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Life is not Easy: Mexico's Quest for Stability and Growth

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During the past 15 years, Mexico experienced what Latin American social scientists call a change in its "development model." Gone is the import-substitution industrialization model that had characterized Mexico since the 1930s. Instead, Mexico has become a fairly open economy in which state intervention is limited by a new legal and institutional framework. Under the new model, the tendency has been for the market to replace regulation, private ownership to replace public ownership, and competition, including that from foreign goods and investors, to replace protection. One vivid illustration of this change in strategy was Mexico's embrace of the North American Free Trade Agreement (NAFTA) in 1993.

This shift in development strategy was prompted by the debt crisis in 1982. In the next six years, Mexico struggled with falling output and runaway inflation. By the early 1990s, many analysts and observers viewed Mexico as a model reformer among developing nations, a country that would soon reap the benefits of its new development model. However, while inflation was substantially lower, Mexico's economic growth in the early 1990s turned out to be lukewarm, even before the country was staggered by the financial crisis of 1995. Since then, Mexico's economy has experienced healthy growth. From 1996 to 2000, Mexico's GDP enjoyed an average growth rate of 5.4 percent per year. But given that this growth occurred

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while rebounding from the 1995 dip, and at a time when the U.S. economy (where over 80 percent of Mexico's exports go) was booming, such a performance seems less impressive. Furthermore, all in all and despite the widespread economic reforms, Mexico's per capita output grew by only 0.45 percent per year between 1980 and 1999. This is disappointing, particularly for the roughly 20 million Mexicans who live on less than $2 a day (measured at purchasing power parity exchange rate of 1985 U.S. dollars).

This paper begins by discussing Mexico's quest for macroeconomic stability and growth since the eruption of the international debt crisis in 1982. The following section gives an account of the process of opening up the economy including the implementation of NAFTA. The final section focuses on the evolution of poverty and inequality, and how it is affected by the economic crises and trade liberalization.

The Rocky Road to Macroeconomic Stability and Growth

The Debt Crisis of the 1980s

In mid-1982, Mexico was deep in economic crisis. Macroeconomic mismanagement and an adverse external environment were the primary causes. In the late 1970s, the Mexican government engaged in a spending spree, based on the mistaken assumption that the rise in world oil prices and the availability of cheap external credit would continue. (At that time, oil represented over 70 percent of Mexico's exports.) The fiscal deficit increased inflation rates and the trade deficit, but the fiscal and external gaps were filled with external borrowing. Total public debt rose from $23 billion in U.S. dollars in 1977 to $53 billion in 1981. But in 1981, the price of oil began to fall. External credit became more expensive and of a shorter maturity, and many commercial banks stopped lending.[1] This unfavorable international environment exacerbated the consequences of domestic imbalances and contributed to rampant inflation, capital flight, and chaos in the financial and foreign exchange markets in 1982. The debt crisis—which ended up affecting not just Mexico but a large portion of the developing world, particularly in Latin America—had begun.

From Stabilization to Recovery

Throughout the 1980s, the Mexican government focused economic policy on restoring stability. In particular, it focused on lowering the rate of inflation and keeping the loss of international reserves in check. Initially, the policy response followed the traditional International Monetary Fund (IMF) recommendations of a drastic reduction of the fiscal deficit and a large devaluation of the peso. The

[1] The rise in world interest rates was to a large extent the result of poor macroeconomic policy in the United States: a large fiscal deficit had to be countered by an anti-inflation policy based on tight monetary policy which raised world interest rates.

Mexican government also engaged in several rescheduling of debt payments with external creditors, which were followed with a record of compliance.

The first attempt at stabilization, however, failed. It failed partly because Mexico was subject to additional external shocks such as a fall in oil prices in 1986. But it also failed because the corrective measures fueled inflation. The devaluation and higher public prices (to cut the fiscal deficit) caused other prices in the economy to rise and the gains expected from a lower fiscal deficit were outpaced by the inflationary inertia. Eventually, the Mexican authorities opted for combining fiscal discipline with incomes policy (including pegging the peso-dollar rate) to bring inflation down. This policy combination successfully reduced inflation from monthly averages close to 10 percent at the beginning of 1988 to about 1 percent by year's end. However, growth had not been resumed, as shown in Figure 1. For the period 1983–88, average GDP growth was equal to 0.2 percent (and negative in per capita terms).

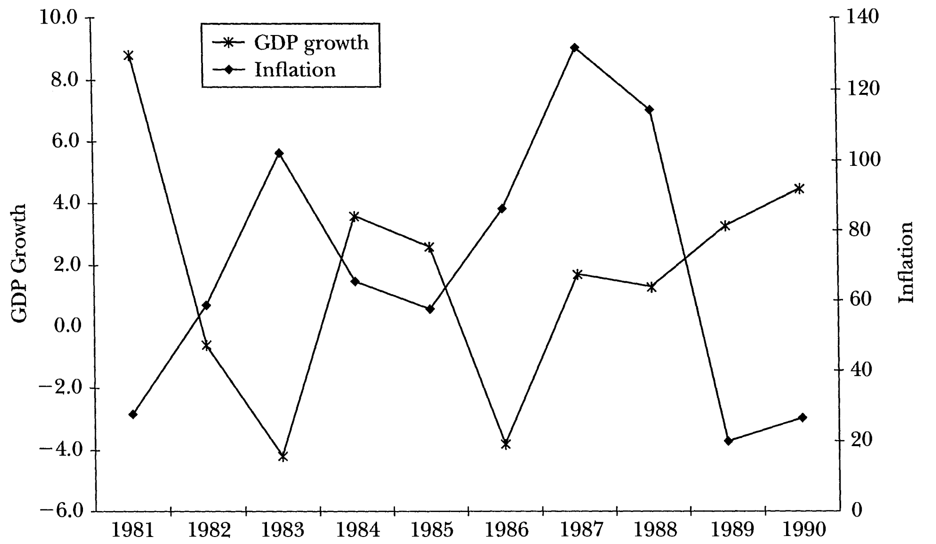
Economic difficulties, not political ones, were at the heart of Mexico's slow growth recovery. The adverse economic conditions that had brought the debt crisis to a boil continued through the 1980s: in particular, high real world interest rates, low availability of credit and low oil prices. By 1986, the price of oil had declined more than 60 percent below its 1981 level. These adverse external conditions resulted in large net resource transfers to the rest of the world: the high interest rates kept Mexico's debt payments high, while the lack of external credit meant that little foreign capital was coming in. Moreover, these effects were compounded by capital flight, which after 1983 was itself a result, to a large extent, of the adverse external conditions because of their impact on expectations. Between 1983 and 1988, net resource transfers from Mexico to the rest of the world averaged 5.9 percent of GDP.

Large resource transfers to the rest of the world present severe economic problems. Real domestic interest rates have to be high to attract capital inflows and deter capital flight, but high interest rates negatively affect domestic investment. In addition, high domestic interest rates place the sustainability of fiscal discipline in doubt, thereby fueling inflationary expectations and additional capital flight.

By the end of 1988, it appeared that Mexico had reestablished the preconditions for growth. Fiscal and monetary discipline had been attained, and runaway inflation had been brought to a halt. Relative price adjustment, particularly the reduction in real wages, had been achieved, and structural reform in the public sector and the trade regime was moving ahead. Mexico could also count on the industrial base and entrepreneurial capacity developed in the post-World War II period. However, these preconditions were insufficient to attract foreign investment on the scale required for recovery.

A sustainable recovery required a turnaround in the flow of net resource transfers: that is, some combination of higher external credits, lower external debt payments, capital repatriation, and higher foreign investment. A series of events in 1989 and 1990 made this possible. In mid-1989, Mexico signed an agreement with its commercial banks to reduce its medium- and long-term debt under the so-called Brady Plan

Figure 1
Mexico's GDP Growth and Inflation: 1981–1990



(named after U.S. Treasury Secretary Nicholas Brady, who launched the plan). Also in 1989, the IMF signed an extended fund facility, and the World Bank and the Inter-American Development Bank (IDB) increased their lending substantially. In the first part of 1990, the Mexican authorities revealed their interest in a free trade agreement with the United States. They also announced a decision to reprivatize the banks and sell several public enterprises (including the privatization of Telmex, the telephone company, in 1990). These events were followed by immediate capital inflows, both from new foreign investment and capital repatriation.

Total "foreign" investment (including capital repatriation) equaled roughly $10 billion in 1991, almost three times the average of the previous three years. Starting in 1991, the growth rate of per capita gross domestic product rates turned positive for four consecutive years, as shown in Table 1—the first time that per capita GDP had grown for four consecutive years since 1981. When NAFTA was approved in 1993, Mexico appeared to be on a firm path to economic prosperity.

From Slow Growth to the Peso Crisis

But events turned out differently. The recovery Mexico enjoyed between 1989 and 1991 became unsustainable, for reasons shown in Table 1. In particular, the current account of the balance of payments deteriorated sharply. Mexico's exports grew at a slower pace and imports surged as a result of the appreciation of the peso. Mexico's output growth slowed down in 1992 and 1993, which was especially disappointing given the important economic reforms (trade liberalization, privatization of state-owned enterprises, and deregulation of markets) that had been introduced since the mid-1980s.

Table 1
Macroeconomic Indicators: 1991–1998

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Gross Domestic Product	4.2	3.6	2.0	4.4	−6.2	5.2	6.8	4.8	3.7
GDP per capita	2.3	1.7	0.1	2.6	−7.8	3.4	5.0	3.1	1.7
Inflation[a]	22.7	15.5	9.8	7.0	35.0	34.4	20.6	15.9	16.6
Fiscal Deficit[b]	−0.5	1.5	0.7	−0.1	0.0	0.0	−0.7	−1.2	−1.1
Real Exchange Rate[c]	91.1	78.5	72.9	75.2	125.6	129.0	115.2	115.8	105.0
Real Wage[d]	6.6	8.9	7.2	3.7	−13.5	−11.1	−0.6	2.2	1.4
Current Account Balance[e]	−14.6	−24.4	−23.4	−29.7	−1.6	−2.3	−7.4	−15.7	−14.0

Note: Annual percentage change except when noted otherwise.
[a] Consumer prices, annual average.
[b] Percent of GDP, difference between total revenues of the non-financial public sector.
[c] 1990 = 100.
[d] Average real remuneration in manufacturing.
[e] Billions of U.S. dollars.
Source: Banco de Mexico (1996, 1999); Annual Report (1999); population figures to estimated per capita GDP are from CELADE 2000.

Confidence in Mexico's prospects was shattered when, at the end of 1994, Mexico ran out of international reserves and faced a serious foreign exchange crisis, which became popularly known as the "peso crisis." That caused output to drop by more than 6 percent in 1995.

Understanding what went wrong in a country that was a darling of international investors and multilateral lending institutions is potentially of great importance. Are the same market-oriented reforms that received so much praise from the international community to be blamed for Mexico's disappointing economic performance? The short answer is "no," but with some qualifications.

One qualification is that the expectation that Mexico's market-oriented reforms would pay off in a year or two was unrealistic. The reallocation of factors of production, the adoption of new technologies, and the upgrading of the labor force are processes that take a number of years, not a few quarters. After all, it took Chile more than ten years—and a severe financial crisis in 1982—to reap the benefits of market-oriented reforms and macroeconomic discipline. Now, Chile features the highest sustained average growth rate in Latin America. Second, the fact that in Mexico some sectors, such as the regulatory framework that governed contracts or the provision of basic energy (electricity and gas) and telecommunications services, had not been reformed yet may have contributed to the delay.

A third qualification is that there do appear to be industries where Mexico's reforms weakened a specific economic sector because of institutional shortcomings. Banking and agriculture provide two examples. Mexico's banks were privatized in the early 1990s without putting in place an adequate system of prudential regulation. Inadequate prudential regulation contributed indirectly to the peso crisis of 1995 in several ways. It led to an overly rapid expansion of consumer credit, whose counterpart was a fall in private savings and a rise in the current account deficit. In addition, the weak banking system forced a relatively looser monetary policy during 1994 than might otherwise have been preferred, because it was feared that higher interest rates could trigger a banking crisis. One clear lesson is that the institutions that guarantee a well-functioning financial system have to be given high priority before large-scale financial liberalization is undertaken. Chile in the early 1980s and Mexico in the mid-1990s learned this lesson the hard way. Since the crisis, the Mexican authorities have introduced a number of changes to make the banking system less prone to crises. In particular, before the crisis of 1994, financial sector legislation restricted the participation of foreign capital in the banking sector. These restrictions were relaxed by legislation passed in February 1995.[2] Banks that operate internationally are bound to be more robust.

Mexico's market-oriented reforms also initially hurt performance in agriculture, where elimination of state interventions left an institutional vacuum and many producers with less access to credit and technical assistance. In developing country economies with market failures in the traditional sectors—in credit and insurance markets, for example—policies to enhance productivity cannot rely simply on withdrawing state intervention, but must rather seek out an appropriate balance of state and market.

However, with these qualifications noted, the primary reason for Mexico's slow growth in the early 1990s was not its market-oriented reforms, but rather its strategy of macroeconomic stabilization based on the (quasi-)fixing of the peso-dollar exchange rate. Since the goal of Mexican authorities was to lower inflation to the level of Mexico's major trade partners in a rather short period of time, the exchange rate was effectively pegged. Although this action helped bring inflation down, it also caused two big problems.

First, because Mexican inflation did not instantly fall to the level of Mexico's trading partners, the (quasi-)fixed exchange rate meant that Mexico's peso appreciated in real terms in the early 1990s, as shown in Table 1. Foreign goods became relatively cheap, which shifted demand from the internal to the external markets and hurt domestic output. Furthermore, the peso appreciation not only made the trade liberalization measures less credible, because the pressure to reverse it could prove unbearable to the government, but also encouraged a consumption spree of imported goods, thereby lowering private savings.

It should be noted, however, that the real appreciation of the peso was not the result of the exchange rate regime throughout the entire period. In particular,

[2] It raised the maximum percentage of foreign individuals and companies as a group to hold voting capital of (Mexican-controlled) banks from 30 percent to 49 percent, lowered the percentage of the share capital of its subsidiary that a foreign financial institution required to hold control from 99 percent to 51 percent, and it authorized the Ministry of Finance to increase, on a case-by-case basis, the market limit for foreign investment in the financial sector provided for in NAFTA. For example, under NAFTA, a single foreign-controlled bank could represent up to 1.5 percent of total capital of the banking system; the new legislation increased that percentage to 6 percent. Although NAFTA restricted the amount of all foreign-controlled banks together to 8 percent of total capital, the new arrangements raise that limit to 25 percent (IMF, 1995).

during 1992 the peso appreciated because of large capital inflows—particularly portfolio investments—that resulted from the large-scale privatizations, among other things. Large capital inflows were thus a blessing and a curse. They were a blessing because capital inflows meant more resources to invest in productive activities. They were a curse because they put pressure on the exchange rate regime and fueled a large surge in domestic credit for which the regulatory framework of the banking system was not prepared. But what made these capital inflows particularly a problem was their volatility, as subsequent events showed. In retrospect, it seems that Mexico should have reacted to the surge in short-term capital inflows with more caution by introducing, for example, a tax on such inflows, as had been done by Chile.

A second problem with the pegged exchange rate regime, a lack of flexibility, arose in the course of the peso crisis. Under a flexible exchange rate regime, the peso would have depreciated significantly in April 1994 following a period of large capital outflows. However, under the existing arrangement the authorities resisted a devaluation, because they feared it would affect Mexico's reputation with the investor community in the wake of Mexico's presidential elections in mid-1994.

Hoping for the best, the authorities decided to wait it out. But pressures for devaluation continued to build, and when it finally occurred in December 1994, the loss of reputation was devastating. The devaluation itself was viewed by (particularly foreign) investors as a "breach of contract." But the loss in reputation also resulted from the mishandling of the devaluation, from the way it was announced to the dissatisfaction with the accompanying measures. In particular, the absence of a solid macroeconomic and debt management program created a lot of uncertainty among the investor community.

An important lesson of this experience appears to be that fixed (or quasi-fixed) exchange rate regimes can help to stabilize prices, but can impose severe costs when they become unsustainable and the authorities must renege on their commitment.[3] Learning from the experiences of 1994 (as well as 1976 and 1982), exchange rate policy in Mexico has been flexible since the end of 1994.

Was the Mexican peso crisis of 1995 a result of policy mistakes or bad luck? Clearly, some of the factors contributing to the crisis were beyond the Mexican government's control. During 1994 Mexico confronted a number of political shocks such as the peasant uprising in the state of Chiapas in January, the assassination of Luis Donaldo Colosio—the PRI's presidential candidate—in March, and the assassination of the party's Secretary General in September. It also faced a rise in interest rates in the United States. Also, Mexico's experience highlights the difficulties posed by volatile capital flows. When real returns were higher in the United States and Mexico's political future became uncertain following the Colosio assassination, capital simply left.

But the Mexican authorities also made some policy judgements that turned out

[3] In speaking of a rules-based fixed exchange rate regime, I would also include a currency board.

badly. In 1994, Mexico's strategy was based on the presumption that bad news (political shocks) was temporary and that good news (NAFTA, fiscal prudence, market-oriented reforms) was permanent and that capital flows would resume.[4] Thus, a decision was made to maintain the exchange rate regime and "sterilize" the presumed short-term capital outflows by increasing domestic credit. ("Sterilizing" capital outflows meant that when international reserves fell because people demanded dollars in exchange for pesos, the Mexican central bank compensated for the fall in pesos circulating in the monetary system by buying bonds in the open market). By sterilizing outflows, the hope was to keep interest rates from rising and avoid a crisis in the newly privatized, ill-regulated banking sector which already had a good share of nonperforming loans. Also, to deter capital outflows, the government encouraged investors who feared a devaluation to switch from peso-denominated short-term government debt to debt indexed to the dollar, called *tesobonos*. As a result, the composition of foreign investment in Mexican government securities shifted dramatically. In January 1994, only 6.4 percent was in *tesobonos*; by August the share was equal to 63 percent. This meant that, for all practical purposes, the (short-term) dollar liabilities held by the government rose sharply. The beliefs that good economic news would soon outweigh the bad, and that sterilizing capital outflows and keeping the peso-dollar rate unchanged were the appropriate response were, at least in retrospect, clearly wrong.

A related complication arose because of the market that had developed in financial derivatives based on the *tesobono* bonds. The derivatives market appears to have helped transform the fear of default that followed the December 1994 devaluation into a self-fulfilling financial crisis. When rumors of a Mexican default on *tesobonos* or capital controls spread, *tesobonos* could not be rolled over and their prices fell sharply. As their prices fell, Mexican banks that had pledged the bonds as guarantees faced margin calls and had to go out and buy dollars. With that, the peso fell further, the fear of default increased, and so on. This perverse process had to be stopped, and the only way to do so was by offering Mexico financial resources large enough to put the default fears to rest.

Stopping this vicious cycle is why the financial rescue package of close to $50 billion assembled by the IMF and the United States in early 1995 was needed.[5] It stopped the peso from collapsing and prevented the crisis from spreading to other countries. Its success can also be seen in how rapidly Mexico recovered its access to international capital markets and in the fact that the Mexican government fully repaid its loans to the United States several years ahead of schedule. Had it not

[4] Reacting to bad news by postponing hard decisions while hoping for better news is hardly unique to Mexico. But interestingly, optimistic expectations—about the evolution of oil prices and access to international credit—were also behind the decision to postpone policy actions in the wake of the crisis in 1982.

[5] The original announcement mentioned that the financial rescue package was of the order of $50 billion. However, it soon was evident that the only real money which would be available were the amounts pledged by the IMF and the United States. Furthermore, the U.S. contribution would be released in tranches as long as the Treasury felt comfortable with the measures taken by the Mexican authorities.

been for the rescue package, Mexico's output would almost certainly have contracted much more drastically and recovered much more slowly. However, it should be noted that precious time was lost by both the Mexican government and the international community before putting together an adequate response. It was only well after two months into the crisis that Mexico put together a credible macroeconomic program and the financial rescue—particularly, the contribution from the United States—was ensured. This delay meant a larger contraction in output that would have been the case otherwise. In particular, if an adequate response would have been in place more quickly, the peso might have devalued less and domestic interest rates could have been lower—this would have meant fewer bankruptcies and a less severe banking crisis.

The Mexican peso crisis was a wake-up call to the international community. It showed that in a global economy of huge capital flows and derivative financial instruments, major financial crises no longer necessarily mean that a country is running large fiscal deficits. Instead, they can arise largely as a result of external shocks and magnifying effects of global financial institutions. At present, the IMF is the institution best-suited for assembling financial rescue packages. During the increasing movement to globalized capital markets, the international monetary system will continue to require a sizable safety net. The 1997–98 east Asian crisis was another patent proof of this need.

A Recovery with Question Marks

Mexico's economy recovered quickly from the peso crisis and since 1996 the average growth rate of GDP has been 5.4 percent per year. A flexible exchange rate regime and sound macroeconomic management helped Mexico withstand the shockwaves sent by the 1997–98 east Asian crisis, the financial debacle in Russia later, and the drop in oil prices in 1998. The depreciation of the peso created some difficulties in reducing inflation as quickly as had been planned. However, inflation has declined and preliminary estimates for 2000 put the inflation rate at about 10 percent.

Despite Mexico's solid macroeconomic performance in the last few years, it is too early to declare victory yet. Mexico's growth in the last few years occurred against a backdrop of remarkable growth in the United States. As the U.S. economy slows down, Mexico's economy will be hit.

Moreover, Mexico's agenda of fiscal and market-oriented reforms is not yet complete. At present, some 40 percent of government revenues come from oil, and so government needs to undertake a fiscal reform to diversify its revenues to reduce the impact of volatile international oil prices on fiscal policy. Mexico's financial sector has not recovered from the crisis it faced in 1995, whose rescue has been estimated to cost between 15 to 20 percent of GDP in present value terms. As a result, Mexico's banks are hesitant to lend, which has created especially serious credit constraints for small and medium enterprises because—in contrast to the large corporations—they face practical obstacles in obtaining credit from abroad. Finally, it will be necessary to introduce additional reforms in the telecommunications and energy sectors and undertake a major effort to upgrade the skills of

Mexico's labor force, to improve overall competitiveness and convert Mexico into a fully modern economy.

Despite these words of caution, Mexico's medium-term prospects are positive, particularly as the benefits of greater integration with the United States reaches out to more sectors and regions which today are lagging behind.

Opening Up to the External World

The single biggest change in Mexico's development model is the shift from a defiantly inward-looking approach to policies that accept and endorse the economic gains from interactions with other countries—especially the United States. Trade liberalization was perhaps the most important and far-reaching of Mexico's economic reforms.

Industrialization in Mexico during the post-World War II period proceeded with a combination of tariff and nontariff barriers that protected local production from foreign competition and a restrictive regime for foreign direct investment. Between 1950 and 1981, the proportion of imports subject to permits rose from 28 to 83 percent. The government also relied on domestic content requirements and other policies to stimulate domestic production. Since the protected industries were unable to compete in external markets, in the 1970s the government sought to promote exports through selective incentives. For example, Mexico's automobile and microcomputer industry received import protection and fiscal incentives in return for export achievements.

The Mexican economy enjoyed a period of economic growth under this inward-looking model in the 1950s and 1960s (when GDP grew at an average of over 6 percent per year) and developed local industry and a local entrepreneurial class. But by the 1970s, and certainly by the time of the 1982 debt crisis, it became clear that any benefits of inward-looking policies had run their course and that such policies faced fundamental constraints and problems.

First, using a complicated and opaque set of government interventions to shape the allocation of resources had led to gross inefficiencies and a low pace of innovation and adoption of new technologies. Second, the debt crisis cut off Mexico's historical source of foreign savings—that is, lending by foreign commercial banks to the government. It also made clear that depending solely on that pathway of foreign capital was not desirable. New sources such as foreign direct investment had to be enticed. Third, the debt crisis made evident that the Mexican economy's capacity to cope with adverse external shocks depended on the diversity of its sources of foreign revenues and on the speed with which domestic output and exports responded to changing incentives such as a devaluation of the currency. An inward-looking economy meant more rigid responses, which in turn meant that external shocks brought a higher-than-necessary contraction in output associated to an external shock.

These considerations were the primary basis for the outward-oriented reforms that began in mid-1985. At first, these reforms primarily affected the prevailing trade and foreign investment regimes. Institutional initiatives such as joining GATT in 1986 and the passage of NAFTA as well as a series of other free trade agreements have also been an intrinsic part of the strategy.

Liberalizing Trade and Foreign Investment Regimes

Mexico's path to trade liberalization started in 1985, as illustrated by the data in Table 2 (for the manufacturing sector).[6] In the course of the next five years, the maximum tariff was lowered from 100 percent to 20 percent, the production-weighted tariff fell from 23.5 percent to half as much, and the domestic production covered by import licensing dropped from 92.2 percent to 19 percent. Liberalization continued in the 1990s. Between 1993 and 1997 the weighted average tariff level fell from 7.8 percent to 2.7 percent. Trade restrictions were maintained in some sectors that comprise around 7 percent of total imports. These sectors include some agricultural products—especially corn, petrochemicals, and automobiles and their components (for this sector restrictions will be maintained until 2003).[7]

Sector-specific industrial programs also started to be dismantled. The government liberalized procurement rules, reduced energy subsidies, suspended tax credits, brought down domestic content requirements, and reduced restrictions on foreign investment. In the early 1990s, sector-targeted restrictions and benefits were further reduced. By the end of the 1990s, only production and trade of automobiles and automobile parts were highly regulated with local content and trade-balancing requirements. Foreign ownership in most telecommunications subsectors remains subject to restrictions, and certain features of the sector's regulatory framework seem still to be undermining market openness.

Rules governing foreign direct investment as stipulated in the Foreign Investment Law in 1973 were quite restrictive. Beginning in 1984, the regulatory framework became gradually less restrictive. Majority ownership was increasingly allowed in a number of selected activities, opportunities for foreign investment in petrochemicals were increased by the reclassification of products, rules governing the authorization process were streamlined, and a trust mechanism was introduced to allow for temporary foreign investment in restricted sectors. The government approved a first amendment to the Foreign Investment Law in 1993 that included the new dispositions contemplated by NAFTA. With this new legislation, a majority of the sectors became open to foreign direct investment.[8]

New mechanisms were also introduced to allow for foreign investment through the stock exchange and restrictions on foreign ownership in financial institutions were relaxed over time. In 1990, foreign ownership of up to 30 percent was allowed

[6] Before Mexico launched its trade liberalization in the mid-1980s, it raised protectionist barriers to curb imports and save foreign exchange in the aftermath of the debt crisis.

[7] For a more detailed description on the liberalization process, see Lustig (1998), Lustig and Ros (1998), and OECD (1999a).

[8] For a more detailed description of the liberalization of foreign investment in Mexico, see Salomon (1998) and OECD (1999a).

Table 2
Measures of Trade Liberalization in Manufacturing, 1980–90

Year	*Domestic Product Covered by Import Licenses*[a]	*Production-Weighted Tariff Averages*
1980	64.0%	22.8%
1985	92.2%	23.5%
1986	46.9%	24.0%
1987	35.8%	22.7%
1988	23.2%	11.0%
1989	22.1%	12.8%
1990	19.0%	12.5%

Note: The information is for June of each year except for 1980 (April). From 1988 on, import official reference prices were eliminated.
[a] Average share of output in manufacturing subject to import licensing, as a percentage of total domestic manufacturing output.
Source: Lustig (1998).

in stock brokerage houses, financial groups, and banks. On the same year, a new insurance law lifted the prohibition on foreign participation in new investment in the industry and raised the maximum of foreign participation from 15 to 49 percent. In the aftermath of the 1995 financial crisis, restrictions were further reduced. The limit on foreign ownership in banks controlled by Mexican groups was increased from 30 to 49 percent, and foreign banks accounted for 20 percent of the system's total assets in 1998.

The results of liberalization on trade and investment flows have been remarkable. Mexico's exports multiplied by more than six between 1985 and 1999, going from $21.7 billion to $136.4 billion. Exports have also become more diversified. In 1985, the share of oil and mineral exports over total exports was still 57 percent, even after the oil price declines in the first half of the 1980s. By 1998, oil and minerals were only 6.5 percent of total exports. Foreign direct investment also grew substantially after the process of trade liberalization. It multiplied by around five times between 1986 and 1998, reaching around $10 billion in 1998.

The North American Free Trade Agreement

Mexico's decision at the beginning of the 1990s to seek a free trade agreement with the United States signaled an important shift in the emphasis given to formal bonds with the United States. What explains this shift?

The most important motivating factor was disappointment with the mild economic recovery that had started in the late 1980s. The Mexican government felt a need to find new ways to entice the capital inflows required for economic recovery and sustained growth. It seemed likely that a free trade agreement with the United States would boost private sector confidence in the Mexican economy and increase the expected rate of return on investment in Mexico. In particular, a free trade agreement with the United States would accomplish these goals by ensuring future access to the U.S. market and making a powerful public commitment to the durability of Mexico's open economy strategy.

The decision to pursue NAFTA did not prevent the Mexican government from continuing to follow a plurilateral approach, combining multilateral and bilateral initiatives. Mexico was active in the Uruguay Round of the GATT and joined the Pacific Basin Agreement. Mexico also signed free-trade agreements with Colombia and Venezuela, Costa Rica, Bolivia, Nicaragua, and Chile. Mexico also participates in multi-country initiatives such as the Asia-Pacific Economic Cooperation (APEC), the Free Trade Area of the Americas (FTAA), and became a member of the Organization for Economic Cooperation and Development (OECD). More recently, Mexico is in negotiations to sign free trade agreements with the European Union, El Salvador, Guatemala, Honduras, Panama, Jamaica, Ecuador, Peru, Trinidad and Tobago, MERCOSUR and Israel.

Thanks to Mexico's trade liberalization and the sectoral agreements signed between Mexico and the United States in the second half of the 1980s, trade between Mexico and the United States was relatively free even before NAFTA. However, there was room for further tariff reductions on both sides; in particular, many Mexican products faced a U.S. tariff higher than the 20 percent maximum tariff prevailing in Mexico. The elimination of nontariff barriers was probably more important than reducing the remaining tariffs. Before NAFTA, about 20 percent of imports into Mexico were still subject to licensing, with import licenses for agricultural products and livestock the most widespread. The automotive sector was still subject to important restrictions. For its part, the United States placed important restrictions on the import of textiles, steel, and agricultural products.

Canadian imports from Mexico also faced low barriers even before NAFTA was put in place. In fact, 82 percent of Mexican exports to Canada entered duty-free in 1989 under the most-favored-nation principle of the Canadian General Preference treatment and other arrangements. But higher duties prevailed in labor-intensive sectors such as textiles and clothing.

NAFTA came into effect in January 1994. As part of the agreement, tariffs on about half of all import categories were eliminated. (In 1993, the average Mexican tariff was about 10 percent, and the average U.S. tariff was 4 percent.) Most of the remaining tariffs were scheduled to be phased out by 1999, although a few were scheduled to remain in place for a maximum period of 15 years.

The main reason why some of the tariffs were to be phased out was to make more gradual the impact of tariff reduction on Mexican producers in certain sectors. For example, in agriculture, import licenses were replaced by tariffs, and tariff protection on corn, wheat, and beans was scheduled to be phased out in 10 to 15 years. In textiles, quota restrictions on imports from the United States were scheduled to be removed over ten years. In automobiles, Mexico eliminated tariffs on light trucks and reduced tariffs for passenger cars by 50 percent in 1994, but the remaining tariffs were scheduled to be phased out over a 10-year period. In the financial sector, Mexico was allowed to impose individual and aggregate share limits on U.S. and Canadian foreign firms. The limits were scheduled to be phased out by 2000, but the issue could be revisited if U.S. and Canadian participants acquired a combined market share in excess of 25 percent.

The NAFTA agreement has had a powerful effect on trade and investment flows. Mexican exports to the U.S. economy rose from $43 billion in 1993 to $109 billion in 1999, at which point they were higher than the exports from most southeast Asian countries, every other Latin American country, and some European countries. In Mexico, there has been a corresponding growth in export-oriented firms; between 1993 and 1999, the number of firms exporting to the U.S. market increased 67 percent, to over 30,000. Mexico's share of U.S. imports has increased from 6.9 percent in 1993 to 10.7 percent during 1999. Similarly, Mexican imports from the U.S. reached more than $105 billion in 1999, more than double their value in 1993. At present, 14 percent of total U.S. exports go to Mexico, making it, after Canada, the second most important foreign market for U.S. exports.

Mexican trade with Canada has also increased substantially in percentage terms, although the absolute values are modest compared to U.S.-Mexico trade. Counting imports and exports together, trade between Mexico and Canada increased 129 percent from 1993 to 1999, reaching $9.3 billion. In the same period, there was a 110 percent increase in Mexican companies that export products to Canada (from roughly 900 to close to 2000). Canada has become the second most important market for Mexican products, and Mexico has become the third most important market for Canada.

The impact of NAFTA is similar for foreign direct investment. Foreign direct investment has been critical to Mexico. Indeed, Mexican firms with foreign direct investment employ around 20 percent of all workers in the formal sector, with wages 48 percent higher than the national average. The growth rate of employment in these firms is double that of the overall economy; in fact, between 1994 and 1998 firms with foreign direct investment generated one of every four jobs created in the country. The United States is the largest source of foreign direct investment in Mexico. Between 1994 and March 2000, more than 11,000 U.S. firms invested $35.1 billion in Mexico. Canada is the fifth largest source of foreign direct investment in Mexico, with over 1100 Canadian firms investing $2.3 billion between 1994 and March 2000.

NAFTA also played an important role in Mexico's recovery in the years immediately after the 1995 peso crisis. Exports grew by 31 percent in 1995 and exports to the United States by around 28 percent; they were the engine of Mexico's recovery. Also, between 1994 and 1996, foreign direct investment equaled an average of $8 billion, almost twice the level in the three years before NAFTA. Moreover, in 1995, when portfolio flows became highly negative, foreign direct investment was 75 percent above the level in the three years before NAFTA. (By comparison, during Mexico's debt crisis of the early 1980s, foreign direct investment in 1983 fell to one-fifth of what it had been in the previous years.) Clearly, the business opportunities brought by NAFTA had a positive impact on foreign direct investment, the peso crisis notwithstanding.

What has been the impact of opening up the economy and greater integration with the United States on productivity growth? Answering this question is not simple because of data shortcomings. According to one study, the productivity of capital (excluding agriculture) grew at an average of 2.3 percent a year between 1988 and 1994 (while it had been decreasing during the previous 17 years). An explanation for this productivity boost is that as the economy opened up the variety of capital inputs available to producers increased.[9] In contrast, the growth in labor productivity for the same period was an average of 0.45 percent a year, similar to the rate observed in the past. However, in sectors undergoing a rapid process of capital deepening such as textiles and clothing, labor productivity went from very low—and even negative—growth rates prior to 1988 to an average of 3.7 percent between 1988 and 1994.

Since NAFTA came into effect in 1994, labor productivity has grown fast in the tradeable sectors (between 20 and 40 percent) but has been lagging in the nontradeable sectors. The sectors that are integrating with the U.S. market (becoming part of the production chain) are modernizing quickly while those producing for the domestic market are not. This is consistent with anecdotal evidence: many firms are being set up to supply U.S. producers and retailers in different areas of the country, but particularly in the border states. The sectors that are more integrated with the United States also tend to have better access to credit. The big challenge for Mexico is to support the lagging sectors so that they also modernize and become more productive. Otherwise, the already strong regional inequalities will not only remain but become exacerbated.

The Unfinished Agenda: Poverty and Inequality

In Mexico, economic inequality and the incidence of poverty—particularly in some areas of the country—have been traditionally high. It was hoped that the change in Mexico's development strategy in the mid-1980s would result in visible improvements in the living standards of the majority of the Mexican population. Some 15 years later, this goal largely remains unfulfilled. Moreover, the distance between the haves and the have-nots increased in the 1980s and has remained wide through the 1990s. The persistence of extreme poverty is disheartening in itself. In addition, frustrated expectations could trigger a backlash. In its extreme form, poverty and the feeling of being left behind could contribute to violence. In the 1990s, several episodes of rural violence occurred, particularly in the southern—the poorest—part of Mexico. Although these bouts of conflict are seemingly under control, they remain worrisome.

The Evolution of Mexico's Poverty and Inequality

During Mexico's debt crisis of the 1980s, poverty and inequality increased. Table 3 shows poverty rates—that is, the proportion of individuals with incomes

[9] This analysis could not be done for the period after 1994 because there were no data on capital stock.

below a prespecified poverty line—using different poverty lines. Using the World Bank's $2/day (a line that is somewhat below the official poverty line), poverty rose by almost 14 percent between 1984 and 1989.[10] The other poverty figures shown in the table use the official extreme and moderate poverty lines, where the extreme poverty line is the amount of income necessary to buy a basic basket of food and the moderate line is roughly twice that amount. As also shown in Table 3, the share of income going to the top 10 percent of the population increased from 35.8 percent in 1984 to 41.8 percent in 1989. Income inequality as measured by the Gini coefficient also increased substantially.

With the incipient economic recovery in the early 1990s, poverty then declined very slightly by all three measures from 1989 to 1994. However, if households are classified into subcategories according to criteria such as location, occupation, and activity, a more differentiated pattern emerges. Although the incidence of urban poverty fell between 1989 and 1994, poverty rose in the agricultural and mining sectors. Evidence also points to strong regional differentiation between the southern and central regions and the northern part of the country. Poverty in the southeast is more than five times higher than in the northeast and close to 40 times higher than in the Federal District (the part of Mexico City that is equivalent to Washington, D.C.). More important, while in some of the regions poverty fell and in others it rose very slightly, between 1989 and 1994 poverty in the south and the southeast rose. These trends suggest that a process of rising economic differentiation among regions may be underway.[11] The rising poverty in Mexico's southern states arose even though this area was among the main target of antipoverty efforts supported by the multilateral development banks during the 1989 to 1994 period.

The growing poverty in the south and southeast is particularly significant because in the 1990s, rural violence has been particularly conspicuous in the three southeastern states. Chiapas is the cradle of the Zapatista Army's uprising, while Guerrero and Oaxaca are the two states where another guerrilla group, the EPR (Ejército Popular Revolucionario or Popular Revolutionary Army), targeted most of its actions in the second half of the 1990s.

The trends in poverty in agriculture and in the southern regions of Mexico can largely be traced to issues relating to agriculture, which is especially important to the economy of the region. Historically, a large proportion of Mexico's peasant farmers worked in the *ejido* sector. *Ejido* is the land unit in which the *ejidatarios* were given (by the state) the right to exploit the land, but they cannot sell, rent, or borrow against it. The *ejido* sector had been characterized by strong state controls and subsidies. But over time, this system of controls and subsidies eroded, and the *ejido* sector entered a period of crisis that lasted more than two decades. The final

[10] For more details on the data sources and methodology, see Lustig and Szekely (1998). The data have been corrected for underreporting of income. Separate poverty lines have been used for rural and urban households.

[11] The household survey for 1998 has not yet been made available and hence it cannot be assessed whether this trend has continued.

Table 3
Poverty and Inequality: 1984–1996
(*percent*)

	1984	*1989*	*1992*	*1994*	*1996*
Poverty[a]					
Extreme[b]	13.9	17.1	16.1	15.5	. . .
Moderate[c]	28.5	32.6	31.3	31.8	. . .
International[d]	18.8	21.4	19.3	19.7	23.4
Inequality					
Gini[e]	47.40	53.12	53.13	54.04	52.76
Top 10%[f]	35.8	41.8	42.0	43.0	44.1

[a] Poverty is defined as the headcount index (for individuals).
[b] Extreme poverty line of 197.3 pesos from 1994 per capita per month.
[c] Moderate poverty line of 378.3 pesos from 1994 per capita per month.
[d] International poverty line US$60 ppp 1985 per capita per month. This line is used by the World Bank.
[e] The value of the Gini coefficient goes from 100 (perfect inequality) to 0 (perfect equality).
[f] Share of total income held by top 10% of the individuals.
Sources: Lustig and Szekely (1998). Szekely and Hilgert (1999).

elimination of these controls and supports became an inherent part of the modernization program of the Mexican government in the late 1980s. The most salient feature was the reform of article 27 of the Constitution in 1992, which changed the legal statute regulating the use and ownership of *ejido* land, essentially legalizing the rental and private ownership of *ejido* land.

As noted earlier, Mexico's efforts to modernize agriculture have caused many of the public institutions supporting the sector to be privatized, reduced, or eliminated. The decline in the role of the state in agriculture has left an institutional vacuum. In the case of the *ejido,* there was "only a very partial reconstruction of alternative institutions to support the *ejido* sector. In general, this reduced availability and raised the cost of access to credit, insurance, markets, modern inputs, seeds, water, and technical assistance" (De Janvry, Gordillo and Sadoulet, 1997). To compensate for this, the authorities introduced new programs subsequently.

In the early 1990s, the news for small-scale Mexican farmers seemed mainly bad. The appreciation of the peso was hurting revenues to *ejidatarios.* The very large fall in coffee prices in the early 1990s following the dismantling of the International Coffee Agreement—a decline of about 60 percent from their average price in the late 1980s—undoubtedly affected the poor very deeply in the southern states of Chiapas, Veracruz, and Oaxaca. Interest rates were increasing. Government support prices for the main staple crops were falling, and subsidies to the sector were being cut. Although the Mexican government had developed an antipoverty program that focused primarily in the building and refurbishing of infrastructure for the poor (the Programa Nacional de Solidaridad/National Solidarity Program, or PRONASOL), no real safety nets were available to deal specifically with external shocks to agriculture.

A process of social differentiation seems to be emerging in Mexican agriculture, with some producers turning into successful entrepreneurs while others are lagging behind or even abandoning their land. The successful entrepreneurs tend to be those who are relatively better off, and who either have more land or more access to credit and irrigation. On the other end of the spectrum are the small farmers who have lost their state support, but find it difficult to modernize and diversify because of the limited access to investable funds and institutional services.

Living Standards and the Peso Crisis

Several indicators suggest that the impact of the peso crisis on households' living standards must have been quite strong. Private consumption declined by 9.5 percent in 1995. Unemployment rose from the 3.7 percent average in 1994 to a peak of 7.3 percent in September 1995. During 1995, more than one million jobs were lost in the formal sector and average real wages declined by 13.5 percent. In addition, anecdotal evidence suggests that many families lost homes and household items because the double squeeze of very high interest rates and lower wages forced them to default on their loans. Although the open unemployment rate fell during 1996 to 5.5 percent on average, real average wages continued their decline (shown earlier in Table 1). Cumulatively, between the onset of the crisis and July 1997, real wages in manufacturing fell by some 30 percent. In 1996, the incidence of poverty as measured by the $2 per day poverty line was almost 19 percent higher than in the pre-crisis year of 1994, as shown in Table 3.

The Mexican government did make some efforts to soften the blow of the peso crisis. However, Mexico has no unemployment insurance, and there were no employment programs like the ones that existed in Chile during its economic downturns in the 1970s and 1980s. For lack of a better solution, the government decided to use the program designed for retraining unemployed workers as an income maintenance program. Eventually, the government instituted a short-term employment program in 1995 to operate in rural areas. In addition, the Mexican government did make some effort to limit the impact of austerity on the publicly funded social services. As a proportion of non-debt (excluding interest payments and amortizations) expenditures, social spending actually rose slightly from 51 percent in 1994 to 52 percent in 1995. Nevertheless, because the government had to reduce fiscal spending and devoting a larger share to debt servicing, social spending contracted by 12 percent in real terms.

All in all, at the time of crisis, Mexico did not have adequate mechanisms to help poor people cope with the crisis. Also, it appears that spending targeted to the poor contracted by more than overall non-debt related spending (Wodon and Hicks, 1999), precisely because such safety nets did not exist. This situation changed at the end of the 1990s because programs that could act as safety nets had been introduced.

Economic Openness and Inequality

Although there has not been a full assessment of the effect of trade liberalization on overall poverty and inequality, some studies have looked at its effect on the wage gap in manufacturing between skilled and unskilled labor. Between 1984 and 1995, real wages for skilled workers rose by around 8 percent and unskilled wages decreased by around 22 percent. Given that Mexico's most abundant factor of production is apparently unskilled labor, it was expected that the removal of trade restrictions should result in a relative improvement of unskilled wages. Instead, the skilled-unskilled wage gap widened substantially after 1985. Such a trend is consistent with the finding of other studies that have observed that the return to schooling increased during the 1980s.

Is trade liberalization the cause of this widening gap? Hanson and Harrison (1999) estimate that Mexico's reduction in tariffs and the elimination in import-license requirements can account for 23 percent of the increase in the relative wage of skilled labor over the period 1986–90. One possible explanation for how trade liberalization made unskilled labor worse off is that Mexico had offered relatively high protection to the industries that made intensive use of unskilled labor during the inward-looking period, and, hence, those were the hardest hit sectors by the removal of barriers.[12] It is important to note, however, that the main contribution to the widening of the wage gap stems from skill-biased technical (and organizational) change.

Overall, these trends suggest that unless Mexico engages in a serious effort to upgrade the skills of its working population, the process of economic modernization is likely to be accompanied by a rise in income disparities among wage earners of different skills.

Investing in the Human Assets of the Poor

Can Mexico grow its way out of poverty? If the distribution of income were to remain unchanged, GDP grew at 5 percent a year, and population growth continued to decline at the same pace as in the 1980–95 period, it could take between 40 and 50 years to eradicate extreme poverty (as measured by the proportion of people living on less than $2 a day). In contrast, if it were possible to transfer resources to the poor (with zero costs of administration and zero reduction in the poor's level of work effort), then eradicating extreme poverty would require redistributing about 2 percent of the income of the top decile (or 0.90 percent of GDP) and giving it to households living in extreme poverty. If Mexico relies on a rising tide to lift all ships, it probably means that extreme poverty will be around for decades. However, a well-targeted and sustained redistribution effort could eliminate extreme poverty in a very short time.

[12] In addition, although Mexico is intensive in unskilled labor when compared with, for example, the United States, Mexico may have an intermediate abundance in skilled labor vis-à-vis other developing countries. For example, greater exposure to competition from China could have contributed to a decrease in the relative wage of unskilled workers in some sectors.

The Mexican government has started to work toward such a redistribution by launching the antipoverty program Progresa in mid-1997.[13] By mid-2000, the program reached some 2.5 million households, 80 percent of them living in extreme poverty in the rural areas. The beneficiary families of Progresa receive an income transfer with the condition that parents take their infants and small children to regular visits to the health posts. They also receive scholarships for children between the third grade of primary and the third year of secondary school with the condition that the children attend school. Beneficiary families receive between $25 and $30 a month, which is equivalent to raising the average income of a beneficiary family by over a fourth.

Progresa is a highly attractive program because it both raises the current income of the poor and stimulates investment in the human capital of the children of the poor—thereby raising their potential income in the future. Preliminary results indicate that beneficiary families increased the school attendance for children in grades three to six by 2.2 percentage points and for children in grades seven to nine by 4.9 percentage points. The proportion of children from beneficiary families going to secondary school after graduating from primary school rose by 17 percent. In 1996, the poorest 20 percent in rural areas had 3.4 years of schooling while the richest 20 percent in urban areas had 11 years of schooling. If this program is maintained, it may play an important role in closing the education gap between the poor and the better-off and expanding the economic opportunities for many Mexicans who have, so far, seen little benefit from their country's 15 years of economic reforms.

Of course, efforts such as Progresa are not enough. The challenge remains how to bring economic opportunities to the population living in the more disadvantaged regions or working in the sectors that are lagging behind. A modern version of a developmental state may be in order; that is, a state which, instead of subsidizing inefficient state-owned enterprises and the better-off through general consumer subsidies, takes actions to attract investment and facilitate the access to markets, credit and technology of the more disadvantaged areas of the country. The United States could also help in the poverty reduction efforts by allowing more Mexicans to work within its borders. Remittances are a very important source of income for many poor families in Mexico.

Conclusion

During the past 20 years, the Mexican economy went through a series of severe shocks and widespread economic reforms. The series of large shocks—in particular, the debt crisis of the 1980s—explain why output per capita in 1999 was only 9 percent higher than it had been in 1980. However, the benefits of reforms have

[13] Progresa is the Spanish acronym for Programa de Educación, Salud y Alimentación (Program of Education, Health and Nutrition).

also been slow in coming. The Mexican experience shows that the process of economic modernization can take a long time and can be subject to many setbacks.

At present, the prospects for Mexico seem definitely brighter. Sound macroeconomic policy has paid off in the form of more stability, both in prices and output. The benefits of integrating with the United States are showing up in productivity increases, particularly in the sectors that benefit most from the integration. But the remaining challenges are large. In particular, the biggest challenge is to reduce the levels of extreme poverty that a middle-income country like Mexico should not have. Faster growth is part of the answer, and if the European experience with integration can be taken as an example, Mexico's future seems bright. Portugal's output per capita, for example, was one-third of the output per capita of its European partners in 1951 (Mexico's is close to 15 percent of the output per capita in the United States). Fifty years later, Portugal is close to two-thirds. However, even with high rates of economic growth in Mexico, the elimination of extreme poverty will be slow. More aggressive policies to address the imbedded inequities in access to education and economic opportunities will continue to be necessary.

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