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Mexico's inflation problem

Following a trip to Monterrey and Mexico City, David Goldman assesses the situation and the potential remedies.

The most frustrating thing about Mexico's present 30 percent inflation rate is how easy it would be to reduce it, if the right sort of economic relations prevailed with the United States. That is not to say that inflation—and the enormous interest charges that go with it—have not made financial life a heachache for most Mexican businessmen. If the country's economic planners fail to carry out the directive of President José López Portillo—to deal with inflation by enhancing output—there will be trouble not much later than the beginning of 1982.

However, I came away from two weeks of informal meetings with Mexican government and private-sector leaders with a strong sense that the country will find effective means to handle the problem. How smooth the going will be depends largely on how the United States chooses to deal with a monetary policy that has, in the words of the Bank for International Settlements annual report, threatened the world with a crisis resembling that of the 1930s. Mexico is leaning hard against economic distortions that arise from its close economic relationship with the United States. These distortions, not the ambitious and well-funded government development plan, are responsible for the inflation problem.

Of course, Mexican opinion is divided. Many of the private-sector commercial banks, including the largest and oldest, Banamex, argue that the government will have to scale down the growth rate from the present 8 percent per annum to perhaps 6 percent in 1982—although they admit that this implies a sacrifice of national economic interests in order to compensate for distortions imposed from the outside. A foreigner doing business in Mexico is likely to run into this approach.

But it is striking that the same Mexican bankers who take the most pessimistic attitude concerning inflation are also most active in steering foreign investment into Mexico. The June 11 inauguration of the New York-based Mexico Fund, a mutual fund for the Mexican stock market managed by Merrill Lynch, surfaced a pattern of interest that has been quietly at work for some months. The issue is not at all whether Mexico will develop, but according to what model it will develop, and on whose behalf.

First—contrary to what has unfortunately become conventional wisdom—neither the sharp rise in government expenditures nor increase in monetary aggregates has any direct relationship to inflation. Inflation is mainly the result of the inability of the basic consumer-goods sector to grow fast enough to keep up with the consumption requirements of a rapidly growing economy. This, in turn, is the result of the adverse credit markets environment in the dollar sector of international credit. On the surface, the problem appears to be "demand-pull" inflation. More profoundly, the problem is "interest rate-led inflation."

What is, at first, strange is that the growth rates in those industries that have provided the bulk of Mexican output during the past 30 years has been markedly slower than the growth rates of the new heavy industries that form the core of the new development program.

Output as a whole has grown by about 8 percent per year during the past three years, while output of non-durable consumer goods has grown by only 5 percent on average. Meanwhile, agricultural output has risen by less than 3 percent a year over the same period. This contrasts with an increment of output during those three years of 47 percent in petroleum, 45 percent in chemicals, and 53 percent in capital goods.

The government-based investment programs are putting wages and salaries into circulation, but the new demand is not matched by a sufficient supply of *basic* consumer goods, i.e., food, clothing, and housing. Unlike most industrial and developing countries, where inflation begins with rising energy prices, Mexico runs into inflation much further down the production cycle, mainly at the finished-goods end. For that matter, Mexican energy prices have reflected the actual cost of production to Pemex rather than rising international market prices, such that energy-price inflation has been only a few percentage points per year.

It is possible, but entirely misleading, to argue that government expenditures for capital investment should be held back to "wait" for the other sectors of the

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economy to catch up. The problem in this line of argument is that it is, or should be, substantially easier to raise output in the less capital-intensive sectors of agriculture, food processing, and food distribution. As the Mexican president insists, the appropriate cure for the inflation problem is to raise output here, not to reduce it elsewhere.

The most perspicacious Mexican economists point to two problems that account for lagging output in the basic consumer goods sector, both of which are potentially subject to rapid amelioration. The most pressing one involves the impact of the Federal Reserve's credit policies on the Mexican economy; the second is a management, or political problem, for the Mexican government.

A peculiarity of Mexico's credit system has thrown the private sector of the economy, for the most part, onto the troubled dollar credit markets. Mexico operates a dual credit system. Roughly half the government's expenditures are financed by the central bank, the Bank of Mexico, which either borrows from abroad or creates currency to purchase obligations from the Mexican Treasury. In this respect, the Bank of Mexico ironically functions as the local agent for the country's foreign creditors. It also finances a group of development finance institutions, the most important being Nacional Financiera (Nafinsa), which lends on concessional terms at interest rates lower than 10 percent. Nafinsa and its sister institutions, such as Somex and Banrural, provide less than 20 percent of the credit requirements of the private sector.

The Treasury directly finances petroleum, which has been nationalized since 1938; port construction; steel; and other heavy industries. However, the private banking system—in contrast to most of its counterparts in the advanced sector—has little recourse to central bank funds. The volume of discounts of private-sector paper at the Bank of Mexico is negligible. The private sector's problem at the moment is that it relies, structurally, on private savings, and the real volume of private savings is negative.

During 1978 and 1979, the take-off point for the new development program, the private sector had the resources to make substantial productivity improvements, but failed to do so. Typical is the case of the self-styled "Monterrey Condominium," the northern industrial group that started a century ago with a brewery and now makes everything from consumer durables to steel. The Monterrey families provoked the wrath of several Mexican state governments by declining to invest in new capacity, preferring to buy up additional capacity. According to some estimates it now controls 80 percent of the food-processing capacity in Mexico, following a three-year conglomeration binge.

The investments that should have been made to upgrade the country's low-productivity food processing and clothing industries, and to streamline the incredibly inefficient food distribution system, were not made. This fact by itself probably accounts for half of the country's 30 percent inflation. Like other private sector powers, the Monterrey group still thinks in terms of the "import substitution" programs of the 1960s. Thirty percent of the tangible goods consumed in Mexico are imported from the United States; too many of these are luxury consumer items. Before oil provided a springboard for heavy-industry development, Mexican industry relied on heavy tariffs on consumer items to compete with U.S. goods at lower productivity levels.

Of course, luxury consumer items make no contribution to the future economic prospects of Mexico; the country is short of basic consumer items, and cannot devote too much of its resources to either producing luxury goods at home, or importing them at high cost from abroad. The "import-substitution" errors of the past 30 years have resulted in a situation where Mexico has one of the lowest ratios of goods to services in Gross National Product of any industrializing nation, and one of the lowest ratios of capital goods to consumer goods as well. How questionable the country's prowess in producing consumer goods was appears in the present shortage of *basic* consumer items. This has profound potential consequences for the development of a generation of workers entering the labor force.

Dollar-denominated credit

Now, of course, the inflation has become a self-aggravating problem. The shortage of basic goods in real terms translates, in financial terms, into a net negative savings position of the banking system. There is simply no peso-denominated credit available. Stated interest rates in Mexico are now 30-odd percent, but the lack of availability of lendable funds has made the actual situation much worse. Compensating balances for Mexican loans run to half to two-thirds of the total loan (compared to about 15 percent in the United States). For small business, the small business federation Canacintra estimates, effective interest rates start at 60 percent and can go above 100 percent.

The majority of all loans to the private sector now provided in Mexico are denominated in dollars. Big commercial banks, like Monterrey's Banco Serfin, syndicate loans in London and distribute the proceeds in smaller packages to their Mexican customers. Small businesses are more likely to go to the Mexico City office of Bank of America or Citibank to obtain dollar loans than to borrow from Mexican banks. This phenomenon is called "dollarization" locally; it corresponds to the "Eurodollarization" experienced in the American banking system. Under these circumstances, appropriate rates of private-sector capital formation are

impossible.

What will happen if this continues? If dollar rates continue to rise, the effects on the dollar-dependent sectors of the Mexican economy would be disastrous, private bank economists believe. Higher U.S. rates would mean a depression in the basic goods sectors, and considerably more inflation. Some of the private sector economists take this for granted. "Mexico has entered an era of permanent inflation," one Monterrey group economist told me. Said a Mexico City banker, "We are already in an inflation situation like that of Brazil, except that no one is talking about it."

I am not so sure the course is fixed in this direction. Clearly, under a worst-case scenario, Mexican inflation could double by the end of 1982. But Mexico has been through tough ones before, and Americans sometimes forget that the strongest impression made on the present generation of Mexican leaders was the 1938 nationalization of the oilfields under President Lázaro Cárdenas.

Prospects and policies

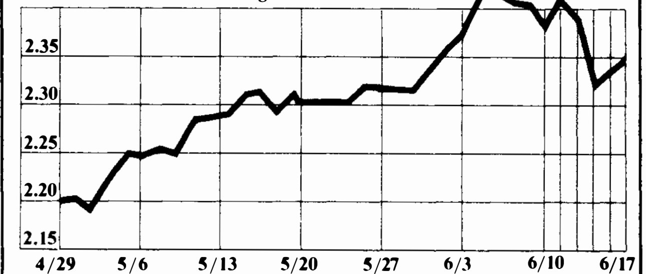
The single most important anti-inflation measure Mexico could take would be to drastically change the composition of the 30 percent of its economy which overlaps with the United States. This is far from impossible, especially after the Phoenix-like rebirth of Mexican-American relations during the recent visit to Washington of the Mexican president, following the enmity of the Carter years. Mexico is now in position to stop worrying about cheap-labor assembly industries based on the American border, and concentrate on selling oil. It needs to import technology and knowhow—including the cattle-raising and dairy technology the United States is supremely equipped to provide—and shut off the inflow of nonessential consumer items.

There are some real political problems in the way, e.g. the braking effect on agricultural productivity of the present land-distribution system, and the reported recalcitrance to modernization of the country's dreadful transport system on the part of the railway workers' union, which seems to enjoy the worst reputation of any organized group in Mexico.

But my sense of the people I met is that they will find the means to chop through these problems. They are likely to play financial hardball of a type that will create some upset here, if the United States does not change its monetary policy over the next several months. To be specific, speculators who bet on a big devaluation of the Mexican peso are running the risk of walking away with bandaged fingers. Mexico's credit system has caught a cold from a northern neighbor with influenza. Americans would be right to view this as a short-run problem. In reality, business opportunities for Americans who understand what kind of knowhow Mexico needs are only beginning.

Currency Rates

The dollar in deutschemarks
New York late afternoon fixing



The dollar in yen
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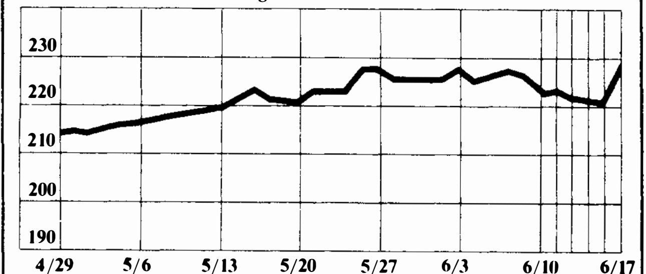
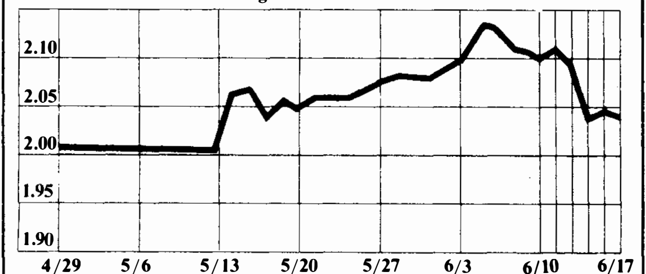


The dollar in Swiss francs
New York late afternoon fixing



The British pound in dollars
New York late afternoon fixing