A Review of Mexico's Trade Policy from 1982 to 1994

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1. INTRODUCTION

FROM the early 1950s until the early 1980s Mexico, like many other developing nations, employed a growth strategy based on import substitution. Relying on protection from the world economy and government intervention in the domestic economy, this strategy encouraged investment in industry, suppressed agricultural prices (at least until the mid 1970s), and expanded government enterprises. Following its debt crisis in 1982, Mexico began to change course. Starting in 1985, under then President Miguel de la Madrid Hurtado, Mexico initiated a policy of openness (*apertura* in Spanish) to the rest of the world. In 1986 it acceded to the General Agreement on Tariffs and Trade (GATT), and in 1994, together with Canada and the United States, it formed the North American Free Trade Area.

Over the past decade Mexico has restructured its economy dramatically, cutting inflation sharply, privatising most government enterprises, deregulating domestic commerce, and eliminating barriers to foreign trade and investment. The successes of Mexican economic policy in recent years resulted in popularity for the ruling political party at home and respect and emulation abroad. Like a bucket of cold water over the head, however, the Mexican financial crisis of December 1994–February 1995 has caused most observers of — and participants in — the Mexican economy to stop and re-evaluate, not only the perceived successes of recent Mexican economic policy, but the policy itself.

During the 1988 Montreal midtern review of the Uruguay Round of the GATT, the contracting parties established, on a trial basis, a Trade Policy Review Mechanism. The trade policies of intermediate size nations like Mexico are reviewed every four years. This paper is a report on the Trade Policy Review (TPR) of Mexico, a review that was put together during 1992 and the beginning of 1993. The 1993 TPR did a good and balanced job of summarising and analysing Mexico's trade policy, in the context of its more general economic

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policy, during the period 1982–92. Events in Mexico in 1994 and early 1995 make even a critical assessment of the TPR a sterile undertaking for both the author and the informed reader. Consequently, this paper will do more than summarise and assess the review; it will also provide a critical history of the events leading up to the 1994–95 financial crisis and attempt to draw lessons from the experience gained during the crisis.

In one sense analysing the TPR — and with it Mexican trade policy — jointly with the 1994–95 financial crisis is easy, and in another sense it is hard. On the one hand, mistakes in policy are easy to identify after a crisis has occurred. Policy judgements involve calculated risks, and poor judgements are far easier to identify if there is a run of bad luck than if there is not. On the other hand, it is difficult to draw lessons from experience before the dust has settled and the debris cleared away.

The tentative conclusions of this paper — that presage a second TPR on Mexico in 1997— are that Mexico's trade and foreign investment policies from 1985 through 1993 were fundamentally sound. In 1994, however, faced with political instability, rising US interest rates, upcoming elections, and falling foreign investment, the administration of then President Carlos Salinas de Gortari made two decisions that later events proved unwise. First, it allowed the Mexican peso only a small devaluation (a nominal 12 per cent) against the US dollar, and in maintaining the value of the peso it lost much of Mexico's foreign reserves. Second, as the Salinas administration refinanced Mexico's government debt during 1994, it allowed the debt to become mostly short-term and dollar-indexed. The combination of these two policy decisions left Mexico open to a speculative attack, when investors realised that the *Banco de México* did not have enough reserves to continue supporting the peso, and, shortly afterwards and perhaps even worse, a bank-run situation, when bond holders realised that the *Banco de México* might not have enough reserves to meet the payments coming due on the dollar-indexed debt.

It is easy to identify these policy mistakes now. Yet they are related to longer term Mexican economic policies that, at least until 1994, seemed spectacularly successful: using the exchange rate as a nominal anchor in the anti-inflation programme by tying its value closely to that of the dollar and opening Mexico, not only to foreign direct investment, but to substantial portfolio investment. The financial crisis in Mexico calls both of these policies into serious question. The debate over the extent to which the combination of these two policies was to blame for the recent financial crisis is sure to continue for years both in Mexico and abroad. The verdict of this paper is mixed. Something like an exchange rate anchor was an effective policy instrument in 1987 when the economy was in danger of hyper-inflation and was relatively closed to foreign investment. As inflation fell and the economy opened itself to foreign investment, however, this policy became riskier in the face of volatile foreign investment.

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One explanation of the crisis proposed by, among others, Dornbusch and Werner (1994) is, simply, that the Mexican peso was overvalued against the US dollar in 1994. The simple solution in terms of this simple explanation was a large devaluation. As Calvo (1994) has pointed out, however, this explanation of the problem and proposed solution to it are overly simplistic in that they ignore the effect that a devaluation would have on the credibility of Mexican policy makers and the impact that the loss of credibility following a devaluation would have on foreign investment. Subsequent events have painfully shown Calvo to be right.

It would have been difficult for the 1993 TPR to have foreseen the 1994–95 financial crisis. Hindsight allows us to see aspects of Mexican policy that could have been subject to more criticism, however. Principal among them is the way in which the Mexican government published data related to its international financial position — in particular, its foreign reserves and the composition of its debt — that is, with significant delay and, in the case of reserves, aggregated into monthly or quarterly, rather than daily, averages. The atmosphere of secrecy and rumour that surrounded the Mexican government's international financial position in 1994 contributed to the crisis.

2. A BRIEF ECONOMIC HISTORY 1970–1994

The import substitution strategy for development, once widely accepted by policy makers in developing countries and by a significant number of academic economists, has been so thoroughly rejected over the past ten years that it now seems absurd. It is important to remember, however, that at least in its early stages this strategy had some notable successes. Mexico was one of them. Between 1960 and 1981 Mexico experienced an average increase of real GDP of 7.0 per cent per year; even with the high rate of population growth in Mexico over that period, this translated into an average increase of GDP per capita of 4.0 per cent per year. (Unless explicitly stated otherwise, all real GDP figures are based on the purchasing-power-parity indices produced by Summers, Heston, Aten, and Nuxoll, 1995, and described by Summers and Heston, 1991).

During the *sexenios* (six year periods of presidential administrations) of Luis Echeverría Alvarez (1970–1976) and José López Portillo (1976–1982), however, the import substitution strategy began to unravel. As the 1993 TPR explains, partly in response to social and political tensions and partly because of a sense of increased prosperity resulting from the discovery of large oil reserves, the Echeverría and López Portillo administrations both followed policies of deficit spending and monetary expansion financed by public sector borrowing from international banks. The result of this policy was rising inflation, which together with a fixed nominal exchange rate led to substantial real exchange rate

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appreciation and growing current account deficits. At the end of each of the two administrations there was large devaluation: a devaluation of 60 per cent in late 1976, which was the first devaluation in Mexico since 1954, and a devaluation of 368 per cent in late 1982, which was followed by further devaluation over the next five years. In spite of massive economic imbalances during the Echeverría and López Portillo *sexenios*, the Mexican economy continued to grow, however, averaging a growth rate of real GDP of 6.2 per cent over 1970–82 (see Table 1).

In 1982, the Mexican import substitution strategy, and the Mexican economy with it, ran into a wall. Faced with a massive public debt owed to foreign banks, international interest rates that were rising sharply due to US monetary policy, and international oil prices that were falling due to the worldwide recession, Mexico found itself unable to meet its debt service obligations. In the final months of the López Portillo administration the government announced that it

TABLE 1
Major Mexican Economic Indicators 1970–1992

	Population[1]	*GDP*[2]	*GDP/Capita*[3]	*Exchange Rate*[4]	*Inflation*[5]
1970	50.3	200.4	3985	12.5	4.8
1971	52.0	218.9	4211	12.5	5.2
1972	53.7	236.4	4403	12.5	5.5
1973	55.4	255.5	4609	12.5	21.3
1974	57.2	273.4	4783	12.5	20.7
1975	58.9	290.1	4928	12.5	11.2
1976	60.6	301.2	4974	15.4	25.8
1977	62.2	305.0	4902	22.6	22.0
1978	63.8	332.5	5209	22.8	16.2
1979	65.4	367.9	5621	22.8	20.0
1980	67.0	405.7	6051	23.0	29.7
1981	68.6	443.6	6463	24.5	28.7
1982	70.2	417.2	5941	56.4	98.9
1983	71.8	387.7	5400	120.1	80.8
1984	73.3	405.0	5524	167.8	59.2
1985	74.8	420.3	5621	256.9	63.7
1986	76.2	402.4	5283	611.8	105.7
1987	77.6	408.0	5260	1378	159.2
1988	78.9	422.1	5347	2273	51.7
1989	80.3	447.0	5566	2461	19.7
1990	81.7	476.0	5825	2813	29.8
1991	83.3	501.1	6015	3018	18.8
1992	85.0	531.0	6250	3095	11.9

Notes:
[1] Millions.
[2] Purchasing-power-parity, Laspeyres index; billion 1985 US dollars.
[3] Purchasing-power-parity, Laspeyres index; 1985 US dollars.
[4] Yearly average; (old) pesos per dollar.
[5] Change in Consumer Price Index December to December.

Sources: Summers, Heston, Aten and Nuxoll (1995) and Banco de Mexico.

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TABLE 2
Major Mexican Trade Indicators 1981–1994
(Billions of US Dollars)

	Gross Domestic Product	*Exports*	*Export Share Per cent Petroleum*	*Imports*	*External Debt*
1981	174.4	20.1	72.5	25.0	74.9
1982	170.5	21.2	77.6	15.0	86.7
1983	148.7	22.3	71.8	9.0	89.8
1984	175.6	24.2	68.6	12.2	96.4
1985	184.4	21.6	68.2	14.5	96.6
1986	129.5	16.2	39.0	12.4	101.0
1987	141.0	20.5	42.1	13.3	107.4
1988	172.9	20.5	32.7	20.3	100.9
1989	205.3	22.8	34.5	25.4	96.4
1990	241.8	26.8	37.6	31.3	98.2
1991	283.0	26.9	30.1	38.2	104.3
1992	327.6	27.5	30.2	48.2	116.6
1993	362.6	30.0	24.7	48.9	117.6
1994	355.8	34.6	21.4	58.9	130.2

Sources: GATT, *Trade Policy Review: Mexico 1993* and IMF, *International Financial Statistics*, various issues.

could not meet its obligations, the peso collapsed, the government nationalised banks, tight exchange controls were implemented, and the economy fell into deep recession. From 1981 to 1987 real GDP declined on average by 1.4 per cent per year and real GDP per capita declined by 3.4 per cent per year.

In late 1982 under newly elected President Miguel de la Madrid Hurtado, Mexico started on the long road to recovery. Because the Mexican government wanted to generate large trade surpluses quickly so that it could resume payments on its debt, restrictions on imports were initially tightened, and Mexico became even more closed: during 1982 and 1983 all Mexican imports required import licences, and imports fell from USD 25.0 billion in 1981 to USD 9.0 billion in 1983 (see Table 2).

The 1993 TPR employs the Organisation for Economic Cooperation and Development's (1992) division of the years 1982–91 into three distinct periods: a 1983–85 period of tight fiscal policy that saw modest reductions in inflation and the beginnings of resumption of growth; a 1985–87 period that saw a relapse into financial crisis, rapidly rising inflation, and falling output; and a 1987– period — which we will extend until the end of 1993 — that saw rapidly falling inflation and the resumption of economic growth. In addition, we will add a fourth period, 1994 and the first months of 1995, which constitute the events heading up to the recent financial crisis and the crisis itself.

During the 1983–85 period, with financial support from the International Monetary Fund, the de la Madrid administration implemented a series of policies

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designed to cut the public sector deficit and to turn the large trade deficit into a surplus. These policies included reductions in government expenditures, increases in taxes, increases in the prices of public services, elimination of many subsidies, and the closure of some public sector enterprises. Foreign trade and investment policies included the enforcement of licence requirements for all imports; the abolition of exchange controls, although a dual exchange rate was maintained; and, following a large nominal devaluation of the peso, the institution of a crawling peg against the dollar. Although this economic programme was successful in turning the trade deficit into a surplus and — more modestly — in lowering inflation and in raising GDP, it collapsed in late 1985: fiscal discipline began to falter, IMF funding ended, the earthquake in Mexico City caused disruption and imposed significant costs, and international oil prices started on a steep decline that was to continue into 1986 and 1987.

The 1985–87 period was one of falling output and accelerating inflation. It was during this period, however, that Mexico began some of the policy reforms crucial in the return to prosperity during the 1987–93 period. Specifically, the de la Madrid administration began the process of *apertura* — of opening Mexico to foreign trade and investment — and, starting in 1986, Mexico benefited first from the Baker Plan and later the Brady Plan for restructuring its debt.

The central feature of the 1987–93 recovery was a series of social pacts — generically referred to as the *Pacto* — negotiated by representatives of government, business and labour. The first version of the *Pacto*, the *Pacto de Solidáridad Económica*, was implemented in December 1987, during the de la Madrid *sexenio*. (The 1993 TPR mistakenly places this event during the Salinas *sexenio*, 1988–94). Subsequent versions of the *Pacto* have continued in force throughout the Salinas *sexenio* and, until 9 March, 1995, when the government announced an economic programme not officially backed by business and labour, during that of Ernesto Zedillo Ponce de Léon (1994–2000).

Under the *Pacto*, government, business, and labour leaders met unannounced, after financial markets closed for the day, and before markets opened the next day a new agreement was presented to the public. Policies enacted under the *Pacto* system included establishing the Solidarity Programme (*Programa Nacional de Solidaridad* or PRONASOL), a social welfare programme targeted at the poor; setting increases in the minimum wage, a wage level to which many labour contracts were then indexed; decreasing the value-added tax as improved law enforcement led to increased revenues from income taxes; controlling the increase in public sector prices, which became less important as the number of such prices was reduced by privatisation and the elimination of subsidies; and, under later versions, the issuance of guidelines for wage and price increases. Probably the most important elements of the *Pacto*, however, were those related to foreign trade policy: reductions in tariffs and commitments on the amount that the peso would be allowed to move against the dollar. Under some versions of the

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Pacto the exchange rate was fixed, and under others a maximum daily devaluation was set.

The policies associated with the *Pacto* were successful in reducing inflation from an annual rate of 159.2 per cent in consumer prices in 1987 to 7.1 per cent in 1994. Furthermore, between 1987 and 1994, real GDP in pesos rose by 23.1 per cent, after having fallen by 8.0 per cent between 1981 and 1987, and real wages rose by 19.4 per cent, after having fallen by 30.0 per cent between 1981 and 1987.[1] Trade liberalisation and the nominal exchange rate anchor played major roles in establishing the credibility of the government's commitment to low inflation — credibility with its *Pacto* partners, with the Mexican public, and with foreign investors.

3. *LA APERTURA*

Between 1982 and 1994 Mexico went from being a relatively closed economy, even by developing countries' standards, to being one of the most open in the world. In 1982 tariffs were as high as 100 per cent, and there was substantial dispersion in tariff rates; licences were required for importing any good; and, as a general rule, foreigners were restricted to no more than 49 per cent ownership of Mexican enterprises. By 1994 the maximum tariff had been cut to 20 per cent, and the tariff code had been substantially simplified; import licences had been eliminated for 89 per cent of imports; and restrictions on foreign investment had been effectively eliminated for most industries and substantially reduced for many others.

As the 1993 TPR points out, in 1982–83 import licences, not tariffs, were Mexico's most significant trade barrier. Starting in late 1983, the de la Madrid administration began to replace quantitative restrictions with tariffs. The portion of tariff items subject to licence requirements fell from 100 per cent in 1983 to 65 per cent in 1984. The process accelerated in 1985, as this percentage fell to 10 per cent. By 1992 this percentage was 2 per cent. Even so, the portion of the value of imports subject to licence requirements fell more slowly: from 100 per cent in 1983 to 83 per cent in 1984, to 35 per cent in 1985, to 11 per cent in 1992. Import licences are still required for crude petroleum products, some basic agricultural and agro-industrial commodities, and for the automotive industry, although even here they are being phased out.

As import licences were replaced by tariffs as the principal tool of trade policy, average tariffs initially rose and then fell: the simple average of tariff lines went

[1] Data have been pieced together from various issues of IMF *International Financial Statistics* and the *Economist*; in terms of the purchasing-power-parity GDP data, real GDP rose by 30.1 per cent between 1987 and 1992 — the latest year for which such data are available — after falling by 8.1 per cent between 1981 and 1987.

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from 23.2 per cent in 1983 to 23.3 per cent in 1984, to 25.4 per cent in 1985, to 13.1 per cent in 1992; the trade-weighted average tariff went from 8.0 per cent in 1983 to 8.5 per cent in 1984, to 13.3 per cent in 1984, to 11.1 per cent in 1992.

Equally significant with the changes in average tariff rates during the *apertura* was the simplification of the tariff schedule. The number of tariff rates was 16, with a maximum rate of 100 per cent, in 1982. The number of tariff rates fell to 13 in 1983, to 11 in 1986, and to 5 in 1987, where it currently remains. The maximum tariff fell to 45 per cent in 1986 and to 20 per cent in 1987. The dispersion of tariff rates (defined as the standard deviation of rates divided by the average rate) fell from 22.5 per cent in 1984 to 4.5 per cent in 1992 in terms of number of tariff items and from 11.9 per cent in 1984 to 6.7 per cent in 1992 in terms of trade-weighted tariff items. By 1992, for example, 48.9 per cent of Mexico's tariff items — accounting for 36.5 per cent of Mexico's imports — were subject to the 10 per cent tariff rate.

The impact of the unilateral reductions in Mexican trade barriers can be seen in the trade figures presented in Table 2. Notice the steady increase in exports starting in 1987 and the even more pronounced increase in imports from the low levels following the 1982 debt crisis.

The elimination of licence requirements and the simplification of the tariff schedule from 1983 to 1992 were major steps in making Mexican trade policy less protective and more transparent. These steps were accompanied by a number of other significant policies: Mexico acceded to the GATT in 1986, adopting the Harmonised Commodity Description and Coding System in 1987. In 1991 the 1985 Law on Procurement was modified to allow more foreign bidding on government procurement, although the law still recommends a preference for domestic suppliers. In connection with its accession to GATT, Mexico adopted a Foreign Trade Law in 1986 and the GATT Anti-Dumping Code in 1987, which allowed its Ministry of Trade and Industrial Promotion (*Secretaria de Comercio y Fomento Industrial* or SECOFI) to implement anti-dumping and countervailing duty provisions. While the Mexican government has made some use of these measures, especially against US, Brazilian and Chinese exporters, Mexican trade officials continually express distaste for them, and Mexican trade negotiators favour their elimination in GATT or greater restrictions on their use.

A significant change in Mexican policy that is only briefly discussed in the 1993 TPR is the 1992 agricultural reform. The 1917 Mexican Constitution had formalised the *ejido* system of community property rights in much of the agricultural sector. Under this system, which dates back to pre-Hispanic times in some areas, the *ejidatario* — the individual member of the *ejido* — had a right to work a specific plot of community land, but not to sell it, to use it as collateral in obtaining loans, or to rent it out. Furthermore, the maximum size of individual plots was tightly restricted. A substantial segment of the Mexican population are *ejidatarios*, mostly living in poverty, working small plots of rain-fed land in the

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Southern and Central parts of Mexico, and cultivating maize. A change in the Mexican Constitution in 1992 allows the *ejidatario* the option of becoming the owner of the plot that he cultivates or of remaining part of the *ejido* system. Land can now be sold, used as collateral, or rented out. Restrictions on foreign investment in the agricultural sector are being gradually lifted. This agricultural reform, although not part of Mexican trade policy *per se*, is likely to have a major impact on Mexican trade patterns and on the Mexican economy in general, as many *ejidatarios* migrate off their lands, and crops are shifted away from maize.

Two other significant aspects of Mexican trade policy during the *apertura* were its negotiation of regional free trade agreements, especially NAFTA, and its reduction in barriers to capital flows. The changes in these two sets of policies and their impacts on the Mexican economy are discussed in the next two sections.

4. TRADE PATTERNS AND TRADE AGREEMENTS

During the *apertura* the size and composition of Mexico's foreign trade changed significantly, as Table 2 illustrates: exports grew, imports grew even more, and petroleum became less important an export as its relative price fell and manufacturing exports expanded. The reliance of Mexico on trade with the United States became even more pronounced over this period, going from 56 per cent of Mexico's trade in 1982 to 70 per cent in 1992.

Table 3 shows the composition of Mexico's trade in 1992. It is worth noting that the machinery and transportation category has replaced mineral fuels (petroleum) as Mexico's largest export. Looking at this process over the longer run, the 1993 TPR traces out the shift in the composition of exports from being largely agriculture and minerals and metals in the 1960s, to being largely fuels in the late 1970s and early 1980s, to being largely manufactures and fuels in the 1990s.

The TPR discusses a problem that plagued analysts of Mexico's trade patterns: what Mexican data said about imports and exports did not match what other countries' data said about these numbers. In 1990, for example, Mexican data say that Mexico exported USD 18.8 billion to the United States while US data say that the United States imported USD 30.8 billion from Mexico. The major problem was that Mexican data did not count into imports and exports the transactions made by *maquiladoras*. These are in-bond assembly factories, originally established by an agreement with the United States in 1965. Imports of unfinished goods enter Mexico duty-free, and the importer posts a bond that guarantees the export of the finished good. (If the good is not exported, the applicable duties on the unfinished goods are deducted from the bond.) Since 1965 the number of *maquiladoras* has expanded rapidly; *maquiladoras* have been built outside the US-Mexico border region; and the *maquiladora* programme has

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TABLE 3
Mexico's Composition of Trade 1992
(Millions of US Dollars)

		Imports	*Exports*
0	Food and Live Animals	4,096	2,682
	04 Cereals	1,240	—
	05 Vegetables and Fruits	341	1,488
1	Beverages and Tobacco	315	331
2	Crude Materials	2,431	1,052
3	Mineral Fuels	1,675	8,114
	33 Petroleum and Products	1,210	7,932
4	Animal, Vegetable Oils	383	—
5	Chemicals	4,397	2,079
	51 Organic Chemicals	1,461	733
6	Basic Manufactures	6,655	3,105
	67 Iron and Steel	1,791	688
7	Machinery, Transportation Equipment	23,012	8,604
	71 Power Generating Equipment	1,098	1,577
	72 Specialised Machinery	2,627	166
	73 Metalworking Machinery	994	—
	74 General Industrial Machinery	3,257	502
	75 Office Machines	1,759	758
	76 Telecommunications	2,085	114
	77 Electric Machinery	2,578	877
	78 Road Vehicles	7,938	4,442
	79 Other Transportation Equipment	676	133
8	Miscellaneous Manufactured Goods	4,870	1,152
	87 Precision Instruments	1,045	102
9	Goods not Classified by Kind	43	58
Total		47,878	27,207

Source: UN, *1992 International Trade Statistics Yearbook.*

been expanded to include other countries (see US International Trade Commission 1990). Over 80 per cent of *maquiladoras* are still located in the US-Mexico border region, however, servicing the US market by assembling such goods as electronic products, textiles and apparel, furniture, and transportation equipment.

As the 1993 TPR points out, excluding *maquiladora* trade from Mexican trade statistics causes us to understate the importance of trade in manufactures. Using US trade data from 1990, for example, we could estimate that total Mexican exports, including those by *maquiladoras*, were 44 per cent higher than reported (USD 38.8 billion rather than USD 26.8 billion). Most of this difference is

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manufactured goods. Like the US-Canada Auto Pact of 1965, the *maquiladora* programme paved the way for the North American Free Trade Agreement (NAFTA). Fortunately, this problem with the data is rapidly disappearing for two reasons: first, starting in 1993, Mexico has begun publishing trade figures that include *maquiladora* trade, and second, as NAFTA is implemented, less and less trade will be done on an in-bond basis — instead it will be simply duty free.

In 1992 the United States accounted for 65.0 per cent of Mexican trade (see International Monetary Fund, 1994). If we include *maquiladora* trade, by following the TPR in inferring that it is the difference between Mexican trade data and US data, US trade with Mexico is as high as 74.4 per cent of Mexican trade (exports to the United States of USD 40,598 million out of 58,347 total imports and imports to the United States of 35,886 out of 44,396 total exports). Japan accounts for 5.2 per cent of Mexican trade, Germany 3.9 per cent and Spain for 2.7 per cent. No other country accounts for more than 2.5 per cent of Mexico's trade, and the rest of the Americas, led by Canada and Brazil, accounts for only 8.6 per cent.

On 1 January 1994, the NAFTA went into effect, linking the economy of Mexico with those of Canada and the United States. The 1993 TPR devotes significant attention to NAFTA, even though at the time the review was written the agreement had still not been approved by the US Congress. This attention was rightly placed because NAFTA can be viewed as a commitment by the Mexican government to the policies of the *apertura*. (Of course, NAFTA also represents significant commitments to free trade by the US and Canadian governments.) To be sure, NAFTA involved trade liberalisation on the part of Mexico that goes beyond that achieved during 1985–92: all tariffs among the three member countries are to be phased out over a fifteen year period. Remaining nontariff barriers, most significantly those in agriculture and transportation equipment, are being eliminated. Restrictions on foreign investment are being eased further; most significantly, US and Canadian providers of financial services in Mexico are to be accorded the same treatment as their Mexican counterparts. Dispute resolution mechanisms have been established, and, as part of side agreements negotiated after NAFTA itself, trinational commissions have been established to deal with issues involving labour rights and protection of the environment.

In general NAFTA does not raise barriers against nonmember countries, and the three member countries remain committed to further multilateral trade liberalisation within GATT. The 1993 TPR is not sufficiently critical of two significant moves towards protectionism embodied in NAFTA, however: First, the North American content provision that determines whether automobiles and light trucks qualify for duty free treatment has been raised to 62.5 per cent of net cost from the 50 per cent value-added provision in the US-Canada FTA. Second, Mexico, a major importer of sugar, has agreed to raise to US levels its external barriers to sugar imports from nonmember countries. Clearly, these provisions in

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NAFTA were designed to make the agreement attractive — or less unattractive — to special interest groups in the United States.

As a member of the Latin American Integration Association, Mexico also gives preferential treatment to imports from a large number of Latin American countries. In addition, Mexico has signed FTAs with Chile (September 1991), Costa Rica (March 1994), Colombia and Venezuela (May 1994), and Bolivia (September 1994). These FTAs are not likely to have a significant impact in the near future on Mexican trade due to the small sizes of the other countries involved and the low current levels of trade with them. Nevertheless, these agreements are significant in that they demonstrate Mexico's commitment to extending free trade to the rest of Latin America.

5. EXCHANGE RATES AND FOREIGN INVESTMENT

Along with the liberalisation in trade policy that occurred during the *apertura*, Mexico significantly lowered its barriers to foreign investment. During the presidency of José de la Cruz Porfirio-Diaz Mori (1876–1910), the Mexican government encouraged foreign investment. During the Mexican Revolution, however, the government built restrictions on foreign investment into the 1917 Constitution. President Lázaro Cárdenas went as far as to nationalise all foreign owned oil companies in 1938. In 1973 Mexico combined the various restrictions on foreign investment that had accumulated since 1917 into a single Law to Promote Mexican Investment and to Regulate Foreign Investment. In general nonresident foreigners were restricted to 49 per cent ownership of Mexican companies, although companies that had been foreign-owned before 1973 were exempted.

Starting in 1984 Mexico began to lift restrictions on foreign ownership, not by changing this law, but by changing the administrative regulations and guidelines designed to enforce it. In 1989, the newly elected Salinas administration issued a comprehensive revision of these regulations. The Foreign Investments Commission (*Comisión Nacional para la Inversión Extranjera* or CNIE) had been empowered by the 1973 investment law to waive restrictions on foreign investment when it deemed the foreign participation to be in the public interest. Following the 1989 change in regulations CNIE granted automatic approval for investment projects in 'unrestricted industries' in cases that met guidelines designed to promote foreign trade and to create jobs outside of the major industrial areas of Mexico City, Guadelajara, and Monterrey. In cases where the industry fell outside of the unrestricted category or where the guidelines were not met, the foreign investor has to petition CNIE for approval of the project. The foreign investor was guaranteed a response within 45 days, otherwise approval was automatic. The 1993 TPR reports that since 1989 CNIE had approved 98.4 per cent of the investment projects proposed. In December 1993 a new Foreign

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TABLE 4
Mexican Financial Flows 1981–1994
(Billions of US Dollars)

	Foreign Direct Investment	*Foreign Portfolio Investment*	*Current Acct Surplus*	*International Reserves*
1981	2.8	1.2	−16.1	4.1
1982	1.7	0.9	−6.3	0.8
1983	0.5	−0.7	5.4	3.9
1984	0.4	−0.8	4.2	7.3
1985	0.5	−1.0	1.1	4.9
1986	1.2	−0.8	−1.7	5.7
1987	1.8	−0.4	4.0	12.5
1988	2.0	0.1	−2.4	5.3
1989	2.6	0.3	−5.8	6.3
1990	2.5	−4.0	−7.5	9.9
1991	4.7	12.1	−14.9	17.7
1992	4.4	18.0	−24.8	18.6
1993	4.9	28.4	−23.4	24.6
1994	8.0	8.2	−28.9	5.8

Notes:
[1] End of year.
Source: IMF, *International Financial Statistics*, various issues.

Investment Law was enacted that did away with most of the restrictions in the 1973 law. There remain some sectors where foreign participation is prohibited or limited. These include the extraction of petroleum and natural gas, transportation services, and communication services.

The impact of the 1989 regulatory changes can be seen in the increase in foreign direct investment that has occurred since then (see Table 4). The sources of foreign direct investment in Mexico look like the list of Mexico's trade partners. Again, the United States dominates with 63.4 per cent of total foreign direct investment in 1991.

Perhaps more impressive, however, than the increase in foreign direct investment since 1989, has been the surge in foreign portfolio investment. In 1989 CNIE and the National Stocks Commission were authorised to approve trust funds through which foreigners could buy equities issued by Mexican firms without acquiring shareholder voting rights.

Foreign investors were attracted to the Mexican stock market by the large returns available. In 1991 share prices rose by 77.1 per cent in US dollar terms, by 49.4 per cent in 1992, and by 10.6 per cent in 1993. During the 1991–93 period Mexico was able to offset its substantial current account deficit with substantial inflows of foreign capital.

Over 1987–93, the Mexican peso appreciated substantially against the US dollar. Using consumer price indices from the two countries to calculate the real

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TABLE 5
Real Appreciation of the Peso 1987–1994

	Peso/Dollar Exchange Rate[1]	*Mexican CPI*[2]	*US CPI*[3]	*Peso/Dollar Real Exchange Rate*[4]
1987	2.210	49	89	100
1988	2.281	73	93	72
1989	2.641	88	97	73
1990	2.945	119	103	64
1991	3.071	134	106	61
1992	3.115	149	109	57
1993	3.106	161	112	54
1994[5]	3.446	172	115	57

Notes:
[1] End of year; (new) pesos per dollar.
[2] End of year; 1990 average = 100.
[3] End of year; 1990 average = 100.
[4] Real exchange rate = Exchange rate × US CPI/Mexican CPI.
[5] 19 December 1994.

Source: IMF, *International Financial Statistics*, various issues.

exchange rate as in Table 5, we see that the value of the peso rose by 46 per cent compared to the dollar. The Mexican government over this period was letting the peso's value decline at a slower rate than the difference in inflation rates as part of its *Pacto* commitment to lowering inflation. Yet the *Banco de México* had no trouble maintaining the value of the peso. In fact, it had to intervene to keep the value of the peso down; as Table 4 shows, the *Banco de México* accumulated reserves every year from 1988 to 1993. Unfortunately, the situation changed in 1994.

6. THE 1994–95 CRISIS

On 20 December, the Mexican government announced that it would widen the band in which it let the peso move against the dollar. On currency markets the peso immediately fell to the floor of this band, 3.97 pesos/dollar as opposed to the level of 3.45 pesos/dollar. After two days at this level, the government announced that the *Banco de México* would no longer support the peso, and it fell even further.

The simple explanation of this collapse was that the peso had become overvalued during the period 1987–94, as shown in Table 5; the *Banco de México* spent most of its dollar reserves supporting the peso; and when it ran out of reserves the value of the peso plummeted. Although there is some validity to this story, it neglects two important facts. First, over the period 1987–93 the *Banco*

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de México was accumulating reserves, as shown in Table 4. Second, the peso depreciated in real terms against the dollar by 6.6 per cent from the end of 1993 until the onset of the crisis. If the peso was overvalued in 1994, it was even more overvalued in 1993, and yet there was no crisis in 1993.

What precipitated the crisis of December 1994–February 1995 was a combination of three factors. First, foreign portfolio investment fell sharply, as shown in Table 4, because of increased political uncertainty in Mexico and rising interest rates in the United States. Second, Mexican authorities did not react soon enough, in either tightening the money supply or letting the value of the peso fall in reaction to declining foreign investment, leading to a fall in reserves. Third, in an effort to decrease the debt service, Mexican authorities converted much of Mexico's public debt to short-term, dollar-indexed *tesobonos* from peso-denominated *cetes*.

1994 was a difficult year for Mexico politically: there was an uprising in Chiapas in January; the presidential candidate of the ruling Institutional Revolutionary Party (*Partido Revoluccionario Institutional* or PRI) Luis Donaldo Colosio, was assassinated in March; the Secretary General of the PRI, Jose Francisco Ruiz Massieu was assassinated in September; and there were threats of a new uprising in Chiapas in November.

Perhaps even more significantly, there were presential elections in August, with the new President, Zedillo, who had replaced Colosio as the PRI candidate, taking office in December. These elections were widely regarded as the most honest in Mexican history, and the victory by the PRI was considered as a mandate for the economic policies of the previous ten years.

Nevertheless, the change of government was, as it has been every six years in Mexico since 1928, a time of great uncertainty. At the end of each of the previous three *sexenios* there had been large devaluations. (The one at the end of the de la Madrid administration actually occurred in 1987 rather than 1988.) Mexicans and foreign investors feared another one.

While the Salinas administration might have considered devaluations during the summer of 1994, it is clear why it did not do so: reserves were at a high level by historical standards, a devaluation would have led to a loss of credibility for the government within Mexico and with foreign investors, it was hoped that the political shocks were transitory and that foreign investment would return, and there was a presidential election coming up. During the Fall of 1994, however, the situation became unsustainable.

7. WHAT HAPPENS NOW?

As its part of Clinton's 31 January package for Mexico, the IMF expanded its earlier line of credit for Mexico from USD 7.8 billion to USD 17.8 billion. In

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announcing this expansion of credit, the IMF Managing Director Michel Camdessus explained the move as a concrete illustration of the IMF's support for Mexico's unprecedented adjustment programme, the *apertura* of 1985–94 (*IMF Survey*, 6 February, 1995). Mexico has indeed come a long way since 1985, and prospects for its long-term recovery appear good.

Unfortunately, 1995 will be a difficult year for Mexico. The current economic programme includes an increase in the value added tax rate of 10 per cent to its 1983–91 rate of 15 per cent, a cut in government expenditures, and an increase in the minimum wage of 20 per cent, which will fall far short of the increase in prices. There are some good signs, however; the government remains committed to the policies of *apertura*. Zedillo himself currently enjoys a surprising amount of popularity, given the economic situation, for having appointed a member of the opposition National Action Party PAN as attorney general; reopening the investigations into the Colosio and Ruiz Massieu assassinations; insuring that the PRI gracefully acknowledged the victory of the PAN in gubernatorial and mayorial elections in Jalisco, home of Guadalajara, Mexico's second largest city; and showing his commitment to make Mexico a country where the law applies to everyone and where the political party in power receives no special treatment by the government. It is possible that the changes in Mexico's political system that will occur during the Zedillo *sexenio* will be as significant as the changes in the economic system that occurred during the de la Madrid and Salinas *sexenios*. It will be important for the 1997 TPR to focus some attention on these political changes. For the Zedillo administration to carry out political reforms, it needs to survive 1995 with a minimum of damage to the economy.

At the global level, we are still learning lessons from the Mexican crisis and its rapid spread to developing countries in Latin America and Southeast Asia and even to European countries like Italy, Spain, and Sweden. What seems to be needed is a new international monetary authority to serve as lender of last resort. To operate effectively, however, an international lender of last resort would need some regulatory power — imposing regulations before a crisis occurs, not only afterwards.

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