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MEXICO'S NEW ECONOMIC PROGRAM

Ernest C. Olson

On September 1 the President of Mexico delivered his 1948 annual message to Congress. After reviewing the accomplishments of his administration, the President presented an analysis of Mexico's recent balance of payments problems and outlined a twenty-three point economic program for the future. Under this program the federal budget is to be balanced, public works curtailed, and loans for other than industrial and agricultural purposes are to be discouraged. A new official rate of exchange is to be established but not until the peso's behavior in the free market has been studied and the Central Bank's international reserves replenished. In view of the devaluation of the peso on last July, the address is of special interest as an indicator of the direction which corrective measures may be expected to take in the future.

During the war Mexico, in common with other Latin American republics, experienced an unprecedented rise in gold and foreign exchange resources due principally to large export surpluses. As a consequence of the growth of international reserves and the expansion of credit in which Government borrowing from the Central Bank played an important part, a substantial inflation followed.

As merchandise became available after the war, imports rose sharply, surpassing exports by a considerable margin. The long deferred demand for the

replacement of worn-out capital equipment was augumented by the capital goods requirements of extensive economic development programs. Luxuries formed a substantial proportion of all imports as did commodities for mass consumption,1/ but the latter were not imported on a sufficiently important scale to contribute materially to check inflation.

In the absence of exchange controls, the large postwar trade deficits contributed greatly to Mexico's loss of gold and foreign exchange. Dollar reserves reached such critically low levels during the latter part of 1947 and the first half of 1948 that Mexico was obliged to resort to both the International Monetary Fund and the U. S. Stabilization Fund, drawing $22.5 million from the former (the maximum annual amount available to Mexico under the Articles of Agreement of the Fund) and $37 million from the latter. With these resources depleted and the monetary reserve threatened, the Bank of Mexico on July 22 withdrew its support of the peso, allowing it to "seek its own level" in the open market. 2/

The principal points of the new economic program may be grouped for convenience into three categories:

1. Fiscal policy.
2. Credit policy.
3. Trade and price controls and the fixing of a new exchange rate.

The fiscal measures proposed call for a balanced budget, the limitation of public works expenditures to "revenue derived from taxes", and the continuation of efforts to simplify the tax structure. Inasmuch as inflation has been sustained if not aggravated by excessive Government expenditures, the balancing of the budget is of paramount importance to the solution of Mexico's financial difficulties. It is unlikely, however, that the budget for this year will be balanced since present estimates indicate a probable deficit of 150 million pesos. It is understood that this deficit will be met with funds obtained from the Central Bank, repayable by the end of 1949. In order to extinguish this debt with receipts from current revenues, the Government next year will be faced with the necessity of producing a budgetary surplus of similar magnitude. While the deficit will probably not exceed 10 per cent of the new budget, provision for its liquidation will add to the Government's difficulties in achieving a balanced budget.

1/ Such imports consisted chiefly of wheat, lard, dairy products and, at times, corn, supplied by the United States under allocation. Mexican imports of these commodities were limited, therefore, by U. S. export allocations.
2/ Recent quotations indicate that the peso has dropped from its former pegged rate of 4.85 to approximately 6.85 per dollar, but it is believed that the rate has been influenced by Bank of Mexico dealings in the exchange market.

It is generally believed that fiscal receipts of the Mexican Government would be substantially increased if tax evasion could be reduced. In recognition of this, the Government in the immediate future will attempt to increase its revenues primarily by taking steps to improve tax collection procedures, rather than by levying new taxes (with the exception of the new export tax discussed below). The Government has issued a warning to taxpayers that it intends to scrutinize income tax returns and is prepared to exact the penalties for evasion provided by law. The need for a thorough overhauling of administrative practices is illustrated by Mexico's recent experience with the new mercantile tax, which was established at the beginning of this year. Recent estimates indicate that this tax is being evaded by nearly 2/3 of those subject to its provisions.

One of the most important proposals is that calling for a limitation of expenditures on public works. While investments in irrigation works, highways, ports, railroads and electric power facilities are necessary for Mexico's economic development, it is questionable whether they should have been undertaken during a period of inflation when prudent fiscal management would have required the curtailment, if not the elimination, of such expenditures. Presumably future projects will be initiated only as tax receipts permit and those projects now in progress will be abandoned or retarded where feasible.

The new economic program also proposes changes in credit policy directed toward the prevention of speculation and the channeling of credit into productive uses. Only loans to increase agricultural production and to facilitate the development and expansion of manufacturing industries are to be encouraged. Maximum rediscount rates for agricultural paper are to be 3-1/2 per cent, for industrial paper 4-1/2 per cent, and for commercial paper, 8 per cent. In contrast to these rates the former rate for agricultural and industrial paper was 6 per cent. However, private banks are no longer to have rediscount privileges with the Central Bank except in emergencies, and then only if 60 per cent of their loan portfolios represent loans to agriculture and industry.

The plan further provides for the amendment of the banking law to make possible the extension of long-term loans "through channels which are more effective than the 'Financieras'" (Government credit institutions and associated private agencies). This proposal represents a reversal of the policies of Central Bank and the National Banking Commission which have heretofore discouraged banks from holding other than short-term liquid obligations. Insofar as commercial banks are concerned, it is questionable whether permission to make long-term loans will materially affect their lending policies. Since such institutions have emphasized liquidity and have been primarily concerned with minimizing the risk and maturity of loans, it is unlikely, in the absence of greater inducements than those proposed, that commercial banks will want to make many long-term loans, particularly for agricultural purposes. This is especially true in Mexico where the hazards of crop failure and loan renewals are great. In a further attempt to induce private banks to increase agricultural

loans, banks in the interior are to be allowed to employ a maximum of 25 per cent of their legal reserves in extending credit for the raising of livestock and the cultivation of certain crops. It is estimated that after private banks have liquidated their rediscounts with the Central Bank as they are required to do, they will have, by virtue of this provision, more than 40 million pesos available for agricultural credit.

The rediscount privilege is also to be withdrawn from the Government banks which have been the principal source of agricultural loans, but these institutions are to have their capital increased by the Government as a compensatory measure. As of the middle of September the amount of capital increase had been determined for only one bank, and the amount fixed was equivalent to the bank's agricultural loans during 1947. This presumably reflects the Government's policy to continue to give some encouragement to agricultural loans while at the same time providing funds from non-inflationary sources. The Government is reluctant to apply any drastic restrictions on credit to agriculture in view of the need to augment agricultural production for consumption and export. However, the effect of the absolute withdrawal of the rediscount privilege from Government banks and the limited withdrawal from private banks is expected to exercise some restraining influence. By supplementing the capital of Government banks the Government may be able to provide for legitimate agricultural credit needs. By providing this capital from regular budgetary sources, agricultural credit needs could be met in a non-inflationary manner.

The intention of the Government of Mexico to exercise greater control over credit is also evident from the announcement that henceforth the operations of the Nacional Financiera will be limited to the financing of industries which are of fundamental interest to the country. The activities of this agency are to be directed principally toward financing domestic currency expenditures of industries which have in the past or which may in the future obtain foreign loans for the purchase of machinery and equipment. In effect, this seems to imply that for some time to come the operations of the Nacional Financiera are likely to be closely related to the volume of credits which Mexico may obtain abroad, principally from the Export-Import Bank and the International Bank for Reconstruction and Development. In addition, this agency will also grant credit to industry and agriculture for the importation of machinery and equipment, utilizing its own foreign exchange reserves for this purpose.

The President's address included a number of points pertaining to the fixing of a new official value of the peso, international trade restrictions, and price controls. An official rate for the peso is not to be established until the Bank of Mexico has had an opportunity to observe fluctuations in the free market and has replenished its international reserves at least sufficiently to meet expected seasonal demands for foreign exchange.

After due consideration, the importation of certain merchandise, presumably luxuries and non-essential goods, presently prohibited, may be permitted

under a quota system. The prohibition of such imports has led in practice to a thriving contraband trade which has afforded large profits to those engaged in such operations. By admitting such imports under the quota system proposed, the Government presumably will share in these profits. While Mexico will thus join other Latin American countries in establishing luxury import quotas, the manner in which the Government is to participate in the profits of this trade marks a departure from usual practice. Whereas in other Latin American countries, importers of luxuries are required to pay premium prices in domestic currency for their foreign exchange because of exchange taxes and multiple exchange rate systems, in Mexico importers will bid at auction for import licenses, with foreign exchange to be supplied presumably at the new official rate when it is established. As yet there is no indication of any steps taken to implement this proposal. While the measures proposed may reduce contraband operations to some extent, the principal deterrent to such traffic will be higher peso prices which have resulted from the devaluation of the peso.

Basic foods in short supply are to be imported for the account of the Government, and will be sold at prices which would have prevailed were the former exchange rate of 4.85 pesos per dollar still in effect. The Government will sell such imports through its own markets in order to avoid large price markups by private distributors. In 1947, Mexican imports of food from the United States, which supplies nearly all such imports, were equivalent to about 300 million pesos at the rate of 4.85 pesos per dollar. At an exchange rate of 6.85 per dollar the value of these commodities would be nearly 425 million pesos. If the volume and price levels are not materially different in 1949 from what they were in 1947 and if the peso-dollar rate remains near its current level of 6.85, the difference of 125 million pesos can be taken as a rough measure of the magnitude of the subsidy which will be required.

These funds will be obtained from a 15 per cent ad valorem tax on exports, which is expected to yield about 400 million pesos. The imposition of this tax concurrently with an exchange depreciation of 40 per cent is designed to absorb part of the exporters' windfall profits and to raise much needed Government revenue. The Government hopes this tax will also prevent local price increases for export commodities traded in domestic markets.

It should be noted, however, that while serving the above objectives the tax reduces the encouragement to exporters provided by the exchange depreciation. A dilemma is thus evident. Should the promotion of exports and additional foreign exchange receipts be made subsidiary to the control of domestic inflation? In an effort to solve this dilemma, the Government announced that it was prepared to grant exemptions up to 80 per cent of the tax in certain cases. The immediate effect of this announcement was a reluctance on the part of exporters to ship goods until their applications for exemptions had been considered. Effective administration of the exemption provision may permit some reconciliation between the objectives of balance of payments equilibrium and the objectives of controlling domestic inflation.

In a parallel move to hold down the cost of living, and one which also reflects the above dilemma, the export of foodstuffs and other articles of prime necessity will be prohibited unless proof can be shown that domestic requirements have been satisfied. The prices to be used in determining whether domestic requirements have been met will presumably be those which have prevailed under the influence of various indirect controls. A new agency is to be established to coordinate the various price control functions which are currently exercised by several agencies. The new coordinating body will also control the import and export of such commodities. In addition, import duties on raw materials, semi-manufactured and manufactured products as well as on machinery and equipment not manufactured in Mexico, are to be lowered in order to offset domestic price increases due to the devaluation.

Apart from these restrictions, exports are to be encouraged. In the event that countries desiring to import Mexican products are prevented from doing so because they lack foreign exchange, Mexico will undertake to negotiate barter agreements. However, inasmuch as the barter program has been in effect for more than a year and has not produced any significant results, it is doubtful whether such arrangements will be an important factor in Mexican trade, at least in the near future.

In principle the economic program proposed by President Alemán has many commendable points. Certainly the curtailment of public works, the elimination of budgetary deficits, and stricter credit controls intended to curtail speculation and provide credit on more favorable terms for productive purposes are essential to Mexico's orderly economic development and the welfare of its people. Equally important in the immediate future are the measures proposed for preventing sharp increases in the prices of commodities which claim a large share of the public's meager incomes.

While more thorough-going controls and reforms would inspire greater confidence in Mexico's economic outlook, the political obstacles involved would be too formidable for the Government to overcome. Even the present program can be expected to meet with considerable opposition, not only from the legislature but also from those who stand to lose by its fulfillment. However, the success of these or other reform measures will depend at least as much on their vigorous enforcement as on their legal provisions. If there are sufficient numbers of public servants of adequate administrative competence and integrity, and if the Government will impartially and vigorously administer the law, the new economic program may very well enjoy a substantial measure of success.

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EUROPEAN PRODUCTION IN THE SECOND QUARTER

Randall Hinshaw

In the June 29th issue of this Review, the writer introduced a composite index of industrial production covering nine countries participating in the European Recovery Program. At that time, the index was carried through the first quarter of 1948. It is now possible to add a preliminary figure for the second quarter.

The index is on a 1938 base, and employs fixed weights throughout. Each country is weighted according to its share in European industrial production in 1938, as estimated by the Economic Commission for Europe. The countries included in the index, with their respective weights, are as follows: Belgium, 4.71 per cent; Denmark, 2.34 per cent; France, 15.71 per cent; Western Germany, 24.17 per cent; Italy, 10.53 per cent; the Netherlands, 4.54 per cent; Norway, 1.37 per cent; Sweden, 5.18 per cent; and the United Kingdom, 31.45 per cent. These nine countries in 1938 accounted for 68.8 per cent of the industrial production of Europe (excluding the U.S.S.R.), as estimated by the Commission.

Minor revisions have been made in the index, and certain technical deficiencies have been eliminated. In the case of the British series, the post-war figures are now related to the base year on the basis of a recently released official estimate instead of the unofficial estimate by the Economic Commission for Europe. For further details concerning the construction of the composite index, the reader is referred to the original article in this Review.

Two overall indexes, one of which excludes Western Germany, are shown in the table on the following page. The component series also appear in the same table. It will be noted that, with the exception of Western Germany and Italy, industrial production in each of the included countries is now above, and in some cases much above, the 1938 level. A comparison of the two composite series shows rather dramatically the drag of Germany on European recovery. However, it may be pointed out that the latest available figures are not recent enough to show the effect of the introduction of the new currency in Western Germany.

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LEVEL OF INDUSTRIAL PRODUCTION IN ERP COUNTRIES

QUARTERLY

(1938 = 100)

	Belgium	Denmark	France	Western Germany	Italy	Nether-lands	Norway	Sweden	United Kingdom	Overall index	Overall index, excluding Germany
1946											
	77.8	99.0	67.3	23.1	35.3	61.4	92.7	133.5	95.9	67.1	81.1
-I	84.8	93.7	82.7	26.4	60.1	68.3	103.3	135.2	100.7	75.1	90.6
III	90.1	104.0	77.0	30.5	71.5	75.9	94.7	132.7	100.4	76.8	91.6
IV	99.2	108.0	89.7	30.0	66.0	88.1	110.0	137.3	110.9	83.0	99.9
1947											
I	102.5	108.3	93.0	25.0	62.2	83.8	113.3	136.3	97.9	77.7	94.6
II	108.2	107.7	100.3	31.9	80.3	89.1	119.0	137.6	111.5	87.4	105.1
III	100.8	114.0	91.3	34.7	90.0	91.1	106.3	136.0	110.9	87.1	103.8
IV	113.1	118.3	95.7	36.1	85.8	105.3	120.0	137.6	121.7	92.6	110.7
1948											
I	115.6	124.0	109.7	38.1	79.5	101.7	125.3	139.6	122.1	95.0	113.2
II	115.2	122.7	114.0	40.3	82.4	106.6	133.3	141.9	124.1	97.6	116.0

SOME THOUGHTS ON THE NATURE OF DEVELOPMENT LOANS

Lewis N. Dembitz

Current financial problems in several Latin American countries raise an interesting question as to the economic criteria for determining whether a country can be regarded as a proper applicant for a "development loan" from a public lending agency. For the present discussion, it is assumed that the country wishing to borrow is an acceptable credit risk, and the question then is whether the purpose of the loan warrants an extension of credit by such an agency as the Export-Import Bank or the International Bank for Reconstruction and Development.

The first purpose of the International Bank for Reconstruction and Development, as set forth in its Articles of Agreement, is:

> "To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes ..."

The economic development of borrowing countries has also been considered an important objective of Export-Import Bank lending. However, to apply these broad objectives to actual cases requires some further definition of a "development loan."

This note will suggest that in considering whether a loan can properly be called a development loan, the particular items to be imported with the proceeds of the loan are not necessarily the main determinant. More strictly defined, the purpose of a loan depends on what items will be added to the borrowing country's imports because of the obtaining of the loan. Beyond this, however, it is pointed out that in order for a loan really to be a development loan, it must result in adding to the productive capital of the borrowing country -- i.e., in net capital formation in that country.

Ordinarily, one attribute of a development loan is that the loan is to pay for imported capital equipment or for materials or equipment that will be incorporated in a capital asset to be constructed. 1/ However, any country's imports during any period of time will include some imports of such capital goods; the mere fact that such goods are being imported does not necessarily mean that there is any net addition to the country's productive capital.

For example, one might consider a country in which new investments in productive plant are only equal to current depreciation (or depletion or obsolescence) of its existing assets. Here, there is no net capital formation,

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1/ For a discussion of circumstances in which a foreign development loan might also be justified for the purpose of paying domestic expenditures in connection with such a project, see this Review for October 5, 1948, pages 9 to 12.

and the expenditures for capital goods (whether imported or domestic) serve merely to maintain the value of the country's existing plant. Suppose also that that country has an unfavorable balance of payments equal to its expenditure on imported capital goods, and that these capital goods imports are financed by means of a foreign loan. In this case it seems clear that the loan is for the maintenance of existing plant rather than for development in a broad sense.

Furthermore, in view of the fungibility of money, it is not always realistic to say that the purpose of a loan is to buy capital goods merely because the loan proceeds are used to pay for imports of capital goods. It would seem more accurate to say that the purpose of a loan is to finance the purchase of those items which the applicant will buy if it obtains the loan but which it would not buy if it did not obtain the loan. 1/

Unfortunately this test, which defines the purpose of a loan in a very logical manner, is often in practice difficult to apply. Sometimes, of course, its application is easy, as where plans for a particular project are definitely contingent upon the granting of a particular loan. Often, however, the test becomes too subjective to be practically useful. As a relatively simple example of this, one might suppose a case where, if a loan were refused, the applicant government would be left with a choice between eliminating imports of currently needed equipment (such as trucks or agricultural machinery) and eliminating imports of consumer goods of types that might be considered non-essential. In this case, if it is the capital goods that the government would in fact eliminate, then the loan request might seem to qualify as being for the purchase of capital goods rather than for the purchase of non-essential consumer goods. Of course, in such a case, the lending agency might still review the policy of the applicant and decide that the capital goods ought to be covered by eliminating non-essential imports rather than by a loan.

Further difficulties in defining the purpose may be illustrated by another case where a country's plans call for devoting large amounts of its domestic resources to development projects, for importing consumer goods, and for borrowing abroad to cover its unfavorable balance of payments. If the foreign loans should prove unavailable, the country might have alternative plans for shifting domestic resources from development to the production of consumer goods at home; this would mean that the imports to be eliminated would be consumer goods but that the ultimate expenditures to be cut out would be those on the development projects. Under these circumstances, although the direct purpose of the loan is to import consumer goods, it would seem more

1/ Sometimes the inability to obtain the loan will not cause the elimination of any purchases at all, but will merely cause the applicant to draw down existing reserves; in this case, it might properly be said that the purpose of the loan is to maintain reserves.

significant to consider the development projects as the real purpose. 1/ More realistically, however, continuing this same example, the unavailability of foreign loans might call for a whole new round of debate by the country's authorities to determine how the cutting back of national expenditure should be divided between cutting development plans and cutting consumer goods. Where this is the case, there seems no basis for characterizing the loan application as being for one or the other ultimate purpose; the most accurate statement would be that the country has a program which includes certain expenditures and imports and a balance-of-payments deficit, and the loan is to cover the balance-of-payments deficit that the program as a whole entails.

Development Loans and Net Capital Formation

In an economic sense, one might start with the assumption that the country's productive plant is to be maintained and that an amount of expenditure on its productive plant equal to current depreciation is a current expense rather than a capital investment. Surely a foreign lender must begin by looking at the country's economy from this point of view.

On this basis, a country applying for a "development loan" should be able to show that it expects, using the loan, to experience an amount of net capital formation at least equal to the amount of the loan. Net capital formation would be regarded for this purpose as the amount of net addition to the country's productive plant, after deducting current depreciation but without making any deduction for increases in the country's external liabilities. The lender must make allowance for special cases where a particular program of development, not involving any net capital formation in a strict accounting sense, will nevertheless increase the country's productivity; but such special cases do not appear to invalidate the general rule.

A lender might well go further and require a showing that the planned amount of net capital formation is at least equal to the amount of the loan in addition to the amount of net capital formation that the country could reasonably be expected to finance out of domestic savings. The estimating of a reasonable rate of domestic savings would, of course, involve a full consideration of the country's various economic and other characteristics, including all available data on its past rates of savings and capital formation.

As a practical matter, estimating the rate of net capital formation is difficult, especially for the typical country that would be applying for a

1/ The stated purpose of the borrowings might be to pay for consumer-goods imports, or the borrowing might be done for the company or government agency undertaking the development project. In the latter case, while the stated purpose could be to pay local currency expenditures on the project, the foreign exchange proceeds of the borrowing would still be used to pay for the consumer-goods imports.

development loan. Hence there arises this question: To what extent can the type of capital item to be acquired serve to indicate whether or not net capital formation will result? The acquisition of a completely new item, such as a new dam or a new railroad line, may imply net capital formation (on the assumption that the country would be keeping its existing productive plant while acquiring the new item); the acquisition of new locomotives to replace old ones would fail to carry any such implication. Such implications, however, may be misleading. The investment in a new dam or railroad lines does not represent net capital formation if it is offset by depreciation in the rest of the country's productive plant during the period of construction. And conversely, an investment in locomotives (even if they replace an equal number of obsolete locomotives) represents genuine net capital formation if the amount of the investment exceeds the current period's depreciation on the rest of the country's productive plant. Furthermore, as has been pointed out earlier, it may well happen that imports of consumer goods will enable a country to carry out a program of net capital formation that would otherwise have been impossible. In fact, a basic hypothesis of the European Recovery Program is that loans (or grants) to supply consumer goods will assist the recipient countries to carry out programs of reconstruction and development.

If it is required that a country applying for a development loan must expect to increase its net capital by at least the amount of the loan, this implies that the country will have reached a position where its current consumption is within its current production -- i.e., that the country is currently "living within its means". Most desirably, of course, this would reflect a condition of internal equilibrium, in which demands for goods for current consumption are fully covered by available supplies. Alternatively, where this condition does not exist, it implies a system of import or exchange controls that is effective in preventing domestic demand from unduly affecting the balance of payments. Or, where the country has an adverse balance of payments, it may be meeting this adverse balance out of its existing reserves; this might be particularly appropriate if a country had during wartime accumulated abnormally large reserves and were using these reserves after the war to permit consumers to replenish their stocks.

Loans Where There is No Net Capital Formation

A lending agency will sometimes find it desirable to make a loan to a country that is not having net capital formation. In some cases of this kind, it may be advantageous to let the loan take the form of a development loan.

Take, for example, a country which has been living beyond its means and has depleted its foreign exchange reserves in meeting balance of payments deficits. Suppose further that the country is prepared to undertake vigorous reforms in order to bring its domestic consumption within its income, but that it will take some time (e.g., 6-12 months) to realize the effect of such reforms

if they are to be put into effect without an unduly violent transition. A lending agency might well decide that the extending of credit in these circumstances is desirable in order to allow time for an orderly transition and thus to aid international stability. This is clearly not a "development loan"; it is a loan to finance the country's current deficit during the period of transition to a balanced position.

Nevertheless, it may be desirable for the loan to take the form of a development loan. This could be done by selecting, out of the country's prospective imports, a group of capital items for whose purchase the proceeds of the loan would be earmarked. Any country would ordinarily be importing some amount of agricultural machinery, or industrial equipment to replace obsolete equipment, or new railway cars or motor trucks, which could be selected for this purpose. Such imports constitute lasting assets for the borrowing country, and they also tend to increase the country's ability to earn foreign exchange; therefore, attaching the loan to such imports might increase the country's later willingness to repay. It might also be good for public relations purposes, both in the lending country and in other countries that may later be loan applicants. It is clear, however, that the criterion for the lending agency, in deciding whether to grant or refuse applications for such loans, is not the productiveness of the particular capital items to be financed, but is rather the general effect on domestic and international stability that granting or refusing the loan would have.

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