The North American Free Trade Area, Mexican Debt Constraint and Structural Reform

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ABSTRACT

Mexican policy reform can only be understood in the context of the severe economic conditions following the debt crisis of the 1980s. Faced with long term declines in real per capital incomes, broad based reforms have been taken in the country’s trade and payments regime, and structural reforms that have decreased quasi state enterprise by two thirds. These reforms have attracted capital flows back into the country, increased capital investments and substituted private for public external debt.

At a meeting in June of 1990, Mexican President Salinas asked President Bush to consider negotiating a free trade agreement (FTA) between the United States and Mexico. In spite of the negotiations in 1987 for closer economic ties, and the “Trade and Investment Facilitation Talks” in 1989, the request by Salinas in March of 1990 to negotiate a FTA was a radical departure from past positions of Mexican governments toward closer ties with the United States.

Previous Mexican governments dating back to at least 1917, have maintained a hands off attitude toward involvement with the United States both with regard to trade relations, where explicit government policy could be characterized as inward oriented with severe restrictions applied to all manner of direct foreign investments. Why then did the government of Salinas move to reverse policies which had been long standing and supported through many decades in Mexico?

The answer to this, which I will argue in the pages that follow, lies in the clear choice which Mexico faced between inward oriented policies, implying stagnating or declining per capita income, or a move toward an open economy with the prospects of dramatic income growth and the potential to become an industrial economy. The choice to become an open economy and to eventually integrate the economy with its northern neighbors can only be understood in the context of the severe economic conditions in the wake of the debt crisis of the early 1980’s. These conditions pressured the government to accept economic well being over sovereignty and the various political obstacles and risks associ-
ated with policy reform. The liberalization and structural reform which Mexico entered into in the late 1980's as well as the willingness to enter into a North American Free Trade Area, are part of the same Mexican response to an unacceptable future.

1. ANTECEDENTS TO LIBERALIZATION: THE DEBT CRISIS

The Mexican debt problem and that of other Third World countries had its roots in the rapid growth and development of the 1960's and early 1970's when credit was readily available and inexpensive. That long period of sustained world growth created the excess demands for petroleum and other natural resources which provided the right conditions under which the Organization of Petroleum Exporting Countries (OPEC) could become an effective force for monopolizing world petroleum trade.

The fourfold increase in petroleum prices initiated by OPEC in 1973–74 shocked the world economy. The principle short-run effect was to create, for most trading countries, a balance-of-trade disequilibrium. The high-income oil exporting countries generated significant trade surpluses. At the same time the oil importing countries generated balance-of-payment deficits. For the case of Mexico and other middle income oil exporters, the perception that oil prices would continue to increase led to substantial borrowing against expected future earnings, which, of course did not materialize. The longer term effect of the oil price increase was significant debt accumulation by developing countries, setting the stage for the current world debt problem.

The industrial countries employed easy monetary policies both before and after the first oil shock, which moderated the decline in real income and permitted continued economic growth in developing countries. The change in trade flows and expansionary monetary policies in the member nations of the Organization for Economic Cooperation and Development (OECD) generated financial surpluses previously unavailable to the international financial system. International bankers recycled this liquidity in the form of "petrodollar" deposits by beginning a massive lending program focused primarily on middle-income developing countries. Bankers seemed to behave as though they anticipated high returns to investments and assumed that a country guarantee was adequate provision against repayment defaults. Whether funds were being invested in such a way that a stream of foreign exchange earnings would be forthcoming to repay the loans, in retrospect, appears to have received little attention.

The world economy weathered the first oil crisis without much apparent difficulty. Initial debt levels were low enough that accumulation did not overly burden the world payments system. Furthermore, the infusion of large amounts of international capital into the world economy generated an international expansion led by export growth. For all non-OPEC developing countries, the total dollar value of exports was 2.5 times greater in 1980 than in 1975. Furthermore, annual real growth in gross domestic product (GDP) for all developing countries averaged 5 percent during this period.

The oil price rise of 1973–74 set the stage for the large debt accumulation, and the second oil shock of 1979–80 set the stage for the world recession of 1980–83. The latter petroleum price increase was more significant than the first because of the large debt that had accumulated and the far different policy responses of the industrial nations. The reaction to the 1979–80 increase was for the major industrial countries to simultaneously restrict available credit.
The resource-driven inflation that was initiated by the 1973–74 oil price increase and accommodated by expansionary monetary policies proved unacceptable to the industrial countries. The rapid and uncontrolled rises in resource costs were significantly reducing real manufacturing profits, eroding confidence in the future, and lowering investment. Only traditional measures could deal with the anticipated inflation. The sudden decline in monetary growth sharply slowed the world economy, raised real interest rates, and increased the real cost of debt service. The effect of the policy responses of the developed countries in the second oil shock triggered the repayment problems.3

Mexico tended to follow the general pattern which preceded the debt crisis. Mexico borrowed heavily throughout the 1970’s (Table 1). By 1980, it increased its international debt from $6.5 billion to more than $57 billion. At the same time, Mexico’s debt to GDP ratio increased from 18 to 31 percent. However, as an oil exporter, it is only after the second oil crisis in 1979/80 that the unsustainable increases in debt occurs. Between 1980 and 1983, total debt level grows from $57 billion to $93 billion and the debt to GDP ratio goes from 31 to 78 percent. Mexico tried to sustain the old policy regime in the face of a very different world environment and paid a heavy price for it.

Per capita income increased in real terms from $1310 to $2040 between 1970 and 1981, but declines to a low in 1986 of $1590 (Table 2). After experiencing GDP growth rates of as high as 10 percent in the 1970’s, GDP declines in 1982, 1983 and 1986, and grows only

### TABLE 1. Mexican Foreign Debt 1990–91

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Debt Billions of $</th>
<th>Total Debt GDP Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>6.5</td>
<td>18</td>
</tr>
<tr>
<td>1975</td>
<td>16.6</td>
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<td>1983</td>
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<td>1984</td>
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<td>1985</td>
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<td>38</td>
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<tr>
<td>1991</td>
<td>85.9</td>
<td>33</td>
</tr>
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</table>

**Note:** Source: 1970–89, World Debt Tables, 1990–91 DRI.


<table>
<thead>
<tr>
<th>Year</th>
<th>GDP/Pop $</th>
<th>GDP Growth Rate %</th>
<th>GDI/GDF %</th>
<th>Exports bil $</th>
<th>Imports bil $</th>
<th>Net Exports bil $</th>
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<td>1.21</td>
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<td>20.57</td>
<td>26.19</td>
<td>29.00</td>
<td>-2.81</td>
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marginally in the balance of the decade. Only after the reforms in 1988 does real per capita income growth return.

The real measure of what was happening to the Mexican economy from the debt crisis appears in the investment and trade accounts. Gross domestic investment declines from a peak of 27 percent in 1980–81 to a low of 18 percent in 1986. While exports stagnate at around $20 billion during the 1980's, imports are cut to reduce the deficit and generate surpluses for loan repayments. Imports fall from a high of $24 billion in 1981 to a low of $8 billion in 1983, a cut of two thirds.

The leadership in Mexico by the middle of the 1980's was faced with the prospects of a continuing stagnant economy with the potential for further declines in per capita incomes. The situation was ripe for a change in policy and that is, indeed, what happened.

2. STRUCTURAL REFORM AND ECONOMIC GROWTH

Before discussing the specific reform program undertaken by the Salinas government, a more fundamental issue is worth addressing: what can a government do to significantly alter its growth path. In a profound sense, that is exactly what the Salinas government is attempting to do.4

Based on the Lucas (1988) and Romer (1990) arguments,5 governments which focus on overcoming the negative externalities of market failures induce higher growth rates than governments which try to control market processes by directly intervening in markets. A strong case could be made that not only do governments which focus on direct market interventions reduce potential growth by not focusing on public investments, but that also such interventions lead to inefficient outcomes because government policy restricts economic behavior which would otherwise lead to higher production for a given set of resources. Thus the potential benefits from policy reform is two fold: improvements in efficiency and increases in economic growth rates.

Import substitution policies tend to be associated with direct market interventions by the government whereas outward looking policies promote government policies focusing on market failure. This is not by accident. Inward policies are most easily maintained by controlling access to foreign exchange and markets. Thus, characteristic of such economies are high tariff walls, import licensing, and state trading monopolies. The movement to outward orientation involves free trade which does not permit any of these interventions. Furthermore, the control of economic activity through high trade barriers encourages inefficient investment and loss of economic opportunity which reduces the rate of investment and often results in capital flight. Thus, credit controls also tend to go along with inward oriented policies.

A structural reform program whose purpose is to remove the government barriers to growth would tend to be characterized by a free trade regime, a free investment regime, and removal of artificial government constraints to market activities. Substantial benefits can be achieved just from reducing the negatives.6 On the positive side, however, the refocusing of government policy on overcoming areas of market failure can also have substantial benefits. Transportation, communication, information, education, public research and development and public extension are clear areas requiring government investments.

The mentioned endogenous growth literature suggests that optimal growth rates are
obtained when the private and public returns to investments are equal, effectively, a situation where investments flow to the activities with the highest private and public returns. Since market interventions entail control of foreign exchange and finance, the freeing up of these sectors is a major element of any reform process.

Using this basic criteria, we can begin to assess the process of reform and international negotiations against a stated objective of using the tools of economic policy to liberalize the Mexican economy so that rapid growth and development could occur.

3. REFORM OF THE MEXICAN ECONOMY

Mexican officials declare that the decision to change the policy course was initiated in 1985. It is apparent that by 1986, the first major step of reform had been taken when Mexico joined the GATT and thereby agreed to moderate its trade policies. But other reforms were also instituted. These include foreign investment, monetary policy, and sectoral or structured reforms.

3.1 Mexican Trade Liberalization

Under the conditions for joining the GATT, Mexico agreed to a maximum bound tariff of 50 percent. In addition, they agreed to remove all licenses on imports. In practice, although they have substantially reduced import barriers, some significant barriers remain.

Virtually all imports were subject to import licenses in 1982. Only two percent of imported items were subject to licenses at the end of 1989. Although current plans call for a total elimination of import licenses over the next five years, the remaining licenses are on the most sensitive products where it will be the most difficult to remove current restrictions. For instance, licensing requirements still remain on key food staples, corn and dry beans, which are also the two most important agricultural import commodities to both the Mexicans and U.S. agriculture. Although the number of licenses has been dramatically reduced in line item terms, the remaining licensed items still represent approximately 40 percent of agricultural imports in value terms.

Average tariff rates in 1982 were 85 percent. Maximum tariff rates are currently 20 percent and average rates are under 10 percent. Foreign exchange is also unrestricted thus eliminating an additional import barrier.

The reduction of trade constraints has resulted over the last several years in substantial increases in both imports from and exports to Mexico. The projected growth in income from the change in policy posture is also likely to bring substantial increases in demand for U.S. products in the future including large growth in food grain, feed grain and livestock exports to Mexico. The growth in income and the continuation of existing reforms into the future is, however, predicated on the assumption that the Free Trade Agreement and other means of institutionalizing the reforms will be realized.

3.2 Liberalization of Direct Foreign Investment Rules

One of the most important changes in regulations has been to encourage direct foreign investment. The objective of the 1989 reform was to match the open trade environment with an open investment climate. The transaction costs associated with foreign investment
was sharply reduced and more areas were opened to foreign investment without the requirement of prior approval.

Benefits from encouraging foreign investment are immediate: the current account deficit can be financed by private investment flows, rather than government borrowing. Thus, inflationary pressures are again reduced, and an automatic stabilizing mechanism comes into play—foreign investment now means more exports later. We can expect flows of goods to service private debt, rather than flows of international borrowing to service publicly-guaranteed debt.

The Mexican government recognized that direct foreign investment is a substitute for foreign debt, but with several distinct advantages. There are no explicit repayment requirements. The risk is largely transferred abroad. Investment is specific to enterprises that promise to produce an excess of social value.

The new regulations specify that two-thirds of all business activities require no prior approval. These include projects which are outside of major cities, consist of investment funds from abroad, and will not lead to a net outflow of funds from Mexico in the first three years of the operation. Foreign ownership and investment in Mexican companies is subject to the same criteria. Otherwise, the project must be approved by the National Foreign Investment Commission within 45 working days of when the application was submitted. Failure to act within 45 days means that the project is automatically approved. Foreign investments in agricultural are activities that needs specific approval. However, although there are restrictions on land ownership, a foreign-owned company can own land through trusts.

The objective of the Mexican government is to double the level of direct foreign investment by 1994 or to obtain a total of $60 billion between 1989 and 1995. Registered investment in 1990 was $4.4 billion, double the level of 1989. The sectoral composition of the investment (expressed in percent) is divided as follows: industrial (58), service (35), commerce (6.4), finance (2.3), mining (1.6), and agriculture (0.4). The United States provided 63 percent. Germany and the UK have approximately 6 percent each. Japan has 4.7 percent followed by France (4.3) and Switzerland (4.2). The director of the National Foreign Investment Commission gave an informal guesstimate that an FTA would lead to an additional 33 percent in direct foreign investment per year.9

Associated with reform of foreign investment policy, are arrangements for increased technology transfer. New laws provide for increased protection regarding the ownership of intellectual property rights. This relates to franchise licensing and patent protection.

3.3 Shift in Macroeconomic Policies

To accommodate the change in the economic climate, a significant shift in economic philosophy took place. Fundamental to this shift is a realignment from a state-controlled to a competitive economy, led by the mentioned emphasis on international trade and investment. There are two key sets of macroeconomic indicators that point to this change. First, the rate of inflation has been sharply reduced. Second, the external debt burden has been substantially reduced permitting the fight against inflation to be fought at a lower cost.

The reduction in inflation is the most valuable sign that the future is playing a more important role than the present in economic policy making. Fiscal policy and monetary policy in Mexico are not independent. Excessive government spending always involves
borrowing from future generations. In Mexico this is accomplished by money creation. Thus, the cost of weighing the present more heavily than the future is seen immediately in inflation. When the fiscal deficit rose to 16 percent of GDP in 1987, inflation surged to over 160 percent. The decline in government borrowing, to 3.5 percent of GDP in 1990, puts much less pressure on the monetary authorities.\textsuperscript{10}

Inflation may also be controlled by exchange rate policy. Mexico has slowed the rate of depreciation of the peso against the dollar to less than five percent per year by the use of a preannounced crawling peg (depreciating by 40 centavos per day). The long term objective is to stabilize the peso and dollar exchange rate once the inflation rate achieves the 6 percent current target. This means that the central bank, the Bank of Mexico, may expand its money supply only in accordance with monetary policy in the United States.\textsuperscript{11} Inflation in Mexico will then partly depend on inflation in the United States. During the last period of fixed exchange rates, between 1971 and 1976, Mexico had the lowest average rates of inflation in the past 20 years. The 1980's saw the peso alternately undervalued and then overvalued, making planning and contracting very difficult.

Inflation may also be controlled by increasing competition. The Mexican government has increased competition in three ways; by eliminating monopolies (in the form of state-owned enterprises), by opening Mexico to foreign competition, and by eliminating regulations which tended to stifle competition.\textsuperscript{12}

The decision to privatize many government enterprises has had two further benefits for fiscal policy. First, subsidies to government-owned enterprises have been reduced to half. Second, revenues from the sale of government-owned businesses have been placed in a "stabilization fund" to both reduce debt and as a hedge against future uncertainties. This fund currently is in excess of $4 billion.

This fundamental change in philosophy regarding inflation is one way of explaining many of the changes instituted in policy in Mexico since December of 1987. Inflation leads to the inefficient use of resources—investment declines as agents search for ways to hedge against price increases, savings disappear, capital flees, and wages are eroded. Innovation and entrepreneurship are channeled into unproductive activities.

The reduction of Mexico's foreign debt in 1989, under the auspices of the Brady plan, has had a substantial impact on the conduct of fiscal and monetary policy, the investment climate, and outlook for the economy. Total external debt fell from $101 billion at the beginning of 1989 to $87.5 billion by the end of 1990 (Table 3). The result has been a fall in the debt to GDP ratio from 59 percent in 1988 to 39 percent in 1990, a significant 20 percent in just two years. More of Mexico's output can now be used for investment, rather

\begin{table}[h]
\centering
\caption{Selected External Debt Indicators}
\begin{tabular}{lcccccccc}
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\hline
\textit{Billion dollars}\textit{ } &  &  &  &  &  &  &  \\
Total foreign debt & 96.7 & 101.0 & 107.5 & 100.9 & 95.1 & 87.5 & 89.2 \\
Debt service payments & 15.3 & 11.5 & 12.8 & 13.9 & 13.4 & 11.9 & 12.1 \\
\hline
\textit{Percent}\textit{ } &  &  &  &  &  &  &  \\
Debt/GDP & 63.3 & 81.0 & 78.0 & 58.8 & 47.8 & 38.7 & 34.0 \\
Debt service/GDP & 10.0 & 9.2 & 9.3 & 8.1 & 6.7 & 5.2 & 4.6 \\
Debt/total exports & 324.9 & 426.3 & 359.4 & 315.3 & 264.8 & 221.7 & 200.8 \\
Debt service/total exports & 51.4 & 48.6 & 42.8 & 43.4 & 37.3 & 30.1 & 27.3 \\
\hline
\end{tabular}
\end{table}
than paying for past borrowing. The Brady plan for Mexico has increased the optimism of investors, consumers, and government officials in that country.

The most important benefit of the debt reduction has been the lowering of current obligations. Debt repayments took one-half of all export earnings as recently as 1986, and over 45 percent as of December 1987. However, that ratio declined to below 30 percent in 1990 and should be near 25 percent in 1991. The net outflow of resources was six percent of GDP between 1982 and 1988, but is now slightly over two percent. At six percent, the reward for resources producing $100 of income was only $94. Viewed this way, the debt burden was a real drain on economic incentives.

Debt service payments displace investment on an almost dollar for dollar basis. Thus, the decline in repayment obligations is critical for sustaining and expanding capital inflows into Mexico. Moody's investment services, in December 1990, rated Mexico's foreign currency debt at Baa, the first rating issued since August of 1982. This means, for the first time since 1982, that Mexico has the potential for borrowing on the international commercial market.

Debt service on guaranteed debt also competes with other fiscal obligations. This may prove inflationary. The reduction in current repayments is thus an important element in the fight against inflation. The reduction in inflation therefore involves many aspects of a move away from "state" control to market mechanisms. Monetary policy depends solely on external accounts. Fiscal policy has been placed on a sound footing of budgetary balance. Credit policy is dictated by the private sector, rather than by government needs.

3.4 Structural Reforms

Along with the substantial changes in policy posture has been a radical structural reforms program. In addition to the move toward a more open economy with the reduction of trade barriers, and the redefinition of direct foreign investment rules, the structural reform program includes the divestiture of public enterprises, and the deregulation and reregulation of other critical sectors such as transportation and finance.

There were 1,155 public enterprises in Mexico in 1982. About 425 remained as of the end of 1990, with another 200 scheduled to be either divested or liquidated. These government divestitures include government-owned hotel chains, sugar refineries, steel mills, insurance companies, TELMEX, some banks and other companies. Transfers to support public enterprises have been reduced by half, and will decline further in 1991. Further divestitures are becoming increasing difficult, although divestiture of nationalized banks, a large insurance company, steel mills, fertilizer plants, a railroad manufacturing company, and the national airlines are being planned. The national petroleum company (PEMEX) will remain a part of the government; it contributes about 20 percent of total government revenue.

Deregulation and reregulation is viewed as, perhaps, the single most important element of the reform program. Major reforms in regulations have been instituted in banking and finance, transportation, insurance, packaging, customs, petrochemicals, sugar, cocoa, and direct foreign investment. It was asserted by one senior Mexican official that the improvement in efficiency generated by deregulation was the single most important explanation for the reinvestment and growth in Mexican economy at a time when substantial contraction in government expenditures was being undertaken. The freeing of many formerly regulated prices is viewed as largely responsible for the one-time jump in inflation in 1990.
There has also been a significant liberalization of the regulation of banks and other financial institutions. The government, prior to 1988, dictated loan portfolios, interest rates, and liquidity requirements. Banks were used as a means of raising capital for the government via increasing reserve requirements at the central bank whenever new government financing was needed. As a result, there was little private financial intermediation.

Interest rates have now been largely freed. Lending is by discretion rather than by government rules. Reserve requirements have now been fixed at 30 percent of deposits rather than changed arbitrarily. Banks will soon be completely privatized.

Several important consequences of the deregulation process are evident. There has been a substantial increase in the flow of savings into financial institutions (29 percent in 1989 and a further 13.5 percent in 1990). This was associated with the freeing up of interest rates and the movement to very high real rates of returns from previously controlled rates at negative real returns (Table 1). Consequently, credit to the private sector has increased dramatically in real terms (by 67 percent in 1989 over 1988 and a further 28 percent in 1990). Increased private credit demand has allowed private investment to largely replace government investment, and has encouraged capital inflows.

The substitution of private for government investment frees the government to concentrate on infrastructure. The government is expected to increase expenditures on education, health, transportation, and communication while, at the same time, decreasing transfers to public enterprises.

Several issues are particularly important to the implementation of the structural change process. Transport costs are much higher than in the United States or Canada, largely a product of the inefficient transportation system. The solution to this has involved the deregulation of inland transport and port facilities, as well as increased public investment.

One question that immediately arises is whether the most affected interest groups have had a chance to protest deregulation and restructuring. The largest group, government workers (including those in newly-privatized industries) may well benefit from policy changes. The Mexican solution, for those who may object, is to unilaterally make changes without consultation with affected parties, then let results build a new clientele for liberalized policies. This is an important way to institutionalize change which may be partially unique to the Mexican political system.

4. MEXICO AND THE NAFTA

Mexico has thus travelled a rocky road from the boom days of the 1970's through the difficult 1980's and responded by instituting major reforms. One way of viewing this is to understand the reform process as a political response to a situation in which the ruling Institutional Revolutionary Party was seeing its support being undermined by the depressed economic conditions. But why did Salinas feel that entering into a NAFTA would also make sense at this juncture?

Since U.S. barriers to Mexican trade are already fairly modest, one would not expect great trade benefits from reducing modest barriers. Furthermore, since in a real sense, the bulk of the Mexican reforms have already been put in place, further benefits from reforms are also modest. What then are the reasons why Mexico wants to pursue the NAFTA?

The answer to this lies in two directions. The first involves the dynamics of growth while the second involves politics. The major benefit which Mexico hopes to achieve by
the NAFTA is to increase the flow of real investment into Mexico. Since the United States is the dominant investor accounting for more than 65% of Mexican direct foreign investment, it makes sense to focus increases on the United States through an agreement such as the NAFTA. The second major reason for the NAFTA is political. The reforms which has been put in place are dramatic and radical. Under the Mexican election law, Salinas can only serve one five year term. How can he be sure that the reforms implemented by him will not be undermined by the next administration?

Mexico has had a tradition of adhering to international treaties. By locking the reforms into international agreement such as the NAFTA, and the GATT, Salinas will make it more difficult for the next administration to go back into the old mold of inward orientation and special interest rent seeking. In this way a NAFTA serves the purpose to insuring a continuation of the reform process into the next century.

5. CONCLUSION

The recent history of Mexico demonstrates the relationship between policy change and economic necessity. Global events, poorly formed policies, and misuse of international borrowing combined to place Mexico in an unacceptable long term outlook. The economy faced long term stagnation, declining per capita incomes and poor prospects for change. The weak economic situation was undermining the confidence in the ruling Institutional Revolutionary Party. Faced with this bleak outlook, Mexicans were fortunate to have political leadership that was prepared to make the dramatic decisions to change the course of the future.

Mexican structural reform cannot be viewed in isolation. Conditions were right for change. The body of economic development analysis had amassed an impressive array of evidence that inward oriented policies were clearly inferior to outward oriented one. One country after another were implementing radical reforms from the planned systems of Eastern and Central Europe to developing countries in Latin America and Africa.

Not all of the reforms will prove equally successful. The key difference between future success and failure is understanding and commitment. Salinas, a Harvard Ph.D, was the right man at the right time. He has boldly altered Mexico's economic path. Preliminary results are encouraging, but only future events will really prove whether the process of reform will be sustained.

Acknowledgment: The views expressed are the author's alone and do not necessarily represent those of his agency.

NOTES

1. The agreement was called the “Framework of Principles and Procedures for Consultation Regarding Trade and Investment Relations.”

2. The restrictions on agriculture were even more stringent than for manufacturing. The constitution prohibits land ownership by non-Mexicans within a wide band of area within Mexico.

3. For a more complete exposition of the Third World debt crisis see Shane and Stallings (1984 and 1987).
4. There is a growing body of literature which looks at the related issue of how to explain the very large differences in growth between countries. This literature is characterized by an attempt to develop growth models which will allow for substantial growth rate differences. Several central articles in this literature include "On the Mechanics of Economic Development" by Robert Lucas (1988), and "Endogenous Technical Change" by Paul Romer (1990).

5. Both Lucas and Romer limit themselves to narrow basis for changes in growth rates. In the Lucas case, increasing returns from learning by doing, while in Romer's example, increasing returns are realized by technical change having a design characteristic which allows it to be utilized fully in all production processes once the design is completed. The discussion here focuses on a more general process of how governments can induce increasing returns to evolve in an economy.

6. Chinese growth in the mid to late 1980's is an example of this. When the prohibition of private land management and crop specification was removed, agricultural output doubled within a few years.

7. This was told to the author by various Mexican government officials in the Mexican Ministry of Finance during an official visit to Mexico City in April 1991.

8. Arbitrage will also ensure convergence between the "official rate" and a floating market rate. Differences will reflect only transaction costs.

9. Told at a seminar for the United States and Canadian delegation for exchange of information and data for the upcoming NAFTA in Mexico City in April 1991.

10. There is evidence that the government deficit as a percent of GDP was below two percent in 1991.

11. When the rate of devaluation rises, inflation increases. A fixed exchange rate (where the rate of exchange is zero, such as between 1971 and mid-1976) means that the central bank must reduce the money supply if there is an overall balance-of-payments deficit. Thus, money supply growth is governed by external balance.

12. The Mexicans had strict regulations of overland transport and it was not uncommon for them to grant a monopoly to one company on a route from one city to another and a different monopoly on the return route.

13. See page 11, for a further discussion of privatization.


15. Krueger (1990), Roe (1992) among others suggest that policy reform should entail the selection of policy instruments and institutional arrangements (such as NAFTA) that decreases the incentives of special interest groups to rent seek, and thus assist in preventing a return to the old policy regime once an economic crises is resolved.

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