THE DEVELOPMENT GROUP FOR ALTERNATIVE POLICIES

THE DEVELOPMENT GAP

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Good morning. My name is Carlos Heredia. I am an economist, formerly with the Mexican Ministry of Finance and now working with the Mexican Non-Governmental (NGO) community. I come to the United States through a partnership between The Development GAP and Equipo PUEBLO, a Mexican NGO. This is part of a wider rapprochement between citizen coalitions promoting economic justice and democratization in our two countries.

Mr. Chairman, I would like to thank you and your staff for inviting me to testify in this hearing. The Development GAP and Equipo PUEBLO have done extensive work on the impact of structural adjustment policies on the workers, the family farms and the people of our two nations. Today I want to focus particularly on the high cost that the current model of economic liberalization has imposed on small business and small farmers in Mexico. In particular, I will discuss the effect of extremely high real interest rates and an overvalued currency on these sectors of the population.

The Political Economy of Devaluations in Mexico

Is the peso overvalued? The number of analyses that say it is has increased in recent weeks. Should the peso be devalued? Conflicting opinions on this point have multiplied in the last couple of months, and confusion prevails. Will the Mexican government be able to postpone a devaluation of the peso until NAFTA is ratified, or to avoid a devaluation altogether? Right now, all bets are off.

Let me now describe what devaluations have meant for different sectors of the population in Mexico. They have always been traumatic, because deep inside Mexicans are led to believe that devaluing the national currency is paramount to an offense to national pride. One Mexican president went as far as stating that "a President who devalues the currency, devalues himself." So, beyond economic implications, there are a lot of political consequences to a devaluation. With the presidential elections looming on the horizon, a devaluation would seriously hurt the possibilities of the three Cabinet members most often seen as the leading PRI (Partido Revolucionario Institucional) candidates.

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Historically, Mexico's upper class has an extremely high propensity to import, one that rests upon a well established habit called "malinchismo" by Mexicans. Although the Central Bank continues to claim that capital and intermediate goods account for 80% of total imports, some analysts believe that this figure is riddled with methodological problems. According to the Bank's method of classification, most of Mexico's imports have resulted in an enhancement of the country's productive capacity or, at the very least, the upkeep of current production levels. The truth is, however, that there is not all that much new creation of real capital, but rather a massive surge in imports of consumer goods.

Relative exchange-rate stability since December 1987 has been a blessing for the middle class, and certainly for the conspicuous consumption habits of the rich. Many analysts have pointed out that there is a strong correlation between the popularity of Mexican presidents vis-a-vis these segments of the population and the stability of the peso/dollar rate. For the majority of the population, though, a devaluation can very well mean a tragedy to the extent that it translates into higher domestic prices.

Paradoxically enough, the very policies advocated to achieve stability have fostered the current instability. Since 1986, and especially after 1989, the quick-paced, across-the-board economic liberalization and indiscriminate tariff reduction have resulted in a deluge of imports from all over the world, but mainly from the United States. The authorities have pointed out that this opening to imports was consistent with reining in inflation, because a lot of imported goods were cheaper than their Mexican equivalents. It was time to lift protection, we heard, and make the national manufacturers become more efficient. But in this respect, as in many others, we outdid our trading partners, and many a local producer was priced out of the market. This did not have to do only with efficiency, but with economies of scale, and, most of all, with access to cheap credit and consequent low financial costs.

We now have relatively stable prices, but they are at levels that are not affordable to the majority of the population. Wages continue to be suppressed in an effort, supposedly, to remain competitive. There is an increasing gap between income and purchasing power for most Mexicans, and even a family income of two to three times the minimum wage (currently $125 a month) is not enough to pay for a "basic basket" of goods and services.

The Impact on Small Business and Consumers

In a period when we supposedly have a healthy growth of the economy, non-performing loans are going through the roof. Such loans used to account for no more than two or three percent of the portfolio of any given Mexican bank; now they are in excess of eight percent of all outstanding loans in the system. Mexican middle class consumers are facing enormous difficulties in paying their mortgages and their car loans.

Servicing their debt becomes too heavy a burden, so many people are ultimately forced to give up their assets. Mexico's foreign debt has been rescheduled several times, but how is this massive indebtedness of Mexican consumers going to be rescheduled? Who will bail them out?

Neither the commercial banks nor the government would publicly admit that this situation is widespread. Not the commercial bankers, because they paid a very high price for the recently privatized banks. Not the government, because this crisis damages the myth that trickle-down economics is expanding the domestic market and benefitting everyone.

Right now in Mexico the overwhelming majority of productive establishments are fighting to survive. Even many of those big, publicly owned firms whose stock is traded on the Mexican Bolsa incurred losses in the first quarter of 1993. These firms have access to external financing in dollars at 8 to 10% interest rates, instead of the rates of 35% to 40% available in pesos to smaller companies. For most of the last two years, real interest rates in Mexico have been over 2.5 times higher than comparable rates in the United States. It is difficult for small businesses to use loans at such high rates. The spread between active and passive rates has not been reduced enough. An effort by the Central Bank in the last few weeks to bring rates paid on Mexican Treasury Bills (Cetes) to a 15% level seems to have touched bottom, and it is likely rates will bounce back in the following weeks. As of 31 March 1993, foreigners owned 78% of public holdings of Cetes.

Take now the unemployment figures. According to official data, the unemployment rate in January was only 3.5% of the workforce, as opposed to 7.0% in the US and 11.0% in Canada. This unemployment figure is one that not even those who compile the statistics believe, because they know their methodology is biased: people are asked whether they have been employed or have looked for work for at least one hour in the past nine weeks to be counted amongst the official work force.

Out of a workforce of around 28 million people, only 12 million belong in the so-called "modern" sector. One would think that the 130,000 workers dismissed by PEMEX alone in the last two years would make the unemployment figure go up, but officially it hasn't budged.

Many larger businesses are firing employees. The banks, the public enterprises that are being streamlined to be privatized, etc., can afford to do so. In the case of small businesses, the combination of high real interest rates, "fiscal terrorism", and the absence of the rule of law have created a hostile environment that is forcing them to close shop. As a result, the current level of employment in the manufacturing sector is still under the 1988 level when the Salinas Administration was inaugurated, and well below the 1980 level.

The Impact on Peasants and Small Family Farms

One of the most significant components of the adjustment policy related to the agricultural sector is the reduction of credit for the production of basic grains and for regions considered to be less productive. In an upcoming study for the NGO Working Group on the World Bank, we have found that the federal government has been phasing out development-bank credit, with the total number of hectares receiving credit from Banrural between 1987 and 1992 falling from 7.5 million to 1.3 million. In the last ten years, the number of producers receiving credit from Banrural fell from 2.5 million to only half a million. The government has, since 1989, offered loans through Pronasol, the social-investment fund, but that credit is severely limited.

Mr. Chairman, let me illustrate this with the ordeal that small rural producers in the state of Chihuahua are facing. Only a few weeks ago, they staged a tractor blockade of a border-crossing bridge between Ciudad Juarez and El Paso to call attention to the severe debt crisis affecting their communities. Small producers in Chihuahua are much better off than peasants in Central and Southeastern Mexico; yet this crisis has forced them to send various members of their families to work in the United States. In fact, a peasant federation in Chihuahua is planning a massive walk and border-crossing to the United States, in what has already been called "the NAFTA Exodus", to again call attention to their need for urgent debt relief and accessible credit.

NAFTA, it is claimed, will stem the northward flow of migrant workers. However, it, like the related liberalization policies of the past decade, would, in its current form, favors corporations and banks over the needs of small producers, farmworkers and poor communities. So, in reality, the northward migration would only intensify.

A Secret Exchange Rate Deal in NAFTA?

The question remains open as to whether the Mulroney government, at the outset of the negotiations for the U.S.-Canada Free Trade Agreement, made a secret commitment to the U.S. to raise the value of the Canadian dollar relative to the U.S. dollar. In "Take Back the Nation 2," a book by Maude Barlow and Bruce Campbell published in Canada earlier this year, the authors tell us that, in 1985, former Tory industry minister Sinclair Stevens told the Toronto Star that his U.S. counterpart, Malcolm Baldridge, indicated that a dollar deal was the key to getting a free-trade agreement. Baldridge told Stevens that it would have to rise close to the 90-cent range and remain there for four years. The dollar was trading at 71 cents U.S. at the time.

The U.S. National Association of Manufacturers warned that there could not be a free-trade agreement unless there was a deal on exchange rates. They saw the negotiations as a way to force up the Canadian dollar and thereby reduce Canada's trade surplus with the United States, which was Cdn. $20 billion in 1985.

In late 1986, Chief U.S. trade negotiator Peter Murphy told an audience of U.S. and Canadian business executives that, although the exchange rate was not formally on the free-trade bargaining table, the U.S. Congress saw it and free trade as "inextricably linked". By October 1987 the Canadian dollar had climbed to 75 cents and a year later to 83 cents, and from the beginning of 1989 through most of 1991 the dollar stayed between 85 and 87 cents U.S. Currency traders observed that the Bank of Canada intervened very heavily in the currency markets when necessary to ensure that the Canadian dollar stayed within this range. We have seen U.S. retailers benefitting from massive cross-border transactions at the devastating expense of their Canadian counterparts.

Barlow and Campbell go on to describe how the Bank of Canada engineered an interest-rate hike that was the main factor responsible for driving up the value of the Canadian dollar, noting that: "the correlation between the signing of the free trade agreement and the implementation of the interest-rate policy is compelling. It is not hard to imagine the Canadian government, desperate for an agreement that Brian Mulroney had publicly staked his political future on, making a secret exchange-rate deal."

Any resemblance to trends in recent years in another U.S. neighbor could be a mere coincidence. But it so happens that, at the outset of the trilateral negotiations to extend free trade to Mexico, the U.S. Manufacturers asked the Bush Administration for assurances that any new agreement "seek to prevent exchange-rate manipulation for a country's competitive advantage."

The Canadian analysts conclude: "whether or not the Conservative government made a secret commitment to jack up the Canadian dollar, its high-interest/exchange rate policy has been deliberate. It has dramatically increased the pace of harmonization and restructuring and, in the process, is ravaging the Canadian economy. David Abramson, editor of the International Bank Credit Analyst, sees it as a deliberate strategy to discipline firms to cut wages and other costs - or fail, in such a way that the ones remaining are the ones that compete."

Is there a similar exchange-rate understanding between the governments of Mexico and the United States in the NAFTA? These governments should disclose any such commitment. Some analysts in the two countries have already pointed out that a massive devaluation of the Mexican peso would offset the advantages of tariff reduction or tariff removal in bilateral trade.

So When's the Next Bailout?

Let us ask ourselves again: can a devaluation in Mexico be avoided indefinitely? Mexico's current-account deficit reached U.S. $22.8 bn in 1992. It is largely being financed by external capital inflows, which can only be maintained with sky-high yields.

Although the Central Bank's reserves are still sizeable (around U.S. $20 bn, we are told), pressure on an overvalued peso is mounting. The Mexican government does not seem to want to devalue. The question is, to what extent is that position sustainable? The solution so far has been to "freeze" the economy, with higher unemployment and a multiplication of bankruptcies the result. Recession is the price to be paid in order to prevent devaluation.

The Financial Times, in its 12 May 1993 survey on NAFTA, tells us that "...the Mexican economy and political system is in a state of great uncertainty." It goes on to say that "the side agreements have extended the agony surrounding ratification." Along this line, officials at the highest level in the Salinas Administration have come to the United States to say that Salinas needs room to choose his party's presidential nominee. If by the end of the summer, it is argued, it is not certain that NAFTA will go into effect on 1 January, chaos will erupt: investors will divest from the Bolsa, capital flight will surge and the Mexican economy will collapse, bringing with it a maxi-devaluation of the peso and a massive exodus of workers to the United States.

Should a financial collapse break out in Mexico, it is highly likely that the U.S. Treasury would eventually have to face the question of whether to bail the Mexican regime out once again, much in the fashion of what it did after the debt crisis of 1982 and the stock-market crash of 1987. What is the point, however, of bailing out a government's economic program that has failed to meet the interests of its people? Massive amounts of financing from the international financial institutions have been injected into Mexico over the past three years, but little real development has been engendered. What we are talking about is not so much a problem of financing as one of policy. It would certainly be far better for the Mexican people if we were to address the question of the country's underlying economic strategy.

Policy Recommendations

In Mexico, macroeconomic beauty portrayed by the government's propaganda in the media coexists with microeconomic disaster. The production apparatus is in a shambles, and the quality of life for the vast majority of the Mexican people has deteriorated. The truth is that, at most, 20% of the population are true consumers -- the rest are fighting to survive. The REAL Mexico -- the one with over half its population living in poverty, an eroding middle class and an extremely wealthy elite -- is quite distant from the FORMAL Mexico pictured in the media. Just remember that after a decade of trickle-down economics, the migration of Mexican workers to the U.S. reached a record high in 1992.

With or without a NAFTA, economic policy in Mexico is approaching a dead end, because a model that relies on heavy capital inflows from abroad and results in a steep concentration of income and wealth is hardly a good basis for medium and long-term stability. Instead of imposing a sort of "market dictatorship" under which it curbs

inflation by enforcing a ceiling on wages and suppressing independent trade unions, manages the currency markets, and gives a high premium to financial speculators, the Mexican government should concentrate its efforts on a new strategy to foster production and sustainable development.

Mexico has had trade liberalization, but it can hardly be said that it has had export-led growth. What it is having now is import-led, insufficient growth. A sustainable trade strategy is not feasible without three vital elements: a) a competitive exchange rate; b) an industrial policy that designates areas of priority and allocates resources accordingly; and c) import controls (quotas, high tariffs) to protect strategic sectors. Recent World Bank research reported in The Financial Times ("Miracles beyond the free market," 26 April 1993) indicates that in Southeast Asia governments have intervened with these kind of policies more often and in a more systematic way than is acknowledged by Western free- traders. This strategy may very well translate into reduced U.S. exports to Mexico, but it would also bring with it healthier and more balanced growth to the Mexican economy.

It is also essential that interest rates be brought down to reactivate that economy, to bolster the purchasing power of the eroding middle class that is increasingly unable to buy the very goods they produce. A little more growth in exchange for an increase of two or three points in the inflation rate would not be out of place. This overall strategy would stimulate production, discourage speculation and reduce exchange-rate volatility. In addition, it would do far more in the long run than would NAFTA to save American taxpayers the cost of having to prop up and bail out the Mexican regime once again.

Thank you.

CARLOS HEREDIA is a Mexican economist with a graduate degree from McGill University in Montreal, Canada. He has been an adviser to small farmers' cooperatives in southeastern Mexico, and, during most of the last decade, worked for the Mexican Ministry of Finance. Since 1989 he has been Director of International Programs for the Mexican non-governmental organization, Equipo PUEBLO, and is active in a number of citizen coalitions, including the Mexican Action Network on Free Trade and the Citizens' Movement for Democracy. He is currently a Visiting Fellow at The Development GAP in Washingon, D.C.