# MEXICO'S REFORMS LOOK BEYOND NAFTA

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The NAFTA debate in the U.S., both among the policy makers in Washington and in the media, naturally has focused on the agreement's likely impact on the U.S. economy. Rightfully so.

However, by focusing solely on the agreement, many politicians and pundits have missed what certainly will be a more important development in the long run. That is, Mexico's economic reforms introduced over the last several years have resulted in the U.S. and Mexican economies becoming increasingly entwined. These reforms, which have made Mexico's economy one of the most open in the world and have helped turn the country around, will continue regardless of U.S. trade policy. Many of the difficult decisions, including getting Mexico's public finances in order, deregulating the economy, and privatizing much of the state sector, were taken well before President Carlos Salinas de Gotari's government began pursuing a trade agreement with the U.S.

## ECONOMIC REFORM

Mexico's policy makers believe that the most effective way for the country to benefit from modern technology and management is by opening the economy to foreign investment and competition. Thus, the process of economic reform began with Mexico's entry into the General Agreement on Tariffs and Trade (GATT) talks in 1987. In just a few years, average tariffs were reduced to 9% from 45% (tariffs against American products currently average 13%) and many import licensing requirements were reduced. In fact, NAFTA is not the only trade agreement the country is party to. Mexico and Chile have signed a free-trade pact that will phase out tariffs between the two countries by 1998, and Mexico is negotiating similar agreements with Colombia, Ecuador, and Uruguay. In addition, Mexico expects to join the Organization of Economic Cooperation and Development next year. As a result, many Mexican firms already are facing the full brunt of foreign competition. In addition to lowering trade barriers, the country's export emphasis has shifted from oil to manufactured goods. Consequently, the export of manufactured goods grew from 14% of total exports in 1982 to 55% in 1989.

Mexico also has privatized large parts of its economy, including the telephone company, the two national airlines, as well as extensive holdings in food processing, automotive products, petrochemicals, and textiles. To date, more than 80% of Mexico's 1,155 state-run companies have been sold, merged or closed. The country's 18 commercial banks alone were sold for over $12 billion, with the majority of the proceeds used to reduce Mexico's foreign debt. Transportation, electricity, mining, and tourism are just a few of the many industries that have been deregulated; the benefits of which are manifold. Freight costs, for example, have dropped 25% since the trucking industry was deregulated in 1989, and productivity in some industries has increased as much as 50%. Overall, labor productivity has increased 19% in the last three years. These achievements are impressive both in themselves and for the break with the past they represent, as Mexico's economy had been highly regulated and dominated by the government since the Mexican revolution of 1917.

## FISCAL REFORM

Economic reform has been accompanied by a complete overhaul of government finances. The first step was taken in 1990 with the renegotiation of the country's external debt with commercial banks. The new debt repayment framework decreased both principal and interest payments and restored confidence in Mexico's economy. A good deal of the remaining government debt has been paid down through, among other things, the sale of government-run enterprises discussed earlier. In addition, the public sector, which ran a budget deficit equivalent to 16% of GDP in 1987, is projected to run a surplus of 1.7% in 1993, making Mexico one of two countries expected to do so. These measures have brought down Mexico's outstanding public sector debt to approximately 40% of GDP, compared with about 67% in the U.S. and 65% in Japan. Thus, Mexico, which began the 1980s with a ballooning federal deficit, crushing foreign debt, triple-digit inflation, and a decrepit industry, has undergone an economic transformation that is beginning to bear fruit.

## MEXICO'S REVITALIZED ECONOMY

Mexico's economy, which had ground to a halt between 1982-1988 as GDP declined on average 2% a year, is on the upswing. The country's GDP expanded on average 3.8% between 1989 and 1991 and is forecast to grow about 2% in 1993. Mexico also has dramatically cut inflation from a peak of 159% in 1987 to 12% in 1992, with 1993's rate projected to fall to 8% or less. Industrial investment has recovered from a negative 11% (on average) between 1980 and 1988 to a real annual rate of 10% between 1988 and 1992. Overall, investment has increased from 17% of GDP in 1988 to 22% in 1992.

Investors have responded enthusiastically to the government's economic policies and improved business climate. Capital is flowing from Mexicans who stashed their savings abroad and from foreigners investing both in Mexican financial instruments and directly in Mexican companies and manufacturing facilities. Non-Mexican investors have benefitted primarily from a 1989 amendment to the foreign investment regulations that allows 100% non-Mexican ownership in two-thirds of the country's economic sectors. As a result, foreign direct investment during the Salinas years--two-thirds of which has been in manufacturing--topped $25 billion earlier this year. Incidentally, only 8% of the total has gone to maquiladora plants on the U.S.-Mexican border. Nissan Motors Corp., for example, recently

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completed a new $350 million assembly plant in north-central Mexico. The vast majority of foreign direct investment comes from the U.S. (65%), with the European Community (25%) and Japan (5%) trailing far behind.

### U.S.-MEXICO LINKS

The increase in U.S. direct investment in Mexico mirrors the growth of U.S.-Mexican trade. Since Mexico joined GATT in 1987, bilateral trade has surged to $77 billion from $27 billion. U.S. exports to Mexico have tripled over that period to $41 billion, making Mexico the U.S.'s third largest trade partner. Over 70% of Mexican imports come from the U.S., and the U.S. enjoys a $5 billion trade surplus with Mexico.

Even more important than the growth of trade is the perceived climate of economic stability in Mexico. Consequently, the last several years have seen steady growth in new international equity and bond financing abroad by Mexican entities reflecting, in large part, the increased acceptance of Mexican corporate debt. The second quarter of 1993 alone saw almost $3 billion of international bond issuance, the majority of which was purchased by U.S. investors. Mexican international equity offerings amounted to $3.1 billion in 1992. The volume is down significantly this year ($882 million through three quarters). However, this is largely a reflection of a lack of substantial privatizations rather than poor investor demand. Importantly, most U.S. institutional fund managers, both equity and fixed income, are beginning to look beyond NAFTA to Mexico's economic and financial fundamentals in making decisions to invest in Mexico.

In sum, U.S. businesses and investors have over the last several years dramatically increased their participation in the Mexican economy through trade, portfolio investments, cross border alliances, and acquisitions. This trend will doubtlessly continue as Mexico's efforts to reform economic policy and improve economic performance goes forward.

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