The War Against Inflation

The cornerstone of the economic policy pursued by the Salinas administration is the Pact for Stability and Economic Growth *(Pacto para la Estabilización y Crecimiento Económico, PECE)*. Widely known as *El Pacto*, it has created a common understanding between government on the one hand, and labour and the private sector on the other.

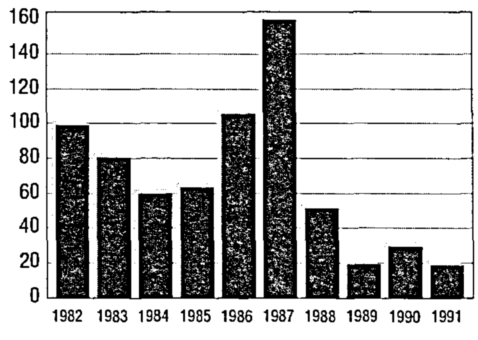
As part of a general campaign to build public awareness of the need to combat inflation, merchants and restaurateurs display signs of support for El Pacto in their shop windows and store premises.

El Pacto was originally conceived as a tough four-year stabilization program. Introduced in December 1987, it was aimed at reducing inflation which by then had reached annual rates of 180 percent. Through a combination of tight fiscal and monetary policy, and wage, price and exchange rate controls, the program has been tremendously successful, reducing inflation to an annual rate of 18.6 percent in 1991 (see Figure 1.3).

In November 1991, *El Pacto* was extended to January of 1993. In this second phase, it aims to further lower the inflation rate in 1992 and eventually to reach the single-digit range. Other key features of this new extension are a reduction in the rate at which the peso is devalued from 40 to 20 centavos per day (by Government decree, however, the peso is also subject to market fluctuations), a 12 percent increase in the minimum wage, and a reduction in the rate of the *Impuesto al Valor Agregado (IVA)*, the value-added tax, from 15 percent to 10 percent.

The Mexican peso has been devalued by some 23,000 percent in just 12 years as a result of inflation. At the end of August 1992, one US dollar was worth approximately 3000 pesos. Calculating even simple transactions was proving to be extremely cumbersome. At the beginning of September 1992, the government announced its intention to introduce a new peso that is to be worth one thousand old pesos. The measure is not a devaluation but a re-denomination that amounts to eliminating three zeros from all prices. Effective as of September 1, all prices are to be posted in both old and new pesos as part of a program of public education. After their appearance on January 1, 1993, the new notes will circulate in parallel with the old pesos throughout 1993 after which the old peso will be withdrawn completely.

Figure 1.3
Inflation in Mexico – Changes to the Consumer Price Index, (December to December)
(in percent)



Source: Bank of Mexico.

Dealing with the Foreign Debt

Mexico's foreign debts became crippling after the collapse of oil prices in the early 1980s, the sudden rise in international interest rates, and the withdrawal of enormous amounts of capital from the country as investors sought to escape the rapid devaluation of the peso. When Carlos Salinas de Gortari began his term as President of Mexico in December 1988, the country's foreign debt had grown to $US101 billion, equivalent to 59 percent of GDP. In that year, debt servicing and repayment of the principal amounted to 10.2 percent of GDP and effectively strangled economic growth.

The Salinas administration made renegotiation of foreign debt one of its priorities. Any attempt to stabilize wages, prices and the national currency could not succeed over the longer term if the problem of the debt was not resolved. In tackling it, the government actively pursued four fundamental objectives:

1. reduction of the accumulated debt;
2. reduction of the net transfer of resources abroad;
3. an agreement with foreign creditors that would cover a period of several years; and
4. reduction in the debt as a percentage of GDP.