the private sector.

At the same time, existing regulations pertaining to the private sector would need to be greatly simplified, so as to serve the needs of a modern economy. This would involve liberalizing prices and labor legislation which have introduced considerable rigidities in the economic system. There is further need for drastically reducing the scope of discretionary decision making which tend to discourage in particular small and medium-size enterprises, with adverse effects on employment. Finally, fundamental property rights should be ensured and internationally acceptable rules for patents and copyrights established.

The modernization of existing regulations would make Mexico more attractive for foreign direct investment. At the same time, regulations affecting foreign investment more directly would need to be reviewed, including the length of the procedures involved in dealing with applications, the 51 percent Mexican ownership rule, and the admissibility of international arbitration.

Mexico may have been the gainer in the IBM case, where it has obtained considerable concessions in response to accepting 100 percent foreign ownership. However, the length of the procedure, approximately two years, and the reversals observed during this period have created mistrust on the part of other potential investors, so that in the long run Mexico may well have been the loser.

In general, there would be need for simplifying the procedures involved in handling applications for foreign investment. Also, the conditions under which such investments are permitted should be clarified and
In addition to banking, the private sector would need to be given a greater role in manufacturing and in commerce. While the government may wish to retain ownership in petroleum and basic petrochemicals, it should reconsider its role as a producer in the competitive sector. This would mean extending and, to a considerable extent amplifying, the government's present privatization program. At the same time, on the British example, one would need to apply a well-thought out plan to ensure that privatization is carried out in an orderly manner.

The remaining public firms in the competitive sector should be transformed into independent enterprises, that are to be given the objective of maximizing profits, with the manager being made responsible for profits and losses. This would necessitate separating the financial operations of these enterprises from the government budget and eliminating the paraphernalia of bureaucratic control, such as annual operation programs, disbursement authorizations, and monthly operational reports. It would further be desirable to strengthen the role of the board of directors while ensuring their independence from the government administration.

The proposed measures would contribute to cost reductions, thereby reducing the burden on the government budget in financing the losses of public enterprises. At the same time, these enterprises should be put on an equal footing with private firms by eliminating their privileges in regard to credit and budgetary allocations, to be replaced by the payment of dividends.

There is room for improvement in the production of public services as well. Considerable operational savings could be effected in the railways, where efficiency by international standards is low. Improvements may also be made in electricity generation and distribution, and in postal and telephone
nationalized banks have a 100 percent marginal reserve requirement, except for loans to agriculture, exports, and housing, which receive about 9 percent of the funds that become available.

Large public deficits have also contributed to high real interest rates and to inflation. Real interest rates are today in the 20-25 percent range, creating considerable hardship for private firms, and the rate of inflation has again reached 70 percent. These adverse consequences have occurred, notwithstanding reductions in the deficit of the public sector after 1982, bringing it slightly below 10 percent of GDP. Further reductions were budgeted for 1986, but the precipitous decline in oil prices has since importantly added to the deficit.

Considerations of macroeconomic equilibrium and the need to provide financial resources to the private sector call for further reducing the public sector deficit. Such reductions become cumulative, creating a virtuous circle, as lower deficits lead to lower interest rates by decongesting financial markets that, in turn, reduce the budget deficit, which reflects in large part the high interest cost of domestic borrowing.

Reducing the deficit of the public sector should preferably take the form of lowering expenditures, rather than increasing taxes that would again limit the availability of financial resources to the private sector. While steps have been taken in this direction, more would need to be done. Even before the deregulations proposed below take effect, the size of the government bureaucracy could be reduced by eliminating certain functions and by not replacing government workers who depart for reasons of age, health, or for the private sector. Improvements in the operations of public enterprises would give rise to further savings.
There would also be need to lower consumption subsidies that led to the pricing of a number of goods and services much below the cost of production. An extreme case is the availability of free telephone in the streets of Mexico City. Subsidies for public transport and for many products sold by CONASUPO are also high.

The deficit may be further reduced by phasing out preferential credits. Apart from their budgetary costs, these credits introduce considerable distortions in the allocation of capital. At the same time, it would be desirable to increasingly link domestic interest rates to foreign rates, with allowance made for a risk premium.

While these measures would represent a first step towards the remonetization of the economy following a decline in the ratio of the broadly defined money supply to the gross domestic product, \(^1\) additional steps would need to be taken to ensure improvements in financial intermediation. These steps would include the development of short-term and long-term financial markets. Mexico may also follow the example of Portugal in permitting the establishment of financial institutions that can perform commercial banking functions in competition with the nationalized banks. Furthermore, the December 1984 regulations on investment finance would need to be liberalized in order to encourage the establishment of investment companies and, in particular, venture companies. Finally, the practice of the government unilaterally setting interest rates on Treasury certificates (CETES) should be discontinued.

\(^1\) Between December 1981 and December 1985 the real value of money and quasi-money combined (M4) declined by 30 percent to its lowest level since 1978, although GDP increased by 28 percent during the seven-year period.
greater flexibility introduced in accepting majority foreign ownership in investments oriented towards export markets.

The refusal to accept Chrysler's proposal for truck manufacturing in partnership with a Mexican firm, only a month after the IBM decision, also raises queries. It seems to reflect the view that the national market is divided among domestic firms (three in the present case) without considering the possibilities for exportation, even though the Chrysler proposal would have entailed a considerable foreign exchange gain for Mexico. In fact, truck manufacturing is a labor intensive activity and, on the example of Turkey, Mexico could become a net exporter.

It would further be desirable for Mexico to devise an arrangement by which it would accept international arbitration. This could be done by generalizing the agreements reached with Chile and Ecuador, under which the parties may appeal to international fora if remedies on the national level have been exhausted. Participation in the Multilateral Investment Guarantee Agency would also increase Mexico's attractiveness for foreign direct investment.

In this connection, it should be emphasized that, in adopting an outward-oriented policy stance, Mexico needs foreign investment to provide technical, managerial, and marketing expertise. Also, foreign direct investment creates new employment opportunities and provides foreign exchange, thereby easing the debt situation.

**Concluding Remarks**

This paper reviewed the policies applied in Mexico during the 1973-83 decade of external shocks and examined the extent to which Mexico exploits its comparative advantage in manufacturing industries. It further made
recommendations for policy reform designed to serve the double objectives of coping with the debt situation and promoting economic growth in Mexico.

The cornerstone of such a reform is the adoption of an aggressive exchange rate policy, accompanied by import liberalization. This would entail, in particular, the abolition of the import prohibitions introduced in September 1985, reductions in the scope of quantitative import restrictions, elimination of the use of official import reference prices, and reductions in tariffs in excess of 40 percent.

The net effects of these measures would be to promote exports as well as efficient import substitution, in particular in the agricultural sector that is not protected. The existing bias of the incentive system against exports would need to be reduced further in subsequent years through the elimination of quantitative import restrictions as well as reductions and rationalization of tariffs. And while additional incentives may be provided to new activities on a temporary basis, sectoral programs do not appear to be appropriate vehicle for doing this.

It would further be desirable to limit the scope of the public sector in the Mexican economy. This would involve reducing the public sector deficit, chiefly by lowering expenditures; liberalizing financial markets, involving also the establishment of private banks; undertaking denationalizations outside basic industries; ensuring the independence of the remaining firms in the competitive sector; improving operations in the production of public services, with a view to lowering costs and promoting the development of a modern economy; and reforming existing regulations to conform to the needs of a modern economy. Finally, regulations concerning foreign
direct investment would need to be reviewed so as to increase Mexico's attractiveness for foreign investment.

Re-establishing confidence on the part of the private sector is of particular importance. This would require providing for stability and predictability in exchange rates and in the system of incentives in general. It would further necessitate drastically reducing the scope of discretionary decision making by public authorities.

Inflation is a source of uncertainty for business decisions. Present rates of inflation could not be maintained for a protracted period without causing economic dislocation. Nor can one expect to reduce inflation rates to earlier levels through traditional means of macroeconomic policy.

These considerations point to the need for monetary reform. Proposals for such a reform have been made recently. Their implementation, however, requires establishing an appropriate climate, with an understanding on the part of government, business, and labor on the principles of the reform.
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