A Monetary Will-O'-The Wisp: Pursuit of Equity

Through Deficit Spending

by

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NOTE: This (July 1976) draft monograph was written during 1975-76 when the author (fresh at that time from more than four years as chief of the Planning Secretariat to President Echeverria of Mexico) was in residence as a visiting research associate of R.P.D.S. with funding from the Social Research Council and the Income Distribution and Employment Programme portion of the International Labour Organization's World Employment Programme. The draft has been issued as a two-part working paper by W.E.P., ILO, Geneva, both papers being dated March 1977. Since the supply from that source may be limited, it now seems appropriate to make our local supply available to R.P.D.S. Discussion Paper readers -- with the usual proviso that the material is preliminary and is not to be reproduced, cited, or quoted, without permission of the author (who is presently Deputy Director of the Central Bank of Mexico).

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A MONETARY WILL-O' THE WISP: PURSUIT OF EQUITY THROUGH DEFICIT SPENDING

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This is an essay in political economy which tries to assess the recent economic developments in Mexico, especially the attempt at economic reform in the early 1970s. At the beginning of the present decade Mexican politicians and economic policy makers realized that the traditional goals of income per capita growth and price and balance-of-payments stability were no longer sufficient. Therefore, they added a new objective, namely the improvement in income distribution. Thus an effort was made to begin to translate the concept of equality into economic reality. I was fortunate enough to witness this process -- sometimes quite closely -- as head of the economic programming directorate of the Secretariat of the Presidency during 1971-75.

When Luis Echeverría became President of Mexico in 1970, the country was ripe for change. Ever since Cárdenas' presidency in the 1930s, Mexico had enjoyed a good deal of political stability and economic growth. Cárdenas' policies, especially his social and economic reforms, were the highlight of the Mexican revolution, and at the end of his administration, the main institutional features of modern Mexico took shape. The early 1940s marked the beginning of the phase of "national unity," when harmony and accord among pressure groups replaced the armed revolution and ideological and class struggle of the previous years. The 1960s saw the end of that stage of Mexican history. For the first time during this decade Mexico achieved continuous price stability; and this stability plus sustained economic growth became known as Stabilizing Development. The concept was in many ways an a posteriori rationalization of the chain of economic events that followed the 1954 devaluation and the subsequent
short-lived inflationary spurt. Politically, the Stabilizing Development period meant a coalition -- sometimes called the "development alliance" -- of the beneficiaries of the economic progress, namely organized labor, the bureaucracy and private entrepreneurs.

At the end of the 1960s, the economic policies of Stabilizing Development became subjected to mounting criticism. The main issue was income distribution: it became clear that the lower half of the families in the income scale were relatively worse-off, regardless of the evidence of production indicators. The general political dissatisfaction of the middle class (despite the fact that it received many benefits through the Stabilizing Development period) was dramatically expressed in the 1968 student riots. The police repression of the movement turned the Díaz Ordaz administration into a lame-duck government, incapable of taking initiatives in matters of national importance. Observers of Mexican affairs commented that the political development of the nation lagged behind its economic growth, that political institutions had become stale, and social mobility frozen. At this moment, the incoming President Luis Echeverria issued a call to the country in his Inauguration speech of December 1970, asking all Mexicans to support him in his efforts to make Mexico a more equitable and just society.

* * *

The first chapter of this book examines the period of Stabilizing Development in order to provide the reader with a framework necessary for judging the environment in which the attempts at economic reform were undertaken. The chapter is a piece of applied economics and it tries to assess the now too frequent attacks against that phase of economic policy.
The following three chapters discuss the economic policy objectives of Echeverría's administration, the attempt at tax reform and the change in the structure and practices of public spending. The final chapter evaluates the experience and draws some inferences about the nature of decision making in economic policy and the constraints faced by a government that wants to use economic policy as an instrument for the promotion of social welfare.

The style varies in the different sections of the book. The first chapter shows the detachment from the subject matter expected of an economist. The following three chapters describe events in which I took part, and therefore are written from a far more personal point of view. The concluding chapter contains afterthoughts arrived at within the intellectual environment of Princeton University which is so conducive to serene and reflective thinking.

I have included intact some staff papers prepared in the rush of the moment. Those papers were written quickly, usually in a few hours' time, and therefore contain some faulty analyses, and their style is rough. I decided not to manicure them in order to give the reader a fresh and honest view of the pressures, satisfactions and frustrations of an economic advisor.

* * *

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Chapter I

STABILIZING DEVELOPMENT

A Sketch of the 60s

Economic growth and price stability

Mexico has had a long history of political and economic instability. Although political stability was assured with the merging of the revolutionary groups and forces into one political party in 1929 (PNR, later PRM and now PRI),\(^1\) economic order in the form of price and balance-of-payments stability came into being much later, nearly three decades afterwards. The peso devaluation of 1954 that fixed the exchange rate at the current rate of 12.50 pesos to a dollar, was a traumatic event indeed. Policy makers of that time comment to this day that the labor unions' response triggered by the devaluation shook up the whole party structure.\(^2\) A wage increase was granted to appease the workers because it became evident that the economic growth with price instability was unacceptable to them. The share of wages and salaries in national income had actually decreased during the 40s\(^3\) and policies had to be devised to prevent labor from bearing the whole burden of growth, i.e., to prevent labor's income share going down further. The prevailing explanation of the time was that prices lead, wages lag, real wages go down. Inflation had to be stopped. This was in fact achieved in 1956-57, and since 1958 economic variables have shown quite a different pattern of behavior. The 1958 recession of the

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\(^1\)PNR: Partido Nacional Revolucionario; PRM: Partido de la Revolución Mexicana; PRI: Partido Revolucionario Institucional.

\(^2\)José Luis Reyna, El movimiento obrero en 1952-1964, (forthcoming), where the repression of the railroad workers' union by the López Mateos Administration is related to the 1954 devaluation.

North American economy, however, depressed the early years of the price stability period and some analysts argued that the stabilization policies of the time were driving the country to stagnation.\textsuperscript{1} Private investment slowed down and a sharp and critical exchange of comments between the public and private sectors took place, showing that a recession eroded the amity between entrepreneurs and the government. The ascent of Castro in Cuba also affected the private sector's prevailing mood. In that context, the 60s started, and with them, Stabilizing Development. We are fortunate enough to have a yardstick for judging the economic policies that followed in the 60s. At the 1969 Annual Meeting of the World Bank and the International Monetary Fund, Antonio Ortiz Mena, Secretary of Treasury from 1958 to 1970, presented a comparative analysis of the 1950-58 period, which he called the inflation-devaluation cycle, and the 1959-67 period which he called Stabilizing Development.\textsuperscript{2} The document contains a useful conceptual framework that merits a detailed description.

Ortiz Mena states that during the inflation-devaluation phase, in a cyclical upswing of investment, spending outpaced voluntary savings, increases in the price level closed the savings-investment gap, and subsequent changes in factor shares led to the worsening of income distribution. Stabilizing Development was intended to raise voluntary savings, improve the allocation of savings, and increase the stock of capital per worker. Tax policies were geared to foster the reinvestment of profits and subsidies were selectively extended to favor the most productive projects.


\textsuperscript{2}"Desarrollo Estabilizador – Una década de estrategia económica en México," México, El Mercado de Valores, No. 44, Nov. 1969, Nacional Financiera, S.A.
Profit reinvestment promotion, we are told, meant convincing investors that future capital gains — not taxed currently — were more attractive than current dividends which would be taxed.\(^1\) Tax practices were adjusted in a way to support the processes of capital deepening; capital was also to be spread out in the productive absorption of the growing labor force. Debt policies were designed to tap both domestic and foreign savings. Foreign and domestic debts were quite low at the beginning of the 60s. The Central Bank's reserve requirement mechanism was used to channel domestic savings into financing government deficits and complementing foreign funds in order to achieve levels of borrowing that would be, on the one hand, non-inflationary and on the other, sufficient to promote development. To that end, government spending was budgeted at levels that would avoid excessive issues of high-powered money. In order to increase domestic voluntary savings, in the form of additional flows of financial intermediation channeled by financial institutions, and to induce a stream of capital inflow, real interest rates were set at levels sufficiently above those prevailing in the U.S. market. Interest was kept tax-free — or taxed at very low, flat rates — and an array of fixed income securities was permanently pegged at nominal prices. Such financial issues were in fact free of risk of capital loss, and as time passed with the exchange rate unaltered, foreign exchange risk as perceived by investors and reflected in international rate differences gradually diminished.

In the external sector, Stabilizing Development had -- according to Ortiz Mena -- two aims: to keep the foreign exchange rate of the peso fixed, and to borrow abroad to compensate for insufficient foreign exchange coming from exports, and for insufficient public investment coming from

\(^1\)Ibid, p. 506.
tax collections.

The analysis of Stabilizing Development showed that GDP in real terms grew 6.5 percent annually in 1959-67 — it had been 5.6 in 1951-58 — which was at a faster rate than during any previous period in Mexican history. The price deflator of GDP rose only 3.6 percent a year while it had been 7.5 percent in the 50s. Inflationary expectations gradually diminished. The ratio of price changes to real GDP changes fell from 1.34 in 1951-58 to 0.55 in 1959-67. The other objectives of Stabilizing Development (besides more rapid growth and slowing down of the rate of price change) were achieved to a certain extent: a rise in the savings ratio, increases in factor productivity, an improvement of real wages and an expansion of the wage-share in national income, and a stable foreign exchange rate. The record shown in Tables I-1 and I-2, however, merits some additional comments. In order to raise the savings/income ratio, policies focused on domestic price stability and on improving the competitive position of Mexican financial institutions vis-a-vis the U.S. financial market by introducing high nominal interest rates on Mexican financial paper. A higher proportion of domestic savings was diverted to banks and especially to other financial institutions — mainly financieras — and these resources were complemented by a much more active use of foreign funds, mainly in the form of long-term loans to official institutions, which also passed through Mexican financial intermediaries. Total savings, which averaged 0.13% of GDP in 1951-58, increased to 0.21% in 1959-67. Foreign loans and domestic credit accommodated the government's financial needs without forcing inflationary monetary expansion. Public spending was kept at levels that required no inflationary financing and made it possible to
keep the exchange rate unchanged. International capital flows became increasingly free of foreign exchange risk. The use of foreign savings made up for the insufficient inflow of commodity export earnings, and for low revenues from tax collections. Consequently, the public sector was forced to supply energy and other essential public services at low prices and was able to do so without severe supply restrictions.

As a complement to a higher savings ratio, the government intended to raise the productivity of capital. In this context, the official attitude favored external economies, the channeling of investment into activities of high productivity (thereby increasing product per unit of labor input), fuller use of plant capacity, and a decrease of the share of depreciation in gross investment. Public spending—especially on the capital account—was directed toward increasing the profitability of private investment. In general, however, private expenditures were favored by a system of tax benefits, exemptions and subsidies which were used to promote the reinvestment of profits by the private sector but which made fiscal policy ineffective in its ability to increase tax revenues.

This chapter will examine the economic record of the 60s with separate sections devoted to the following developments: import substitution and growth of manufacturing, stagnation in agriculture, boom in financial intermediation, tax reform attempts, and distribution inequality. The final section will deal with the evolution of economic policy and will offer some conclusions on domestic and foreign equilibrium.

Before turning to the economic analysis of the 60s, however, we may ask what was the political meaning of Stabilizing Development. We may suggest that the objectives of stability and growth were supported both by the entrepreneurial class and by organized labor who mainly appropriated the benefits of growth. The middle class, although belonging to the
beneficiaries,¹ lacked channels for overt political participation. More importantly, however, the position of lower classes worsened relatively. Budget constraints on public sector spending meant that the sectors and social groups unable to apply political pressure, especially those outside the modern or commercial segments of the economy, were by-passed by public spending, and their efforts to be subsidized or otherwise supported and thereby to improve their income and wealth positions were thwarted. This was to have important political and economic repercussions in the latter part of the 60s, which will be discussed in the final assessment of the overall characteristics of the decade.

1. Import substitution and the growth of manufacturing

During the 60s, economic growth was fairly steady, 7% annually, varying from a low of 4.7% in 1962 to a high of 11.7% in 1964, the last year of the López administration. Income per capita exceeded a level of U.S. $700 in 1970. The structure of the spending components of GDP showed some changes: there was a relative decrease of private consumption and exports, government consumption increased, and gross fixed investment gained nearly three percentage points, reaching 19.0% of GDP in 1970, a figure well above the 12.8% achieved 20 years earlier. The structure of output changed somewhat with agriculture and cattle raising declining from 15.9 to 11.6% of GDP, and industry increasing to 34.4% of the total (see table 1-3).

In manufacturing, the production of consumer goods continued losing importance in the aggregate, but at a slower rate than during the 50s. Petrochemicals became significant, especially under the leadership of Jesús Reyes Heroles -- head of PEMEX and later President of PRI. Food, beverages and tobacco, textiles, clothing and leather goods lost relative position: the opposite happened to intermediate and capital goods, especially engineering products, and chemicals. The imports of intermediate goods showed a low rate of increase, 5.2% per year, while imports of investment goods rose sharply, by 10.9% annually, reflecting the vigor of investment demand and the late start of the Mexican capital goods industries. Import substitution continued to shift towards intermediate and capital goods. The process of industrialization was inward oriented in a peculiar way: manufacturing, which had gained a foothold in export

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1 The data, unless otherwise noted, are from México, Secretaría de la Presidencia, Lineamientos para el Programa de Desarrollo Económico y Social, 1974-1980, Anexo Estadístico, México, 1974. See also table 1-2.
markets during the 40s, lost its position through the 50s and 60s with its share in total exports, decreasing from \(0.165\) in 1950 to \(0.087\) in 1969 (see table I-4). Since mining had stagnated in the 30s and in later years continued growing at very modest rates, \(2.2\%\) in 1950-70, which was well under the rate required by the income-elasticity of the demand for minerals or by the 1950 and 1960 input-output tables) the result was a sharp decrease in the share of minerals in total exports. Something similar happened with agriculture: although with a different timing, the result was the same -- a decrease in the share of products being sold abroad. Import substitution conformed to -- and was guided by -- the then prevailing dogma of industrialization: compress the import/income ratio, \(^1\) and the effects of this policy will spread through the whole production structure lowering the export/income ratio of all sectors. It seems worth noting that while in 1950 exports were heavily concentrated in industries with capital/labor ratios below average, in 1969 the same industries' share of exports had declined, along with resource-intensive industries, to be replaced by industries with capital/labor ratios above average. \(^2\)

A number of government entities have authority in matters of industrial policies, and an array of policies was used to promote and direct the process of industrialization. There are three main tools of protection: tariffs, quantitative controls of imports (import licensing), and programs to

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\(^1\)The total import/income ratio fell from \(0.154\) in 1950-52 to \(0.101\) in 1967-69. For manufacturers the decrease was from \(0.184\) to \(0.115\). See CEPAL-NAFINSA, La Política Industrial en el Desarrollo Económico de México, México, 1971, table 7, p. 80.

promote production in manufacturing. Parallel to these are fiscal incentives and various financial facilities designed, for example, to stimulate reinvestment of profits, export of manufactures, and decentralization of industrial location. During the 60s, administrative procedures were improved specifying and detailing more clearly and accurately the control of import commodities in order to increase the effectiveness of tariff protection and to widen its coverage from two fifths to two thirds of all import items. Between 1964 and 1970, approximately one thousand new import categories were created per year, the total reaching 12,900 at the latter date. This policy accommodated entrepreneurial requests for the protection of new products or the enlargement of the margins of those already protected. It has been estimated that if domestic industrial product during this period had been valued at world instead of domestic prices, the indicated level of output would have been lower by 25%; and its annual growth rate from 1950 to 1967 would have been 6.2% instead of the officially reported 6.9%. For revenue and balance-of-payments purposes, tariffs were also raised in order to discourage imports that were deemed unnecessary. In 1962, a surtax on luxury goods was introduced and a 6% nominal tariff increase was implemented in 1965. Despite that, the revenue obtained from tariffs decreased substantially — from 36% of total federal government tax income in 1930, to 21% in 1959, and to 13% in 1968. The margin of import duty coverage followed roughly a degree of processing criterion: agricultural machinery (no duties), raw materials (5-15%), intermediate products for industrial use (15%), machinery and tools (20-25%), other manufactured products (25-35%), automobiles (100%).

1 CEPAL-NAPRESA, OP. CIT., p. 38.
Although the level of tariffs in Mexico is generally low in comparison with other developing countries, quantitative controls drastically reinforced the protectionist effect. Import licenses were introduced in 1948 and systematically expanded until, in 1970, an estimated 65% of the value of imports, and a similar number of import items, were covered by license requirements. A new scheme was introduced in the form of manufacturing programs aimed at inducing firms to produce domestically the inputs, parts, or other intermediate goods required in their manufacturing operations. A manufacturing production program stipulates, in a negotiated agreement between the firm and the Department of Industry and Commerce, the timing and scheduling of the vertical integration of the firm in substituting local manufactures for imported inputs. The agreement guarantees import licenses on all the inputs not yet substituted which the firm will have to import over several years. Usually, the agreement is also complemented with tax rebates.

Fiscal incentives have been used to favor manufacturing over other productive activities. Incentives were intended to foster capital formation, stimulate fixed capital renewal and the reinvestment of profits. A law of industrial promotion was passed in 1955 (Ley de Industrias Nuevas y Necesarias) to grant tax rebates to new industries -- those that were going to produce commodities not previously manufactured in the country -- and to the so-called necessary industries -- those whose output was not yet sufficient to supply 80% of the domestic market. For both categories, the tax rebates covered all import duties on machinery, equipment, and raw materials, 40% of the corporate income tax, and 100% of stamp and sales taxes. This had the effect of increasing effective protection and enlarging its variance over different products. In 1961, the corporate income tax
was amended to allow for accelerated depreciation, permitting the deduction of charges from taxable profits at quite flexible rates. Another feature for inducing capital formation was the so-called "Cláusula XIV" which permitted the import of complete industrial plants as whole packages, regardless of whether they entered the country in one or several shipments, the result being lower import duties and lower capital costs. This was combined with exemptions from tariff burdens — 65% of the corresponding duty. In the latter part of the 60s, fiscal devices began to be used as export promotion devices in the form of rebates of indirect taxes.

At the same time, raw materials, intermediate goods, and capital goods were fairly easy to import and paid lower import duties with the result that effective protection rates for manufacturing became higher than nominal tariff protection. Non-durable consumer goods decreased their relative share in total imports; imports of machinery and equipment increased their share, from 23% in 1940 to 36% in 1970. The infant industry argument was consistently applied, and protection, once imposed, was never removed despite the fact that in principle, import licensing could only be granted for periods of three to five years. Protection made the advance of industrial activities more firm, but it resulted in high economic costs and the strengthening of entrepreneurial groups which pressed for the self-perpetuation of the protection. The entrepreneurs were given seats on those committees of the Commerce Department empowered with the approval of import licenses, and often granted the licenses to import specific goods to the domestic producers of the same goods, thus giving them monopoly power. It is unquestionable that protection raised capital's profit rate in manufacturing, but it discriminated against other sectors whose expansion
might have produced higher economic benefits. It seems correct to state that import substitution policies protected final consumer goods (especially those produced by traditional manufacturers who generally satisfied total domestic demand) more than intermediate or capital goods. Protection resulted in an anti-export bias, since export prices were ruled by world markets and import substituted goods were overpriced relative to world prices. The aforementioned bias can be seen by the excess of nominal over implicit (price estimated) effective protection rates: in 1950 export activities had a minus 5% level, import substitutes a plus 39%.\(^1\) The decreasing share of manufacturing products which are exported is thus not surprising. Price changes due to protection contributed to the worsening of relative agricultural prices, as will be seen below. Thus protectionism had an anti-agricultural bias: implicit effective protection was 1% for agriculture, and over 20% for manufacturing.\(^2\)

Joel Bergman\(^3\) has made a comparison of commercial policy effects in six countries, including Mexico. He distinguishes between allocative inefficiency, technological inefficiency, and monopolistic inefficiency and argues that trade protection leads to higher prices due to unavoidable higher costs, to avoidable higher costs and to monopolistic returns. The last factor implies that the commodity can be produced at costs below the protected domestic price and closer to international prices; but due to excessive protection, wages and profits get pushed above their opportunity

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\(^2\)Ibid.

costs. According to Bergsman's estimates, allocative inefficiency is not very important, while technological inefficiency and monopolistic distortions are far more significant. He states that in Mexico the welfare costs of protection have been 2.5% of GDP, with only 0.3% of this being due to allocative inefficiency, and 2.2%—seven times as much—resulting from technological inefficiency and monopolistic pricing.

In the market for factors, protectionism introduced distortions that became more and more acute and evident through the 60s, especially in the case of the labor market. The preferential importation of capital goods, the subsidies for investment in physical capital, and the preferential access to loanable funds at subsidized rates distorted the relative use of labor and capital, discriminating against labor. In addition, tax and wage policies taxed labor utilization—social security payments, a payroll tax for education, a wage profit-sharing rule, etc. Thus the labor absorption capacity of industry tended to decrease. Even in those cases where there seemed to be low or no capital-labor substitution at the level of the firm, the labor absorption capacity of an industry branch decreased when government policies favored other branches with higher capital densities. This changed the total product-mix, and consequently increased the demand for capital vis-a-vis the demand for labor, and led to higher capital-labor ratios than would have existed otherwise.

Over the last quarter of a century the labor absorption capacity of Mexican industry has decreased about 15% in relation to the GDP rate of growth, which was partially due to productivity gains. Sectorally, for instance, a million pesos of gross output required the employment of 100 workers in agriculture, 55 in food procession industries,
42 in textiles, 23 in chemicals, and 15 in basic metallic industries.\textsuperscript{1}

Typically, capital-labor ratios are higher in import substitution activities than they are in firms that account for most of the industrial exports.

Import substitution policies turned the domestic market into the engine of growth. Final domestic demand, concentrated in traditional industrial centers, became the paramount object of production. Given low domestic transportation costs of raw materials — especially in the railroads, but also with cheap, subsidized gasoline, gas and diesel — and uncharged spatial price differentials for energy inputs and other public utilities services — water for instance — large urban areas continued to be the preferred locational sites for industrial activities. This was especially true in Mexico City and its metropolitan area. Public investment policies contributed to this development. Supplies of urban public services, rigid rates of public utilities, and improvement in transport facilities represented additional stimuli to make industrial concentration even more centralized geographically. Better and expanding urban services, enlarged industrial facilities, and higher incomes, among other influences, generated social pressures and requests for more and more public services in what appeared to be a self-perpetuating process. Stabilizing Development and industrial policies in the 50s did not take account of the fact that they were promoting a spatially more centralized development process. Consequently, the urban-rural split became a variable that explained better than any other the existing income inequality. At the end of the decade, nearly 80\% of GDP originated in a handful of cities. Moreover, Stabilizing

Development had some features that by themselves produced negative externalities without creating mechanisms or incentives to internalize rates. A rapid growth rate by itself, however, solves some problems in the face of policy inaction. Some industries were able to overcome technological inefficiencies by the sheer growth of the domestic market. Nitrogen and phosphate fertilizers are cases of these types. From very high production costs in the early 50s, they reached plant sizes and operating practices that made it possible to produce at costs similar to the standards used by efficient world producers. Marginal costs decreased well below world prices. Something similar happened in the steel industry, where international competitiveness is being reached in sectors producing strategic inputs. In some cases it has been observed that nominal effective protection is less than implicit effective protection, an indication that domestic competition is making trade protectionism more and more redundant. Bueno shows that in the primary sectors implicit and nominal rates of protection are similar, but in manufacturing, nominal protection exceeds implicit — 33 to 25 percent — by margins that vary widely between branches.

\[\text{Bueno, op. cit.}\]
2. Agriculture: The "Green Revolution" comes to a standstill

Land reform, water control, and agricultural research which succeeded in substantially raising agricultural output and yields per hectare during 1940-1960, still had some influence in 1960-65. The second half of the 60s, however, was a period of slow agricultural growth. The decade looks sharply different if split in half. During 1960-65, the growth of agricultural production was over 6% a year, while in the second half its rate of increase fell to only 1.2% per annum. The result was, at the turn of the decade, a lack of agricultural export growth, and the beginning of the heavy imports of grains and oilseeds that would become a nightmare in the early 70s. Three factors seemed mainly responsible for such a change from growth to stagnation: public investment spending, credit policies, and changes in relative prices.

Public investment in agriculture.

Throughout the 50s, the share of agriculture in public investment fell from about one fifth to less than one tenth, and it was not until the late 60s when agricultural stagnation was evident that a modest recovery began. Together with the lack of thrust of public investment in agriculture there was a similar and related or induced softening of private investment in the sector, with the result that the share of investment in agriculture in total gross fixed capital formation decreased from 14.0% in 1960 to 4.5% in 1970. It should also be recalled that the share of agriculture in value added decreased from 15.9% to 11.6% of GDP in the same period.

1 Including cattle, forestry, and fishing.

2 The share of agriculture in total public investment which had been 19.9% in 1947-52, and 13.9% in 1953-58, was 10.6% in 1959-64, and 10.4% in 1965-70. The expansion of irrigated areas followed the share of investment: 626,000 hectares in 1947-52, 758,000 in 1953-58, 245,000 in 1959-64, and 383,000 in 1965-70.
Public funds budgeted for agricultural investment lost relative importance perhaps not so much as a result of deliberately discriminatory policies but rather because of a host of other circumstances: the widening of the nationalized sector, which meant additional requests for public funds; low income-elasticity of tax collections; rigid prices of products supplied by government-owned enterprises which required more government support; and fixed rates of public utilities that forced increasing transfer payments from the federal purse. Spending ceilings determined by budgetary reasons, although geared to maintain monetary stability, unfortunately resulted in a very slow growth of public investment allocations to agricultural allocations to agricultural projects and severely curtailed water control programs and the clearing of land for agriculture, among others.

Sources of agricultural growth.

It is useful to classify the sources of agricultural growth in three categories: the expansion of cultivated areas, rises in yields per hectare, and crop composition.

Expansion of cultivated area.

According to Venezian and Gamble,¹ the agricultural record of Mexico demonstrates that in earlier years the enlargement of area determined the increase in the production of beans, sugar cane and coffee; while yield increases were of paramount importance for output expansion of cotton and wheat. They estimated that about 40% of the growth of agricultural production between 1949-1951 and 1964-1966 was due to the expansion of the area under cultivation. The determining factor of area

increase was land reclamation and irrigation. Thus the stagnation of funds for public irrigation projects in the 60s eliminated one of the factors that had accounted for most of the agricultural growth of the proceeding twenty years. Earlier land reform had the effect of adding new land for cultivation, land which in part had been previously idle, and thus contributed to area increase. In the second half of the 60s, the newly distributed land was of inferior quality, low productivity, and in part, not well suited for agricultural use. Property rights on agricultural and grazing land became more legally entangled and froze some land making it unavailable for agricultural use. More and more land requests were not granted as a result of population pressure and land scarcity. By the end of the decade, there was no more land of good quality to be distributed. Such land as there was required substantial investments, or was classified as private grazing land and withdrawn from agricultural use (even if suitable for it, as much of it was) because if cultivated it became subject to potential expropriation for land distribution.

Increase in yields

In the 50s, productivity gains were quite dramatic due to irrigation — as already mentioned — crop research, fertilizer use, mechanization, and the expansion of the agricultural labor force. Most of these factors did not sustain their drive during the 60s, which contributed substantially to the stagnation of agriculture. This experience deserves to be examined in some detail.

Corn and beans have traditionally claimed about 70% of the harvested area. Both crops had smaller productivity increases in the 60s than the previous decade. Wheat and cotton whose yields had increased the most in the past, saw their combined acreage diminished from 1.7 million hectares
In 1960 to 1.1 million in 1970; land was withdrawn from the crops of higher productivity increase. Land use changes thus offset the increase in yields resulting from agricultural research. There were several other causes for the slowdown in yield increases during the second half of the 60s. The prices of fertilizers were kept well above world prices — in some cases by as much as 50% thus limiting their use. Administrative problems within the governmental agency responsible for seed breeding was another cause of insufficient yield increases. This agency was established in the early 60s with exclusive rights to reproduce the seeds developed by research institutes, and was given an effective monopoly on hybrid corn and beans. The agency thus made it difficult for farmers to take advantage of new knowledge in agricultural research, and slowed down the spread of the use of new high-yield varieties. This was most unfortunate since the introduction of new high-yield varieties by the farmers would have increased the profitability of their operations and could have offset or cushioned the unfavorable impact of import substitution on agriculture.

Agricultural extension services have been traditionally directed towards irrigation districts, especially toward the commercial farming areas of the North and Northwest. As a result of the strict area limits of irrigated regions, the secondary effects of extension work — the spread of new techniques to farmers not directly reached by the service — were limited as well. The government's strategy for agricultural development was reaching the point of diminishing returns. Once the initial impact of the new seed varieties had raised yields to quite high levels, rates of productivity increase slowed down. If research and extension had been more balanced and had reached rain-fed areas more widely, the initial and secondary impacts would have boosted yield increases more broadly. This
was unfortunately not the case.

Credit extension to agriculture operates as a force of technological improvement, and is thus very important. After the 1954 devaluation, however, rediscounts to official agricultural banks were discontinued. Since then, the official banks' only source of funds has become the federal government — or government guaranteed loans secured in foreign banks. This practice reduced the availability of funds for agricultural credit, because private banks are generally reluctant to extend credit to agriculture on commercial basis, especially in ejido\(^1\) lands. As a result agricultural credit, as a share of total credit, decreased from 15% in 1960 to 9% in 1970. In the first half of the 60s, cotton farmers were still moving from one part of the country to another, planting the adaptable cotton in various regions — which was made possible partly by private, non-institutional loans extended by cotton traders to cotton farmers. The phasing-out of cotton production decreased these private credits, and the farmers' demands have subsequently had to be met by official credit institutions, resulting in a crowding-out effect on marginal borrowers of agricultural credit.

**Crop Composition**

In 1961, Conasupo\(^2\) was founded as an agency whose task was to purchase agricultural goods, regulate their trading, and support agricultural prices. It was to deal exclusively in basic crops for domestic consumption. In 1964, Conasupo fixed some prices at levels well above world prices — in some cases by as much as 50%. Since export prices were at world market

\(^1\)Communally-held land.

\(^2\)Compañía Nacional de Subsistencias Populares.
levels, Conasupa changed relative prices, raising domestic/export price relation, discriminating against export crops and changing the crop-mix in favor of domestic commodities, which in some cases had to be exported with substantial margins of subsidy. Crop composition changed towards less valuable products, as support prices induced their migration into irrigated areas (wheat instead of cotton, for example). The heavy subsidies on water in irrigated regions encouraged the spread of crops better suited to rain-fed areas. Consequently, the regional comparative advantage was distorted by the price support policies. In addition, lower valued agricultural commodities (wheat, corn and sorghum, among others) were also less labor-intensive. Thus the change in crop composition violated the country’s static international comparative advantage.

Price changes help to explain the agricultural stagnation of the second part of the 60s. During 1960-65, the index of agricultural product prices rose 4% annually, while agricultural input prices only increased 1.7% per annum. In the second half of the decade, however, relative prices worsened; agricultural commodities prices rose only 0.3% a year, inputs 1% a year. There are several reasons which suggest that the price change was far more influential than those figures would indicate at first sight. The stability of prices of agricultural commodities reflects the fact that the price support scheme was being used to maintain price stability rather than to increase farmer’s income.

The output mix of agricultural commodities varied as a result of dissimilarity in price changes of different goods. Cotton prices -- an export crop -- decreased 1.1% a year in the period, while input prices

\[1\] For instance, the number of sprays for plague control increased several fold because import substitution constrained formulae changes needed to adapt to insect resistance.
rose and the area was reduced in half. It is also significant to note the substantial increase in yields of cereals and oilseeds, whose area expanded substantially and whose price increases, due to the support of Conesupo, reached levels well above world prices. At the same time, export crops were sold at world prices minus transportation costs and showed no comparative gains. There was little research conducted in export crops, while, as indicated, research was quite successful in domestic crops.

Effects of agricultural stagnation in the labor market.

The impression that one gains from examining the performance of agricultural growth — or lack of it — in the late 60s, is that of increasing production difficulties and, as was the case in the industrial sector, of a diminished derived demand for labor. Land use changed towards capital-intensive crops in the commercial sector, and population pressures diminished farm size in the subsistence sector, which led to a lower demand for hired labor. Rural workers found it increasingly difficult to find employment in the countryside. There was less land to be distributed, and that which was given was of inferior quality. After 50 years of land distribution, land reform could no longer be an effective means of appeasing social pressures in rural zones. Employment was also significantly affected by changes in crop composition since the growing of grains uses far less labor than cotton or other export crops. It is generally accepted that employment in agriculture in the 50s increased at a rate similar to that of the labor force that is, employment and underemployment did not

1Cotton which had expanded in the Northeast in the first half of the 60s, in rain-fed areas, was discontinued after several harvest setbacks.
expand). In the 60s, however, employment opportunities increased less than the agricultural labor force: the labor absorption capacity of agriculture shrank. The product-elasticity of the population gainfully employed in agriculture (paid to do a job) fell from .28 in 1950-60, to .11 in 1960-70.\footnote{Oscar Altimir, "La medición de la PEA en México, 1950-70," \textit{Demografía y Economía}, 1974, Vol. VIII, pp. 50-83.} Agricultural product increased less rapidly, and the derived demand for labor paid in the market, per unit of product, showed a decline. As minifundia became more widespread and commercial farming moved towards more capital-intensive crops, employment opportunities for labor in agriculture diminished.
3. The Boom of Financial Intermediation

Along with Treasury Secretary Ortiz Mena, another architect of Stabilizing Development, was Rodrigo Gómez, governor of the Central Bank for nearly two decades. In 1964, he noted that "more private and public investment projects were being undertaken and more loans were being extended through the budgetary and credit mechanisms which prevent inflation rather than yielding to pressures that consider inflation a way to promote development." He added that "... in more than a quarter of a century not a single bank had gone bankrupt," and claimed that "a sustained and longstanding increment of real income and productivity is a strong factor contributing to reduction of (economic) inequality and one that while enlarging the middle class, promotes voluntary savings ... to be deposited in banking institutions which will use them to finance the productive activities of efficient businessmen."\(^1\)

Rapid growth of real income, stability of the foreign exchange rate, the pegging of the nominal prices of bonds and other liabilities of financial institutions (which eliminated the risks of capital gains or losses on financial assets, or of banks defaulting), and increased real interest rates were the ingredients that promoted the financial and economic development in the 60s. The record is quite impressive: total assets of financial institutions increased from one third to one half of GDP in the decade (see tables I-5 and I-6). The data seem to support Gómez' assertion that economic growth with monetary stability permitted a rapid development of financial intermediation, so that credit both to the private and to the public sector increased substantially, and more

rapidly than their respective investment flows. As a ratio to GDP, claims on the private sector increased by two thirds (to .338), claims on the public sector by more than three times (to .112). Marginally, the access of the public sector to the resources of financial institutions contributed somewhat more to the financing of public investment than shown in table I-6, due to the under-reporting of government securities held by private financial institutions as well as to the fact that some credits to public sector corporations were included as claims on the private sector.

Bonds issued by financial institutions and time deposits showed the highest growth rates over the decade. Both are composed of fixed interest yielding paper and indicate how the non-monetary end of the market was the segment that grew fastest. Bonds were purchased by the most sophisticated and wealthiest investors, time deposits — especially savings deposits — by the growing middle class. The time-deposits paid low rates of interest but were in practice redeemable on demand and carried high administrative costs. They came to be quite widely held among the population. Bonds and other liabilities of financial institutions were also quite liquid, and the growth of the whole spectrum of financial debt was nearly all in the form of highly liquid paper which, given the conditions of full and unrestricted convertibility, could become explosive in the event of a run on the peso. The rationale behind not acting to change the debt structure was that as long as GDP was continuously growing, savings were increasing, and the peso was stable, any redemption of financial paper by some investors was more than covered by acquisitions of the same paper by other investors. In other words, repurchases would always exceed redemptions, registering a sustained net increase in the
amount outstanding. Therefore, bonds and other types of financial paper could continue to be supported at nominal prices, thus eliminating the risk of capital gains or losses. There was only one attempt to issue paper redeemable only at maturity dates, with prices determined in the securities market, and the yield reflecting the term structure of interest rates, i.e., the bond's length of time to maturity. These were called "certificados financieros." Unfortunately, the financial authorities mismanaged the conditions of issue because of mistrust -- which they shared with policy makers -- of the functioning of the market and of the price mechanism. The authorities tried to predetermine and fix the term structure of interest rates, and consequently, the bonds were made too cumbersome to be quoted and traded in the exchanges.

The prevailing conditions of the liquidity of the market thus left no room for market operations that could cushion short-term foreign capital movements, the movement of Central Bank reserves being an exception. The government continued to be vulnerable to any private sector threat of capital flight. Whenever contemplated domestic policies were dis-tasteful to the private sector, investors were able to wield the threat of capital flight as a weapon against the policy changes.

The rigidity of financial policy became an obstacle to the development of the bond and stock markets, discouraging corporations from borrowing directly on the market. Consequently, they were induced to borrow through financial institutions. It has been said that "for Mexican corporations the after-tax costs of long-term debt are lower than the costs of new equity." And
The demand and supply factors ... contribute to a vicious circle which limits the size of the capital markets in Mexico. The several elements reducing potential demand hold down the price investors might be willing to pay for equity shares. The low price level or low equity capitalization rate make it expensive for firms to obtain new financing through equity issues. To partially complete the circle, the lack of supply contributes to the thinness of the market, which is one of the factors reducing demand.¹

The record shows, however, that monetary stability is a self-supporting, cumulative process. Price stability raised real interest rates (since nominal yields were kept quite rigid), decreased the risk of new devaluation of the currency, and improved the competitive position of domestic paper vis-a-vis foreign financial assets. It all resulted in an increasing financial-savings/GDP ratio, so that budgetary deficits (the main inflationary pressure of the past) became more and more manageable, since they could be financed with voluntary savings. Even a deficit representing a rising share of GDP became manageable. And at the same time, according to Gómez, it was still possible to extend more credit to the private sector -- both absolutely and relatively.

The most successful manifestation of Stabilizing Development was this boom in financial intermediation. The widening and deepening of credit and loan operations presumably permitted a better allocation of resources, especially useful in an economy with so many imperfections in commodity and factor markets. Financial intermediation supported fiscal policy so that it became possible to divorce, to certain extent, spending decisions from tax revenues. Monetary policies thus became a partial substitute for tax policies, but also partly constrained them: taxing interest at progressive rates could erode the after-tax yield and the competitiveness.

of Mexican paper in foreign financial markets. Taxes on interest income had to reckon with, and were limited by, yield spreads between Mexican and foreign markets. Thus the very success of monetary policy hindered tax flexibility and tax reform.

Perhaps what is worth underlining is the reliance that was placed on monetary stability. It was believed that once it had been achieved, the world would be forever stable and no change or strengthening of the structure of the financial system would be necessary. In fact, no change was seriously attempted. Success paralyzed change and inventiveness as well. This position was going to look paradoxical when, in the 70s, inflation played havoc with the operations of the financial markets.

A commentator on the Mexican scene wrote in the early 60s:

"Three important judgments ... underlie the Mexican approach to guiding financial development. One is the assumption that total demand for loanable funds will always exceed the supply arising from non-inflationary sources at interest rates which are politically acceptable. A second is the belief that the efforts of the private sector to make profits are likely to lead to uses of funds which contribute little to economic growth. The third is a presumption that the public sector, taken as a whole, will always have a large deficit with the rest of the economy and that this deficit must be financed on terms more favorable to the public sector than voluntary lenders would accept. All of these positions had a measure of usefulness in the past; all are now partially or wholly obsolete."¹

Sheldon's three points could be labeled: first, the excess-demand for loanable funds,² second, the mistrust of the price mechanism, and third the inability of the government to tax and of public utilities and public services to price correctly. The last is associated with the first, and


²Excess demand for funds is a symptom that interest rates were not high enough to clear the market.
essentially boils down to the same problem. Obsolete as these attitudes may have been, no policy changes in these areas were undertaken during the period of Stabilizing Development, despite the fact that the actual financial situation departed dramatically from the outmoded initial assumptions. It was as if the growth of the economy and price stability were sufficient as a core of financial policy.

Financial policy served to maintain Sheldon's third judgment (the weakness of taxation and of public sector earnings) as a quasi-permanent fact of life. However, his first judgment (permanent excess demand for loanable funds) was apparently overcome by the development of the financial market resulting from the sheer thrust of growth: the recession of 1971 seems to have made it clear that the demand for funds was less than the supply of funds, and the excess reserves of financial institutions had to be absorbed by the Central Bank. These developments will be described in the following chapter.

One may suggest that financial development in the 60s contributed to a more mature economy in several ways. Sheldon's assertion of excess demand for loanable funds in the early 60s was not unique by any means, and although the assumption is open to question, several authors writing in the early 60s used it as well. Brothers and Solís, Koehler, and Bazdresch, among others, have attempted to explain the mechanism by which excess demand for funds could be maintained. The argument goes as follows: The monetary authority fixes a nominal interest rate below the marginal productivity of investment. Given, (a) the public sector deficit, and (b) the level of net foreign borrowing by the public sector, then (c) the amount of government spending to be loan-financed domestically is equal to (a) minus (b). From savings channeled by financial institutions
the amount (c) is obtained through the reserve requirement mechanisms of the Central Bank — which applies to all financial institutions. Whatever is left of savings deposited in financial institutions after accommodating the government’s requirements, is extended as (d) credit to the private sector. The total finance available for private investment consists of (d) plus self-invested savings plus whatever the private sector is able to borrow abroad directly.

Since the Central Bank in the 60s fixed the lending rate at levels lower than necessary to clear the market, credit rationing in the domestic market became commonplace, but with features that provided some flexibility. Additional credit charges and reciprocal balances were used as means of raising interest rates. Such devices as the queuing of would-be borrowers and the requirement of high asset/debt ratios were also used in order to limit the accessibility to loanable funds. Borrowing abroad by the private sector was a possible offset to credit rationing, but it was of limited importance. Although foreign banks could operate domestically, they could only do so through local representatives with no administrative facilities available, and therefore extended credit exclusively to the largest domestic borrowers.¹

Early in the century, the Mexican revolution had practically destroyed the incipient banking system, and subsequently the great depression, the war time and postwar inflation (which showed wide fluctuations of domestic prices) retarded the development of the financial system. The net result was an acute imbalance between the real side of the economy

¹Domestic banks could not openly borrow abroad, because they had to balance out short-term assets and liabilities in foreign currencies. They could not guarantee the borrowing operations of domestic corporations abroad since the Central Bank used several devices to prevent them from doing so, in effect preventing interest rate equalization.
and its financial counterpart. Before the 1960s, the government gradually crowded some private borrowers, especially agricultural borrowers and small and medium sized enterprises, out of the market. Financial groups developed composite, complex industrial and commercial corporations linked by ownership with banks and other financial institutions. Full leverage was assured only at the group level -- rather than at the level of the isolated individual -- and therefore, belonging to a financial-industrial group came to be a necessary condition for profit maximization. Banks became borrowing windows of economic, industrial-financial groups.

The boom of financial intermediation changed the nature of the market drastically. Financial institutions received more funds than their group members and traditional customers could use and had to search for borrowers.¹ Borrowers began to diversify their lenders -- a process of rate equalization was underway, internally and externally. At the end of the decade and the beginning of the 70s, economic groups were splitting and financial institutions were separating from industrial and commercial ventures. This was the case of the Banco Commercial Mexicano - La Comercial, after the death of the prominent financiero Carlos Trouyet.

Gradually the interest rate became the dominant market clearing devise. At the end/the Central Bank was forced to allow rate adjustments to accommodate external rate changes. The monetary authorities had to accept interest rate changes in domestic deposits and liabilities to avoid unwelcome short-term capital flows. Once they accepted rate changes on the liabilities side, they had to tolerate them on the asset side of financial

¹ A "financiera" in the general case, tripled in size in real terms every three years. Administrative structures became insufficient for the normal processing of lending funds.
institutions' balance sheets. In the recession of 1971, the phenomenon of excess reserves in financial institutions and excess liquidity in the economy became widespread. The incompatibility of domestic and external equilibrium was evident at the Central bank which could not let the interest rate fall because it would cause a loss of foreign exchange reserves. To prevent this, the Central Bank had to absorb the excess liquidity of financial institutions. The money market was experiencing cyclical fluctuations of a Keynesian type.

1Excess reserves were already noticeable during the 1968 slowdown.
4. Taxing or Borrowing?

It has become commonplace to criticize the Mexican tax load as one of the lowest of the world. When referring to the skewness of the country's income distribution, the usual comment has been that the low tax/income ratio shows that fiscal policy has not been used as a redistribution device — if anything it has contributed to a further concentration of income. After it became clear in the early 50s that labor and mixed income had fallen from 59 to 48% of national income\(^1\) during the war and early postwar years, the tax structure was criticized over and over again as/its overall load much too low. Although income tax has been rising as a share of total revenue (with export taxes falling) the tax/income ratio remained stubbornly under one tenth of income during the 40s, 50s, and 60s.

This section discusses tax reform efforts undertaken in the 1960s. Two features of the proposed changes were fundamental: a) the principle of accumulation, by which the taxpayers' capacity to pay would be assessed by aggregating earnings from different sources (instead of income reporting and tax payment by functional income categories or sources of income, sistema cedular); and b) the elimination of the right to hold wealth anonymously, i.e., the requirement that the taxpayers report their wealth positions to the tax collector (abolition of the anonimato or elimination of bearer bonds and bearer shares and the requirement to disclose ownership of rented buildings and dwellings).

From its inception the Mexican income tax included both the corporation income tax and the personal income tax. In the latter case the law

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recognized different sources of earnings as different income categories to be taxed separately, thus in fact preventing the tax from becoming an effective overall income tax. Wages and salaries were one category, income of non-incorporated professionals another, interests and dividends yet another. Rental income from houses and office buildings was separately reported and subject to a stamp tax. Each income category was taxed independently of the others. Thus, the progressivity of tax rates was annulled for those taxpayers able to fractionalize income into different categories. Proprietors of businesses were able to dodge the progressivity of the tax rates by splitting income earnings: drawing a salary, collecting dividends, extending or faking a loan to their own business and receiving interest, etc. Several tax loopholes were available as well, e.g., businessmen could deduct many personal and family expenses as business expenses. Property owners could incorporate, fractionalize income, average and lower the tax burden, take advantage of deductions and exemptions, and pay taxes at rates even lower than those prevailing for wage income. Moreover, an array of exemptions and loopholes made the burden on property income even lower.

Wage earnings, normally the only source of income for factory and clerical workers, had to support the tax burden and bear the progressivity of tax rates, because these earnings, except in the case of senior managerial personnel, could not be manipulated to shift or offset the incidence of the tax. Thus the income tax unevenly discriminated against workers. Professional income received mixed treatment, somewhere in between the other two categories, but it was easy to underreport these earnings and evade the tax anyway. The proposed reform consisted of aggregating different sources of income which would have made it possible to better assess the individual income, and consequently to design a more equitable tax system
based on the individual's ability to pay.

The second key issue concerned the confidentiality of wealth ownership (anonymato). Has the State the right to know the wealth holdings of its citizens? Or have the citizens the right to hold property anonymously? Traditionally, stocks and bonds were issued to the bearer and were taxed at a flat rate. Real estate buildings, dwellings and offices were incorporated and rents did not need to be added to salaries, dividends or interest for income tax returns. The proposed elimination of anonymity was obviously a touchy issue because its existence allowed the wealthy to hide illegal sources of income -- including gains from corruption and shady business practices. Therefore, the proposed change was likely to be opposed by upper echelon bureaucrats, businessmen and politicians alike.

The fiscal system became heavily skewed in favor of property owners, because indirect taxes were presumed to be regressive, because an important share of government’s administrative spending was designed to protect private property, and because a good deal of public investment was designed to maximize the value of private wealth. This is an embarrassing situation, to say the least, for a government that fancies itself revolutionary having emerged from the first social revolution of the twentieth century, and being identified with a controlling party formed by working class sectors (workers, peasants and popular).

There was a fair amount of agreement among observers about the nature and scope of tax reform. In a lecture as early as 1956, Victor Urquidi, a prominent Mexican economist and advisor to Antonio Ortiz Mena during the latter’s first term as Treasury Secretary, commented

1 The right to hold wealth anonymously.
on the income tax adjustments made the previous year: "I think, then, that in Mexico we have to face the question of raising the tax load without hindering, of course, the measures to improve its distributional effect.

Nicholas Kaldor, the British economist, was invited by Ortiz Mena to prepare an expert analysis of the Mexican fiscal system. He was received at the airport and taken directly to Cuernavaca, a resort town south of Mexico City, where he remained hidden in utmost secrecy. Although his full report became known only to a handful of Treasury officials, some time later a paper was published that outlined the core of his recommendations in broad terms.

With minor variations, the various proposals intended to substitute a global income tax -- adding all sources of income -- for the fractionalized (cedular) system. This would be complemented by a wealth tax and a wealth inheritance tax. The generalized income tax would apply to all income-earning individuals, include all their earnings, which would be taxed at rates common to all sources of income (defining as such all earnings that increase the individual's wealth). All forms of property nominated to bearer (bearer shares, bearer bonds, etc.) would disappear. All payments of dividends and interest would have to be done through banks or financial institutions. All bonds and shares would have to be permanently deposited at banks or financial institutions that would maintain a confidential registry, keep it up-to-date by registering all transfers of ownership and inform the tax authorities regularly of any changes. It was proposed to have a


3Kaldor proposed to make the family, not the individual, the taxing unit.
basic exemption of about one thousand U.S. dollars for an individual and a maximum marginal tax rate of 40% (to be reached at different levels of income according to each proposal; Kaldor wanted it to be reached rather quickly, at 84,000 pesos or 6720 U.S. dollars). All income would be estimated on an annual basis. Rents from houses and buildings would be defined as income, as would dividends, interests, and capital gains (with a partial deduction due to inflation). All existing deductions on interest earned on public and private bonds and securities in general would be eliminated. As a check on income tax returns, the system would be complemented by a net wealth tax, with full disclosure of wealth positions. It would cover tangible and intangible wealth, net of liabilities, declared at acquisition value. Wealth above half a million pesos would be taxed at a rate of .0025, increasing in equal .0025 intervals with each additional million pesos until the rate reached a top of .01. Administratively the income and wealth taxes would reinforce each other and facilitate tax supervision and tax control. A net wealth tax presumably stimulates the economic use of capital since presumptive income is estimated, but above all, it enables the tax authority to reduce tax evasion.

The intentions of the López Mateos administration (1958-1964) to raise the tax load were made explicit with the presentation of a three year plan prepared by the government of Mexico for the OAS, in fulfillment of the agreements of the Alliance for Progress. Specifically, it was planned that government revenues (federal, state and municipal) as a share of GDP (taxload or carga tributaria) would be raised to 15.5% in 1965 and 19.3% in 1970, as compared with 10.3% in 1960. The federal government tax

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revenues as a share of GDP, which had been only 8% in 1960, would be raised to 12% in 1965 and 16% in 1970. The increase in the tax/income ratio would be the result of the tax reform that was announced in the three year plan.

Several minor tax changes were made at the beginning of the 60s. The first steps taken to modernize the tax structure were as follows:

a) some sources of income were accumulated to overcome the fractionalization of incomes (these changes were only partial); b) beginning in 1962, rents from dwellings were subject to income taxes (not accumulative, however, with other sources of income) with a mild progressivity; c) interest from fixed-income securities -- formerly exempt -- and shares became subject to income tax (2 to 5% of income received from paper yielding above 7% interest); d) capital gains from urban buildings and houses were made taxable; e) distributed profits continued to be taxed at 15%, but an additional 5% was to be charged for bearer shares (although in principle it was a step in the right direction, the rate for bearer shares remained nearly half that for the top wage salary bracket; f) the progressivity of tax rates on wage income was raised once again; g) a one percent payroll-tax for education was introduced; h) a profit-sharing scheme, equivalent to another payroll tax was introduced, a scheme that discriminated against labor-intensive techniques of production.

Meanwhile, a more fundamental tax reform was tentatively submitted twice early in the decade, and again at the end of the López Mateos' tenure, when the Treasury elaborated a reform proposal that was subsequently taken up by the incoming administration of the President, Gustavo Díaz Ordaz.

1Leopoldo Solís, Planes de Desarrollo Económico y Social en México, México, Sepsetentas, 1975, p. 72.
The proposal did not include the wealth tax but maintained the income accumulation feature, adding all sources of income, and for all practical purposes, attempted to eliminate the anonymity of wealth holdings. Díaz Ordaz was sworn in on December 1, 1964, and during his first month in office, the tax bill was discussed with the private sector. Finally, the bill was sent to Congress to become effective for the coming fiscal year starting the 1st of January 1965. Contrary to the basic proposal, however, the principle of accumulation of income from different sources was practically cancelled by the addition of a rider to the bill (artículo transitorio) exempting income from capital (dividends paid and interest from fixed income securities) from being accumulated during the fiscal years of 1965 and 1966 only. The rider was drafted by the representatives of the private sector and the exemption was repeated every year thereafter. Similarly, the anonymity of wealth holdings was maintained. The new practices of tax reporting and administration, contained in the proposal, were not changed -- but they resulted, unexpectedly, in greater regressiveness.

The final tax bill included the following changes:

a) The old fractionalized system of income reporting (sistema cedular) was cancelled. The new scheme separated the corporate income tax from the personal income tax.

b) The corporate tax was unified to cover all corporate income regardless of the business' sectoral activity,¹ and all corporations were to report on the same basis and pay according to the same tax procedures, rates, and deductions: corporate property income consisting of dividends, interest from fixed income securities, rents from dwellings and buildings,

¹Commercial, industrial, agricultural, cattle and fishing activities.
royalties, etc., was to be added up to form the taxable base from which deductions would be authorized.

c) Only distributed profits were to be taxed instead of the previous practice of taxing both distributed and undistributed profits. This change, however, diminished the corporate tax base. Dividends paid by incorporated business were to be partially retained by them for tax collection purposes, but this would not apply when the dividend was paid to other incorporated businesses also subject to the corporate income tax. Share holding of corporations became tax exempt. The exempting of dividends and capital gains from the corporate income tax was designed to stimulate working capital formation by business, reciprocal share holdings and trust holdings. However, the exemption opened a loophole in the corporate tax, namely the formation of holding companies.

d) Loss-carry forward was introduced and the previously existing excess-profits tax was annulled.

e) In the personal income tax the previous practice of treating income from labor differently than income from property was retained (in fact maintaining the worst defect of the old cedular system). The new reporting of the personal income tax substituted one common schedule with progressive rates for the old reporting of fractionalized sources of personal income -- except for property income. Thus the progressivity of tax rates for labor income was increased.

The Díaz Ordez administration wished to increase the incentives for stimulating private investment and the pitch for tax reform was toned down. Ortiz Mena came to say publicly:
"[the] Constitution postulates the proportionality and equity in the distribution of the tax burden ... and this objective can only be achieved ... [if] the incidence of the tax system ... does not contradict but affirm the principle of progressivity." "For such purpose ... it has been required to initiate the reform..." "to undertake the tax reform it would have been enough to design, in an isolated office, a technical project that blueprinted the legal reforms ... and the administrative measures ... but if it had been done that way, it would have been a useless effort — producing disorientation and restlessness ... creating more difficulties for the achievement of the reform itself," "The reform ... has been conceived as a process ... leaving the date ... adequate for its implementation to more favorable circumstances ... Without first convincing taxpayers to accept the principle of accumulation of income, any attempt to establish a global income tax would have been inapplicable..." "In the process of tax reform initiated but not concluded ... we have obtained the acquiescence of the different sectors of the population, because little can be done in any system without a general conviction of the various sectors about the necessity of the measures and the justice and timeliness of their implementation." "The income tax law ... was made listening to the viewpoints of the affected sectors..." [My italics]

In summary, the reform was conceived as a process rather than a structural change. According to the governmental spokesmen, the reform should not originate in the isolated offices of technicians, rather it should be pragmatically negotiated and preceded by the acceptance of the affected groups. The later records show that the tax/GDP ratio did not change during the 60s (see table I-7), though the income tax revenues increased a bit over 1% as a share of GDP in the ten year period.

Bluntly, the attempt at reform had failed, was shelved and had to wait several years — until 1972 — for another try. Those changes that were instituted had a regressive impact and the following effects were noted:

a sharp redistribution of the burden of personal income tax, an increase

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in the share of taxes from labor incomes; a decrease in the share of
taxes from property income. Revenue from labor income as a proportion
of the individual income tax increased from 58.1% in 1960 to 77.9% in
1966, with a drastic increase after the 1964 attempted reform. At the
same time, revenue from property income decreased from 40.5% of the personal
income tax in 1960 to 10.7% in 1966, with a drastic decline after the
aforementioned changes. (See table I-8). Even in absolute terms tax
collections from property income in the individual income tax fell by
55.5%, from 892.9 million pesos in 1964 to 337.5 million pesos in 1966. ¹

The reform could hardly have been more regressive! As a share
of GDP, federal government revenues remained 8.2% in 1960, 8.0% in 1965
and 8.1% in 1970, instead of the 8%, 12% and 16%, proposed in the three
year plan.

¹See "Es justo nuestro impuesto sobre la renta?" Centro de Estudios
from Cuenta de la Hacienda Pública Federal, Secretaría de Hacienda y
Crédito Público, Dirección de Estudios Hacendarios.
5. Employment, Growth and Income Distribution

Diverse analyses of the Mexican economy -- including two input-output models\(^1\) and various aggregate estimates -- have indicated that a rate of 7.5%\(^2\) would be necessary to avoid increasing unemployment. While the population growth rate continued to increase -- reaching 3.5% per annum during the 60s -- the economic system's capacity to generate employment opportunities diminished. It has been repeatedly shown that rapid industrial development is not conducive to a solution of the problem of underemployment.\(^3\)

Estimates of the employment problem in México show very little open unemployment and very large underemployment.\(^4\) For 1969, an employment study concluded that if underemployment included those employed who earn an income lower than the minimum wage, then 44.8% of the labor force was underemployed, of which 3/5 were in agricultural activities, 14.4% in services, 10% in manufacturing and 6.4% in trading activities.\(^5\)

Although the employment information is very scanty, it is generally accepted that during the 50s the supply and demand for labor services grew at nearly similar rates, but in the 60s the demand for labor services

\(^1\) "Exporta" and "LP" - models developed at the Banco de México and Secretaría de la Presidencia.


\(^4\) México, Secretaría de Industria y Comercio, Dirección General de Estadística, Encuesta Nacional de Hogares. Datos preliminares, 1973 y 1\(^a\) y 2\(^a\) trimestres de 1974. Ocupación y Vivienda.

\(^5\) Anteproyecto, op. cit.
slowed down considerably. The disequilibrium in the labor market became more acute and was expressed increasingly in open unemployment.

In 1960-1970 the demand for labor services increased at an annual rate of 2.3%, while the supply of labor services expanded at a rate of 2.6% per annum, the differential being expressed partly in more open unemployment. Value added in agriculture increased 3.7% a year in the 60s and employment in that sector only expanded 0.4% a year; in industry, energy and mining, value added grew 8.9%, while employment grew 4.7%; in construction activities the figures were 8.3% and 3.9%; and in commercial activities and services, 6.9% and 3.2%. For the economy as a whole a GDP growth of nearly 7% expanded employment by only 2.3%. Thus, as stated above, the product-elasticity of employment fell from the 50s to the 60s in all three sectors -- agriculture, industry and services -- but most notably in agriculture, where it declined from 0.28 in 1950-60 to 0.11 in 1960-70. Agricultural opportunities deteriorated markedly not only because of the stagnation of the aggregate output, and the shift of the product-mix towards more capital-intensive crops, but also because labor-saving technological change in relative input prices diminished the labor absorption capacity of the sector.

1See Oscar Altimir, "Medición de la población económicamente activa de México - 1950-70," Oficina de Cooperación Técnica de las Naciones Unidas: CEPAL, mayo de 1973; published in Demografía y Economía, México 1974. Altimir estimated the demand for labor services comparing the 1950, 1960, and 1970 census and considering those employed and paid money wages. He eliminated those employed but not paid in cash, like family employment, especially important in subsistence activities. The supply of labor services was estimated through the increase in the labor force, the discrepancy between/presumably expanding the pool of underemployment.

2Altimir measured it by means of the workers productively occupied and paid in cash in the agricultural sector. See Altimir, op. cit.
The shift in the product-mix towards domestic crops was associated with an overvaluation of the peso and governmental support of agricultural prices. Migrant workers in rural areas were less and less able to find employment and increasingly pressured the government for land distribution. The minifundia farms manned by family members became more labor redundant as shown by decreases of the land/labor ratio, especially in the smaller agricultural plots -- those of a size under five hectares.

In industry, the product-elasticity of employment fell in the 60s as well. Value added in manufacturing and mining increased by 3.9% a year and employment by 4.7% a year. The index of industrial wages rose 7.75% per annum during the decade while minimum wages increased by 9.69% a year. Since prices increased 3.5% a year, the per capita increase in wages in industrial activities (4.2% a year) was not much above the per capita income gains of 3.5% for the country as a whole.

Within manufacturing, firms of larger size have been growing more rapidly than small and medium-sized firms\(^1\) -- due to improvements in efficiency -- and consequently they reached higher capital density coefficients. While this may be seen as a process of modernization, it resulted in a lessened capacity for labor absorption in industrial activities. In manufacturing the dynamic branches -- those that showed higher growth rates in the 60s -- are more capital-intensive. The occupational distribution of the labor force changed somewhat in the 60s as industrial employment increased from 19% to 23% of total employment (14 to 17% in manufacturing). However, the cleavages between the modern and traditional industrial activities widened, with rapid growth and productivity gains being concentrated in selected, large firms.

In manufacturing, as expected by the policies mentioned, relative capital costs diminished. Wage contracts adjustments, social security payments, the education tax of 1963, a payroll and salary tax, and the workers' profit sharing scheme of 1964 were some of the factors contributing to an increase in labor costs that outstripped the increase of capital costs. The profit sharing scheme was estimated to amount to about 2% of the total wage bill; the education tax and the payroll tax added one more percent.

Relative costs constructed with nominal capital costs declined by almost two-thirds in the 1945-64 period. Relative costs constructed using real capital costs declined slightly less than those constructed using nominal costs due to the decreased rate of inflation of later years,¹ (in 1964 the ratio of unit capital costs to unit labor costs was only 36 percent of its 1945 value). Although Witte's estimates end in 1964, the increasing overvaluation of the peso suggests that relative capital costs maintained the same decreasing trend. We may remember that the higher is the elasticity of substitution the bigger is the effect of changes in relative costs in factor use. Witte's estimates of elasticity of substitution lay generally between .5 and 1.0 for different manufacturing branches, not departing much from the coefficients obtained by Moises Syrquin.² Changes in relative costs were acting against labor absorption in manufacturing. The relationship between the labor coefficient (man-years of labor used per 100,000 pesos of real value added in manufacturing) and relative prices shows high correlations, between .73 and .95, which are statistically significant at the


one percent level. It is interesting to notice that the correlations are higher for the latter years of her analysis, the 1955-65 period, than for the 1945-55 period. Briefly, in 1956-65, the labor coefficient was decreasing at 6% per year and relative prices (unit capital costs/unit labor costs) declined at 5% per year. (Estimates of the elasticity of substitution imply that a 10% change in relative prices results in a .1% change in the labor coefficient.)

Employment information, although crude, shows that Stabilizing Development, as a growth strategy, was not well suited to solve or even ameliorate the underemployment problem of the country. Unemployment in the 60s tended to become more acute with less than one fifth of the labor force, the organized part, benefitting from increasing real wages and complementary benefits. Actually, although labor’s income share increased from 29.3% in 1957 to 36.7% in 1967 (the last figure available), labor was just regaining the share it achieved in 1940 before the sharp fall during the inflation years of World War II. Income distribution had to reflect those trends, and although no data are yet available to detail what happened during the 60s, we know that the general tendency was to increase the share of the families in the 50-95% income strata, worsening the situation of the lower half and of the highest 5%. Regardless of the change in income shares, the growth of property income was rapid enough to support the increase in the savings/income ratio, led by corporate savings.  

1Witte, op. cit., p. 84.

2As shown by the 1963 and 1968 surveys of household incomes of the Banco de México. See Appendix A.
6. *Domestic and Foreign Equilibrium*

We may summarize the evolution of economic policy actions during the period of Stabilizing Development as follows: Policy was based on three objectives: 1) economic growth; 2) price stability; and 3) balance-of-payments stability, expressed as maintenance of a fixed exchange rate. Three economic policy instruments were used for achieving these objectives: 1) public sector spending; 2) monetary policy, through the use of reserve requirements; and 3) foreign borrowing.

The record of Stabilizing Development is one of growth with reasonable price stability. Real GDP grew at a rate of 7% a year with little variation between years. Prices increased at 3.5% a year, well under the changes shown in earlier times, and the peso was kept steady at a rate of 12.50 to the dollar.

Public expenditures during the period were determined in such a way as to attain the desired growth of GDP without overheating the economy -- even though there were forces continually pushing for the expansion of public spending that would have disrupted domestic and external equilibrium. This is noteworthy because public sector spending does indeed seem to be the key to the maintenance of domestic and external stability. Changes in the difference between potential gross domestic product (PGDP) and actual GDP (see Graphs I-1 and I-2) are related both to price changes and to balance-of-payments' current account deficit in a manner similar to the Phillips curve.¹ When public sector spending increases, raising aggregate

output, GDP approaches PGDP and the current account deficit expands — as it did in 1963-64 and again in 1968. In 1964, the last year of the López Mateos administration, public investment increased sharply because of the attempt to finish the public works which that government had programmed and which were still underway.\(^1\) Real GDP grew 11.7\% in 1964, and the implicit GDP price deflator rose 5.6\%, well above the 3.5\% annual change that it averaged throughout the decade; the current account deficit jumped from 170 million dollars in 1963 to 351.9 million in 1964. The other year of convergence between PGDP and GDP was 1968, when the curves were drawn together as a result of increased spending for the construction of the Olympic Games' facilities. This time the increase was not as sharp as in 1964: Real GDP increased 8.1\%, and prices moved only 2.4\% this time; however, the current account deficit opened up sharply again reaching 632.2 million dollars — doubling its level in 1965 and 1966. (See Table 1-7.)

One may notice/jumps upwards in the current account deficit tend to be sustained once they occur; the deficit has a widening trend with sharp increases followed by plateaus like those of a step function, with only minor downward adjustments, if any. Tax revenue followed income changes closely with an income elasticity only slightly above one, showing a single exception, 1966, when GDP grew 11.2\% at current prices.

\(^1\) Public sector spending has a cycle of its own associated to the six years life of an administration: lowest spending during the first year, levels off from second to fifth, and is highest during the last. This seems to be the main engine of fluctuation in Mexico's economic activity. See John E. Koehler, Information and Policy Making: Mexico, Ph.D. dissertation, Yale University, 1968. (University Microfilms, Inc., Ann Arbor, Michigan), pp.16-21. Also his "Economic policy making with little information and few instruments: the process of macrocontrol in Mexico," in Garry D. Breuer and R. Brunner (eds.) Political Development and Change: A Policy Approach, New York: The Free Press, 1975.
As noted, internal prices also have been responsive to the
difference between PCOP and GDP, although less so than the current account
deficit of the balance-of-payments. Price increases were fairly modest --
especially wholesale price increases -- when the rate of growth of the GDP
accelerated in 1963-64 and again in 1968 (see Graph I-2). For example,
in 1964, the second year of a boom, when GDP grew 11.7% in real terms,
prices rose 5.6%. In 1968, the other year of high growth in the 60s,
when output rose 8.1% -- the GDP price deflator increased only 2.4% and
the wholesale price index only 1.9%, despite the fact that the Olympic
Games and the student riots triggered a sharp increase in government spending
and in government borrowing. The increased activity happened so suddenly
that its financing could not be all passed on to domestic or foreign lenders.
The Central Bank had to meet the economy's financial requirements with a
larger than normal increase in the money supply. However, in retrospect
it can be seen that 1968 also marked the beginning of the inflationary period
that caught fire in the 70s. From 1968 through 1974, every year except
1971 recorded a larger price increase than the year before. Prices began
to distort the balance-of-payments. The cleavage between Mexican and foreign
prices -- as measured by the movements of the U.S. prices -- was widening.
Domestic price increases, although moderated, had outpaced foreign price
increases since early in the 50s and the peso appears to have been clearly
overvalued after the price upsurge of 1964. Gerardo Bueno reports a margin
of overvaluation of the peso between 17-24% "for most of the decade. Other
estimates are as high as 30%. Internally, relative prices turned in favor

\footnote{That margin seems to have been kept more or less the same until 1972 when
it began expanding. See Gerardo Bueno, "La paridad del poder adquisitivo
y las elasticidades de importación y exportación en México," El Trimestre
Económico, abril-junio 1974, pp. 313-325.}
of the domestic market and discouraged exports. At the same time, Mexico's inflationary problems and the overvaluation of the peso were camouflaged by the sharp U.S. inflation triggered by the Viet Nam war. Although Mexico's current deficit kept expanding, its financial system was swamped with U.S. funds, allowing the postponement of corrective action.

Let us take a look at the performance of the policy instruments during the Stabilizing Development period. Monetary policy is handled through reserve requirements, which are its most used and effective tool. They work within the framework of an open economy with free convertibility, which limits the capacity of the Central Bank to fix domestic interest rates. One can go so far as to suggest that the monetary base is determined by the balance-of-payments and the government deficit. Conditioned by these factors, reserve requirements then serve to set the money supply function. Reserve requirements are used to determine a money supply that keeps domestic interest rates in line or competitive with foreign interest rates (domestic rates as adjusted by devaluation expectations). Reserve requirements are also a means of allocating credit between the public and private sectors of the economy, since all the funds resulting from the application of these requirements to private financial institutions are channelled by the Central Bank into financing the federal government. In practice, reserve requirements are determined by considering the size of the public sector deficit and the prospect of foreign borrowing, as well as allowing for an expansion of the money supply corresponding to its income-elasticity.

Reserve requirements moved upward during the period of Stabilizing Development. Their weighted average was more than two-fifths of total liabilities and they increased more on the non-monetary side of the market -- its more dynamic side -- channelling a growing share of domestic credit to the public sector.

In its fiscal policies, the government succeeded in keeping a rein on spending and preventing its deficits from disrupting internal or external stability for the time being. Nevertheless, the way in which public sector spending was outrunning revenues, and current account imports were growing faster than current account exports, was storing up problems for the future.

Thus during the 60s, with public sector savings flat, with import substitution policies aggravating the overvaluation of the peso, and with export growth lagging behind GDP growth, foreign debt operated as a slack variable. It complemented domestic credit in the financing of public sector deficits and kept the exchange rate stable regardless of the growing current account deficit. As noted, the widening of the current account deficit came in steps, but the trend of growing dependence on foreign savings was strong. The foreign public debt, which was 1327 million dollars in 1962, jumped to 4.2 billion at the close of 1970 (3.3 billion due at more than one year and 0.9 billion at less than a year)\(^1\) reaching a service ratio of 22.5% of current account earnings.

Given the pattern of policy just sketched, one might expect expansion to be choked off by either of two mechanisms. First, if, as might appear, the current account deficit in the balance-of-payments was governed more by the rate of increase in the level of national income, a boom might be checked by the deficit becoming unsustainable and/or foreign credit drying up. Second, one might imagine that the very high growth rates in domestic financial savings experienced in the late 50s and early 60s could not have been sustained, thereby narrowing down the possibilities for domestic non-inflationary financing of the public sector deficit. But the data do not bear out either of these hypotheses in any simple or convincing way. In actuality, the course of events was more complex.

Except for 1966 — the year when tax revenues, as a result of the unsuccessful attempt at reform, were abnormally low — the growth rates of financial intermediation were always kept very high despite the fact that the spread of interest rates between Mexican and American financial paper of similar characteristics closed considerably. Non-monetary financial liabilities collectable on demand (financial bonds and mortgage certificates and bonds) grew steadily and very rapidly, at 31.4% annually. Liabilities at fixed term (financial certificates, debentures, mortgage certificates, somewhat less and deposit certificates) increased rapidly, 28.4%, and showed more variability. Presumably the latter, which include debentures of over one million pesos each and pay higher interest, were purchased by the wealthiest, while the former — which grew more rapidly — were acquired by the not so wealthy. This accords with the income distribution data mentioned earlier, namely that gains were particularly concentrated in the higher middle-income groups. (See the Appendix A on financial growth.)
The interest rates experienced in the U.S.A. through the second half of the 60s were substantial, while yields in Mexico were kept fairly steady until 1969 when they finally began to climb. An example of this movement can be seen in the case of Mexican financial bonds which yielded 9% all through the 60s until the second half of 1969, while medium-term bonds of the U.S. government increased from around 4% in 1964, up to 5, 6, 7, and nearly 8% at the end of 1969 and beginning of 1970 (see table I-11). Although the interest spread narrowed from nearly 5 percentage points down to less than 2, the growth of savings channelled by the financial system was kept at very high rates,\(^1\) thus considerably increasing the scope for using non-inflationary lending to handle public sector deficits.

Nevertheless, the plain fact was that the public sector deficit fluctuated, with a tendency to increase as a share of GDP. Because a part of the deficit had to be financed domestically, an increase in the Central Bank's reserve ratio became necessary time after time until the usefulness of that instrument seemed to have been nearly overreached.\(^2\) By 1970, deposit banks in Mexico City, which handle half of the financial assets of the country, had 50% of their liabilities taken in as reserve requirement, and the requirement for the banks of the interior was 25%. The overall ratio was 30% for savings banks and 20% for financial banks (see Tables I-11 and I-12). While the aggregate data are quite poor, they serve to illustrate the general points being made: From 1965 to 1970, public savings decreased

\(^1\)At growth rates twice as large as those of nominal GDP.

\(^2\)The changes do not show clearly in the statistical tables because in part the increases were nonstatutory and covered additional institutions previously exempt.
from 0.056 to 0.038 as a share of GDP. Public investment, on the other hand, rose from 0.067 to 0.073 in the same period. Savings in financial institutions increased, also on a share basis, from 0.044 to 0.057 of GDP, half of them being channelled by the Central Bank into financing the public sector (see Table I-13).

Particular attention should be drawn to two factors in the 60s that made the economy less and less stable and more and more difficult to manage. One was the growing substitutability between domestic consumption and exports with more manufactured goods exported as residuals after supplying domestic demand. A similar situation happened with minerals and agricultural products. The increased potential for substitution between internal and external demand resulted from the export diversification drive into new commodities and from the stagnation of traditional exports of the plantation type: sugar, coffee, hard fibers, etc. Minerals also were increasingly diverted towards the domestic market. Thus, changes in domestic activity had a significant influence on the current account deficit; they retained their traditional import effect, because imported goods are complements of domestic production, and they acquired a stronger export effect since expanding domestic consumption tended to divert exports towards the home market. As export goods became more near to, or closer substitutes for, domestic goods, the inconsistency of internal and external equilibrium was increased.

The other factor contributing to instability was the gradual undermining of the effectiveness of monetary policy. During the early phase of excess demand for loanable funds -- the late 50s and 60s -- monetary policy was quite effective either at restraining or at easing the money market. Thus it was a good tool for controlling aggregate spending. Keynes compared monetary policy to a string that can be pulled
but not pushed; it can curtail aggregate demand but cannot effectively expand spending in the face of pessimism on the part of private investors that outweighs the effects of a diminished interest rate. In a situation of an excess demand for loanable funds, any increase in the availability of funds by the monetary authorities would be immediately either borrowed or invested. Although at the beginning of the 60s, monetary policy still was an effective anti-recession instrument, by the end of the decade it had largely lost that capacity — if we are right in our hypothesis that meanwhile the financial boom had erased the conditions of excess demand for loanable funds. The recession of 1971-72, which will be examined later on, was going to demonstrate clearly the inefficiency of monetary policy as an anti-recession weapon. The points we want to stress here are that the management of macro-economic activity for dampening the business cycle became more complex, and that the incompatibility or cleavage of internal and external equilibrium became more acute.¹

One can outline the increasing incompatibility between domestic and external equilibrium along the following lines: suppose that from some initial position in the national accounts an increase in public spending forces up aggregate demand and actual GDP rises. Productive capacity is strained, imports increase and exports may slow down — pulled back by the enlarged domestic demand — with the current account deficit expanding. Prices start climbing more rapidly. To restore control of the balance-of-payments, the government has to slow the increase of spending (as happened in 1965 and 1969) which decreases GDP growth and slows the upward movement of prices and of imports. However, although the rate of growth of imports

¹ Additionally, the financial system grew more in its less stable part.
decreases, the new, absolute, level of the deficit in the current account of the balance-of-payments either becomes sticky or expands slowly. Even if exports react upward after the demand increase is constrained, they may only prevent the deficit from getting bigger, since the enlarged absolute deficit stays more or less at the new and higher level already attained.

There was, of course, an interplay among the policy instruments and it is interesting to underline the appearance of some tendencies in the external accounts and the public finances that narrowed the capacity of instrument variables for achieving policy objectives -- both specific objectives in the short run and those longer run objectives relating to the general evolution of the economic system. From 1964 onward, the peso was clearly overvalued, and relative prices were turning against exports. Public spending was systematically growing faster than both nominal GDP and public sector revenues, which were growing at a rate similar to GDP. Thus public savings were declining as a share of GDP, falling, as we have noted, from 5.6 to 3.8% of GDP in the five years, 1965-70. As a result, reserve requirements had to be raised time after time to compensate for the deterioration of public sector finances and to permit the continued use of the reserve ratio as a policy instrument. Foreign borrowing had to be systematically expanded as a share of exports of goods and services and as a share of GDP as well.

The effectiveness of monetary control was associated with the high rate of return of private investment and with the inflexibility of changing reserve requirements. But as reserve requirements moved only upwards to support increasing public sector deficits, each additional increase narrowed the possibilities for further increases, and the instrument was approaching total uselessness -- in an extreme case, obviously,
reserve requirements cannot go above 100%. Thus the structure of the system was such that the country was facing the possible loss of its most effective instrument of economic policy. From this perspective it becomes clear how damaging the 1964 failure of tax reform was, not only because it failed to add a new instrument to the arsenal of policy tools, but because it accentuated conditions that would eventually cancel the effectiveness of the most powerful existing instrument.

The overall behavior of the economy during the Stabilizing Development period was thus rather unsatisfactory. Import substitution policies and stagnation in agriculture contributed to large underemployment and sharpened the differences between industrial centers and the rest of the country. The failure to carry out the projected tax reform in fact worsened the fiscal position of wage earners in comparison with property owners. The great boom of financial intermediation and the ample possibilities for foreign borrowing by the public sector enabled the government to postpone much needed fiscal measures to tighten its finances and enlarge its social spending. Thus the main legacies of the 60s were a mounting stress in the labor market, persisting income inequalities, and weakening fiscal and balance-of-payments positions. The government was unable to increase spending in social programs -- in education, for instance, \(^1\) -- and improve the position of the lower half of the population, which was in a clear contrast to its constitutional mandates and its background as a revolutionary government.

\(^1\) It has been said that 1968 was a year of less than normal increase in government spending in education which deteriorated the student/teacher ratio in higher education at public universities, at a time when the student enrollment was expanding widely in university education. The educational system was strained beyond its breaking point, as evidenced by the student riots of that year.
Chapter II

ECHEVERRÍA'S CAMPAIGN AND FIRST YEAR OF ADMINISTRATION

1. The setting

The Campaign

President Echeverría's campaign stirred up a great deal of enthusiasm as a result of his open way of campaigning, his ability to stimulate people to express their opinions freely and critically, and his uncommon energy and inexhaustible capacity for attending long and strenuous political gatherings in a journey that lasted from November 1969 to June 1970.

It was not long before this campaign that the repetitious rhetoric of the Mexican Revolution seemed to have emptied the old revolutionary slogans of content. It looked like a middle-aged revolution that had not yet accomplished its objectives, had no clear ideological direction, avoided the mention of society's main problems, and was in need of a new leader and a new course. Echeverría seemed to be the man for the task. Matured within the Mexican political system, he had expressed few views of his own in his long, mostly bureaucratic career. He took to campaigning with zest, showed an exceptional patience in listening to the people, traveled the longest journeys, visited the smallest villages. He acted very much in the style of Lázaro Cárdenas, 35 years before. Unlike Cárdenas, however, once a candidate, he expressed his opinions profusely and improvised speeches on the most diverse subjects anywhere. Given the few-words nature of the outgoing President and the political problems created by the 1968 student riots -- a cold bath for most Mexicans -- Echeverría's style injected a new vigor into a politically indifferent society. Two political objectives --
actually negative objectives -- became stressed and expressed in the most diverse forms: no repetition of the 1968 student riots which had ended in army repression; no devaluation of the peso as in 1954, which had produced labor unrest and had shattered the credibility of the labor union leadership associated with the PRI.

Perhaps the most significant features of the campaign were the efforts to bring students and intellectuals to an understanding with the government. An open attitude of negotiating (apertura) in an unprejudiced political style was deliberately adopted early in the campaign. Looking for a dialogue, inviting the expression of opinions, rewarding adverse judgments with new opportunities for the critics to be heard and to reach the mass media, the presidential candidate encouraged an atmosphere of reappraisal and self-criticism. Students and intellectuals were invited to join for portions of the campaign journey and new proposals were generated, considered, adjusted and incorporated in the future government's program. The search for the cooperation of students and intellectuals reflected the candidate's intention to solve political problems by political means, avoiding the use of the state's repressive capacity, as had happened in 1968.

Reform and "Keep Talking"

The Cuban Revolution had cooled the relationship between the private sector and the government early in the 60s. The nationalization of the electricity and power industry by the López Mateos' Administration in 1960 had also contributed to a sharp exchange between both sectors and led to a fall in private investment and a capital outflow that forced the government to back down. This friction undoubtedly caused the postponement of the tax reform package of the early 60s, and then contributed to its failure in 1964. Subsequently, the antagonism was patched
up during the Díaz Ordaz Administration. With Echeverría, a fresh approach was attempted in order to avoid a new rupture. Contact with the private sector was to be kept close and permanent through constant discussion. It was hoped that business representatives would be persuaded by the force of events and by the strength of the evidence of inequities and widespread poverty to accept the necessity of reforms. The private sector, located in all parts of the country, would participate in the process of examining the prevailing situation. Keeping in touch with businessmen, showing them the evidence and explaining the decisions was thought to be the way to prevent a repetition of the misunderstandings that occurred in the time of López Mateos — it was the formula for achieving reform without weakening the governing coalition.

Private entrepreneurs, tycoons, representatives of the private sector, and respected members of the business community were invited to accompany the candidate in the campaign. They rotated in joining Echeverría through all of it. There were no acts in which some speakers or representatives of industrialists, manufacturers, commerce, or banking were not present. Some meetings were especially prepared for them, to listen to their proposals and attend to their grievances. It was certainly not a coincidence that the campaign ended with a meeting about industrialization, in Naucalpan (an industrial zone in the Valley of Mexico) before the powerful local association of manufacturers, where, in his final speech of the campaign, the candidate underlined the important role of nationalistic industrialists in a healthy and growing economy, independent of foreign domination.
Economic Objectives

The economic objectives of the new government were thus framed through the campaign and were finally expressed in the Inaugural speech of December 1, 1970.¹ A call for reform, especially for political and economic reform, ran through the whole speech. A call for the people to rally around the new President, to right the existing wrongs, was forcefully formulated. The speech's objectives for economic policy can be summarized as: economic growth, improvement in income distribution, and economic independence from disturbing foreign influences. The youth and intellectuals were also to receive a good deal of attention in the economic and social programs, as demonstrated by the emphasis on the link between the educational system and the productive apparatus, and on the need to encourage individual initiative and to tailor the learning process to local conditions. The speech called for a strengthening of the technical and scientific capacity of the nation. Ceaseless work, never to feel tired, was the path to a new era of equity and progress.

Let us now review the way the new Administration sought to translate these objectives into action.

After Echeverría's inauguration on December 1, 1970, the initial staff work of the Economic Programming Office of the Presidency was to establish some economic priorities in order to prepare the 1971 public sector budget that had to be sent to Congress within a month. The budget was to be shaped in such a way as to incorporate the new government's views on economic policy. The priorities were classified by categories that could be translated into budgetary items, and that corresponded to the objectives

¹Full text of relevant paragraphs in Appendix C.
in the Inauguration Speech. They were as follows:

**Agriculture:**

a) **Capital Formation:** Infrastructure spending; reclamation works; feeder roads; rural electrification; creation of centers of adequate economic density; investment in physical capital.

b) **Technical Changes:** Extension services; basic and applied research; technological adaptation.

c) **Credit:** Lengthening the term structure of loans; closer coordination among lending institutions; clearing of property rights; formation of cooperatives.

d) **Commodity mix:** Regional relocation of crops; decrease of input prices; charging water users for water costs; support prices.

e) **Markets' Operations:** Integration of national market structure oriented to improve the performance of agricultural markets (information networks, wholesale trading centers, etc.)

f) **Social works:** Social security; rural education.

g) **Coordination:** Formation of coordination bodies.

**Industry:**

a) **Improved efficiency:** Low protection; elimination of tax rebates; better integration; export orientation.

b) **Quality improvement:** Quality control devices; standardizing procurement practices of the public sector.

c) **Employment creation:** Tax adjustments; decentralization of economic activities.

**Public Sector Finances:**

a) **Revenues:** Elimination of inequities; control of tax evasion; tax reform.

b) **Spending:** Improved project evaluation; higher efficiency in current spending.
External Sector:

a) Protection: Substitution of tariffs for import permits; smoothing of tariff differentials; coordination of tax and subsidies on exports and imports.

b) Tourism: Development of new areas.

c) Foreign debt: Restructuring of public sector finances to ease-off the use of foreign loans.

Education:

a) Efficiency of the system: Improvement of area coverage; research on additional techniques; teacher retraining; integration of higher education systems.

b) Equality of access: Adjustments of regional spending; generalization of criteria for granting subsidies; student loans.

Energy:

a) Tariff and price adjustment: Harmonization of prices according to thermic power of fuels; regional pricing to incorporate transport costs.

b) Supply adequacy: Avoid supply shortages whose saved costs produce larger losses than benefits.

The Cabinet

The new cabinet was structured in such a way as to balance ideological positions within a spectrum wide enough to reach the groups of outsiders who were gradually to join the ruling coalition. The political coalition of the 60s had been composed of entrepreneurs (industrial, commercial, and financial), organized workers (especially labor aristocracies), professional politicians and bureaucrats, and some groups of the middle class; now, the appeasement of university students involved in political activism and the effort to overcome the resentment and criticisms of intellectuals influenced the formation of the cabinet. An attempt was made to rejuvenate the political ranks
by giving newcomers, and a new generation of politicians, access to positions of power in the new administration.

The economic part of the Mexican cabinet is composed of the Treasury (SHYCP), the Department of Industry and Commerce (SIC), the Department of National Property (SEFANAL), and the Secretariat of the Presidency (SP).

The Treasury is endowed with the formal fiscal powers of taxing, debt operations, control of the current spending of the public sector, and transfer operations, as well as housing authority over all national credit institutions including the Nacional Financiera, and the Central Bank. The Treasury is like the U.S. Treasury and the Bureau of the Budget put together, with direct authority over the Federal Reserve System.

The Department of Industry and Commerce has three main tasks; the administration of import licenses, manufacturing programs, and price controls.

The Department of National Property supervises the operations of government-owned corporations, checks on the procurement practices of the public sector, and oversees the mining sector -- in the latter case authorizing mineral concessions which by law are under federal authority.

In the economic sphere, the Secretariat of the Presidency has planning functions, in the sense of coordinating public sector tasks, and handles the public investment part of the budget. In addition, the Secretariat has political and legal duties.

There is a good deal of overlapping of functions, mainly between the Treasury and the other three Departments, but also among the latter themselves. The Treasury and Commerce share the control of foreign trade:
the Treasury fixes import duties and import subsidies, while Commerce grants import licenses. They may offset or reinforce each other. Industrialization policies are shared by them as well. The Treasury imposes and administers an extensive system of tax subsidies which in fact provide discretionary benefits to manufacturing programs supported by the import licensing mechanism, administered by Commerce. The Treasury and National Property overlap in the approval and sanctioning of the budgets of nationalized corporations. The Treasury has to share the authorization and budgeting of public investment projects with the Presidency.

National Property and Commerce overlap and sometimes collide in pricing decisions for nationalized sectors (energy for instance) and in the control of the manufacturing and import substitution activities of nationalized corporations -- which are important and even dominant in many industries. National Property and the Presidency overlap in procurement operations related to the public investment budget.

There is a relationship between the sphere of action and the political profile of the Secretaries. Typically, the Treasury, which has to tax the wealthy and conduct debt and ex-cit operations, is headed by a moderate or conservative, a lawyer by training with some economic background. The Commerce Secretary is often an economist, most often a modern liberal or a progressive. Thus the economic nationalism and import substitution bias of Commerce counterbalances the more growth-oriented, balance-of-payments consciousness of the Treasury. Traditionally, there has been a good deal of political bickering between the two secretaries. The Secretariat of the Presidency and the Department of National Property also represent different interest. The head of the economic section of the Presidency is
usually a close and trusted political associate of the President, closely identified with him, while the National Property Secretary traditionally performs the role of a controller, a watchdog of national interests.

The appointment of the Echeverría Cabinet followed tradition in the Treasury, Presidency and Commerce. In National Property, however, a blunt, outspoken economist-by-training, and a self-proclaimed leftist, Horacio Flores de la Peña, was appointed. He was suspicious of the conservatism of the Treasury — and of the Central Bank. He was known to be honest and capable, but also inconsistent and lacking in tact. The other three were mild-mannered men, willing to compromise, all three with political backgrounds, with the Secretary of the Treasury having returned from being ambassador to Washington. Flores de la Peña was the anchor on the left of the cabinet, also functioning to bridge the gap with the intellectuals by using his background as a former Director of the School of Economics of the National University. The old feud between Commerce and Treasury — whose appointees this time had no problem understanding each other — was substituted by the antagonism between de la Peña and the Treasury. In order to maintain his credibility among the students and the left, de la Peña was forced to voice constant criticism of big business and the private sector, threatening that wherever they were remiss or lagged, the government would be willing to step in to avoid any bottlenecks or prevent any abuses. He spoke loudly but carried no big stick. The Treasury, on the contrary, projected an image of confidence in order to encourage investors: improvement in tax collection practices instead of drastic reforms, stability of the peso, a drive towards efficiency rather than radical change.
The result of such conflicting attitudes was that the signals sent to economic agents were confused most of the time and quite often even contradictory.

In the area of foreign trade a new institution was formed, the Mexican Institute of Foreign Trade (IMCE), tailored after Jetro, the Japanese export agency. It was to concentrate functions that were spread all over the government in a drive for export promotion. Industry and Commerce, a Department with important responsibilities and few instruments, was to be divested of some or both, which were to be transferred to IMCE. Ironically, the originator of the proposal to create IMCE and to remove functions from Commerce, Carlos Torres Manzo, was appointed Secretary of that very Department and received an even more weakened agency.

Agriculture, as we have shown in Chapter I, was beset with problems and Mexico was changing swiftly from a grain exporter into a heavy importer. An old politician, the former majority leader of the Senate, was appointed head of the Agricultural Department. Traditionally agricultural government functions have been spread in too many agencies of the most diverse nature, but four, however, are the most important: The Department of Agriculture as such; the Department of Hydraulic Resources (the bureau of land reclamation which administers the irrigation districts); the Department of Agrarian Reform; and CONASUPO (the agricultural marketing agency in charge of administering the agricultural commodities; price support mechanism). There is no formal head of the agricultural sector and all Secretaries report directly to the President. An obvious problem of coordination was eased somewhat this time by the appointment to Hydraulic Resources and CONASUPO of two able

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1 One expert of CIDA has counted 76 different agricultural agencies, not considering organizations with some functions in agricultural matters.
politicians, competent in running their agencies, skilled in negotiating, and willing to compromise. Both agencies, moreover, had expanding budgets in the past, had a secure financial base and were competently staffed. The Department of Agrarian Reform was quite a different story. From its inception it has had to perform conflicting tasks: it is in charge of land distribution, of supervising the functioning of the *ejidos* (individual or collective farms formed with distributed lands), and of keeping the rural land property ownership records. The Department is subject to the pressure of the requests for land distribution and of the needs of peasants operating in *ejidos*. ¹ Thus the agency is the guardian of property rights in rural land and at the same time is also responsible for/distributing the very same property rights, a two-edged, conflicting function difficult to perform. Since its beginning, the working of the Agrarian Reform Department has been characterized by corruption, technical incompetence, inadequate budgets and, sometimes, revolutionary zeal. To head the Department, Echeverría appointed Augusto Gómez Villanueva, a former student leader turned PRI politician, who had recently led the peasant sector of the Party. He was supposed to inject new vigor and militancy into the unfinished agrarian reform: the old recipe was to be applied once again. Gómez Villanueva was quite willing to play this role.

¹ There were more than 28,000 ejidos covering 62.8 million hectares and 2.5 million peasants. An overpopulated ejido is a permanent source of requests for additional land that the Department has somehow to accommodate.
2. The developments until early 1972

The attempt to restore price and balance-of-payments stability

The year of 1970 closed with a current account deficit of 908.8 million dollars, which was almost twice as much as the deficit registered the year before (see Table I-9). In December 1970, the government raised the domestic price of sugar by 48% (sugar is controlled in distribution and partly government owned in milling), and imposed a surtax on luxury goods.¹ As a result of these actions, the consumer price index recorded a sharp 1.1% rise in January 1971 (1.6% in the sub-index of food products, beverages and tobacco). GDP grew 6.9% in 1970, slightly above its long-run trend.

The financial authorities recommended that economic policy should be aimed at checking the increasing deficit in the balance-of-payments current account and the increase in prices. Since both were monetary targets, monetary restraint could have been the principal means for pursuing both of them.² Instead, public spending was budgeted at a very low level in order to decrease GDP growth. Thus a real variable was used, and more than that, an objective (growth) was relegated to the role of an intermediate instrument for achieving the monetary objectives of price and balance-of-payments stability. A drastic cut in public sector investment was budgeted. Compared with a budgeted level of 30.3 billion pesos and the actual level of 29.2 billion in 1970, a 1971 Public Investment Budget of 27.5 billion — down 9.1% from the comparable figure a year before — was proposed by the new Secretary of the Treasury who had taken

¹The surtax was repealed in September 1971.

²The nonexistence of a bond market to split the monetary and real effects of government spending was crucial here.
office right after the presidential election in July 1970 in order to smooth the transition. In reality, however, at the end of 1971 the actual Public Sector Investment was only 22.6 billion, 82% of the amount originally budgeted. The Koehler cycle had been ignored.

It is clear now that it was unnecessary to cut the absolute level of the investment budget, let alone to do it so sharply. The decreased spending capacity of an incoming administration was sufficient by itself to lower real public investment spending. The cut in Public Sector investment had three important effects: 1) real public spending decreased more than was desired; 2) the new priorities that were to be implemented were sacrificed in the very beginning of the new presidential term when the budget was set at the new, lower, level; and 3) the Treasury became isolated politically because it cut the programs of the new Secretaries. These three changes were to have important implications for the evolution of the new government.

The First Recession

By mid-1971, it was obvious that as a result of the cut in public spending, a slump had already started. The Presidency was estimating a GDP growth below 5%, and its estimates of public investment showed that it was way behind schedule, that private investment, affected by the slowdown, was sagging below its long-run trend. Exports, although growing, were not making up for the downturn in total investment. The financial authorities continued to reassure the President that economic conditions were near normal, and that GDP growth would not dip under 5%. The Managing Director of the Central Bank, after his June 25th regularly scheduled meeting with the President, stated:
"Concerning the internal economic situation, the President was informed that various signs indicate that the objectives of achieving price stability and checking excessive increase of imports are being achieved, as well as the objective of combining the above goals with economic growth which seems to have been reinitiated as the first months of readjustment have passed. In this respect, the President was informed that there are generally good harvests and good prices in the agricultural sector which means that the farmers' demand for industrial goods will not diminish.

Concerning the public sector, it was noted that current expenditures increased and the program of public investment was being completely normalized, and therefore, that this aspect of the economy would not represent a restriction on industrial activity.

According to available indicators -- despite the fact that the construction industry and the industries selling durable consumer goods, in addition to the effect of relative diminution in sales of beer and refreshments, caused by particular reasons¹ according to the indicators of the Banco de Mexico which include a very great number of industries and cover a wide spectrum of industrial activity, there is no general decline, with the exception of industries producing materials for construction and of sales of durable consumer goods and beer and refreshments, where there appears certain diminution which has been fortunately compensated for by the expansion of other industries. In these conditions, the problem of each beginning administration which consists of a certain stretching out of plans for public and private investment has already been successfully overcome and the country has fully embarked on a course of constant progress which has always characterized it.

In this respect, it is considered very favorable that the investors react positively to the mechanism established by the government, namely the discussion between public officials and industrialists, merchants and workers about the general situation and the particular situation of each branch of economic activity, with consideration of measures necessary for confronting the different problems that the constant growth of our economic activity -- as a governmental objective -- raise for the country.²

During the preparation of the 1972 budget at the end of 1972, the Treasury proposed a new low-level budget, with an investment of 30 billion pesos, and no major change in taxing practices -- except for a

¹The sentence is not completed in the Spanish original.

minor adjustment on taxing interests. The Presidency, on the other side, pressed for a larger level of spending, 32 billion pesos for public investment, and suggested a tax reform. Late in November 1971, I presented the following paper to the President:

**Measures necessary for realization of the President’s program**

**INTRODUCTION**

In order to reorient the Mexican economy towards a better income distribution, and in order to attack the causes of underdevelopment, the government has to use public expenditure which is the only instrument that can assure the realization of these goals.

In the next years, the public expenditure has to: 1) increase in volume, 2) change in structure, 3) improve the quality of investment projects. These changes will have to be made in such a way that the deficit in trade balance does not force the country to increase foreign indebtedness excessively in order to guarantee the present exchange parity between peso and dollar.

1) **PUBLIC INVESTMENT**

Minimal amount of public investment in the following year should be approximately 32,000 million pesos – which is far less than desirable but is consistent with some tax increases and a reasonable increment in external indebtedness.

This volume of investment should be structured in such a way that there is an increment in resources directed to: 1) agricultural sector, especially traditional agriculture; 2) education at all levels; 3) social welfare.

It is possible to increase the investments in agricultural sector in several forms: a) extension, b) agricultural research, c) feeder roads, d) minor and major irrigation, and e) technical agricultural education, not only for specialized technicians but also for the greatest possible number of peasants who should be taught how to take care of the land, how to grow crops of high economic density successfully, etc.

The investment in education should include: a) attention to physical necessities of equipment of modern educational systems, and b) creation of resource funds to assure adequate financing of teaching and research staffs.
Closely linked to the expenditures in education is the investment in social welfare which should extend to the great masses of the rural population that at present lack practically all services except the most elementary ones. It is thus necessary to increase: 1) the number of programs of child care, 2) medical services for rural population, 3) services of social security, especially in the countryside.

Satisfaction of the indicated necessities will not be adequately met even if, in the enlarged 1972 budget, investment in traditional categories increases proportionately to the amounts proposed in 1971. It will also be necessary to increase investment in some categories and decrease it in others; the decrease could be in projects with high capital content and low generation of employment.

The changes in the quality of public investment imply that the projects carried out by the State should contribute to: 1) increase of employment, 2) income redistribution, 3) decentralization of economic activity. The fulfillment of all these objectives depends on adequate evaluation of projects: thus, for instance, in order to increase employment generated by public works, it is necessary that the responsible authorities favor or subsidize the use of manpower even if it results in an increase of costs of particular projects.

2) CURRENT EXPENDITURE

To carry out the educational reform and to broaden the services of social security demands an increment in investment, and also an increase in current expenditure. It would not be correct to establish better schools and universities with teachers who have low salaries, or to have better police installations while the policemen receive insufficient wages. Therefore, current expenditure will have to increase, which in turn will require new increases in fiscal income. These increases will evidently generate some protests from the private sector but they are certainly not impossible and in fact, are a part of the modernization of tax collection system.

3) DIFFICULTIES

There are three kinds of difficulties to be overcome in order to realize this program: 1) obtaining of financing, 2) overcoming the resistance of the most powerful entities.

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1 The authorized public investment this year was under 28,000 million, and therefore, the proposed increase was about 4000 million pesos.
of the public sector to the relative reduction of their investment programs, 3) creation of profitable projects in the categories listed above.

Financing. This is the most serious difficulty because it will require a serious fiscal effort — which will certainly provoke adverse reactions from the private sector — to increase investment by 4,000 million in the next year and to increase current expenditure for education and social welfare by an unspecified amount, while simultaneously keeping the deficit of the balance-of-payments in check.

Reduction of investment in some entities of the public sector. A vicious circle has been created in the following respect. The entities that have plentiful resources act in the interest of the private sector in order to obtain more investment and resources. At the same time, these entities pay sufficient salaries so that they can count on efficient planning cadres capable of generating projects. This situation, however, results in deficiencies because the public sector becomes very rigid in its operations. For example, the building of expensive construction projects engenders the political forces essential for continuation of projects of the same type, regardless of their usefulness.

Generation of new projects. The entities whose operations are manifestly insufficient, as for instance the Department of Agriculture, do not have enough resources to attract personnel capable of generating plans for investment projects which would divert funds to the desirable categories.

This could be changed only by carrying out an intensive campaign of persuasion through the planning units, by stimulating the action of the entities themselves and finally by accepting the risk that some new projects will fail.

4) REVENUE POLICY

Following are the measures necessary to realize the program indicated above with our resources. Additional external financing implies a reliance on a resource which is becoming more and more expensive and whose obtainment in the required amount, due to present situation, is not guaranteed. In addition, our suggestions are tied to the Executive's goals of justice, equity and income distribution.

Evasion

Problem. There is an enormous degree of evasion. It has been calculated that enterprises do not pay more than 20% of their taxes on profits, and in addition independent professionals pay substantially lower taxes than they should.
Recommendations. Existing administrative mechanisms of control, proven and efficient, could practically eliminate tax evasion. However, an effective control which would be imposed within the present rate structure would bring too heavy a burden on the profits of enterprises. The present effective burden, with evasion incorporated in the calculations, probably does not exceed 10% of profits. The elimination of fraud and of those practices which, while being legal, do not lead to a correct determination of profits, would result in a burden possibly in excess of 50%. This would in turn affect the level of economic activity and might nullify the gains in tax collection. Consequently, it is necessary to combine better control of enterprises with a decrease of rates, which would also make the reform politically more acceptable. The decrease of rates would have additional beneficial effects that are examined below.

**TAXES TO ENTERPRISES**

Problem. High marginal rates on profits raise the price --- even though the effect seems paradoxical --- of the credit contracted by small firms because interest is deductible for the computation of a taxable base; thus the higher is the tax rate, the lower is the net cost of interest. This mechanism facilitates the access to credit for the big companies and considerably increases the price of financing for small companies, which also have fewer possibilities for using the stock market. This situation constitutes an artificial limit to competition and facilitates creation of monopolies; but beyond that, together with other factors, it has also contributed to the formation of powerful economic groups.

Recommendations. Proportionately lower tax rates (20 to 25%) would eliminate this type of distortion. As noted above, tax collection, even with lower rates, would increase if it is accompanied by an improvement in the system of control. Another possibility is to make interest accumulative. This alternative has not been studied with required depth to make it operational, but in case it is considered viable, several more concrete suggestions could be made.

**TAXABLE BASE**

Problem. There are groups, for instance rich and efficient farmers, some cooperatives and others for whom a preferential treatment is not justified.

Recommendations. The definition of a taxable base should not allow exceptions nor privileges. There should be no discrimination either by type of activity or by organization. It is undoubtedly difficult to measure the net result of the existing multiplicity of measures, but a uniform application of general
criteria would improve equity and efficiency of taxes. Although it is true, for instance, that the agricultural sector is favored by a diminution of its base for the computation of tax from profit, it is also affected by the supply of inputs at artificially high prices. In addition, these inputs have to be used in order to have petitions for credit approved. The previous might seem a digression, but in fact there is no difference, analytical or practical, between tax policy and price policy.

EQUALITY

Problem. There is a profound inequality in the fiscal treatment of persons of the same economic capacity. Income from capital (gains from revaluation of assets, income from interest, etc.) is favored in comparison with the fiscal burden on income from wages and salaries. In addition, the effective progressivity is practically nullified because the proportion of favored income -- income from capital -- is higher in relation to the total as income increases.

Recommendations. To eliminate the still prevailing structure which is in fact fractionalized, and to define the taxable base including all sources of income without exceptions. In the case of non-registered assets, as for instance bearer bonds; it is possible to adopt the following measure: if one does not desire to reveal the ownership of the bonds, one would have to pay the maximum marginal rate of interest, otherwise it will be accumulated with other income. For the difficult problem of real estate valuation which, if not solved, would hamper the taxation of considerable gains through revaluations, we have a concrete proposal described in another document.

FOREIGN TRADE

Problem. Mexican foreign trade is affected by a chaotic multiplicity of rates, permits, quotas, etc. Not only our capacity to export, but also the welfare of the national consumer, is seriously affected by this situation.

Recommendations. A complete study of the economic and administrative aspects of foreign trade is necessary. For instance, permits should not be issued through the present mechanism because the domestic value of an article often exceeds the sum of taxes and international price. It means that the importer collects a kind of rent which should be appropriated by the state. This situation can be improved by selling licenses or packages of licenses to the highest bidder. But in any case, the selling of permits should be transitory as the permits are gradually replaced by tariffs. Once the system is converted to tariffs, they should slowly and gradually become uniform. In addition, efficient assignment of imports implies an effective control of smuggling.
Exports, including tourism, should be subsidized by a sufficiently high uniform rate. The most efficient technique for promoting exports would be a subsidy to the sales price. In order to be efficient, the subsidies should be granted with administrative flexibility.

**PRICES OF GOVERNMENTAL ENTERPRISES**

**Problem.** To a great extent, the financial problems of enterprises of public sector and the inefficient assignment of resources are caused by an incorrect price policy.

**Recommendations.** A total revision -- through a careful study of cost conditions and demand structures -- of tariff policy pursued by governmental enterprises such as Pemex and CFE, and also a revision of pricing policy by organisms which supply services, such as Department of Distrito Federal, through charging marginal cost prices.

The dollar starts floating. A lost opportunity for economic reform.

In terms of foreign economic policy, two events of 1971 are worthy of consideration. When the Nixon administration applied the 10% surtax on imports in August 1971, it heralded the end of the belief in Mexico, perhaps also in Canada, of having a special relationship with, or receiving special treatment from the United States. The Mexican government sent a high level mission to Washington seeking special exemption, arguing that since Mexico had not contributed to producing the crisis, it should not be penalized by the measures taken to deal with it. The Mexican delegation was met with cold indifference. From then on, Mexican alignment with Latin American and Third World countries became more marked. The second important event happened on August 15, 1971, when the dollar started floating. A decision about supporting the peso, which had been under a par-value system since Bretton Woods, and had had a stable rate of exchange of 12.50 to a dollar since April of 1954, had to be made. Let us remember at this point that the peso had been overvalued since the mid-60s.
The morning following the announcement of the floating dollar, I was asked to present an opinion on the subject, and a meeting was set for later in the afternoon. During the day I prepared the following paper and submitted it to the President.

**Alternatives of the Economic Policy**

**INTRODUCTION**

In the next few days, the government will have to decide what attitude to adopt concerning the measures taken by the U.S. government in defense of their balance-of-payments. This presents an opportunity and a risk which, however, should be analyzed together with the economic measures that will have to be taken in the near future to achieve the objectives of the President of maintaining a steady economic development aimed at income redistribution.

The decision that the government will make at this moment can define to a great degree its strategy of development, which should be subjected to a careful analysis. It is hoped that the following considerations about the matter will contribute to such an analysis.

**PERSPECTIVES**

The evolution of economic indicators available to the Secretariat of the Presidency up to now suggests that the behavior of the economy during this year will have the following characteristics: a) the deficit in the balance of foreign trade will be similar to, or somewhat lower than, last year; b) prices will increase by a percentage 50% higher than the average increase during the 1960s, even though it will probably be only half of the increase in 1970; c) the rate of income growth will probably be lower than the average rate during the two previous six-year periods; d) the structure of public investment in 1971 has remained approximately equal to that of the last decade, since there have been no available resources to permit an increase in investment in rural health and social services, etc.

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1 Estimates arrived at in this office suggest that the rate of growth of national product during this year will be between 3% and 5%. 

The next years

In the following years of the presidential term, the foreign debt will increase to such a degree that even with income and employment growth rates lower than the average rates observed during the four previous administrations, service on the foreign debt will tend to become more and more burdensome. According to some optimistic estimates, the service of public and private debt (including dividend remittances of the foreign companies) will absorb 42% of revenue in the current account of 1976.

Causes

The limited success of economic policy during the present year can be explained by two factors: a) the effects of anti-inflationary programs initiated at the beginning of the year which restrict the growth of national product, but will have only a moderate effect on the correction of the deficit in the balance-of-payments; b) the practical sequel of the same strategy of growth adopted during the previous administrations.

Thus, for instance, lack of changes in the structure of public investment in 1971 results from the reduction of the total amount of investment because 'there was no place' for new programs and public investment was generally directed, in the traditional way, to those works that most benefit the profitability of private enterprise.

Necessity of changes

The perspective of the balance-of-payments is such that, except in the case of a happy coincidence of favorable events (possible but not probable1), sooner or later the government will have to face the dilemma of devaluation or unemployment unless it changes its strategy. In addition, whatever alternative might be adopted, it will be necessary to take complementary measures to fulfill the government's promises to improve the income distribution.

ALTERNATIVES VIS-A-VIS DOLLAR

The devaluation of the dollar presents a favorable opportunity to begin to change the strategy of growth.

The present situation of the dollar would make it possible to float the peso against the dollar, arguing that it is the

1. This coincidence would include: a slower increase of imports than up to now, a sharp decrease in the world interest rates, and an increase in our exports substantially higher than 9% annually (in the first semester of this year, the exports increased by less than 1% annually).
dollar's instability and the U.S. inflation which make the measure imperative.

The government would thus avoid paying the internal political price of unilateral devaluation which will occur in the future if our balance-of-payments is not improved -- but then we would not be able to blame anyone.

To maintain the fixed dollar-peso parity without drastic change in tax collection means a low rate of growth, growing unemployment and the impossibility of using public expenditures to redistribute income. To permit the peso to float against the dollar will probably stimulate our exports, limit our imports and tourism abroad. Also it would not be necessary to limit public expenditures in order to keep the deficit in the current account of the balance-of-payments within tolerable limits. At the same time, the floating of the peso will make it possible to broaden the taxable base and increase public expenditures, which would facilitate the achievement of programs formulated by the President.

If this measure is judged inconvenient, it should be taken into account that the maintenance of peso-dollar parity and the fulfillment of the President's programs require a different use of fiscal policy than has been in effect until now. This policy consists of simultaneous efforts to increase exports, avoid unemployment, achieve stability of prices and a reorientation of the economy toward a more equal income distribution, all of which implies, as will be seen below, a very strong action in tax policy.

Promotion of exports

Any economic policy that has the objective of rapid growth of the country must try to increase exports considerably -- not less than 9% annually -- because at present, the lack of foreign exchange is the most important restriction on the rate of growth.

It is possible to introduce, at least, a much more aggressive policy of subsidies to exports. This fiscal sacrifice, however, would have to be compensated for in ways other than by limiting public expenditures, because the latter technique would impede, as was already stated, the achievement of the objectives outlined by the President.

Public versus private enterprise

Given the fact that subsidies to promote exports cannot bring immediate results, it is possible that the external commercial deficit of this year will still be so high as to necessitate a further reduction in the rate of growth in 1972. This will represent a loss of two years out of the six available for
implementing the President's policies. This possibility, however, does not imply that public investment will not grow because there is no reason why only the public sector should bear the burden of adjustment.

**ANOTHER ALTERNATIVE**

The conclusion from the above exposition is the following: the present administration, in order to achieve its objectives of economic policy, should realize that in the present situation it is necessary: a) to solve the problem of balance-of-payments without excessively diminishing the rate of growth; b) to broaden and reform public expenditures.

Some measures concerning the solution of the first problem have already been taken, but others still should be adopted. These measures cannot be allowed to act adversely upon the second issue, about which very little has been done. Therefore, we suggest a number of actions to be taken in this respect.

**What has to be changed?**

A) Increase the fiscal revenue, reduce tax evasion by broadening the taxable base and making the structure of tax rates more effective and progressive; B) increase the prices of some of the products sold by public enterprise; C) increase the amount of public investment to make possible a gradual change of structure in order to 1) accelerate the rate of formation of human capital through an adequately financed educational reform, 2) stimulate the agricultural sector, especially the production of export crops and the traditional sector, 3) increase certain expenditures on social welfare such as medical service, food for pre-school children, etc., in such a way as would correspond to the objectives of income redistribution and also to the proposed action to combat underdevelopment as outlined by the Federal Executive. The increase of fiscal revenue does not necessarily imply a radical revision of tax rates, because it can be obtained by broadening the taxable base, eliminating some legal deductions which contradict the spirit of the law and only stimulate luxury consumption, and also by taking strong administrative measures to eliminate tax evasion.

The prices of those goods that the enterprises of public sector sell to the private sector, especially diesel, gas and electricity, should be increased to cover at least operating costs and to give a margin for expansion of the corresponding enterprises without excessively increasing their indebtedness.
In summary, the floating of the peso, while reducing the deficit in the trade balance, would permit the maintenance of an increased rate of growth, with a resulting increase in fiscal revenue and a greater opportunity to increase the tax burden, which in turn will lead to more revenues for the State.

However, this proposal did not prevail. Instead, the advice of the financial authorities -- to keep the peso pegged to the dollar -- carried the day, and in a joint press interview, the Secretary of the Treasury and the Managing Director of the Central Bank went on to explain to the nation the President's decision to keep the peso tied to the dollar at the old parity. Devaluation, the Secretary said, in a colloquial way, is "a word that does not exist in my dictionary." The head of the Central Bank stated that gold and foreign exchange reserves were more than adequate to support the old parity. One of the most important decisions of the administration, to support an overvalued currency, rigidly tied to the floating dollar, had been taken without considering its medium and long-run effects. It was explained later, though, by the Secretary of the Treasury.

The decision of the President ... to support the exchange rate with the currency of the country with which we transact 71% of our foreign trade -- and practically 90% of our service transactions -- is in my judgment a decision based upon the defense of the vital interests of the Mexican people and of the national economy, which this administration has included among its highest policy objectives. The reasons supporting this decision, in my view, are the following: defense of the prevailing rate of exchange of 12.50 that, as has been said, we have sustained with full convertibility and no fluctuation since 1954, will allow price stability in Mexico which is especially beneficial for the widest sector of the Mexican people. It will allow us, moreover, to take advantage of the revaluation of other currencies for benefit of our trade balance, that is to say, for our exports, because our competitiveness compared to those countries ... [and] our import substitutive industries competing with revaluing countries will be enhanced, will improve their competitive positions ...."\(^1\)

\(^1\) El Gobierno Mexicano, Presidencia de la República, Vol. 13, Dic. 1971, pp. 219-220.
Economic situation in early 1972

During the first year, the main actions of economic policy were: greater differentiation of the tax brackets and higher rates at the upper levels for the social security system (which made it more progressive); implementation of a housing financing scheme with a 5% payroll tax in order to create a sinking fund for mortgage loans for workers' housing; and modification of the Federal Labor Law to include additional fringe benefits. Thus, the old practice of taxing labor costs was further entrenched during the first year of the new administration. Higher sales taxes were also applied to refreshments and cigarettes.

Early in 1972 it became clear that the economic slump was far more severe than anyone had imagined or admitted. The annual report of the Central Bank, which constitutes the overall official review of economic conditions in the previous year, was presented the last week of February. It departed from the former practice of releasing a GDP figure, and instead, published a range of 3.2 - 3.7 GDP growth in order to lower the importance of any specific figure. Agricultural product grew 2.9%, a rate below population growth, and the first substantial imports of wheat occurred; petroleum, traditionally a very high growth sector (over 9% per annum), only increased by 2.5%. The investment squeeze affected the expansion both of productive capacity and of production. The imports of gasoline, crude oil, refined oil and natural gas started to soar; manufacturing (another 9% a year growth sector) advanced a poor 4.1%; and construction, directly hit by the decrease in public works, moved a bare 1.1%.

The Central Bank reported in early 1972:
Internally, the firm policy of the Federal Government which consisted of making fiscal and monetary adjustments indispensable for the consolidation of national economic development without inflationary pressures and of avoiding the worsening of the current account of the balance-of-payments, coincided with the natural postponement of some plans of public investment inherent in the change of administration, and with the deferral of plans of private investment caused by a reduction in profits and by uncertainty about the tendencies of national and international economy. This resulted in the moderation of pressures hovering over prices and balance-of-payments. All this permitted the successful confrontation of the international financial crisis with positive, even though moderate, increments in almost all national economic activities.

In the first stage of consolidation policy of the present administration, the government limited the growth of imports, checked the tendency of prices to increase, introduced fiscal measures leading to the determination of more adequate taxes on profits and from interest on fixed income-yielding securities and took fiscal and administrative measures leading to the support of exports and the encouragement of larger private investments.

With the first stage of the consolidation program of development considered completed, the second stage of national economic policy will be oriented toward the achievement of levels of economic growth similar or superior to those reached in previous years. This policy is based on more accelerated industrialization and greater dynamism of exports of manufacturers and of tourism, as well as on intensive channelling of resources into agricultural development and massive construction of socially useful housing for the popular and labor sectors, financed by savings additional to those available in banks.1

The slow growth of 1971 was thus explained as an instrument for future faster growth.

The report gave ammunition to the Secretaries on the spending side of the Cabinet whose programs had been curtailed by the decrease in authorized public investment. Lack of efficacy in carrying-out investment

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programs became evident across the board. The report disclosed a fact unknown to government officials engaged in economic policy making. It read,

The slower growth in economic activity in 1971 meant that private banking did not use all of its increased lending capacity during the year. Due to that, the strong injection of liquidity of the Banco de Mexico and deposit banks to the economic system was, in certain degree, counteracted by the considerable increase of the excess reserves of financial and mortgage banks [my emphasis] over and above their reserve requirements at the Banco de Mexico. Financial banks increased their idle lending resources, available on demand at the Central Bank, by 1665 million pesos during the year; mortgage banks increased their excess liquid resources available for mortgage loans of social interest by 971 million pesos; other institutional investors increased too, in significant form, their available resources in the Banco de Mexico.¹

In other words, financial institutions had accumulated excess reserves, in the amount of 2773 million pesos, which they had deposited at the Central Bank (the definitive edition of the report gives a figure 2636 million with a different institutional breakdown, more for financial, less for mortgage banks). The admission added further weapons to the arsenal used by the critics of the Treasury, who included the inner economic quadrangle of Secretaries. They queried: Since public investment had been curtailed by lack of funds, how was it possible that there were idle funds at the Central Bank? Why were those funds not used to finance and expand essential public investment projects? What was the sense of not being oil self-sufficient, of increasing imports while having idle funds at the Central Bank? This policy was leading to insufficient productive capacity of nationalized industries resulting in higher imports of fuels (crude oil, naphtha, natural gas, etc.) and consumer goods (food-stuff, etc.), but more significantly it was causing stagnation and unemployment. The President was quickly informed of the admission of the Central Bank. Then hell broke loose.

¹Ibid, p. 23.
CHAPTER III
THE ATTEMPT AT TAX REFORM OF 1972

A riddle wrapped in
mystery inside an
enigma.

Winston Churchill

1. Economic and political climate in 1972

The Spending Spree of 1972

The 1972 budget approved by Congress in December 1971 called for
an investment budget of 33.5 billion, 10.7% above the 1970 level. When the
1971 slippage of the GDP's growth rate became known, and the existence of
bank's excess reserves, invested in interest-paying deposits at the Central
Bank, was disclosed, a widely shared sense of urgency to restore the tradi-
tional growth rate became apparent. Rough estimates of the number of un-
employed that the decrease in the growth rate implied were quickly cir-
culated. Emergency programs especially designed for maximum employment
effects were to be implemented. Among many other projects intended to
increase aggregate demand and restore the dynamism of the country, a program
of rural roads constructed by hand was quickly started. The President
himself became the chief promoter and overseer of public works spending.
The first casualties of the spending onslaught were the priorities of the
Inauguration Speech. Speed became the sole constraint on spending, agencies
with a capacity to deliver had their whims fulfilled and previously shelved
programs reappeared, were upgraded and quickly approved. Swiftness in
program preparation was the key to obtaining larger shares of the budget.
The administration's initial high priority programs -- most of them still
in an experimental stage -- lost ground relatively since the newly
approved ones -- many of very low priority -- subsequently absorbed a
considerable portion of the budget in order to be continued or completed. The original priorities were harmed in the rush to return to normalcy.

Budget discipline was the second casualty of major importance: budget control was fractured since spending programs were directly approved by the President and the Budgetary Office of the Treasury was reduced to a mere rubber stamp machine. The cost of public investment varied since competitive bidding by contractors was eliminated in order to avoid the delays associated with such a procedure. Special authorizations of public investment increased sharply and were sufficient to boost actual public investment 3.6% above the initial budgeted level.¹ In addition, the agencies ended the year of 1972 with a 7.3 billion peso margin of approved and unspent investment authorizations which was enough to push the 1973 actual public investment by another 43.0% (see tables III-1, III-2). Public investment spending more than doubled in the two years (22.5 billion in 1972, 49.8 billion in 1973), in comparison with the 13% annual growth registered during Stabilizing Development. The largest share of the increase was absorbed by spending on transport and communications which shifted from one fifth to one fourth of the public investment budget. In addition, urban infrastructure in Mexico City was boosted — mainly highways and urban roads for City's automobile traffic and public housing. Both of the latter are low priority sectors and the initial set of priorities had indicated a decrease in their relative participation in the public investment budget. Particularly, improvement in the road system of Mexico City was not vital because Mexico has a relatively well-developed transport network and the

¹This compares with the 19% level of actual investment under the originally budgeted level of 1971.
expansion of highways mainly services the congested weekend tourist traffic. The city's roads serve the needs of the middle class of the Valley of Mexico, the region with the highest income per capita of the nation.

With a lag, private investment increased substantially as well, induced by the strong medicine that public policy was administering. With a quick increase in 1973, private investment moved to its trend line again. From its 50.9 billion level of 1970, it moved to 52.4 in 1971 -- a small decrease in real terms -- to 56.1 in 1972 and 64.6 in 1973.¹ A strong, even though short-lived recovery was under way.

Beginning of inflation

Monthly economic indicators in Mexico are very crude instruments for judging actual economic trends and therefore they must be used with caution. Nevertheless, the story of the beginning of inflation can be reconstructed and is illustrated in Graph III-1. Public investment was especially low in the first months of 1971 and was clustered in the last months of that year. This level of investment led to the normalization of economic activity that appeared to have occurred between the first and second quarters of 1972. The rate of change of industrial production shows a steady increase since October 1971 exceeding its long-run growth trend by March 1972, approximately when the Central Bank's annual report came out. The rate of change of money supply started to increase in October 1971 as well, then leveled off in the first quarter of 1972, and even decreased in April 1972. Therefore, the spending emergency which started in March 1972 came about when economic conditions were already more or less normalized. The monetary ease in May 1972 occurred even later and was implemented when

¹Anteproyecto de lineamientos para el programa, op.cit., Apéndice Estadístico.
the rate of change of money supply started increasing again. The spending wave came on top of a precarious monetary balance and in such a short time span that there was no solution other than printing money. The rate of change of the money supply moved quickly upward from its trough of 5.7% in October 1971 to 12.6% in May 1972 — when the reserve requirements were changed — and up to 15% at the end of June. The economy had presumably reached its physical limit early in the year as shown by the increase in the rate of change of industrial production which exceeded its long-run trend in March, peaked in September 1972, and then fell somewhat towards a more normal level. With excess capacity exhausted, all the emergency spending thrust was monetary. In May 1972, the Central Bank, under the stress of full capacity, abandoned its long tradition of yearly changes of monetary targets in line with real long-run trends, and tried its hand at fine-tuning by expanding domestic credit. The President's spending, and the Central Bank's policy of ease amounted to throwing buckets of gasoline into a fire. The Bank's 1972 report reads:

Monetary and credit policy had as a goal, in the first part of 1972, the support of the Federal Government's policy of accelerating economic activity. Despite the fact that an increase in liquidity and in available loanable funds occurred (originating in the greater internal financing of the public sector and in the increase in the availability of external funds) monetary policy was oriented to an increase in lending by private banks through freeing resources, reducing interest rates on their unused funds, and channelling additional financing of the Banco de México and of private banks to activities of high priority.

The authorities utilized the freeing of funds of reserve requirements and the channelling of resources to high priority activities as the key instruments for stimulating the economy. The means of liberalization (easing) adopted by the Banco de México basically consisted of: a) giving a strong support to the growth of lending capacity of deposit banks; b) a decrease

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1 The rate of change of money supply reached an all-time high in November 1973 when it was 28.9%.
in reserve requirements, giving financial banks a one-shot increase in available funds of approximately 1500 million pesos; and c) reducing from 50 to 40% the reserve requirement on the growth of resources raised through debentures (pagares) by such financial banks.

The Banco de Mexico reduced between one and two percentage points the annual yield that financial institutions received from their excess reserves kept at the Central Bank. This measure was intended to induce them to lend to the public and private sectors (which were demanding additional financing) the excess funds that financial banks had accumulated in the Banco de Mexico as a result of the 1971 contraction in the demand for credit.  

Thus, the Central Bank in 1972 decreased its deposit rate on excess reserves by private banks in order to stop the accumulation of reserves and induce them to increase their lending in the market; granted credit to deposit banks for the same purpose; in May of 1972, freed 1500 million in bank's reserves; and decreased the reserve requirements of financial banks on the last day of May. Graph III-1 shows that the Central Bank's expansionary action came three months after the rate of change of industrial production had already jumped above its long-run growth rate and after the economy had reached production bottlenecks. In addition, the rate of change of the money stock continued to increase. As noted above, the rate of change of industrial production peaked in August-September 1972. Some goods were already unavailable in the market — public investment was increasing and had a large authorized margin of growth — and it was clear that a round of inflation was around the corner and something had to be done to check it.

Prices were blurring the picture, however. The month to month change of the wholesale price index decreased throughout 1971 and in the first semester of 1972 fluctuated under its long-run trend, April being

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the lowest point. This probably deceived the Central Bank into following a policy of monetary ease in May, in an effort to defend itself against the charges that it was thwarting economic growth. As pointed out above, prices react with a lag — which was the case of the wholesale price index. When the rate of growth of GDP accelerates, prices remain stable for some time, presumably through an increase in the productivity of labor resulting from previous incomplete factor use (labor hoarding). Such had been the experience of 1963-64 and 1968, and this time, it happened again. Prices started climbing in May 1972 and with the exception of November 1972, continued to increase steadily reaching the peak in March 1974 (when the rate of change was 31.1%).

Political babble and entrepreneurial attitudes

Something had gone wrong with the tactic of bringing the private sector representatives close to the government, persuading them about the necessity of change and convincing them to cooperate in the attempts at reform. If anything, at the end of 1972 they were unified against the tax proposal and were unexpectedly firm in this attitude. I suspect that the following happened: The criticism of private entrepreneurs by some sections of the government, especially by the National Property Secretary and some of the young, left wing politicians close to the President, aroused mounting suspicion on the part of rank and file of the private business organizations. Even though the President maintained good relations with the leaders of the private sector, and the latter understood the government's point of view and regarded some of the proposed changes sympathetically, the business leaders faced mounting criticism from their associates who questioned the leaders' loyalty to
to private sector interests. At this moment, the business representatives had to be true to their class. The timing was unfortunate, because just when the administration was launching its most important reform, the leaders of the private sector were hardening their position in order to maintain credibility with their rank and file. Moreover, the effort to bring students and intellectuals to the government's fold produced some rhetorical excesses that shattered much of the good will that the President previously had developed with businessmen.

These are conjectures and I do not pretend to substantiate them. I may, however, illustrate the thinking that was then current in the private sector, together with its ideological underpinnings. For the preparation of the 1973 budget, the Presidency commissioned the first "Survey of Investors' Attitudes" that has been repeated twice a year since. The purpose of the survey was to attempt to forecast private investment in order to propose public investment in relation to the likely behavior of the private sector.

We hired a consultant and a research firm to undertake the survey. The firm had a competent statistician who designed the sample, covering the quantitative part. Because it was the first time such a survey was undertaken and because there existed some doubts about the representativeness of the sampling group, a qualitative questionnaire was added. The names of the interviewed businessmen were kept unknown to the Presidency. The firm thought that the questionnaire would be indicative of large business' prevailing opinion about capital formation during 1972 and 1973.

The survey's results give a frame of reference for judging the
political climate under which the tax reform was attempted. In their answers to the questionnaire, the wealthy and conservative businessmen strongly expressed their misgivings about the direction of economic policy pursued by the government. Most of them characterized the prevailing political mood of the private sector as being full of confusion and distrust caused by fears that the country was being led to socialism and by disagreement with the quick pace of changes implemented by the government. Both the general and specific criticisms of the President and the government clearly show that the private sector was opposed to the substantial structural changes — in the economic as well as in the political spheres — that had been promised by President Echeverría in his Inaugural speech of December 1970.¹

¹For the full text of the summary of the quantitative questionnaire see Appendix D.
2. The tax reform proposal and its rejection

By late 1972 it was clear that the budgetary situation was getting out of hand. The impact of public spending in excess of the amount approved by Congress was so large and so sudden that it had an immediate and almost direct monetary effect, and it was possible to foresee that, sooner or later, the excessive spending would have an impact on the balance-of-payments and prices. Agricultural conditions were poor — partly because the summer crop harvest showed a decline in the production of some crops¹ — and some scarcities were evident, prices jumped and price controls were becoming ineffective.

The Treasury was considering a change in the rate of the transactions tax and increases in fuel prices and power rates, which had remained unchanged for ten previous years, as the main revenue proposals for the year. The increases, especially in fuel rates, were to be quite substantial in terms of public sector revenues.

In mid-1972, the President had authorized the formation of a research group to study employment policy and within it a committee was formed to inquire into likely tax reforms. The committee, although consisting of outsiders, worked in cooperation with the Treasury and was in direct contact with the Assistant Secretary for Revenue Affairs. The head of the committee, a known progressive economist who later became the

¹The agricultural product fell 1.8% for the year; the production of cereals decreased: corn, wheat, and sorghum. Imports of 640,000 tons of wheat were realized, about one quarter of domestic consumption. Mexico was turning into a net importer of food and fuels just when OPEC was going to succeed in hiking prices and the food crises emerged; and although we did not know at the time, these two factors were going to have important budgetary repercussions.
Assistant Secretary for Revenue Affairs, had direct access to the President and was often consulted by him on various matters. He was a frequent visitor to the Presidential residence.

The first meeting with the President for the preparation of the 1973 budget came on a Sunday morning of late October. The Secretary of the Treasury planned to show the agencies' requests for spending in the coming year to the President, and intended to suggest an increase in the transactions tax from three to four percent as the most important tax change for increasing revenue. Present at the meeting were the Secretaries and staff personnel of the Treasury, Presidential Office -- including myself -- and National Property, the Governor of the Central Bank and two members of the special tax reform committee. The Secretary of the Treasury opened the meeting with a brief remark on economic conditions and said that the Treasury was looking for the President's instructions about main priorities in order to prepare the 1973 budget. The President answered immediately, addressing the Secretary of the Treasury as if none of the others were present. He questioned the fiscal policy that was being followed and personally queried, "I ask myself if six years from now another President will not, like myself, question the Secretary of the Treasury what can be done in fiscal matters to improve income distribution?" In a long personal expression of his views he said that fiscal policy was out of step with an administration keen on reform. The Treasury should keep pace with the changes that were being undertaken in other fields and come up with proposals that would contribute to the achievement of the administration's goals. Then he left the room for a while to attend to other matters. It was a golden opportunity for the National Property Secretary to block the Treasury from using fuel
prices as an excuse to avoid tax reform, and to point out the Treasury's lack of zeal for reform. It was an opportunity, too, for the outside, parallel tax reform group to push their own views on tax policy. When the President rejoined the meeting, the Secretary of the Treasury introduced the Assistant Secretary for Revenue Affairs who stated that within the Treasury they had been studying possible reform of the income tax, spending surtaxes, and a wealth tax, and that, once instructed, they could come up with a tax reform proposal in a few days time -- in time to have it sent to Congress for the 1973 budget. It was the first time a tax reform was discussed quite explicitly with the President who in fact brought it about himself by his exhortation to the Secretary of the Treasury. Immediately after the exposition of the Assistant Secretary, the President formed a working group consisting of Treasury and Presidency officials and asked them to review the tax reform package and to report to him as soon as possible. Following this meeting, the Treasury adopted a different attitude to avoid being cornered again. It was as if they were thinking: Reform they want, reform they'll get! Treasury officials thus became the strongest advocates of reform, and then it was the turn of the Managing Director of the Central Bank to oppose the change. His main reason was the fear of capital flight that could hamper the stability of the peso.

Despite this opposition, however, a tax reform proposal was quickly drafted by the Treasury. It was based on the 1964 package that never went through, and it stated in the introductory paragraphs:

If we want to avoid violence and anarchy by legal and peaceful means, there is no other way than carrying out a broad fiscal reform that will simultaneously:
- increase public revenue;
- promote redistribution of wealth;
- establish, in an equitable form, the measure of fiscal burden that each person must carry;
- avoid waste of resources and sumptuary expenditures;
- promote investment by Mexicans so that the resources and possibilities of our country are utilized optimally for the benefit of the whole nation.¹

The proposal itself contained the following features:

a) Full accumulation of earnings for the income tax.

b) Disappearance of bearer shares and bearer bonds (all wealth positions to be disclosed to the tax authority).

c) A wealth tax; more for supervisory practices than on account of its revenue possibilities, because the wealth tax was to carry only a token rate.

d) Closing of loopholes.

e) Redefining the tax base — enlarging it.

f) Increasing the marginal personal income tax rate to 42% beyond one million pesos, to equal the corporate income tax. Previously, the highest personal income tax rate had been 35%.

In mid-November, the tax reform was again discussed with the President. Except for the Director of the Central Bank, there was a fairly wide ground of agreement among participants² about the nature of the reform. The only controversial point was the taxing of interest yielded by financial assets. Some proposed that it should be exempted outright except for a flat sum — already being applied — deductible at the source. The other position accepted the deduction of the flat

¹The reform proposal of the Treasury. 1972. Mimeo.

²The Secretary of National Property and the members of the tax study committee were left out from the meetings once the Treasury started pushing for reform.
rate at the source but thought it should be deducted from the personal income tax where all income from interest would be accumulated. Thus the net interest in financial institutions would be competitive with U.S. rates, but the annual income statement would include the whole interest earned minus the tax deducted at the source. It was true that taxes on interest could make Mexican financial paper not competitive with U.S. paper, but the argument was not valid for dividends on stocks, since most corporations are not public but closed family undertakings. It was proposed to treat dividends as fully taxable. There was no reason to exclude dividends in whole or in part from the personal income tax accumulation -- except for dividends of traded stocks of open corporations. Actually, the point was not essential since funds deposited at financial institutions were subject to the withholding tax plus the reserve requirement, which meant a loan to the Treasury at a subsidized rate.

The following meeting with the President was attended only by the Treasury personnel, Presidency, and the head of the Central Bank. The staff of the Presidency supported the full reform position, the Central Bank's Managing Director opposed it, and the Treasury was in between, in favor of reform, exempting interests and dividends from accumulation but supporting the elimination of bearer bonds and shares. After a long and heated discussion it was decided to follow the Treasury's position and keep a margin of favorable differential in net interest after taxes, vis-a-vis U.S. interest rates on all financial paper. Dividends of closed corporations would be fully accumulated, dividends from traded stock would receive the same treatment as financial paper.
The agreement reached stipulated that wealth would be nominative, and bearer bonds and shares would disappear or would be subject to the higher rate of personal income tax. Financial institutions would be registrars of shareholders and would notify tax authorities of bond and share ownership and changes. All bonds and shares would be deposited at financial institutions. Taxes on interest from financial paper would be raised from 16% to 21%, would remain at this level as a flat rate, and would be exempted from the income tax for accumulation. The same would be applicable for dividends on stock registered and traded on the stock exchange. Unregistered and untraded shares' dividends would be fully accumulated for the personal income tax, thus net dividends of traded shares would be taxed less than non-traded ones. This would work as an incentive for corporations to go public and register and raise funds on the stock exchange, which would break the scarcity of the supply of stocks in the exchanges.

At the end of this final meeting which took place at the beginning of December, those still opposing the reform warned that they still feared a capital flight and threat to the peso, even if interest would be exempted from accumulation and a favorable interest differential maintained. They also argued that the reform would have unwelcome political repercussions and would be harmful to private investment. Since they had abandoned the economic argument for political ones, I replied in the same terms, addressing the President. For his government, I argued, this reform was as important as Cárdenas' oil expropriation and land reform in the 1930s — and in the long-run probably more so. It was also an essential step for obtaining the revenue needed to carry out the other reforms he wanted to put through. "Political prestige," I said, "is not an objective in itself,
since it will end with the administration. It only makes sense if it is used to carry out measures that will enhance the welfare of the people. That will lead, in the long-run, to another kind of prestige, not of the type that enlarges the short-run capacity to impose decisions, but rather that which enriches the social heritage of a Nation. The President, in principle, accepted the proposed tax reform and directed the Treasury officials to draft the necessary change in the laws. Some hectic days ensued, in which the details and intricacies of tax legislation had to be studied. We presented the proposal a few days later, and were already running short of time.

At the same time, the proposal of a law of control on foreign investment, on which the President was very keen, was being discussed and the working group that was steering it joined us. There was some reason for combining both groups since a register of the citizenship of share owners was necessary for the control of foreign investment and it matched the elimination of bearer shares of the tax reform bill. Steering the foreign investment law was the Assistant Secretary of Commerce, formerly a private businessman and the leader of the association of industrialists when the 1964 tax reform aborted. He was turning more and more government control oriented, but we feared that because of his background he could disrupt the tax package. Finally, however, both bills moved together through the legal processing, the Attorney General reviewed the changes and the bills were ready to be sent to Congress.

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1 Actually the thought was not mine, I have heard it in Bogotá, where I went on a short trip a few days before, from Rodrigo Botero, the former head of the Colombian Planning Office under President Carlos Lleras. Botero later passed a tax reform very similar to the one we were discussing, as Secretary of the Treasury for President López Michelson.
Over a lunch with the President early in December, after the bills were ready, a question was raised whether it was tactically wiser to send them together or rather one ahead of the other. The Commerce Assistant Secretary insisted that his bill should go first because of the personal interest of the President in controlling foreign investment. The tax group was concerned that if the tax bill went later it might not pass and the Assistant Secretary of the Treasury for Revenue and myself argued against that delay. If anything, the foreign investment law should go second. In a touch-and-go discussion, the President finally agreed that both should go together and instructed the Secretary of the Treasury to meet with the representatives of the private sector later in the day and explain both bills to them. He called the Press Undersecretary and asked him to convene a meeting with some newspaper editorial writers to persuade them to support the proposals and to prepare the public for the changes.

We met twice with the private sector representatives in the house of the Secretary of the Treasury. Present were leaders from CONCAMIN and CANACINTRA (industrialists), the bankers, Chamber of Commerce representatives, and past presidents of the bankers' associations. The second meeting was also attended by attorneys, tax experts and advisers employed by the associations. At the first meeting, we explained both bills to them, and at the second meeting, three days later, a discussion of the bills took place. The private sector representatives were very critical and presented a common front against both bills. Even the representatives of small and medium industrialists, CANACINTRA, who generally cooperate with the government, joined the others in the fear of the changes. Their arguments were more over intention than substance. They saw the bills as
a first step leading to foreign exchange control and argued that tax administration could be improved by using other measures that would not harm investors' confidence as the proposed ones would.

During the discussions, the Assistant Secretary of Commerce was persuasive about the importance of controlling foreign investment and favoring Mexican investors, and the Secretary of the Treasury (the former Ambassador to Washington) showed all his diplomatic skill in overlooking the carping tone of the private sector representatives and went on to explain the bills point by point, countering their criticisms until he left them without further arguments. It was one of the finest performances by a public official I have ever witnessed. He defended the need of reform, the spending requirements, the necessity of closing the public sector deficit and avoiding a new round of inflation. The private sector, while still reluctant, ran out of arguments and withdrew from the discussion, warning at the same time of unforeseen dangers. Although I was not present at the meeting of the press, the editorialists were informed and offered support for the bills. Now the one remaining step was to send the bills to Congress -- which only the President could do.

Christmas was quickly approaching, however, and nothing happened -- and time was running out. There was no reason for the groups to get together again, but we were wondering who would testify in Congress. A special session in Congress in January 1973 might be convened to have a full discussion of the bill.

Those two weeks in mid-December were filled with agony. Finally the President summoned the Secretary of the Treasury and told him that the tax reform bill would be postponed and instead, the transaction tax rate
would be increased as originally proposed. He directed that the Secretary
go to Congress and explain the new budget and the tax changes. On the 26th
of December, the President ordered the foreign investment bill and the new
budget sent to Congress. The Secretary of the Treasury went to Congress,
explained the budget and tax changes, and was asked to resign five months
later. Not long thereafter the Assistant Secretary for Revenue was asked
to resign as well.

What happened during those crucial days of December? Only the
President and whoever convinced him to change his mind know. What is
certain is that no one in the government did. Unfortunately, since the
tax package did not go through, neither the fuel prices nor power rates
were increased as originally envisaged by the Treasury. The public sector
deficit grew from 2.2% as a share of GDP in 1971, to 3.1% in 1972 and
to 5.1% in 1973. This deficit by itself was more than the total level of
savings channeled by the financial system and about one third of the in-
vestment/income ratio. Inflation exploded.
Chapter IV

1973 AND ONWARDS

It takes all the running you can do to keep in the same place.

L. Carroll, Through the Looking Glass.

1. Inflation

Inflation becomes unmanageable

The beginning of 1973 caught the government off balance. The past practice of compensating the shifts of public investment with offsetting changes in private investment was no longer feasible. The evolution of the loanable funds market away from excess demand conditions into an interest-rate, market-clearing mechanism finished the automatic crowding-out of private investment of the 60s. The formation of excess reserves provided a potential for increased private spending that was unleashed in 1972 and 1973. The Central Bank, by decreasing the interest rate for lending and borrowing operations of financial institutions and by liberating reserve requirements in 1972, triggered an upsurge of private investment that moved in the same direction as the now snowballing public spending. Instead of the stabilizing -- offsetting -- compensatory movement of the past, this time public and private spending moved in the same direction. The proposed increase in fuel prices and the tax reform proposal were attempts by the Treasury to transfer resources from the private to the public sector, moderate the increase of private spending and partially cushion the expansion of the public sector's spending. Since the tax reform failure sacrificed both means of curtailing private spending, excess reserves were drawn from the banks and the government's deficit quickly monetized. The decrease of interest rates implemented by the Central Bank reduced the rate differential vis-a-vis
the U.S. market and the inflow of foreign funds was smaller than it otherwise would have been. As a result, the budgetary deficit had to be increasingly financed by an expansion of the money supply. The monthly change of money supply (as compared with the same month of the previous year) kept increasing and reached an all time high of 28.9% in November 1973. Long gone were the days of the 10% annual growth of the money stock.

Prices quickly followed. The wholesale price index moved from an annual rate of change of 7.3% in January to 25.2% in December 1973 (it was going to peak at 31.1% in March 1973). (See table III-3.)

The Central Bank reversed its attitude and adopted a policy of restraint at the end of May 1973, raising the reserve requirement for financial institutions and savings banks. In that month, the money supply was already growing at a vigorous 25.4%. The monetary authorities complemented the restraint by increasing interest rates by 1% in August 1973 and raising reserve requirements for deposit banks. It was too little, too late.

The year 1973 marked the end of the financial boom of the late 50s and 60s: savings channelled by the financial system — in non-monetary form — that had grown by 17-18% per annum during Stabilizing Development grew just 9.7% this time. Negative real interest rates and reduced differentials with U.S. rates were the main factors explaining the end of the financial boom, since the change of the growth rate of real GDP was slight (from 7.5% in 1972 to 5.9% in 1973, in monetary terms 13.2% in 1972, 21.2% in 1973). Therefore higher reserve requirements were now offset with a smaller flow of funds channelled by financial institutions and the major part of the budgetary deficit had to be supported by the old device of printing money.
The consumer price index followed the movement of the wholesale price index with a lag — which shortened when the prices of services began adjusting to the process of inflation, and widespread salary increases were granted. Price changes spread through all components of both indexes when at the end of 1973 tariffs and prices of government supplied goods and services had to be adjusted upwards as well. The prices of imported commodities rose 8% in the year and, although they were not the major cause of inflation (foreign trade representing less than one fifth of GDP), the increase gave an added autonomous impetus to it.

Stop-go policies and the burden of deficit spending.

Four months after the tax reform attempt, the Secretary of the Treasury was dismissed and José López Portillo, who was going to become the PRI candidate for President after Echeverría, was appointed to succeed him. In his first press interview López Portillo disclosed that "in order to protect the real purchasing power of wages and salaries a strictly anti-inflationary monetary policy will be applied and limits set against the unjustified expansion of bank credit extended to activities not directly productive." He added that social and productive public spending would be adequately balanced and a prudent relationship reached with fiscal revenues in order that "external and internal credit do not represent an excessive part of total spending."¹ Later on he announced a 16 point anti-inflation program which included a stricter price control mechanism, more government intervention in the marketing and retailing of basic consumer goods, tailoring of foreign trade policy by searching for adequate domestic supplies of consumer

¹ "El Gobierno Mexicano, Presidencia de la República, No. 31, Junio de 1973, pp. 115-117."
goods, and salary adjustments. For the second time in three years economic brakes were applied and stop-go policies were setting-in.

In mid-September 1973, a general 18% salary increase was granted. It was the first of four wage increases that doubled nominal pay rates between 1973 and 1975. Thus inflation turned from its demand-pull inception into a demand-pull/cost-push reinforcement process.

The public sector deficit doubled from 15.7 billion pesos in 1972 to 31.8 billion in 1973, and kept expanding both absolutely and as a share of GDP. From its low level of 2.2% of GDP in 1971, it jumped to 5.1% in 1973 and, despite policy intentions, it reached 9.0% in 1975 (see table I-13). Inflation released some forces that continued to enlarge the public sector deficit despite anti-inflationary policies. As noted earlier, public investment took advantage of the margin authorized and unspent in 1972 and rose by 46% in 1973 -- compared to 53% of the year before -- which is two fifths of total investment and 9.3% of GDP. Meanwhile, public saving dipped, depressed by the upward momentum of current spending and by the salary adjustments that were initiated by the Federal government in order to force private entrepreneurs to accept the general wage increases. With the government's spending being pushed upwards and public revenues lagging (since tariffs and prices of public enterprises and government services were delayed in being adjusted), the public deficit expanded not only absolutely but as a share of GDP as well. By 1974 the public deficit was almost twice as large as the savings channelled by non-monetary financial institutions. Both the external public debt and the money supply skyrocketed. The government had to act in order to prevent inflation from getting out of hand.
Fuel prices were increased at the end of 1973 by considerable amounts: more than double for liquid gas, more than 50% for gasoline, around 30% for electricity. Other changes to increase revenues took place in 1973 and 1974,\(^1\) when the public sector deficit was rapidly approaching one tenth of GDP. Thus the government had first to move and then run not to be left behind even more. Its actions to deal with the causes and effects of inflation necessitated negotiations with the private sector once again, to which we may now turn.

**Forcing the hand of the Private Sector**

In his annual report to the nation on September 1, 1973, the President explained inflation as a result of external forces, income re-distribution and laggard private investment. In regard to the latter point he said:

Lack of foresight concerning the volume of private investment, which would be necessary for accommodating the demand in some branches, and speculative operations in the intermediate processing of products caused deficiencies in industrial supplies. The social interest is harmed not only by those who violate essential norms of solidarity, but also by those who let the resources generated by the common effort of the Nation stand idle. To affirm that investment and the consequent increase of prices is a result of economic policy adopted by the Government is a lie that only benefits the interest of reactionary groups. Mexico wants to continue advancing within a stable economy. The quantitative and qualitative increase of production ... implies activation of our great national reserve: Organized labor .... The solutions to inflationary problems do not have to be necessarily conservative .... We have decided to increase remunerations of federal employees and to ask Congress to authorize an adjustment of minimum wages. The entrepreneurs agreed to maintain the prices of necessities

\(^1\) However, since public sector salaries were raised before private sector salaries to smooth the process of bargaining the tax changes of those two years were cancelled by the salary adjustments and had no effect in decreasing the public sector deficit.
prevailing on July 21, 1973 during the period ending March 31, 1974.... During this period only the changes in basic costs of production or marketing exceeding together 3% of the present costs will be transferred to prices.... the respective authorities ... would guarantee the effectiveness of this compromise and enforce it in case of non-compliance.¹

The increase in wages to federal personnel was done as a first step to pave the way to the general wage and salary increase that became effective on September 16, 1973, two weeks after the annual report. General price restraint, increases of fuel prices and the regularly scheduled minimum wage adjustment to become effective January 1, 1972, all were negotiated with the private sector. It was only eight months since the President had sacrificed tax reform in order to keep on good terms with the private sector, but now he was forced by the weight of events to pass through a series of changes that were just as unpleasant to the business community.

A third general salary adjustment was going to take place in the autumn of 1974 when prices were no longer accelerating but still going strong. The mistrust between public and private sector had not halted yet and a capital outflow took place in the summer of 1974, increasing as the President's annual report to the Nation approached. During the delivery of the report, the President suspended his reading of the written text and in an improvised form let his feelings be openly known. He said:

In Mexico, gentlemen, as well as throughout the world, no institutions are more discrete, no institutions guard their data with more confidentiality, than banks: Banco de México, the official bank, the mixed and the private banks. I declare to you that they are totally discrete. But in the last three days, not some rich men -- because they are very poor, very poor not only morally, they are poor economically compared

with the great international interests against which we have
to defend ourselves, and therefore they should be closer to
their own nation, to the problems of their nation -- not some
rich men, but let us say, some little rich men, bought un-
important amounts of dollars, and had money orders made pay-
able in New York, or took the money to their homes thinking
that these last paragraphs were about to announce a devaluation.

I tell you that you should return this money on Monday because
it could happen to you what happened in past years, when the
dollar was devalued two times within a few months.

The little rich Mexicans who buy dollars not to obtain
better rates of interest -- as happened several months ago
when the interest rates abroad were increased -- but to
try to provoke devaluation or because they are afraid of
it, these Mexicans are despised by the people, by their
own sons, because they are not building the fatherland for
their sons. In this way, they ruin the young generations
that want to be formed in their homes or in their businesses;
they deceive them about themselves pretending to be courage-
ous folks which they are not; they lead them to social in-
adaptability, to drug addiction, to irresponsibility. It is
these young people who often crash in latest model cars,
driving at 120 to 140 kilometers per hour, who are victims
of accidents, in inexplicable circumstances for people who
study or work; it is their sons who trespass the norms which
are formally remembered after a dinner, every three months
by those little rich men who buy dollars, these poor little
rich men who buy dollars which they should give to their sons.

Thus they build their country, thus they build the small part
of the country, the big part of the country which is represented
by each of its homes, fully trusted and supported by the young
people who are being formed there.

This is the moral retribution that they will receive, that they
have started to receive, that we know they have received in
their homes.

But, gentlemen, the banks are very discrete and I can assure
you that we do not have any exact information.

The critical world situation and the modifications of internal
economic behavior caused by inflation require prompt response.

I want to declare to you that the amount of dollars bought in
the last three days, it means, on Thursday and Friday, in
the banks that were open -- as they said, they were open in
connection with this report -- and the dollars sold at the air-
port -- because there is a subsidiary of a bank there which
exchanges pesos for dollars and other foreign currency -- these
amounts are insignificant compared to the reserves that the Banco de Mexico is holding, due to its policy which is not conservative but far-seeing and fundamentally responsible.

Let them know it well: there will not be, either through modifications of wages or in whatever other way, a devaluation. The effects are calculated. They should not count on it. Yesterday, on Saturday, the banks were closed; we gave instructions for the subsidiary at the central airport to remain open, with boxes full of dollars, so that those who want can buy. This is the situation.

We think that if they see -- if some of them follow this report on television -- tomorrow they will bring their dollars to a safe place, to the banks, so that their capital, small or big -- always small relatively -- is safe, in pesos.

With your permission, I have just remembered something that I want to tell you: frequently, the banks in the Southern United States, some big and some small, banks from San Diego to Los Angeles, California, to Miami, Florida, publish in some periodicals, in some small border periodicals, that the capitalists from the north take their money to other places.

Many bad Mexicans are connected with these interests, with small banks or big banks of the United States that want the money to move so that they can control it. This is how you should judge these individuals, these persons -- certainly very few -- to whom I have just referred.1

The relations between the government and the private sector had become sour after the President had to take measures that were unpalatable to businessmen, among them the fuel prices increase, the price control and the generalized wage adjustments. Those were stop-gap measures to prevent the situation from deteriorating even more, but I am convinced that they did not require more power of decision than the 1972 tax reform would have demanded had it been implemented.


2Of course, labor's unrest and some labor insurgency that appeared in 1974 was not a factor in the winter of 1972.
2. Reform on the spending side

Regardless of the initial 1973 increase in budgetary funds for nonpriority activities, a brighter picture of economic reform emerges from the spending side of fiscal policy. Nowhere is this so clear as in the structure of the investment budget. The high priority sectors, agriculture, exports, and education, gradually increased their relative share of the government's budget. Agriculture, which had a 13.2% share of the public investment in 1970, reached 20.2% for 1975 -- the target being 20%. It was a remarkable achievement. Tourism and export or export related investment projects also gained, relatively speaking, and the priorities of the Inauguration speech gradually prevailed over bureaucratic inertia. Within traditional spending Departments and autonomous agencies the budgetary requests reflected more and more the continuity of economic priorities and operational criteria. The Public Works Department, for instance, used its technical competence for the development of rural areas and created a modus operandi fitted to rural conditions and small works. It also devised innovative methods for using labor-intensive techniques in public works. The same can be said of the Department of Hydraulic Resources which gave new emphasis to small irrigation projects. Both Departments became crucial in promoting a program of rural works which is becoming an increasingly useful and successful instrument for combatting rural poverty. Projects of mining for exports on a large scale and development of tourist resorts in the Caribbean and the Pacific were initiated. A review of all of them is beyond the scope of this work. A mention will be made about the promotion of agricultural development which is a key case of the reform
on the spending side and one with which I am most familiar.

First a rough target of 20% of public investment to be allocated to agriculture was set up in order to reach a 4.5% agricultural product growth for 1973-1980 — that growth rate was obtained from the inter-industry compatibility of agricultural production vis-a-vis the other sectors of the economy. The 4.5% agricultural growth target was negotiated in the Committee of Agricultural Policy Coordination and was split among additional land inputs (irrigated and rain fed), labor inputs, other productive inputs, and crop composition. All these categories were subdivided by states, and within states by agricultural districts, so that the national target had a physical breakdown at an operative level. Each of the 15 members of the Committee of Agricultural Policy Coordination became responsible for specific agricultural districts. The Committee then reviewed regularly and openly the budgetary situation and the actual steps toward the fulfillment of the targets in all areas assigned to individual members of the Committee.

Overall objectives for agricultural policy were also negotiated in the Committee and were summarized as follows:

- achieve production increases to satisfy the expansion of national consumption of agricultural products;
- become self-sufficient in basic agricultural foodstuffs;
- create productive employment to match the increase of rural labor force to raise the levels of rural incomes;
- reach a structure of foreign trade that permits the enlargement of net foreign exchange receipts.

Investment, pricing, credit and operation policies found an expression in a yearly agricultural plan that made national objectives compatible with agency operations down to the agricultural district level.
The yearly agricultural plan detailed each agency's operations and was approved by the President which made it mandatory for the agencies. This was a necessary leverage to raise the share of agriculture in the budget. As a part of a strenuous effort to restore production dynamism in the agricultural sector new irrigated lands, which on average had increased 54,700 hectares in 1965-70, were raised to 97,892 in 1970-74 and were estimated at 202,649 in 1975. The results of the effort are barely beginning to be seen. Annual growth rates of agricultural production were 2.8% in 1971, 0.7% in 1972, 3.0% in 1973 and 0.7% in 1974. Imports of agricultural goods increased, exports of the same decreased and the net external commodity trade shifted from a surplus of 304.5 million dollars in 1970 to a deficit of 35.0 million dollars in 1974, the first year in modern history that Mexico was a net importer of agricultural goods.

It was not until 1974 that the results of agricultural development policies began to exert some effect on agricultural production. The slow start of the programs and their lagged impact explain the negligible production increases up to 1973. A severe frost meant a setback for 1974, the year things should have started changing. When reforms on the spending side consist of a change in the structure of spending, there is a rather long period of maturation and the likely initial impact is a decrease in the productivity of public investment. To illustrate this point we may refer to some unforeseen events in the operation of new facilities. Small irrigation works have been built in the Central Plateau where population pressure is highest. Their estimated impact in terms of employment and income distribution was quite favorable; costs per irrigated hectare were estimated to be lower than in large irrigation
works. It was not until some time after the works were inaugurated that it was discovered that the proportion of irrigated land kept idle became higher in small scale irrigation than in large scale. In addition, yields improved more slowly and did not reach the levels attained in large irrigation facilities. Ex post estimates of the costs showed that the costs per area effectively cultivated (total cost of the project/area effectively worked) were higher than in large scale irrigation works — and resulting benefits were lower because of smaller yields and scarce support facilities. It is only after some experience that realistic cost/benefit ratios can be obtained and the degree of uncertainty narrowed.

Small irrigation works were plagued by land tenure problems and the renewal of land distribution efforts caused the rural development program to bog down in many cases. The President made his intentions to improve rural conditions clear, and this boosted the attempts of the staff of the Department of Agrarian Reform (SRA) to review existing and property rights in land/check into accusations of neolatifundism. It also constituted an opportunity for graft on the part of SRA's personnel, thus making the issue even more confusing. Modernized farmers, fearing land invasions and land distribution requests, switched into more capital intensive (mechanized) crops. Thus the crop mix shifted towards a lower value-added composition, offsetting the impact of resources supporting more irrigation acreage expansion and supplying modern inputs. Efficiency and equity consideration conflicted with each other and delayed the effect of the resources allocated in an attempt to restore agriculture's dynamism. Thus the process of increasing labor requirements in agriculture over and above the increase in labor force was delayed.
The decision to change the structure of public investment, as we have shown above, hindered the level of spending in 1971 and contributed to the fall in activity in that year. The simultaneous efforts to initiate new activities and to change the structure of public investment coupled with the slumping level of spending could not bring immediate results. More coordination and planning is necessary before the effects of the reform on the spending side become apparent.

Reform on the spending side only apparently seems similar to Keynesian deficit spending which, it has been said, makes everyone better-off without anyone becoming worse-off -- thus being politically palatable. It is not quite that easy, however, because reform on the spending side shifts relative power within the bureaucracy and arouses the opposition of the would-be losers who have to be circumvented or rewarded in some other way. The political problems involved may not be as difficult as for example in the case of tax changes or outright expropriations, but the power of bureaucracy cannot be underestimated. Any redistribution device -- except for the use of idle factors -- discriminates against certain groups, either by undermining their power within the system or by depriving them of wealth. Therefore, redistribution of income and wealth in any form is always likely to be opposed.
3. Foreign Indebtedness and Financial Intermediation

Foreign indebtedness soars

The public sector external debt which stood at 3.2 billion pesos in 1970 and was still only 4.0 billion in 1973, multiplied two and one-half times, to 10.0 billion, in the 1973-75 period. Something similar happened in the private sector -- as a result of the domestic credit crunch initiated in mid-1973, the private sector was forced to borrow abroad and at the end of 1975 its external foreign debt was unofficially said to stand at six billion pesos.

The instability of the international economy adversely affected the prices of Mexican imports of agricultural goods, especially grains, oilseeds, and fuels. Two government agencies, Conasupo and Pemex, were mainly responsible for the very rapid growth of public sector imports -- which outpaced private sector imports. The imports of both wheat and corn, which were negligible in the last decade, rapidly increased and were heaviest in 1973 (0.7 million tons of wheat and 1.5 million tons of corn), as a result of the agricultural stagnation prevailing since the mid-60s. Fuel imports behaved similarly, because production was affected by low levels of investment since the late 60s. However, the production of fuel increased sharply in value terms in 1973, peaked in 1974 and a net export position was restored in 1975 due to the discoveries of the new fields in the Southeast.

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Preliminary Prospectus, op.cit. Some newspapers estimates are much higher, in the 15.0 - 18.0 billion range at the end of 1975. See Wall Street Journal, April 13, 1976.
The increase of imports was so acute that the transportation system was overloaded because of the need to haul the record quantities of goods imported. Railroad cars congested the ports of entry on the U.S. border, and ships queued in seaports waiting to be unloaded. Domestic carriers were shifted to handle imports which caused some scarcities in the delivery of domestically produced goods, such as industrial inputs and agricultural inputs and products.

On the side of exports, manufactures, the main component of commodity exports, did well. Livestock and agricultural products increased modestly and minerals increased as a result of higher prices without any quantity changes of importance.

Income growth, increase in import prices, domestic inflation, overvaluation of the peso, and the mounting interest on the public debt led to a drastic deterioration of the current account. The slump of 1971 reduced the current account deficit by 194 million dollars (21%) down to 714.2 million dollars, but in the 3 following years the deficit increased more than three times to 2558.1 million. The surplus on long-term capital account increased from 0.7 to 2.7 billions of U.S. dollars and presumably some short-term capital outflow had to be offset with public sector short and long-term borrowing.

In summary, at the end of 1974 the medium and long-term public sector debt had reached such levels that its servicing was equivalent to commodity exports. Since public investment was being contained and

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1 Mexican consumer prices rose from 106.9 (1968=100) in January 1970 to 155.3 in December 1974, i.e. by 60.7%; U.S. consumer prices moved from 108.7 (1967 base shifted to 1968) in January 1970 to 149.1 in December 1974, i.e. by 37.2% (see Table IV-1).
private investment was being affected by a smaller real income growth, the
increase of the foreign debt was geared to bridge a resource gap and to
keep a lower rate of inflation.

**Changes in the structure of financial intermediation**

The Mexican experience of the first half of the 70s is one more
proof that monetary policy is not the appropriate instrument for stimulating
employment since in the process of monetary ease, monetary relationships
are distorted, severely limiting the usefulness of monetary policy. Let
us remember that the $M_1/GDP$ relationship kept remarkably stable throughout
the 60s, while the $M_2/GDP$ showed a marked upward trend. $M_1/M_2$ fell steadily
and at the end of the last decade registered values of around 0.20-0.25;
1973-74 saw a reversal of the past with non-monetary assets diminishing
both in their rate of growth and in their absolute annual increase (22.0
billion average in 1970-72; 16.3 billion change in 1973 and 1974). Monetary
assets moved in the opposite way. The average annual increase was 4.3 billion
in 1969-71; it jumped to 11.2 in 1972 and climbed to 15.5 and 19.1 billion
in 1973 and 1974 respectively. In 1974, for the first time since the 50s,
the money stock grew more in absolute terms than non-monetary assets.

From the beginning of the expansion of public spending and of
monetary ease in the first quarter of 1972 until December 1973 the money
supply grew faster than prices. But from then on, price increases outstripped
the rate of growth of money supply and monetary expansion was no longer
stimulating; the real value of monetary stock began shrinking and the
opportunity cost of holding money had unduly increased. From October 1973
onward, monetary expansion was stopped, but inflation continued and kept
eroding the real value of financial assets all through 1974. Let us
remember that the GDP price deflator rose 12.4% in 1973, 23.8% in 1974;
monetary assets increased 24.3% and 22% in the two years; non-monetary assets moved 8.1% and 15.2% in the same years.

Two aspects of monetary policy in 1972-73 need to be underscored. The first corresponds to the very quick upsurge of government spending and the monetization of the public sector deficit, the second to monetary actions by the Central Bank. Once full capacity was reached both instruments (public spending and credit expansion) crumbled and two policy tools collapsed into one.

One may recall that the Mexican financial system is liquid or nearly so in all its components on the liabilities side. Therefore a government spending increase cannot be financed by open market operations -- an exchange of money for government debt. It can be financed in three ways: a) issuing money which has a wealth effect; b) raising reserve requirements which curtails private spending to offset public spending; c) borrowing abroad. The last has no wealth effect since the liability is assumed by the public sector and the foreign exchange so obtained is not monetized but is used to support the monetary authority's international reserve position; the proceeds of floating the debt are earmarked for the use of the Central Bank or kept invested in foreign banks' short-term assets, to handle the increased demand of foreign exchange induced by the spending expansion. The foreign debt is used to keep the foreign exchange rate pegged.

Both the increase in public spending and the credit expansion of 1972-73 were so sudden and vigorous that there was no way to anticipate and initiate foreign funding for government spending. Government debt was directly monetized and foreign borrowing was used to prevent an excessive fall in international reserves. Some international reserves
data padding was done by the Central Bank as well. Monetary expansion from the Central Bank's policy of ease was ineffective in stimulating employment since full capacity had been almost reached. As prices moved upward the effectiveness of monetary expansion was gradually cancelled due to the change in expectations about price changes -- the wealth effect was offset by expected higher prices. After 1973 the stimulating effect of both the public sector and of monetary expansion has been offset by price changes which diminished the real value of stock of financial assets; money's functioning as a store of value had been impaired. Perhaps the relevent question is broader than that: if one instrument of economic policy is lost, or severely damaged, has the capacity of the economy to sustain growth been impaired? An attempt to assess this question follows.
4. Assessments

Has the capacity for growth been impaired?

There is indeed a strong likelihood that Mexico's attempt at reform in 1970s which was intended to stabilize the system, in fact led to more unstable conditions. Even if the savings/income ratio had not been eroded by the current inflation, the long-run rate of economic growth may have been reduced. The reasons are mainly related to the efficiency of the economic system. Let us first consider the financial system.

There were two years, 1973 and 1974, in which the real stock of financial assets shrunk. Although preliminary reports show that this did not happen in 1975, it is difficult to believe that inflation will not thwart the growth and depth of the financial system in the absence of policy change. Let us remember that the composition of investment has shifted to increase the public sector's share of total investment, and that bank loans as complementary production inputs are more scarce than before. Thus the contribution of the financial system to an improved allocation of resources will be reduced. For an economy with severe market imperfections in the goods market, the influence of financial intermediation in resource allocation is not negligible, especially within private sector operations. If financial intermediation does not grow more than money income, a return to the domination of the financial-industrial groups is possible, which is a step backwards toward rationing loanable funds by administrative decisions and kin-ownership.

The control of foreign investment has closed some of the investment outlets into which it was channelled -- those of a less clear, or dubious economic usefulness -- and therefore, a lower growth of foreign investment is foreseen. The level of foreign investment is also linked
to the capacity of Mexican investors to contribute funds for joint ventures, since in most cases they have to be majority stockholders.

Since the beginning of open inflation, private investment has taken advantage of price changes and shown a tendency to inventory accumulation. This accumulation has a negligible social productivity and is rather a reflection of the increased transaction costs that are associated with an inflationary process.

We must also consider the widening foreign trade gap which has induced the economic authorities to apply stiffer controls on imports. Already in 1975, all commodities became subject to the import licensing mechanism of the Department of Industry and Commerce, implying increased real costs of imported inputs and a higher degree of arbitrariness in the rationing of foreign exchange.

There are reasons to believe that the productivity of public sector investment may have been lowered, as a result of increased real costs of public sector investment. Labor unions of nationalized enterprises have been granted a share of the construction contracts of their entities' investment spending (40% in the case of Pemex); these contracts were formerly subject to competitive bidding. Naturally the channelling of investment contracts through the unions, whatever its merits on political grounds, is going to raise the real costs of public investment.

Investment in social activities, and in activities of long gestation periods, has been a feature of recent public investment that tends to affect its impact on the growth rate. The scope of public activities has encompassed industrial branches characterized by high capital-density coefficients (fertilizers, shipbuilding, steel, telecommunications, mining, shipping, etc.) all of which require the support of fiscal funds. Thus
the public savings constraint is determining and limiting the growth capacity of the economy.

One may argue that income distribution is worsening and the enhanced concentration supports savings behavior. It is not possible to tell for sure at this point what has happened to income distribution. However, there are enough reasons to believe that the labor absorption capacity of the economy was damaged even further: payroll taxes were enacted, the relative cost of labor rose with wage increases, the peso became increasingly overvalued, small business failures became more common due to the credit crunch of 1973-74 and to changes in labor and social security legislation. There is no reason to think that profit rates have gone up except in very special activities. Under these circumstances it can be assumed that the worsening of resource allocation more than neutralized the possible improvement in savings which could have resulted from an increasingly unequal income distribution.

Orthodox economic policies and a reform minded government

Mexican financial policy in the postwar period was a showcase of the set of policies that accompanied the fixed par-values system that came out of Bretton Woods. Free convertibility was more open and unrestricted than in almost any other underdeveloped or developed country -- certainly more than in industrial countries with strong payments positions such as Japan or France. The Mexican monetary authorities became more orthodox than the IMF itself, especially when the world’s monetary crisis was making the fixed par value system incongruous. At a time when countries were looking for ways to make their monetary and exchange systems more flexible and adaptable to changing circumstances, the Mexican monetary
behavior became, by the sheer fact of doing nothing, more and more rigid. Monetary policy was implemented in the fashion of the Bank of England in the nineteenth century; good for exchange stability, poor for domestic employment stability. Moreover, it fixed the economic system in ways that made it nearly impossible to use other policy instruments -- especially fiscal policy -- in new and novel ways to achieve additional objectives. Hence, when income distribution was added as a policy goal, the goal-instrument policy mix became inconsistent and price stability collapsed.

The failure to enhance the resiliency and adaptability of the Mexican financial system -- to structure a bond and stock market and develop a long end, nonliquid liability side -- became a roadblock to income accumulation for tax purposes. It proved impossible to improve the performance of tax collection and to eliminate income concentration features from the tax system. Consequently, taxation was not turned into an economic policy instrument to improve income distribution.

In addition, the resistance to the effort to reform the policy mix and to improve the performance of economic policy resulted, in a perverse way, in deterioration of the existing instruments and in obstruction to target achievement. In the past, stability bred stability resulting in a strengthened, self-supporting process; in the future, instability may breed instability.

Political timing vs. economic timing. Are politicians short-run maximizers?

It is difficult to avoid the impression that if the President had exercised a level of power similar to his forcing the generalized wage adjustments and price controls of 1973, the 1972 tax reform attempt would have been successful. And although the attempt was too late to check entirely the inflationary pressure that was already brewing -- since it
would have taken more than a year before the revenue effects would have appeared — policy makers would have gained an additional policy instrument and a built-in stabilizer would have been incorporated into the system.

A reform-minded government should undertake reforms in order to enhance the stable adjustment of the system. Such a government should anticipate future developments and implement policy changes before the pressure of events sets in — keeping in mind the fact that the impact of economic measures is never immediate. Unfortunately, very few politicians understand general economic equilibrium and are prepared to act in time — and therefore, it is usually after a situation becomes critical that politicians try to muster political forces in support of reform measures. At that point, however, the worsened situation and the inertia of the forces opposed to changes are much more difficult to overcome and more often than not the reform attempts are thwarted. This observation must lead one to rather general skepticism about the likely success of reformist governments in the economic sphere.

One could generalize this judgment on politicians and apply it to the social classes. If we think once again about the 1972 tax attempt it is hard to understand why some private sector people (bankers, for instance) opposed the reform proposal. It was clear that the reform was a measure that would maintain some degree of stability — or prevent some degree of instability. They knew and were told that one of the first casualties of inflation would be the financial system — especially in the way it is structured in Mexico — and their own area of interest would lose importance, relatively speaking. The influence of their institutions would be diminished, their power watered-down, their customers harmed.
Nonetheless, bankers concertedly opposed the reform. It seems that they reacted purely on ideological grounds, as wealth holders rather than as managerial personnel who would have assessed the issue in strictly rational terms and protected the interests of their clientele.

A comment about the style of Mexican politics and the ideology of the Mexican revolution is in order at this point. According to one analyst, the pragmatism of the system and its lack of clear ideological orientation have resulted in the practice of doing only that which the circumstances permit.¹ According to this view, political leaders test the system, probe for the limits of action, and move where there is no resistance. It is a trial-and-error, or an advance-and-stop strategy to find the boundaries of possible action. Movement is possible where there are no pressure groups that can resist or may retaliate. Such a pattern of action can be pursued skillfully and, in its way, remain a stable process. But in the long-run it narrows a central government’s scope for initiatives, since the pressure groups expand at its expense. In the economic domain, for instance, there is no clear definition of what is a mixed economy. Since there is no concrete orientation in this sense, groups within the government cluster along ideological lines. They formally coincide in objectives, but follow paths that diverge ideologically and result in conflicting advice. To take an example, what enterprises should belong to the public sector? One point of view would include natural monopolies and those cases marred by externalities, another would interpret such moves as intermediate steps toward the socialization of the whole economic system.

Therefore, the first group would sharply mark the nature of property rights, the other would blur them to keep the options open for expanding the nationalized sector whenever the private sector is suboptimal. However, the very fact of questioning the nature and stability of property rights creates conditions that induce the private sector to act in suboptimal ways. This dilemma lies behind the distress that is expressed in some quarters that economists do not seem to agree in anything, and complaints about the contradictory nature of economists' advice. Left without political orientation, surrounded by the pragmatic nature of the realpolitik, they fall back on their own devices, and try to push the system according to their own scale of preferences – of political preferences.
Chapter V

POLICY REFORM IN A DEVELOPING, MIXED-ECONOMY SYSTEM

Any economic policy requires some degree of reform. The reform may be a conscious decision, based on review of economic performance, identification of problems, their evaluation and classification. When these assessments are extrapolated, one can predict the future economic profile of the country in the absence of changes. The prediction clearly shows areas of likely conflicts and difficulties and therefore can lead to reform efforts. Once the decision to undertake reform is reached, the next step is to muster enough political strength to modify the structure of the system. The modifications can relate to the efforts required from the members of the society, the nature of rewards the system provides, or the present costs necessary to avoid much higher costs in the future.

Policy reform may also result from current political disequilibria and in that case, it is usually undertaken in haste in order to prevent political problems from becoming more acute. It can hardly be a well organized and well planned process because a wide degree of improvisation becomes unavoidable.

It is my impression that it was in the latter sense that policy reform was attempted in Mexico. The 1968 and 1971 student movements and their repression by police were the crucial political events that made it imperative to change the structure of the system as quickly as possible. The main objective of political reforms were the opening up (apertura) of the power structure to new groups which had been kept aside until then -- especially middle class intellectuals -- and a commitment to solve political problems by political means, not by force or administrative decisions.
The most important economic objective was better income distribution, which was added by President Echeverría to the array of economic objectives inherited from the past. Despite the fact that some of the actions associated with these aims ran into a heavy opposition and resulted, at least initially, in a less stable -- rather than a more stable -- political environment, the objective of more equal income distribution is there to stay and will have a permanent influence on future Mexican policy decisions.

Both political and economic changes were undertaken at the same time and were so closely connected that they cannot be judged as two separate processes. The evaluation is made even more difficult since the results of changes do not coincide in time. Therefore what follows does not pretend to be a comprehensive assessment of the reform efforts during the Echeverría's administration, but rather a reflection on several aspects of it, and some observations on reform policies in general. Perhaps the best way to describe selected features of the process of economic reform and the difficulties inherent in it, is to point out the forces that are opposed to changes and the obstacles that have to be overcome. Hopefully, the following discussion will help future analysts reach a balanced and well-informed evaluation of the merits and problems of Echeverría's presidency.

* * * * *

Growth per se, it had been repeatedly stated at the end of the 1980s, could no longer be/unique economic objective. The economy had to be modeled in such a way as to spread its benefits more widely while keeping its economic thrust. It became necessary to carry out structural changes that would make it possible to improve income distribution while enhancing
the economy's efficiency. In trying to achieve such objectives, the reform process operated within a framework of political and social forces that by themselves deformed, and even thwarted the efforts to change the social structure.

The day-to-day working of any public administration reflects political and social actions of pressure groups that, in turn, are influenced by the bureaucracy -- to whom they are associated by matters of interest. Each government agency has a "constituency" upon which it acts, and by which is acted upon. The government thus cannot be conceived as an entity immune to its own decisions and corresponding reactions. Promoting structural changes in the economy concomitantly changes the nature of the governmental machinery. When planning a reform, the government acts upon the very essence of itself. It can strengthen or weaken its own structure. In this sense, politics and economics, the short and long run, converge.

The government is a social agent that acts as a clearing house of pressures -- including conflicts -- by social groups. Therefore, one way to assess the political effectiveness of a government, and of the existing political institutions, is by judging its capacity to achieve structural changes that improve the collective welfare, and at the same time widen the effectiveness of political institutions. Lack of political effectiveness -- in the sense of the absence of a capacity to undertake qualitative adjustments in the social structure -- manifests itself in rigidities in response to demands and in the hierarchical nature of decision making. Generally, we may suggest, a government is more likely to adapt to social change when it is itself promoting it and carrying it out. Otherwise, social change lacks control and may trigger political backlash which then pushes the government to use
authoritarianism rather than political persuasion. In other words, a
government can increase its political effectiveness by gaining social
consensus in support of its measures of reform or it can undermine its
relations with interest groups without achieving the measures designed to
enlarge the social consensus.

In other words, policy reform is never undertaken in a political
vacuum. All to the contrary. A decision to carry out economic reform
measures is a political objective, especially when the reforms are con-
ceived as an instrument for the structural transformation of the economic
system. The political meaning of economic reforms should be explicitly
stated in order to avoid misunderstanding. Policy reform always initiates
changes -- even conflicts -- that may improve social conditions and the
performance of political institutions in the long run but that often
erode the political support and the bargaining power of a government in
the short run. In its reform policies, a government faces political con-
straints coming from pressure groups with sufficient power to block planned
actions and proposed changes. Such groups form the institutional environ-
ment where the economic, political and bureaucratic apparatus interplay.
The groups often enter into coalitions, and thus make their opposition to
reform efforts stronger. The success of any reform depends on the level
of political interaction between those who introduce the changes and those
who are affected by the changes.

Let us look at the reactions of political actors to the 1972
effort at tax reform, and try to understand the nature of their response
from the point of view of their sectional interests and the long-run
performance of the economy. For these purposes, we may consider the
following groups: national entrepreneurs' associations, labor unions,
the middle class, political and bureaucratic elites, and foreign investors.

National entrepreneurs' organizations

Domestic producers' associations may form the most important impediment to a policy of economic reform. A reform proposal arouses entrepreneurial opposition and the government is threatened with harsh retaliations. The first line of opposition usually emerges from within the administration, where the private sector's case is being represented by governmental agencies that have authority over private enterprises. They deal with them on a daily basis, regulate their operations, and are responsible for their correct functioning. Government officials who are ideologically identified with entrepreneurial attitudes also tend to defend the private sector; producers' associations frequently have ideological influence and spillovers.

The first line of opposition to the tax reform attempt in 1972 came from within the agencies in charge of financial institutions and policies. The officials argued that the tax reform would damage financial stability and growth, that it might provoke an attack on the peso and make it difficult to defend the peso. The private financial sector repeated these arguments almost verbatim. In addition, the private sector representatives pointed out the adverse impact of the tax reform on investors' confidence, which was at that time barely recovering from the impact of 1971 recession. Some doubts about the legal correctness of the envisaged changes were also expressed. Shortly, the attitude of the private sector was to prevent any change whatsoever.

In addition to the government's economic policy, two other
issues were of considerable concern to the private sector: foreign policy and university students. The government was criticized for the close relations established with the Allende regime and for a general switch to the left (contacts with China, Cuba, Chile and other socialist countries). The entrepreneurs pointed out, with apprehension, that the Chilean example of a transition to socialism was being followed in Mexico. However, this change in Mexican foreign policy resulted from pressing domestic needs.\footnote{Mario Ojeda, "La política exterior del Presidente Echeverría" in \textit{Mexique 1976}, Centre Universitaire de Perpignan, May 1976.} Left wing critics of the government could not help but support the new course in international relations and their opposition was thereby weakened — in some cases, they were even fully coopted.

The invitation to dialogue with university students was received by private sector with suspicion as well. The entrepreneurs did not want to realize or did not care that it was an attempt on the part of Echeverría's administration to revitalize political institutions, to bring some dissident groups into the fold, opening to them channels of normal, democratic political action. This was especially important because PRI had not yet found effective ways of mobilizing the middle classes\footnote{Most university students are middle class extraction.} and the late 60s witnessed street demonstrations of open political dissidence. But the entrepreneurs denounced the opening to the students as tolerance of disorder: "Generally, it is not understood why the government tolerates the numerous labor agitations in many parts of the republic which seem to have a more transcendental character than just simple syndical struggle. Equally, the entrepreneurs do not understand the attitude of the Government vis-a-vis student revolt and other..."
problems that have appeared in the universities." "The government must take firm decision in cases of popular unrest in order to avoid the violation of order and internal peace." Thus one of the main political objectives of the administration, to solve political problems by political means, was arousing entrepreneurial criticism and demands for a more authoritative action to assuage businessmen's fears. To sum up, the private sector was interested in preserving the status quo and was firmly opposed both to political and economic changes.

Labor unions

Labor unions, especially in public and private corporations with high capital densities, may constrain the actions of a reform process. They may break down an income policy, thwart labor mobility, and bid for wage escalation in excess of price changes and productivity gains. They can share rents in oligopolistic and natural resource industries, and often reap the profits of nationalized industries. As a counterpart of wage and fringe benefits, the labor unions of nationalized enterprises form the backbone of the labor sector of PRI and systematically offer support to the government. Their leaders take the biggest part of the Party's tickets for Congress, the Senate, and State legislatures. As a rule, labor's recommendations become part of PRI's platform and governmental policy.

Even though wage income is fully taxed and the 1972 tax reform attempt would have incorporated more equity into the system, without raising labor's burden, the labor unions remained silent on the issue. It is difficult to explain satisfactorily this lack of reaction toward an

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1 See Summary of comments..., Appendix D.
obviously important issue, but one reason might have been the quick
pace of events between the first discussion of the tax reform and the
final decision not to send the bill to the Congress. In contrast to
this passivity, the labor unions exerted their power fully in 1973 when
it was necessary to overcome employers' resistance to wage increases.
If labor had supported the tax reform attempt with a similar determination,
a different outcome could have resulted.

Political and bureaucratic elites

Perhaps no other group can be as detrimental to reform as the
bureaucracy itself -- a fact that is seldom mentioned in the economic
literature. The influence of bureaucracy is especially strong on the
spending side. As a matter of analytical convenience, bureaucratic elites
can be considered together with political elites because appointments
of public officials are often the result of political patronage. The
authority legally vested in bureaucrats is enhanced by the administrative
power which they gather, because policy making traditionally relies on
the exercise of judgment and discretionary decisions. The scope for
personal judgment in routine work makes the good will and cooperation
of key bureaucratic personnel essential for the success of any reform
strategy. Attempts at reform not previously negotiated with them are
doomed to be a failure. The possibilities open to the bureaucracy to
impede a policy of change are countless -- even when they seem to have
accepted it in principle. If the dispute comes out in the open they can
easily muster a powerful lobby on their behalf. Suppose, for example,
that a rural works program with some attractive features such as the
use of local labor, local materials, and application of labor-intensive
technologies is about to be implemented. The program is important
because it will diminish rural unemployment and improve income distribution. Opposition will emerge, however, if the program requires a restructuring of the construction agency's budgetary allocation, for example substituting feeder roads for trunk-line highways. It does not matter that the construction equipment is imported and requires little labor to operate it. The links between the governmental agency and the construction industry will result in the construction lobby attempting to maintain spending on large paved highways that are highly visible, that look like a feat of engineering skills, and keep the imported machinery busy. This is quite similar to the military-industrial complex of the U.S.A., an interest complex between the construction industry and the public works agency formed on the basis of profits, administrative expediency and professional prestige. Technical expertise can be used to maintain bureaucratic autonomy, increase the agency's share of the budget, get approval for their pet projects, regardless of the fact that the results may ultimately be a misallocation of resources or crying out of resources available for new reform programs. Advisers, national or foreign, may be called in to support projects already chosen by the ruling bureaucratic hierarchy. A prestigious expert can be effectively used in support of projects that in practice prevent reform programs and his authority may be invoked in behalf of a well-entrenched and resilient bureaucracy.

Bureaucratic power can be internal to the administration (budgetary, legal, administrative, etc.) or external (political or sectoral, the latter in the sense of support coming from those groups presumably regulated by the corresponding agency).
Bureaucratic elites pursue interests of their own regardless of their functions in the departments and official agencies where they operate. Bureaucrats can adapt their functions to personal or group interests. Their links with their clientele or regulated sector of society fuses in a tacit pact of reciprocal support, which more often than not means maintenance of the status quo. It should not be forgotten that a bureaucracy owes its first loyalty to itself. Governments come and go, bureaucrats stay: they work for self-maintenance and survival. Any policies of reform that may endanger their position, change their routine patterns or disturb their relations with their clientele will arouse suspicions, passive or active resistance, or even antagonism and conflict. The bureaucrat's participation in the design of plan objectives and their involvement in plan implementation are thus essential prerequisites for obtaining their willingness to cooperate in any policy of reform.

The administrative apparatus of the State has a clear-cut shortcomings for acting as an agent of social change. A quick review of the requirements for reformist policy shows a lack of information on target variables -- for example, the urban and rural poor -- and on instruments -- for instance the impact of minimum wages, agricultural support prices, or elementary education on raising incomes and improving welfare. Although the data are generally poor in developing countries, their use is even more deficient that the information available would allow. There is a lack of conceptual harmonization among government agencies in definitions, coverage, aggregation procedures, etc. Statistical data often become the "property" of agencies or bureaucrats that internalize.
the "knowledge" about a problem or a sector. This monopolistic holding of information leads to bureaucratic power; sharing the information means dissipating the power of persuasion and expertise. A well-timed presentation of previously undisclosed information may determine the outcome of a decision. Under such circumstances, a defensive action of competing bureaucratic groups would be to call for more statistical gathering and consequently the data is duplicated and redundant, while continuing to be of a low quality. It is difficult, indeed, to screen the data to achieve the comprehensive view needed for clearly defining the available options for achievement of the planned objectives.

The cohesiveness of a government's functioning is another case of administrative constraint on reform on the spending side. The key issue in this regard is the integration of the reform process with budgetary function. Planning for reform without control of the budget becomes a stale, bureaucratic, and sterile academic exercise. At a minimum, there should be a close cooperation between budget authorities -- the Department of Treasury -- and planning authorities. The former worry about the short-run, the latter are the conscience of the long-run. They have to concur in the trade-off between stability and growth, between resource balance and the shape of development. Planning for reform is impossible if there is no participation of the planners in project evaluation, screening of current spending, estimating of program effectiveness, and linking investment with operating appropriations.

Even under the best circumstances of cooperation with budget authorities, the scope for reform is very narrow. Necessarily, part of current expenditures is "irreversible" in character -- salaries, fringe benefits,
office expenses, etc. On the investment part of the budget, the funds for ongoing programs must be deducted, either because a big project takes several years to be completed — nearly a decade to develop an irrigation district, a nucleoelectric plant or an oilfield — or the demand for a given product has to be met, or programs of smaller scale have to be run close to capacity. There are also the appropriations for maintenance which cannot be altered. After allowing for all these deductions, not even one tenth of the budget is available yearly for new programs.

Departmental effectiveness varies a good deal. It is difficult to make a decision between a high priority program poorly executed and a lower priority program well carried out. Those agencies that have disposed of more resources in the past tend to have better staffs for generating projects and promoting their implementation; they pay better salaries, train personnel, recruit more aggressively. On the other hand, agencies that have been starved for funds in the past will be in a different situation because their performance capacity is low. Here, then, is another kind of inertia, bureaucratic in character: those that have had more will keep getting more, and those that have had less will be unable to get enough to upgrade their performance. How is the policy maker going to measure the effects of learning-by-doing? A change in priorities which implies changing the structure of agencies' share of public funds is going to run counter to efficiency criteria but respecting these criteria may mean over-investment in some sectors and under-investment in others.

It has been already pointed out that the first resistance to the 1972 tax reform attempt came from within the administration.
Generally, however, it is difficult to assemble many concrete examples of the influence exerted by bureaucracy because this influence is used in subtle, unobtrusive, indirect ways. The previous discussion, though, is based on a close observance of the bureaucratic machine over several years.

The middle class

It used to be said that the absence of a middle class was an obstacle to economic development since the middle class provides the skilled manpower and professional expertise for production activities and the mass market necessary to achieve economies of scale. Only recently has it been suggested that the pattern of modernization in developing countries has built a social structure that by itself constitutes an obstacle to reform, especially on the spending side, and that this structure is grounded in the middle class. The behavior of the middle class can place claims on government operations that narrow the benefits that may trickle down to lower income groups. The middle class in developing countries emerges from a different pattern than that of the already industrialized countries. Urbanization often antedates industrialization, but nonetheless, it changes the power structure and the middle class can press for public services and make other demands on the budget. Its requests for new a better urban services, for tariff subsidies and service changes, and for allocations in general may cut down other projects and programs considerably in ways that may adversely affect both growth and distribution. Luxury consumer goods, urban transport facilities, automobile services, and many types of public services -- education, water, fuel, police, etc. -- tilt the allocation of social funds toward meeting the demands of the middle class and away from such
other things as the manufacture of mass consumer goods, public transport, rural works, and social welfare. In this way the middle class acts in support of imported consumption patterns and its behavior becomes imbedded in the social structure. It absorbs scarce resources, domestic as well as foreign exchange, in order to spend them in activities that cannot be justified by economic growth or social welfare. This class raises present consumption at the expense of both future consumption and consumption more equally shared.

The Mexican middle class in the late 60s was pushing for some degree of political change, with the student movement expressing this need quite drastically. Some results in the political sphere were later achieved but it is too early to pass final judgments. The middle class did not exert any influence during the preparation of the tax reform. The question is whether the middle classes would have welcomed any substantial tax changes or whether they were more interested in maintaining status quo.

**Foreign investors**

Generally, foreign investors operate through domestic representatives who are nationals of the host country. There are many instances of differences, even incompatibilities, between national policy objectives and the foreign investors' objectives. Take for instance the use of non-renewable natural resources. It is likely that the optimal rate of exploitation of the resource is different for each party since the rate of discount is not the same. Private foreign investors are not likely to take account of external social costs -- externalities -- while the host government usually wants the investors
to bear such costs. More extreme cases can be pointed out, like the attempts of ITT in Chile to undermine the Allende government.

On the other hand, in many cases the foreign investors do not play the notorious role of international malefactors. During the attempt at tax reform, the intervention of foreign investors was significantly absent. Most of them probably learned about it when it had already failed. They may have been informed through friends that were among the representatives of the domestic private business sector, but since none of these were directly associated with foreign interests, their feedback could have been at most minimal. Probably they were far more interested in the foreign investment control bill which was being introduced at the same time and affected them directly.

**Redistributive mechanisms**

The focus of this book has been an examination of policies of economic change, especially of redistribution of income and wealth. The concluding remarks concern the basic types of redistributive mechanisms.

We may end by submitting that redistributive policies encounter a difficult political dilemma since they try to benefit marginal social groups which, by their very nature, are socially isolated and lack political leverage. Those groups cannot give enough support to a government to bear the cost — the political wear, so to speak — of adversely affecting other social classes. However, since in the long run social subsistence groups are a threat to political stability, a planning mechanism can serve a useful purpose by describing to society the long-run costs of keeping some social and economic groups continually deprived. Hence planning must develop long-run projections and
alternatives. Such exercise can show the underlying advantages of structural change and describe how current costs are an insurance against future risks and costs -- for instance, spending in rural works, aimed at slowing rural-urban migration, compared with future social urban spending; and widening the coverage of the educational system that will make family planning more effective.

Policies of economic reform have to devise ways to transfer income, or income generating assets, between social groups. Income distribution is determined by the distribution of factor endowments, relative prices, use of techniques, and money income. It is linked to factor availability, production structure, and the ownership of property rights. Skewness in the distribution of capital, physical as well as human, is an important influence that shapes income distribution. Moreover, there is a symbiosis of power and capital; political power and economic property are closely associated and limit the possibilities of redistribution.

There are three principal ways to transfer income among social groups: changes in relative prices of factor and products, direct alterations in income streams, and redistribution of assets. Their order of enumeration shows, in crude form, the level of their intensity and the severity of the instrument and speed of the distribution that is to be achieved; it also suggests the character of political power in the country undertaking the transfer, and the certainty with which its effects will be obtained. Assume, for instance, that the objective is to raise the incomes of the lowest income stratum. A change in relative prices could mean increases in minimum wages, legally mandatory; freezing
prices of wage goods, or subsidies to some services. Modifying income streams would mean setting-up minimum guaranteed incomes -- an impossible task in a developing country -- that if not obtained in the market would be complemented by the government and paid out of general government funds -- a negative income tax is a proposal of this nature. Asset redistribution, of course, consists of transferring the property of income yielding assets, e.g., land reform without compensation or nationalization of private enterprises.

A reform strategy has to choose a package of such redistributive measures by taking account of the reliability and efficiency of their respective modes of implementation, the time period in which they are to be achieved, and the social costs -- even production dislocations -- that will have to be sustained. In any case, reforms or attempts at reform always imply political costs -- whether reforms succeed or not.
Statistical tables, graphs and appendices
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¹Estimated by difference, includes inventory change.

Source: Banco de México, S.A., Subgerencia de Investigación Económica, Estadísticas de la Oficina de Producción y Precios.
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Average

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1972 7.3 | 5.6 | 2.8 | 17.2 | 17.3 | 19.5 | 27.5 | 16.2 | 13.2 | 8.3 | 9.8 | 7.3
1973 7.6 | 12.4 | 15.7 | 23.4 | 25.7 | 37.7 | 30.7 | 25.8 | 27.8 | 8.9 | 2.2 | 4.0
1974 5.9 | 23.8 | 22.5 | 48.0 | 39.1 | 117.6 | 43.4 | 42.3 | 31.2 | 5.4 | 0.9 | 15.8

Source: Banco de México, Subgerencia de Investigación Económica, Estadísticas de la Oficina de Producción y Precios; Banco de México, Annual Reports.
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TABLE I-4

Share of exports in Gross Domestic Product by Sector of Production

Millions of current pesos

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1 Agriculture, cattle, forestry and fishing
2 Mining, petroleum and gas, nonmineral extractive activities (stone, sands, clay, etc.)

### TABLE I-5
Domestic Financial Intermediation by the Banking System

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<th>Private banks (4)</th>
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1 End of year liabilities
2 Does not include liabilities with domestic banks
3 Does not include liabilities with foreign banks, which in 1974 amounted to 67.3 million pesos that correspond to the public sector foreign debt.

### Mexican Financial Data

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1Includes other private and official banking institutions.

Source: Banco de México, Annual Reports, and International Monetary Fund, International Financial Statistics.
## Table 1-7

**Federal Government Revenues**

(millions of pesos)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total effective revenues (1)=2+11</th>
<th>Current revenues (2)=3+11</th>
<th>Tax revenues (3)=4+10</th>
<th>Total income taxes (4)=5+6+7+8+9</th>
<th>Corporate Income Tax (5)</th>
<th>Wages &amp; Salaries (6)</th>
<th>Income from Capital (7)</th>
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<th>Other Income</th>
<th>Taxes on current transactions (9)</th>
<th>Non-tax revenues (10)</th>
<th>Income from capital (11)</th>
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1. Taxes on current transactions include taxes on production activities (producción y comercio), excises (ingresos mercantiles), foreign trade, stamps, lotteries, royalties, natural resources, etc.

Source: Cuenta de la hacienda pública federal and estimates of the Dirección de Estudios Hacendarios, Secretaría de Hacienda y Crédito Público.
Table I-8
Structure of Personal Income Tax

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<th>Other Income</th>
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Source: *Cuenta de la Hacienda Pública Federal.*
### TABLE I-9

Balance of Payments
(Millions of dollars)

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1 The method of estimation was changed after 1969.

Source: Banco de México, S.A., Subgerencia de Investigación Económica
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1 The method of estimation was changed after 1969.

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TABLE 11
Marginal Reserve Requirements (continued)

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1 In 1973 and 1974 cash-in-vault is computed as forming part of the reserve requirement.
2 Deposited in Banco de México comprehends cash reserves that yield no interest, cash reserves that yield interest, and reserves that take the form of securities bought and kept at Banco de México.
3 Credits in some cases are bought at Banco de México and monetarily are similar to deposits with interest or securities acquired in the central bank, but generally are extended directly to specified activities.
4 The regulation applied, between 1960 and 1965, a maximum growth of 1% a month. Securities bought at Banco de México through the reserve requirement were 19% of the corresponding liabilities.
5 The Banco de México reports do not specify credits from securities.

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<th>Year</th>
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<th>Cash in vault</th>
<th>Cash reserve in Central Bank</th>
<th>Fixed income securities(^3)</th>
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<th>Reserve ratio</th>
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<td>2548.9</td>
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\(^1\) Liabilities in pesos and in foreign currency.

\(^2\) Includes some balances on correspondent accounts.

\(^3\) The figures include securities bought outside of the reserve requirement scheme but are not significant except when the demand for credit slackens.

Source: Banco de México, Annual Reports.


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Source: Secretaría de la Presidencia, Dirección de Inversiones Públicas; Secretaría de Hacienda, Dirección de Estudios Hacendarios; Banco de México, Indicadores Económicos.
Graph I-1: Potential GDP, actual GDP, prices

- Annual change of wholesale prices
- Annual change of GDP prices
- Ratio PGDP/GDP
Graph I-2: GDP, wholesale prices, balance of payments current account deficit

- Annual change of prices and GDP
- Annual change in wholesale prices
- Annual change in GDP
- Balance of payments current account deficit

Data points for the years 1960 to 1974 are shown on the graph.
TABLE III-1
Federal Public Investment
(millions of pesos)

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<td>1170.5</td>
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1 Includes housing.
2 Includes investments of the Federal District Government and Tourism.

Source: Dirección de Inversiones Públicas, Secretaría de la Presidencia
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<td>1973</td>
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1 Does not include state and local governments.

2 Includes only those public organisms and national enterprises that are under the Treasury's budgetary control.

Source: Cuenta de la Hacienda Pública Federal.
### TABLE III-3
Selected Monthly Economic Indicators 1970-1974
Three Month Moving Averages

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<th>Index of Industrial Production 1970 = 100</th>
<th>Industrial Production - Month to Month Rate of Change Across Years</th>
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<td>March 97.9 101.3 110.7 117.7 130.0</td>
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<td>April 99.8 101.7 114.0 122.7 135.0</td>
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<td>May 102.9 103.3 114.4 121.7 132.6</td>
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<td>July 98.7 102.6 114.0 125.9 131.6</td>
<td>4.0 11.1 10.4 4.5</td>
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<td>7.6 10.4 14.8 1.3</td>
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<table>
<thead>
<tr>
<th>Money Supply Month to Month Rate of Change Across Years</th>
<th>Prices (^2): Month to Month Rate of Change Across Years</th>
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<tbody>
<tr>
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<td>3.2 4.0 23.4 18.8</td>
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<tr>
<td>December 8.3 21.2 24.1 22.2</td>
<td>2.7 5.4 25.2 13.3</td>
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</table>

\(^1\) The Index was twice changed in the period. The data was adjusted equalizing the levels of old and new figures to estimate the comparisons.

\(^2\) Wholesale Price Index of Mexico City, 1939 = 100.

Source: Banco de México, S.A., Gerencia de Investigación Económica, Indicadores económicos (monthly)
TABLE IV - 1

Consumer Prices
1968 = 100

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</table>

11967 Base shifted to 1968

Source: Banco de México, S.A. Gerencia de Investigación Económica
Indica dores económicos (monthly)

### Appendix A

#### NATIONAL SAVINGS BY OCCUPATION OF THE HEAD OF FAMILY

<table>
<thead>
<tr>
<th>Occupation of the head of family</th>
<th>1963(^1)</th>
<th>1968(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operator</td>
<td></td>
<td>-31,645,847</td>
</tr>
<tr>
<td>Worker</td>
<td>-326,521,000</td>
<td>20,142,445</td>
</tr>
<tr>
<td>Day Laborer</td>
<td></td>
<td>-63,355,602</td>
</tr>
<tr>
<td>Administrative employee</td>
<td>163,665,000</td>
<td>262,857,800</td>
</tr>
<tr>
<td>Technical employee</td>
<td></td>
<td>248,646,490</td>
</tr>
<tr>
<td>Independent work</td>
<td>284,462,000</td>
<td>260,840,670</td>
</tr>
<tr>
<td>Owner of business or entrepreneur</td>
<td>4,484,000</td>
<td>492,713,920</td>
</tr>
<tr>
<td>Domestic servant</td>
<td></td>
<td>4,372,016</td>
</tr>
<tr>
<td>Other occupations</td>
<td>14,962,000</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>-131,874,000</strong></td>
<td><strong>220,500,160</strong></td>
</tr>
</tbody>
</table>

**SOURCE:**

1. Encuesta de Ingresos y Gastos del Banco de Mexico 1963.

Occupation of the head of family (field (21) of Archive 5 and (19) of Archive 6) is indicated according to the following code:

1. Operator
2. Worker
3. Day laborer
4. Administrative employee
5. Technical employee
6. Individual work
7. Owner of business or entrepreneur
8. Domestic servant

Manual wage earners
Work at office, store counter, shipping departments, laboratory, etc., or as a technical employee with a salary.
Profitable individual activity without workers or employees
Proprietor of enterprises with workers or employees with wages and salaries.
Remuneration of any type
Appendix B

Model of variable-term deposits, including mortgage certificates

The added series were:

a. Financial bonds
b. Mortgage bonds
c. Mortgage certificates

The model of this series is:

\[
\log \frac{Z_t}{Z_{t-1}} = 0.008 + 0.15 \log \frac{Z_{t-2}}{Z_{t-3}} + 0.16 \log \frac{Z_{t-6}}{Z_{t-7}} \\
0.33 \log \frac{Z_{t-9}}{Z_{t-10}} + 0.33 \log \frac{Z_{t-12}}{Z_{t-13}} + a_t
\]

If we suppose that the increase or decrease of the series is geometrical,
then \( \log \frac{Z_t}{Z_{t-1}} = \log (1 + i_t) \frac{Z_{t-1}}{Z_{t-1}} = \log (1 + i_t) \), and we can write this model in the following form:

\[
\log (1 + i_t) = 0.008 + 0.15 \log (1 + i_{t-2}) + 0.16 \log (1 + i_{t-6}) + 0.15 \log (1 + i_{t-9}) + 0.33 \log (1 + i_{t-12}) + a_t
\]

The consideration of mortgage bonds in the variable-term deposits substantially modifies the model in which the mortgage bonds were included in the series of fixed-term deposits. The deterministic tendency changes from 0.50 to 0.008, the terms \( \log (1 + i_{t-1}) \), \( \log (1 + i_{t-4}) \) disappear, and terms \( \log (1 + i_{t-6}) \), \( \log (1 + i_{t-9}) \) appear.
It is interesting to note an apparent quarterly phenomenon, because there appear terms associated with increments of 6, 9 and 12 months. The model of variable-term documents, until 1973.

The model for this series is:

\[
\log \frac{Z_t}{Z_{t-1}} = 0.03 + 0.23 \log \frac{Z_{t-1}}{Z_{t-2}} + 0.20 \log \frac{Z_{t-11}}{Z_{t-12}} + 0.27 \log \frac{Z_{t-12}}{Z_{t-13}} + a_t
\]

The model was modified substantially because it ended in 1973. The deterministic tendency was much greater until this date: 0.03 against 0.007 in later years. It is also important to note that this series was more stable until this date, which is deduced from the fact that there are more parameters in this model which indicate that the present observations depend at least on what happened a year before, compared to the series until 1975 which says that the present observations depend only on what happened a month before.
Appendix C

President Echeverría's Inaugural speech, December 1, 1970

(Excerpts relating to economic policy)

"The necessities and the hopes of the country present a challenge to the Mexicans of our time. Through the Revolution, we have asserted civil liberties, internal peace, sustained growth and our capability of national self-determination. There persist, however, serious deficiencies and injustices which can endanger our successes: the excessive concentration of income and the marginal position of large groups of population threaten the harmonic continuity of development.

"We cannot rely exclusively on institutional equilibrium and increment in wealth for solution of our problems. To encourage the conservative tendencies which have grown out of a long period of stability would mean to deny the best heritage of our past. The vigor of Revolution can only be maintained by repudiating conformism and accelerating general evolution.

"In all regions of the Republic and in all social sectors, I have gathered evidence on a determined eagerness for progress. I had frank discussions with my fellow countrymen. They have told me what they need, what they aspire after, and what they are determined to realize. They know my ideas and my determination to serve them. Now comes the moment to act. I will faithfully discharge the duties bestowed on me.

"The Revolution will speed up its march. Even though we have abolished old structural inequalities, new ones appeared in the last decades -- but they are only circumstantial and should be temporary."
But as long as the poorest Mexicans do not achieve decent levels of existence our program will continue to be revolutionary, representing a dominant impelling force of the people and their creative work during this century.

"Mexico has lived in an extended period of creative peace. The regime has strengthened the autonomy of the country and generated a broad public consensus which makes it possible to make great decisions. If it is necessary to modify the strategy of our development in order to fulfill the mandates of the Constitution, we will proceed with determination.

"Today, Mexico faces situations whose nature and magnitude could not be foreseen in the beginning of this century. Her population has grown more than three times since the end of armed struggles. Thanks to the realized reforms, the country is acquiring a new appearance. The centuries-old backwardness of many regions exists side-by-side with the newest phenomena of industrial life. Each year, the problems are sharpened by continuing demand for more work and schools and for better living conditions.

"When this decade ends, we shall have almost 70 million inhabitants and within 20 years we shall probably reach 100 million. We are engaged in a difficult battle against time. We must define what kind of country we want and can have by the end of this century in order to undertake, without delay, the qualitative reforms that our system requires.

"I declared on various occasions that the demographic growth is not a threat but a challenge which will test our creative potentiality. The Mexicans do not accept coercive interventions in matters that belong within the range of individual freedom of every person."
"It is not certain that there is an inevitable dilemma between economic expansion and income distribution. Those who preach that we have to grow first in order to distribute later are mistaken or lie because of their own interests. Actually, the employment and income should be increased more quickly than until now. For this reason, it is indispensable to divide income with equality and to broaden the internal market of consumers. It is also necessary that the human effort be more fruitful. In order to achieve that, the distribution should be equal: distribution of welfare, education, and technology.

"We will continue to promote the capitalization of the country in order to achieve quickly a self-sustained progress. The abundance of manpower, the natural resources that we have not yet exploited and the internal market that we are creating offer great opportunities to savings and entrepreneurship.

"To achieve progress with our own resources requires participation of all sectors, and especially of the most favored ones. Excessive expenses, inefficiency and superfluous flight of foreign exchange limit investments and retard growth.

"Mexico does not accept the idea that the production means should be managed exclusively by public agencies, but it has also overcome the theories which leave the promotion of economy totally in private hands. The experience has taught us that it is not enough to increase capital if we do not take care of its correct application. The investments should be made where they are most necessary: in the countryside, in the infrastructure, in obtaining capital goods, in enterprises which require employment of abundant manpower."
We will encourage internal savings, those absorbed by private institutions as well as those in state organisms. The principle of mixed economy established by the Constitution implies that the public investment is sufficiently strong to direct the growth. Free enterprise can only be fruitful if the government possesses sufficient resources to coordinate the realization of great national goals.

Many countries find themselves in serious crises at this time. The Mexican peso, however, has maintained its strength during the last 16 years. The monetary stability which we enjoy has its origin in political stability and in hard work. We will preserve the strength of our currency and will maintain free convertibility.

The popular classes strongly resent the increase in living costs. The real cause of this phenomenon is not wage increases which enlarge monetary circulation but also necessarily stimulate the volume of production. Rather, it is provoked by the scarcity of goods as well as by speculative mechanisms which should be checked for the sake of general interest.

Foreign investment should not substitute for Mexican capital but complement it in useful collaboration. In any case, Mexican capital should direct this collaboration with prudence, authority and patriotism and guide it in such a way that it contributes to the modernization of enterprises. Therefore we will prefer such investments from other countries that would establish, under the guidance of Mexicans, new industries, contribute to the continuing evolution of technology and also produce goods for export, including exports to the foreign investors' own markets.

The Mexican entrepreneurs who sell growing and even flourishing businesses disown the efforts of their ancestors and their own efforts as well. They squander the inheritance of their sons, confess their lack of
capability to prepare them, and also abandon the field of training of new executives whom they should have educated in order to have someone substitute them when they feel tired and have lost the spirit of struggle.

"It is vital to increase the exports in order to be able to finance, without ties, the purchases of technology and machinery not yet produced in Mexico. In addition, only the funds from selling abroad will compensate for the loss of foreign exchange caused by outflow of dividends, payment of interests and the cost of the knowledge that we need in order to progress. We will promote the exports of raw materials as well as manufactured goods without forgetting that, in the long-run, only the selling of industrial goods will balance the foreign transactions.

"We will continue in our efforts to make the relations of international trade more just, especially between countries united by geography and mutual friendship; but we will also explore new markets in all regions of the world and we will generalize the system of specifications in order to encourage the production of articles whose quality and price would be competitive abroad. The entrepreneurs who are not able to achieve higher goals, will be obstructing the international trade.

"Today, technological progress is the best ally of the Mexican Revolution. When technology is lacking, the investments are profitable due to the existence of abundant manpower which is, however, badly qualified and insufficiently paid. It is typical of underdevelopment that costs are high while the wages are niggardly. On the other hand, a correctly oriented productivity permits the system to create abundantly and distribute justly."
We Mexicians believe that neither the model based exclusively on accumulation of capital and exploitation of work, nor the model which suppresses the supreme value of human liberty and the moving force of progress which is individual initiative, are desirable for our development. We want to advance with a great speed but without compromising any of the principles of our ideology: unrestricted respect for individual guarantees and an active public power striving for general welfare.

We will take care that institutional loans do not exceed the anticipated capacity of payment. We will increase the financial prestige of Mexico in the international sphere because it is an invaluable inheritance bequeathed to us by the previous generation.

The demographic expansion and accumulation of problems require constant increases of public expenditure and a greater flexibility in the tax system. We will improve the mechanisms of tax collection so that they are more efficient and allow us to broaden governmental investments and basic infrastructure, with the conviction that if economic growth does not correspond to a proportional increase in the capacity of people to work, create and consume satisfactorily, we will be in fact impoverishing the people.

This Federal Executive intends to distribute the fruits of increased efforts equitably and to make the more fortunate regions and groups contribute to the development of the backward ones. We do not encourage indolence. Let us achieve the principle of equal opportunities in order to offer to everyone a possibility to prosper with one’s own work.
"Mexico must continue to work for the building of a modern society based on her own conditions. The primordial role in this construction is the power of education. Our fellow countrymen believe in schools. They entrust to schools the future of their own children with a touching certainty of a person who -- knowing his own limitations -- always believes in new generation and in human progress through culture. Let us not frustrate this hope because it is the moral force of the republic.

"In all countries, the present times challenge the efficiency of school. A static education can be a source of discord and decline. Let us change each auditorium into a dynamic agent of social change, scientific progress of economic development, so that it becomes a bastion of sovereignty and a source of constructive patriotism. The nation that we want to become should be forged in schools.

"An authentic educational reform must include a profound and permanent revision of objectives, concepts and techniques that guide the teaching. Let us mistrust spectacular changes and arbitrary decisions. The reform that we will initiate will not be a result of bureaucratic imposition. It will originate in every lecture hall and will be based on truthfulness and dialogue.

"It is necessary to support the social, intellectual and moral function of the educator so that he is, in his behavior and dedication to work, a living example of the principles he teaches. He must combine vocation with study in order to fertilize the imagination of his pupil, whose questions probably announce the truths of tomorrow. To a great extent, educational reform is a self-criticism of the teachers."
"In all stages of his formation, the pupil should cultivate his ability for creative action. A peasant should learn to cultivate his environment and to participate in the contemporary economy; and the industry and workshops should be linked closely to schools in order to make them more productive. We must also stimulate cooperation between parents and teachers. In short, we must reduce the distance that exists between the lecture hall and reality -- which puts the former to the test.

The values that we inculcate in our educational institutions are often contradicted within the communities. It would be of little use to promote the work of the educator if we did not change the communication media into instruments of extracurricular education and into agents of collective consciousness, if we did not demand from all sectors that they adopt a new moral attitude and if we were not determined, on our part, to show to the new generations the firmness of our principles and the integrity with which we uphold them.

"Our times are conditioned by scientific and technological advances. Many regions are poor, in spite of plentiful resources, because they lack knowledge and capital to make full use of them. The acquisitions of patents and the payments of royalties are too burdensome for less developed economic structures. Scientific colonialism thus sharpens the differences between countries and sustains the systems of international subjection.

"No nation can develop fully relying exclusively on alien experience neither can it decide its future independently when there are external factors capable of braking or distorting its process of development at any moment. An old principle thus acquires a stronger meaning, namely that knowledge means freedom. Let us look for techniques, wherever they can be found, which are required for the acceleration of progress. Let
us increase our own scientific capacity in order to be able to discern the real usefulness of these techniques, to adapt them to our conditions, and above all in order to innovate on our own.

"An important objective of the government will be the promotion of science. We will supply the universities and technical institutes with means that will enable them to maintain their present intellectual level. We will fully respect their autonomy, because intellectual creation does not exist without freedom of thought. We will solicit their cooperation in a program ranging from basic education to scientific diffusion and training of researchers who would guarantee our independence.

"If we considered only the global figures, we could think that we have overcome underdevelopment. But if we contemplate the surrounding reality, we do have reasons for a deep preoccupation. A high percentage of population lacks sufficient housing, potable water, food, clothes and medical care.

"We have lowered the mortality and increased life expectancy at birth, but we have not succeeded in assuring that human existence always develops in satisfactory conditions. Hunger is the most serious illness suffered by our countrymen. Let us produce more food and bring it to the tables of the poor. Let us banish disease and promote, in a determined way, physical and mental health of all Mexicans.

"We will see to it that the benefits of civilization are no longer concentrated in only a few areas. The economic sphere must be transformed; centers of growth should be created in those places where natural and human resources await the infrastructure. We will multiply the process of penetration in order to meet the rural aspirations. Public works should be
always planned in such a way that they benefit the collective interests and not isolated persons or small groups, whatever their apparent and transitory political and economic influence.

"We are worried about deficiencies in some means of transport. It is not true that the age of railroad is over. We will restore and modernize the railroad network so that it becomes a profitable means of transport and an efficient instrument of the decentralization of activities. We will increase the merchant fleet and improve port facilities. This requires public and private investment, and administrative coordination.

"The reconquest of the land was a basic cause of the Revolution and the origin of contemporary Mexico. Nevertheless, thousands of peasants still live in harsh conditions.

"The ejido, communal property and small individual property are fundamental institutions. We must respect them and make them productive in order to promote peace and prosperity in the countryside.

"The agrarian distribution has not yet been concluded. Legally and physically, there are still lands liable for distribution. I solemnly repeat my promise: I will not rest a single day of my six years in the effort to promote a better life for the peasants and an improvement of rural conditions.

"We will continue to incorporate the greatest possible number of hectares into agricultural land. Colonization means a rational settling of territories. We will come to the regions which are promising, and we will overcome atavistic resistance and avoid errors of past periods. Each nucleus of the population must have at its disposal adequate means to convert its work into well-being."
"Good use of water and access to credit are vital for rural work. We will put in action as many methods as necessary to increase the size of irrigated areas and to improve their distribution. We will transfer a greater volume of financial resources to the countryside and we will administer them honestly. We will induce the private bank to participate more broadly, seeing to it that our peasants are better credit customers each year.

"The minifundia, as a form of exploitation of land, contradict the nature of the system of ejidos. We will strengthen the ejido so that it becomes an active cell of democracy and a true productive unit. Where it is possible and where the peasants want it, we will create rural enterprises by grouping individual plots and by introducing cooperative work.

"We will encourage the farmers to improve their economic ability and to change their mental disposition so that they make full use of machinery and equipment, improved seeds, fertilizers and insecticides. We will reform the distribution methods in order to bring benefits from our collective endeavor that we are going to embark on to our people who work the land and consume its products.

"The oil struggle derived from our desire for autonomy and it stimulated us to undertake industrial development. Today, the strength and prestige of all enterprises that the nation controls through the state depends to a great extent on operational efficiency of the oil industry. We will enlarge the technological research, in order to increase oil utilization and lower the costs of oil production, and we will intensify the exploration of the sea-bed and other regions of our territory."
"Petrochemistry is the industrial sector that grows most quickly. It stimulates the mastering of advanced technology, presents great possibilities of exploitation, and is a decisive factor in the improvement of agriculture. We have to encourage this industry — both the initiative of individuals and the activities directed by the state — so that it grows at an increased speed and thus serves our national interests.

"The disequilibria of foreign trade are partially offset by incomes from tourism. Tourism is a source of human exchange and international understanding. We are alarmed, however, about the fact that the expenditures of our countrymen abroad rise more rapidly than the expenditures of foreign tourists in Mexico. Nothing justifies disproportionate waste or expenses which are frequently only demonstrations of bad taste with which some Mexicans abroad exhibit and stress the errors of our distributive justice.

"We will strengthen our ties of cooperation and brotherhood with the nations that form the Indo-Latin community of the American continent. We share not only historical experiences, traditions, and cultural similarities, but above all, our determination to recover our resources in order to guarantee our sovereignty and to achieve freedom through development.

"A new epoch, more competitive and more mature at the same time, is beginning for our nations. This is reflected in the identity of purpose which guides our actions and in our resolve to transform anachronistic structures within our countries and in our international relations.

"Latin American integration requires unity not only of our markets, but also of our productive potential. We have to create economies of scale which will make the most complex industries profitable and competitive at the world level. We will propose the establishment of multinational enterprises
which would unite the initiative of our investors, utilize raw materials of various countries and avail themselves of advanced technology and institutional sources of international credit. We will also propose a simultaneous creation of multinational Latin American centers of research."
Appendix D

Summary of Comments Formulated by Representatives of the Private Sector in the City of Mexico who were Interviewed About the Factors Affecting Private Investment in the Gross Formation of Capital in Industry.¹

General Observations

I. The interviewed entrepreneurs share the opinion that private investment, both of national and foreign origin, has been stimulated in the last decade by the following factors:

1) Rate of economic development, sustained continually almost without interruptions and with moderate degree of inflation.

2) Political stability.

3) Maintenance of exchange parity and free convertibility of currency.

4) Fundamental continuity of the policy of economic development and social justice throughout the successive presidential terms.

5) Existence of interest rates attractive for investment of national and foreign capital.

II. Most of the interviewed entrepreneurs expressed their conformity with the general policy of the present regime which seeks an acceleration of development and a better income distribution; they agreed that the State should participate in the direction of economy by coordinating, harmonizing, accommodating and stimulating, by trying to channel investment on the basis of social usefulness, and by requiring higher

productivity in all industry.

III. They think that the recession of 1971 was provoked by the Government in order to stop inflation as well as to facilitate the directing of a substantial share of the budget to the diminution of external debt, whose restructuring was being negotiated at that time with the aim of better adapting the debt to the possibilities of payment from federal treasury.

IV. During the year which is ending the economy recovered from recession. The tendency of a growing demand for consumer goods is promising, and therefore the entrepreneurs have made the investments necessary in order not to lose their position in the market. Generally, it is estimated that the private investment of national and foreign origin in 1972 must have exceeded the investment of 1971. This fact was a response to the revival of optimism about the future of economy, based on the increases that most enterprises registered in their sales and profits.

V. By extrapolation of the tendencies, the perspectives for 1973 and the following years should be very favorable and normally should lead to decisions on the part of entrepreneurs to realize dynamic investments in order to facilitate a greater expansion of industry in the future. However, due to various aspects of the governmental policy, a climate unfavorable to private investment prevails.

VI. The prevailing climate is characterized by attitudes of confusion and distrust. The first is caused by the fact that most entrepreneurs do not understand the course of governmental policy and are afraid that the country is being led to socialism. This fear, in turn, results from the bad experience of the countries which have followed this road
and where neither the objectives of economic development nor social justice have been achieved. On the other hand, those who do not share the fear about a march to socialism, are afraid that the regime of mixed economy which our government postulates as the objective of its policy, cannot become an operative reality because it constitutes an intermediate road between extreme positions and our country is not mature enough and does not have sufficient sense of national unity to be successful on this road.

The attitude of distrust originates in the opinion that the Government proposes to carry out too radical changes in too short a time, that it implements measures which were proven to be ill-advised or inoperative in previous experiences, and that it ignores or postpones the solution of basic problems. Also, on many occasions the Government is demagogical in its attitudes and actions — it promises but does not fulfil, declares something and does the opposite, and finally, it gives an impression of acting without a definite long-term plan.

VII. The consequence of these positions is a predominant attitude of waiting on the part of investors, and an accentuation of the outflow of some capital as the entrepreneurs seek to diversify their risks by investing in other countries. The waiting attitude does not hinder the realization of those investments necessary for the satisfaction of increased demand in the short run, but important investments in new projects are not realized, especially by national investors.

VIII. There is a consensus of opinion that if the Government does not substantially improve its program of public relations in order to put an end to the existing confusion, and if it does not, in addition, modify its policy vis-a-vis private enterprise, the lack of investment in
long-term projects and the subsequent acceleration of repatriation and flight of capital, will slow down the rate of development which could then be maintained only by inflation or with greater external indebtedness. Another way of maintaining the rate of development would imply a more extensive nationalization of enterprises, plus additional measures like control of exchange and strengthening of price controls.

If the main causes determining the waiting attitude and reluctance of entrepreneurs are not removed during 1973, we might not witness extreme consequences like flights of capital, but our development might be negatively influenced for example by a loss of risk capital coming from abroad. This capital is lacking in most national enterprises and investment groups, although it is essential for a dynamic development. In addition, the use of resource capital can become more expensive if we do not succeed in retaining the funds from abroad which have been flowing to Mexico drawn by attractive profit rates, and if the external financing for national enterprises is made less attractive by the new fiscal reforms.

The decreases of investments and financing coming from abroad will necessarily have adverse repercussions on industrial development with the consequent negative effect on employment. There is a consensus of opinion among the entrepreneurs that everything that will result in a reduction of investment capital, whether of national or foreign origin, will necessarily affect the level of occupation of manpower, and consequently will endanger the objective of better income distribution which can only be achieved by fighting unemployment and underemployment.
IX. The confusion about the attitude of the Government is general; nevertheless, it is less pronounced among the representatives of big enterprises and among important groups of investors that have access to bigger and better sources of information, and have more capacity for analysis and comprehension. The confusion increases with an increasing dependence on mass communication media.

The questions the interviewed entrepreneurs indicated as main causes for confusion can be summarized as follows:

1) Why does the President permit so many governmental officials of such different ranks to interpret or predict governmental policy, while they contradict each other on many occasions?

2) Why does he attack the private enterprise -- or permits it to be attacked -- thus tainting the prestige of the entrepreneur and denying his function in the process of economic development?

3) Why does he discourage and attack foreign investment on one hand, while on the other hand he invites select groups of foreign investors to realize projects in Mexico?

4) Why does he not clearly explain his objectives and his strategy of development?

5) Why does the Government increase taxes and charges on private investment in a patently inflationary manner?

6) Why does it invest or support investments in enterprises not socially useful, with subsequent losses or inadequate yields?

7) Why does the Government not invest more in works of infrastructure and less in works of demagogical luster?
X. The distrust toward the Government which traditionally characterized the Mexican investor has been gradually reduced in recent years, during which a common task of working for the progress of the country had led to a better understanding and collaboration between the Government and private investors. In contrast, during the two years of the incumbent administration the climate of distrust has been accentuated because of divergence between the objectives, policies and practices that the Government is pursuing and those that the private investors, on the basis of experience, consider more prudent or more efficient. The private investors are also critical of demagogical attitudes which, even if in many cases justified by the need to maintain political equilibrium within the country, in other cases satisfy only the personal interests of the members of Government.

In the course of interviews, the following causes of distrust have been indicated:

1) Private investors are preoccupied about the general direction of governmental policy and specifically about the future policy toward the private sector. The preoccupation with the situation in short-term is stronger than that concerning medium and long-term prospects.

2) The greater participation of the State in economy, through the policy of acquisitions of enterprises and even minority participation, is one of the fundamental causes of distrust within the private sector. On one hand, when those businesses which should be in the hands of private entrepreneurs are administered by the Government, efficiency declines. On the other hand, in many cases these
enterprises become monopolistic or enter in competition with private enterprise which is very unfair because the state enterprises enjoy subsidies or preferential treatment.

3) Some of the interviewed entrepreneurs believe that all acquisitions of enterprises by the State have been justified by the public interest, which at times means preventing the closing of a bankrupt firm on the grounds that such a closing would be of evident social damage to some communities. Several entrepreneurs even suggest that the State has been paying for the sins of private sector. However, the majority believes that the State follows an irreversible course toward the nationalization of enterprises and does not waste any opportunity to realize new investments.

4) The Government is criticized for not being concerned about the promotion of capital markets and about the creation of instruments for institutional investments, for instance the system of "holding" or controlling enterprises.

5) The Government has created a series of stimuli to promote exports, but few stimuli/prompt investment in capital goods used in the manufacture of articles for export. Neither did the Government sufficiently promote those works of infrastructure that would especially help exports, as is the case of port installations.

6) The entrepreneurs comment that the increase of federal, state, and municipal fiscal charges affected small and medium commerce in such a way that its profitability has been substantially reduced. This sector of economic activity emphasizes the disadvantageous position of some of its branches vis-a-vis the competition of
stores and "shops on wheels" of Conasupo and ISSSTE.

7) The proposed reform of social security implies increases in high-levels salaries which will have inflationary effects.

8) The solutions to the rural problems that the Government has promised are still pending.

9) The government resorts to increasing taxes on the profits of enterprises which reduces the funds available for capitalization of the development. This most immediate way of increasing public income is used instead of improving control mechanisms to reduce tax evasion.

10) The projected rise of the tax rates on credits from abroad will increase the real costs of capital available to industry.

11) There is a lack of a realistic approach in the distribution of wealth on the basis of the tax system, because only through the creation of jobs can a consistent advance for the groups with lower income be achieved.

12) The regulation and control of foreign investment consisting in making the registration of shares of commercial societies obligatory, will deprive our incipient stock market of agility, and, because of its negative psychological effect, will possibly discourage direct investment in industrial capital.

13) The Government does not seem to have a directing plan for its policy. The technicians are paralyzed by politicians or have political ambitions themselves.

14) The Government frequently changes the rules of the game which makes long-term planning impossible.
15) The simultaneous enactment of a number of changes in fiscal legislation, social security, control of technology and foreign investment, etc. Regardless of the possible effect that these measures would have if implemented separately, the total effect is much stronger and it discourages the private investment.

16) The laws intended to control the transference of foreign technology and to regulate the capital investment coming from abroad can have grave discouraging effects on foreign investment which Mexico needs to complement the formation of capital for industrial development generated by internal savings.

17) It is anticipated that the proposed law for control of transfer of technology will have an inflationary effect because it will swell the bureaucracy and because the extraordinary accumulation of power in the hands of officials responsible for approving new contracts for technical assistance might give rise to extensive corruption.

18) The continuation of the system of price control of some articles and the continuation of the system of subsidies for basic products manufactured mainly in the decentralized enterprises prevents entrepreneurs from realizing appropriate profits on their investments. In many cases, these subsidized enterprises represent an unfair competition to producers and merchants, and on the other hand, they unsettle the equilibrium of economy without being justified as agents fighting inflation.

19) The policy of decentralizing industry is in principle good and desirable, but practically the possibilities of realization are
very limited. It will be possible to build new industries outside of the metropolitan area and to expand existing industries in the Valle de Mexico to provinces, but it will be difficult to justify the relocation of industries already established in the central zone of the country. "There is not much risk capital in Mexico." Only the big companies with foreign capital can risk without danger. In the same way, only the big groups can undertake effective decentralization of industry on a significant scale.

20) For the first time, the people believe what the Government says and the promises of officials are not taken lightly. Therefore pressures are arising that have to be dealt with by the public power. Private entrepreneurs are preoccupied by the proliferation of groups of discontent in the countryside, among small and medium merchants, among students and teachers, in the unions and even within the government itself.

21) Generally, it is not understood why the government tolerates the numerous labor agitations in many parts of the Republic which seem to have a more transcendental character than just simple syndical struggle. Equally, the entrepreneurs do not understand the attitude of the Government vis-à-vis student revolt and other problems that have appeared in the universities.

22) It is evident that PRI is becoming weaker and that the opinions within the government tend to differ increasingly.

23) The majority of interviewed entrepreneurs believe that political stability of the country is not threatened, but an important
minority thinks that for the first time in many years the
position of the Government is vulnerable because it has neither
the popular support it should have nor the political support
required for stability.

24) The governing style of the President of the Republic has been
a subject of comments and concerns of many entrepreneurs because
of its restricting effects. His intelligence, penetration,
memory, capacity to work and his talent for leadership are extra-
orinary. In this sense, there is no other personality in the
country who could bear comparison with him; but precisely this
quality makes him act impulsively rather than reflectively. He
is a man who acts more under the inspiration of the moment than
according to a carefully thought out plan.

25) The President wants to carry out too many changes at the same
time and excessively centralizes decision making at a high level.
He does not delegate enough authority and absorbs too much time
of his ministers and immediate collaborators. Frequently, he
goes into too many details when analyzing problems. According
to the opinion of some entrepreneurs, he is the most unpredictable
president since Cárdenas.

26) The negative effects of this style of leadership are: the slowness
with which the matters of government are solved because the
officials at various levels lack the inclination to make decisions;
the lack of accessibility of Secretaries to the public and also
to their own collaborators; insecurity among the high officials of
Government because they cannot adequately exercise their functions
within their respective areas.

27) The program that the President initiated and promised to carry out required the availability of extraordinarily numerous and competent human resources. Shortage of available talents and capacities can be a serious impediment to the feasibility of presidential programs.

XI. The interviews contain a series of comments on what the government should do in the short-run to re-establish the confidence and improve the disposition of private sector toward making investments: Evidently, if the Government intends to lead the country to socialism, there is little to be corrected in its present policy. Many attitudes and decisions of the Government can be explained perfectly if one assumes the premise of a deliberate effort to implement socialist regime with all its implications.

On the other hand, if the Government intends to pursue a course different from socialism, it must support the institution of free enterprise and encourage the formation of capital through internal savings, adequately complemented by investment and financing of foreign origin. In this respect, the entrepreneurs indicate the following:

1) The Government must substantially improve its program of public relations in order to put an end to the confusion that it has created.

2) It must modify its policy toward private enterprise so that investment is not discouraged. For this purpose it must stop not the justified criticisms of abuses by some entrepreneurs, but certainly
the generalizations that taint the image of entrepreneur, as well
as general attacks on foreign investment.

3) It must restrict its intervention in private activities to cases
   truly justifiable by the policy of public service.

4) It has to avoid fiscal and economic measures that have inflationary
effects.

5) The Government must take firm decisions in cases of popular unrest
   in order to avoid the violation of order and internal peace.

6) It will be extremely important for the Government to avoid ir-
   reversible measures leading to socialism.

7) The country requires Government plans for its long-term development
   policy in coordination with the private sector.

8) The President has an opportunity to use the conditions resulting
   from present circumstances to create an enthusiasm for work,
   progress, and national unity.

9) Improvement of fiscal control to reduce tax evasion is better
   than the increase of tax rates for captive taxpayers.

10) The Government ought to implement prudently the structural changes
    that the country requires for its development, trying not to cause
    alarm and distrust. Therefore it has to explain the reasons for
    changes frankly and calmly to the private sector. The Government
    must define, with much more precision, the role that the private
    sector is expected to play in the tasks of development with social
    justice.

11) It is indispensable that the general climate of opinion be improved
    and enthusiasm stimulated. It is necessary to fight the apathy and
    reluctance which prevails in the private sector.
XII. On their part, the private entrepreneurs must make changes that would permit them to accelerate and improve investment:

1) They must plan their investments for the long term in order to optimize the use of available human, financial, and material resources.

2) The enterprises that enjoy tariff protection must fulfil their responsibility to produce satisfactorily as far as volume, price, opportunity and quality are concerned, without abusing their situation.

3) Those who require foreign technology must use it wisely and promote the development and utilization of our own technology.

4) The entrepreneurs should follow a dynamic program of investment without waiting for the market to demand it, but rather anticipating its necessities, including those of exports.

5) They must give high priority to the fighting of unemployment and underemployment as the best means to contribute to the objective of social justice in their own enterprises.

It has been noted that the last 30 days witnessed a substantial change that involves the suspension of criticism of private investment and even efforts of high officials to speak well about the entrepreneurs. If this attitude of the Government continues not only could the confidence of many entrepreneurs be reborn, but also national unity could be strengthened.