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Why not Mexico? Policy Recommendations for a Globally-Oriented Economic Strategy

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Claremont McKenna College

Why not Mexico?
Policy Recommendations for a Globally-Oriented Economic Strategy

submitted to
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by
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Abstract

Mexico, one of the world's largest economies and an increasingly relevant actor in international affairs, is at a crucial point in defining its future policy course. Given the uncertainty surrounding the global economy, as well as the political situation in Mexico, it is important to have a clear vision for policy going forward. This thesis offers a foundation for a national economic strategy with a long-term vision, upon which future administrations can build as appropriate to maximize on the country's economic potential. The task is undertaken through a three-part approach. First, a thorough and analytical overview of the country's economic history provides context and lessons from which to learn. Second, key economic issues to be addressed are identified through an evaluation of the current context and economic outlook. Finally, an evaluation of successful policy implementation, domestically and abroad, provides a basis that can be adapted to address the issues identified as they affect Mexico. The result is a series of six policy recommendations along two axes aimed at tackling the aforementioned key issues. These recommendations are by no means exhaustive, nor are they meant to be. The expectation is that they may serve to align national policy to global economic trends, underlying a plausible strategy to realize Mexico's productive potential.

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I. Introduction

Mexico is at a breaking point. I would use the phrase “at a crossroads” but I find it overused and, in this particular instance, insufficient in expressing the position in which the country finds itself. Mexico is nearing the end of the third executive administration since *alternancia* (political alternation) became a reality in Mexican politics and, while each successive administration strove to align their platform to a common, national strategy two decades in the making, the results have been less than stellar. At the same time, tensions between every segment of society have been increasing and the sociocultural revolution is at risk of becoming a real one.

After 12 years of control by the country’s most important opposition party in the XX Century, the country returned to its roots and, in 2012, elected Enrique Peña Nieto, the dashing, young darling of the PRI, to the federal Executive. His promise? To lead a coalition government that promised to deliver on the Mexico’s untapped economic potential.

At the time, political leaders in the country insisted that Mexico was “going through an historic moment,” and the Pact for Mexico was signed to the cheering of the country’s three largest political parties—PRI, PAN, and PRD. The business community found itself equally as ecstatic. Six months into the Peña Nieto administration, Fitch upgraded Mexico’s domestic credit rating to an A- (up from a BBB+) and, immediately following the passage of the financial reform in 2014, BBVA announced it would pour USD 3.5 billion worth of investment into Mexico over the course of the following four years.

Four years later and Mexico's growth has stunted. Since 2014, annual growth has barely reached passed the 2 percent mark, a number more appropriate for a developed economy, and real wages have actually seen a decrease since 2006—a Mexican worker today has roughly the same purchasing power as she would have had 20 years ago. Violence, on the downtrend in 2013, has peaked, reaching its highest level since the country began collecting data on violent death rates—25,339 homicides were recorded in 2017, up 23 percent from a year prior!¹ And President Peña Nieto's approval rating sits at a dismal 21 percent, whereas 69 percent of Mexicans disapprove of him.² As a result, the polls for the general election of 2018—the largest in Mexican history, with 3,226 elected positions up for grabs—point to a cataclysmic shift to the far left, the abandoning of a neoliberal national strategy, and potentially, the collapse of the Mexican democratic experiment.³ So, Mexico is at a *breaking point*.

I do not pretend to single-handedly undertake the gargantuan task that is defining policy for the world's eleventh largest economy. And claiming to do so would set me up for failure. Rather, the impetus behind the research and ideas here presented come from the belief that crafting a new strategy to solidify Mexico's growth and take advantage of the country's potential is a crucial task to stay the course of economic and democratic consolidation which have characterized the country's recent history.

As stated by former Secretary of Finance—and a distant third in this year's presidential election polling—José Antonio Meade Kuribreña, a key policy goal of future administrations

¹ Patrick Gillespie, "Mexico reports highest murder rate on record," *CNN* (22 January 2018).

² Rolando Ramos, "Aprobación de Enrique Peña Nieto," *El Economista* (1 March 2018).

³ Enrique Krauze, "¿López Obrador, liberal?" *El País* (17 February 2018).

will be to position Mexico as a recognized and influential power in the global arena. The current Secretary of Foreign Affairs, Luis Videgaray Caso, has already made inroads on the regional stage: Mexico largely led the Latin American response to the crisis in Venezuela in 2017. And in the recent discussions regarding NAFTA, faced with two challenging negotiating parties with clear goals in mind, the Mexican delegation has been steadfast in its commitment to free trade and defending Mexico's interests, to the surprise of many in Washington and Ottawa.⁴

However, in order to continue along that path, lawmakers in the near future should strive to achieve two things. On the one hand, future economic policy should be developed taking into account the considerations of the Washington Consensus while keeping in mind the particular strengths and weaknesses of the Mexican economic context. On the other hand, in implementing these policies, the government should pay special attention to the broader impact of the policies. In other words, policies should be designed to target economic growth while addressing social issues concurrently. The greatest criticisms of the Consensus have always been the lack of distributive growth and the exacerbation of economic and social inequalities that often arises as a result of neoliberal policies. To continue on a path of sustainable liberalism, the next administration will have to take into account this reality, lest the democratic progress Mexico has achieved be reversed.

The goal of this thesis is to develop a series of policy recommendations to serve as the foundation of a cohesive, inclusive, and growth-oriented strategy for Mexico's short- to

⁴ Patrick J. McDonnell, "Mexico signals tougher stance on NAFTA, may pull out of talks if Trump moves to scrap deal," *Los Angeles Times* (31 August 2017); Franklin Foer, "Mexico's Revenge," *The Atlantic* (May 2017).

medium-term economic policy. These foundations will rest on an in-depth overview of the country's recent economic history, an assessment of the most pressing risks facing the Mexican economy today, and the diffusion of effective policymaking elsewhere adjusted for Mexico's unique context. My hope is that the incoming administration will take into consideration the policy tools prescribed in this composition and take advantage of the opportunities they offer in the definition of the country's new economic strategy. The direction the government takes from this administration forward, after all, will be key in determining Mexico's capacity to realize its potential in the long run.

II. Review of relevant literature

Theories of economic development

The Neoclassical Theory and the International Dependence Theory, the latest and yet outdated theories of economic development, continue to have an outsized influence on policymaking in the developing world. Both theories place a special emphasis in the role of global trade as a tool for development. In this respect, Mexico is not the exception. In Latin America specifically, the impetus for the implementation of policies akin to the two theories mentioned has been the now infamous Washington Consensus. As outlined by John Williamson in 1990, the Consensus outlines specific policy areas which Washington sought Latin American governments reform prior to receiving further assistance from the Washington Institutions—the International Monetary Fund, the World Bank, and the US Treasury—in solving the debt crises of the late 1980s in the region.⁵ The “ten commandments,”⁶ as described by Williamson, are:

1. Fiscal discipline,
2. Reëvaluation of public expenditure priorities,
3. Tax Reform,
4. Liberalization of positive interest rates,
5. Achievement of a competitive exchange rate,

⁵ John Williamson, ed., and Institute for International Economics (U.S.), *Latin American Adjustment: How Much Has Happened?* (Washington, DC: Institute for International Economics, 1990), Ch. 2.

⁶ Philip Arestis, “Washington Consensus and Financial Liberalization,” *Journal of Post Keynesian Economics* 27, no. 2 (2004): 252.

6. Trade liberalization,
7. Removal of limits on foreign direct investment inflows,
8. Privatization,
9. Deregulation, and
10. Protections for property rights.

Over the course of the last thirty years, five presidents and their respective governments have overseen the ongoing transition of Mexico's economy. Generally, policies enacted by each successive administration—all of which have been categorically center-right to right on economic matters—have tended to follow the recommendations set forth by the Consensus. The initial steps in the transition towards economic liberalism were undertaken by President Miguel de la Madrid Hurtado (1982-1988), which included reforms to trade that opened the Mexican market to foreign competition—notably, signing into law the country's accession to the General Agreement on Tariffs and Trade—and the lifting of strict controls on capital flows implemented by the prior administration. Immediately after taking office in 1988, Carlos Salinas de Gortari undertook privatization of virtually all sectors of the economy (with the notable exception of the energy sector) with the explicit goal of shifting the country's model of production to export-oriented industrialization. On 17 December 1992, Salinas and his northern counterparts signed the North American Free Trade Agreement. The treaty officially entered into effect on 1 January 1994 and, in May of the same year, Mexico became the first developing country to join the OECD. The former remains, to this day, the administration's most lauded achievement and one of the highest impact policies on Mexico's long-term economic development.

Following the Mexican peso crisis of 1994, the administration of Ernesto Zedillo Ponce de León was the first to actively pursue a floating exchange rate. Since the beginning of his administration—which ended on 30 November 2000—the Bank of Mexico (*Banxico*) has exercised limited monetary intervention, allowing free-market forces to determine the value of the peso with relation to the U.S. dollar. When Banxico does intervene, the purpose is not to defend a rate of exchange but rather to target inflation and stabilize expectations. Such policies have served the economy well: since then, the managed floating exchange rate, paired with 20 years of responsible public finances, has improved credibility and served as a buffer for the Mexican economy against exogenous shocks that would otherwise destabilize the country.

Recently, the most decisive change in the government's general policy orientation has been the signing of the *Pacto por México* (Pact for Mexico). Notably, the pact delivers the final blow to *Petróleos Mexicanos* (Pemex) and the *Comisión Federal de Electricidad*: the passing of the Energy Reform of 2013. Among other things, the Energy Reform has been the most decisive policy enacted aimed at breaking the cumbersome, legal monopolies that the two aforementioned companies operate in the country's petroleum and electricity industries respectively. The reform works in synchrony with twelve additional reforms in other sectors, ranging from public finance, penal procedures, and the electoral system to banking, telecommunications, and economic competitiveness. The goal of the reform package is to address the underlying obstacles to growth as defined by the current administration: market distortions, low productivity, and corruption.⁷

⁷, Richard H.K. Vietor and Haviland Sheldahl-Thomason, "Mexico's Energy Reform," (Case study, Harvard Business School, January 2017; Revised August 2017), Case: 717-027: 4.

If the idea of a rigid and punishing implementation of the Washington Consensus has repeatedly been rebuked, not only by economists following opposing theories of development, but by the author of the original consensus himself⁸, the recommendations are not necessarily ill-formulated. Indeed, it is imperative to consider the individual country's specific circumstances—especially factors which may impact the effectiveness of changes in economic policy such as the composition of trade, geographical limitations, and socialized understandings of economics at odds with the long-standing Western paradigms. Even so, the general principles on which the recommendations rest have been proved to be solid and applicable to Mexico, subject to adjustments specific to the country's reality.

In order to adequately assess the impact of each of the aforementioned policies, as well as their effectiveness in the larger push for economic development, it is necessary to assess the origin of each policy, considering the national context at the time of their inception and passing. The earliest concrete example was Mexico's signature and later ratification of the North American Free Trade Agreement. Which begs the question: why was NAFTA sought?

Perspectives on liberalism

As of today, the literature available on the topic of trade liberalization, economic reform and the changing in government policies to that effect are varied. The general agreement

⁸ John Williamson, "The Washington Consensus and Beyond," *Economic and Political Weekly* 38, no. 15 (2003): 1476. <http://www.jstor.org/stable/4413431>.

is that low productivity is to blame for the lack of growth in the Mexican economy on an individual level and the gross wealth disparities.⁹

Many argue that the concept of trade liberalization itself—and in effect, the domination of the economy and policies surrounding it by free-market forces—is a fallacy. The argument suggests that neoliberal reforms are a means to a simple reorganization of the institutions which regulate commerce.¹⁰ To this effect, orthodox economic analysis on the country's present situation argues that the reason for Mexico's lack of growth—and the solution to it—are not related to a lack of openness to global markets. It criticizes high labor informality, social safety nets that incentivize informal labor, procyclical monetary and fiscal policy, institutionalized market rigidities owing from the existence of private oligopolies and monopolies, and weak oversight of the state over private enterprise and labor unions, for the lack of dynamism in productivity.¹¹ Most orthodox analysts argue that for the country to progress at every economic level and reduce inequalities, the rule of law has to establish its sovereignty in politics and over the market forces in a way which allows the free market forces to operate without permitting rampant wealth concentration at the top.

However, there are those who oppose this traditional understanding. According to Cárdenas, the period between the beginning of the Mexican Revolution (1910) and the start of World War II, often dismissed as a period primarily concerned with the shifting of power

⁹ BID (Banco Interamericano de Desarrollo), 2013; World Bank, 2014; Banco de México, 2013; International Monetary Fund, 2014.

¹⁰ Richard Snyder, *Politics after Neoliberalism: Reregulation in Mexico*, Cambridge, UK: Cambridge University Press (2001): 195.

¹¹ Blanca L. Avendaño Vargas and Ignacio Perrotini Hernández, "Insuficiencia Dinámica, Crecimiento Y Desempleo En México, 1974-2012," *Investigación Económica* 74, No. 293, Facultad de Economía, Universidad Nacional Autónoma de México, (2015): 100.

between insurgents, was the most important period in setting the economic ideology that would allow modern Mexico to develop.¹² Moreover, it was precisely Mexico's openness to the global markets at the time and its large-scale dependence on import goods which allowed for import substitution to result when flexible national monetary policy devalued the peso, decreasing the price of domestic goods relative to their imported counterparts. Cárdenas makes the case that the "Mexican Miracle" was not so much a miracle as it was the natural consequence of countercyclical policy decisions taken in the country to mitigate the domestic effects of the Great Depression, decisions which, if unintentionally, spurred domestic industry and accelerated domestic growth in a period of global economic contraction. This position, therefore, differs from that of the traditional body of academics, in arguing that intelligent domestic policy, coupled with government restraint and a focus on "capital-intensive" economic growth, will allow the country to sail with the global economic currents—otherwise known as "free-market pressures."¹³

Liberalism, bedrock of democracy

Irrespective of the ideological current to which academics ascribe, few challenge the positive impact that liberalization, integration into global markets, and the expansion of the private sector had on Mexico's long democratic transition.

¹² Enrique Cárdenas, "Mexico's Industrialization During the Great Depression: Public Policy and Private Response", *The Journal of Economic History* 44 (2), (Cambridge University Press, 1984): 603.

¹³ *Ibid*: 605.

The clearest example of this was the PRI's progressive loss of control over local and state governments in the aftermath of the crisis produced by López Portillo's actions in the 1980s. Kelsner describes the unusual arrangements the governing party made with the main opposition party, PAN, to provide congressional support for liberalizing economic reforms, as liberalism was unpopular among political circles for the better part of the century. In exchange, the PRI allowed electoral reforms that took a toll on the party's hold over congress—three years later, the party would lose control of Congress for the first time since the Revolution of 1910.¹⁴ These kinds of developments are at the foundation of the theory of democratization through economic development.

A more nuanced assessment of this impact is presented by Russell Crandall's. Mexico's macroeconomic stabilization achievements represent a momentous shift towards "the end of history," as Francis Fukuyama would describe the culmination of the country's economic and democratic consolidation. However, that end is still distant, and the achievement of broad strategic objectives obligates the shift towards addressing narrower issues across the board, including stable employment, a balanced income distribution, fiscal reorganization to rely on tax revenues, investments in education and other sorts of human capital, and the consolidation of the country's justice system.¹⁵ In essence, it was the centrally-planned, development-oriented strategies implemented during the final years of the PRI's hold on power that paved

¹⁴ Joseph L. Kelsner, "An Electoral Route to Democracy? Mexico's Transition in Comparative Perspective," *Comparative Politics* 30, No. 4 (1998): 482.

¹⁵ Russell Crandall, "Introduction: The Challenges of Democratic Change in Mexico," in R. Crandall, Guadalupe Paz, and Riordan Roett, eds., *Mexico's Democracy at Work: Political and Economic Dynamics*, (Boulder, CO: Lynne Rienner Publishers; 2005): 1-3.

the way for underlying issues to take a front seat in a participatory democracy. This, however, brings on an additional set of challenges.

A counterargument of Mexico's democratic transition, however, highlights the unique nature of the process in the country when compared to its regional neighbors. Unlike Argentina or Chile, democracy did not develop in Mexico as a result of a cathartic uprising against an oppressive military dictatorship. Rather, Andreas Schedler's theory of "democratization by elections" is of particular interest in an effort to understand how the country's political transition came about. Schedler suggests that the gradual development of a democratic political environment in the country meant that political institutions would be ineffective in addressing the increasingly complex issues associated with an open market, a liberal economy, and a participatory democracy.¹⁶ The Mexican case, to a degree, supports this perception.

However, taking into account the former conceptualization of democratization, the inadequacy described by Schedler may be adaptive in nature. As Mexico continues to develop toward a complex and advanced market economy, one where private actors take responsibility in addressing macroeconomic issues, further ground may be opened in the public arena to delve into the complexities of a participatory democracy.

Moreno-Brid and Ros present evidence of this in a historical analysis of the relationship between the state and the economy. Of particular note is the difficulty that the administration of President Luis Echeverría in balancing stabilizing growth with curbing the country's

¹⁶ Andreas Schedler, "The Nested Game of Democratization by Elections," *International Political Science Review / Revue Internationale De Science Politique* 23, No. 1 (2002).

growing inequality. Under near-complete state management, the administration's technical expertise and resources were unable to address both fronts at the same time. The policies implemented for redistributive growth proved effective in reducing income disparities but threw the country's macroeconomic fundamentals into disarray.

Although a balance of priorities is described as untenable, the authors' assessment takes a turn, to argue that the state's detachment from market intervention has not been translated into increased efficiency in addressing social concerns.¹⁷ However, the article was written in 2004, and since then, the last two administrations have taken more decisive action to address many of these social iniquities. Whether they have positive results is to be seen—as with all change, results can be impacted by external factors, and the current economic environment may play a large role in that.

The importance of free trade

Without a doubt, the most important policy decision in Mexico's modern history has been the ratification and implementation of the North American Free Trade Agreement (NAFTA). The agreement is, in its present form, a multilateral free-trade area that encompasses Canada, Mexico, and the United States. However, unlike more integrated trade blocs such as the European Union, Mercosur, or the ASEAN Economic Community, integration within NAFTA is limited to the elimination of barriers to trade—both tariff and non-tariff—without provisions to bring the member states into a common market or an economic union. That

¹⁷ Juan Carlos Moreno Brid and Jaime Ros, "Instituciones y Desarrollo Económico: La Relación Estado-Mercado en México Desde una Perspectiva Histórica," *Revista Mexicana de Sociología* 66 (2004): 164-74.

being said, the economic consensus suggests the agreement's implementation has been behind Mexico's economic leaps in the past two and a half decades and has pushed the trade bloc to be the world's largest and most dynamic economic region.

The rhetoric of the 2016 U.S. election cycle notwithstanding, NAFTA's economic benefits are by no means questionable. In numerical terms, the impact is clear: Mexico's exports totaled USD 70.3 billion in 1994, which represented 13.3 percent of the country's gross domestic product; at the end of 2016, the figure stood at USD 399.1 billion, or 38.2 percent of GDP.¹⁸ And these figures do not represent an overall increase in the country's exports globally. According to the *Atlas of Economic Complexity*, published by Harvard University using data from the United Nations database of international trade statistics, COMTRADE, a full 80.3 percent of those exports—totaling USD 320.5 billion—go to its NAFTA partners.¹⁹ Along similar lines, Mexico's purchasing power has skyrocketed—over the same period of time, imports have grown by USD 334.1 billion; and yet again, the country's participation in NAFTA means that, as of 2016, USD 269.5 billion or 64.44 percent of imports originate in either the United States or Canada. More importantly, as a share of the American offer, the elevated purchasing power has allowed Mexico to become the United States' second largest consumer, capturing just under a sixth of U.S. exports.

Beyond the raw data, the implementation of the agreement has had positive effects on Mexican society at large. Mexico's HDI, a measure of standard of living that takes into account life expectancy, literacy, per capita income, access to services, and degree of marginalization,

¹⁸ World Bank, 2017.

¹⁹ *Atlas of Economic Complexity*, Harvard University, 2016.

among other things, has sustained constant, well-paced growth, indicating a general rise in the wellbeing of the average Mexican. Before continuing to analyze the impact scale of NAFTA's implementation in Mexico, however, consider the factors that influenced Mexico's determination to enter into such an asymmetrical free trade agreement.

III. Economic history and policy antecedents

The run-up to a North American trade bloc

To understand the country that Salinas led into the most avant-garde trade bloc of the era—bar the common market that Europe had been developing since the 1950s—it is important to consider Mexico’s vulnerable position through the better part of the 1980s.

Bank nationalization and the Lost Decade

Through the 1970s, administrations shifted decisively towards economic structuralism, with heavy reliance on public expenditure for infrastructure projects, which were in turn financed through foreign borrowing and the inflows from petroleum exports. However, pressure from the private sector, foreign corporations, and neoliberal economists hindered the implementation of President Luis Echeverría’s plans for a continuation of the country’s growth based on a state-directed economic platform. This “dispute” for control of the nation’s economic future would continue into the following decade—in 1982, the outgoing administration was left to choose between the two and ultimately chose to follow tradition.

During the 1970s, Mexican banks were encouraged to expand operations overseas and participate in international financial markets as a tool to strengthen the domestic financial sector. As would later be condemned by President José López Portillo (1976-1982), Mexican banks became powerful enough to undermine the policy goals of the administration: while Banxico fought for prudence to maintain economic stability, the finance ministry (*Secretaría*

de Hacienda y Crédito Público; SHCP) and the presidency were torn internally between factions looking for sustained industrialization at the expense of the country's economic reality and those who sought to stabilize the national economy by reining in the financial sector.²⁰ According to prominent presidential adviser Carlos Tello, the sheer size of the finance industry achieved through internationalization was a threat to the government's ability to guide national economic policy and remain in control of the country.²¹

With respect to the federal budget, upon taking office in 1976, and with the support of the International Monetary Fund (IMF) among others, López Portillo embarked on financial adjustment plans based on public austerity and curtailing government expenditures. The discovery of vast petroleum reserves in 1978, however, led to a sharp tack: the administration began spending inordinate amounts of money, fueled by the assumption that oil prices would remain steady. Halfway through 1981, oil prices took a serious downturn, and crashed the following year. López Portillo refused to act, and instead continued borrowing from private lenders abroad at exponential rates, propping up domestic job creation and absorbing insolvent businesses as necessary.²² In August of 1982, four months away from leaving office, López Portillo finally gathered a team of advisers to suggest containment strategies in 1982. An official in the López Portillo administration would later acknowledge that the president was wary of rocking the boat in the year prior to election.

²⁰ Sylva Maxfield, "The International Political Economy of Bank Nationalization: Mexico in Comparative Perspective," *Latin American Research Review* 27, no. 1 (1992): 78-80.

²¹ Carlos Tello, *La nacionalización de la banca*, Mexico City: Siglo Veintiuno, 1984.

²² Viviana Elizabeth Zárate Mirón, "Capítulo 1. Marco de referencia," in *Convergencia en el crecimiento de los estados de México a partir del Tratado de Libre Comercio de América del Norte (TLCAN)* (Professional thesis, Universidad de las Américas Puebla, 2009), 3.

As described by Adolfo Aguilar Zinser, a former adviser to Echeverría, and eventual National Security Advisor to the Fox administration (2000-2006), during the PRI's years in power, and especially as the democratic transition of the early nineties neared, rifts within the party were most present at the end of a *sexenio*, when different factions vied for a nomination that would advance their interests. This means the party's hold on power—and by consequence, political stability—were in greatest danger during transition of power.²³ Understanding this dynamic meant that López Portillo knew that he had to maintain trust in the party as the 1982 election cycle neared. The fall in oil prices resulted in reduced revenue from petroleum exports and an overvaluation of the peso—which at the time was still subject to consistent intervention from Banxico to maintain a stable and favorable exchange rate vis-à-vis the dollar. Neoliberal economic policy, aimed at mitigating the effects of external shocks, prescribes that the fall should have been answered immediately by allowing the currency to lose value against the dollar and tightening the federal budget to limit borrowing, as debt repayment should be prioritized under a depreciated peso. The alternative, is a long and painful correction of the overvaluation paired with government insolvency.²⁴ But this amounted to political suicide, and López Portillo was looking to prop up the party's image.

To this end he requested the advice Tello—who by then no longer figured in the president's official counsel—and José Andrés de Oteyza, then Minister of Natural Resources and Industrial Development, among others. Tello and Oteyza were both structuralists,

²³ Adolfo Aguilar Zinser, "Mexico: The Presidential Problem," *Foreign Policy*, no. 69 (1987): 42.

²⁴ Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization, Reform, and No Growth," *Brookings Papers on Economic Activity*, Vol. 1, 1994: 271-276.

educated at the National Autonomous University of Mexico (UNAM) under Horacio Flores de la Peña, an avowed socialist *wary* of neoliberalism and the private sector.

With the election of François Mitterrand to the French presidency in 1981, the French *Parti socialiste* undertook deep efforts towards nationalization of several sectors of the French economy, notably, key productive industries and finance. It is also no coincidence that, in 1982, Mexico's Ambassador to France was the very same Flores de la Peña. When Tello and Oteyza began formulating proposals to bring a plausible, politically popular solution to President López Portillo, Flores de la Peña suggested evaluating the possibility of nationalizing Mexico's financial sector, as France had done a year prior. The president, looking for a politically viable solution, and enraged by the financial crisis facing Mexico, was easily convinced that the proposition would be the most effective way to combat massive capital flight, which drained as much as USD 5 billion in a matter of weeks through Mexico's largest commercial bank, Bancomer.²⁵

Between August and the time Miguel de la Madrid took office in December of 1982, the Mexican economy had already contracted by 0.52 percent. By the end of 1983, GDP had contracted by over USD 100 billion, and the peso had lost 500 percent of its value. Adding to the crisis left behind by López Portillo, the 1985 Mexico City earthquake left behind over USD 5 billion in damages²⁶, and by 1987, inflation in Mexico soared just shy of 160 percent.²⁷ The tragic outcomes in Mexico sent reverberations across the region. While some countries were able to avoid the brunt of the economic collapse through fixed exchange rates which

²⁵ Maxfield: 80-83.

²⁶ National Oceanic and Atmospheric Administration, 2017.

²⁷ International Monetary Fund, 2017.

curbed inflationary upturns, poverty rates, unemployment—and especially relevant in today’s context, employment informalization—and income inequality shot up. Over the course of the decade, Latin America as a whole actually saw a decrease in real per capita GDP. This would be known as the Lost Decade.²⁸

Mexico’s economic aperture: De la Madrid and neoliberalism

As a response to the mess left by his predecessor, President De la Madrid took a drastic turn in Mexican commercial and domestic economic policies. His administration marked the beginning of neoliberalism in Mexico. His primary goal was overseeing the transition of Mexico’s economic model, starting in 1985, from its traditional import-substitution industrialization regime for domestic growth to an export-oriented model.²⁹ In addition to that, he departed from party tradition in a groundbreaking way for a developing economy: he was the first president since the PRI took control of the country in 1929 to convincingly commit his administration to public austerity measures. As explained before, up until his election, the presidency and legitimacy thereof were inextricable from its obligation to bring economic growth through policy decision. However, because of decisions made during the two administrations prior to his, further government overreach would yield no results in terms of growth.³⁰ Instead, De la Madrid focused his efforts on attracting foreign investment to

²⁸ Juan Carlos Moreno-Brid, Esteban Pérez Caldentey, and Pablo Ruíz Nápoles, “The Washington Consensus: A Latin American Perspective Fifteen Years Later,” *Journal of Post Keynesian Economics* 27, no. 2 (2004): 347-8.

²⁹ Patrick Cronin, “Explaining Free Trade: Mexico, 1985-1988,” *Latin American Politics and Society* 45, no. 4 (2003): 64.

³⁰ Manuel Villa, “La política en el gobierno de Miguel de la Madrid”, *Foro Internacional* 30, no. 4 (120) (1990), El Colegio De Mexico: 667.

supply the country with a desperately-needed flow of cash untied to the federal government. Furthermore, he worked to reintegrate the Mexican economy into global financial systems.

The De la Madrid administration's most notable policy feat was the signing and ratification of the General Agreement on Tariffs and Trade in August of 1986. The importance of this cannot be overstated. At face value, it signaled a commitment to global liberalist tendencies which inevitably drew power from the PRI party establishment. More importantly, however, it tied Mexican industry to global markets. Furthermore, he initiated a large-scale privatization of a number of state businesses, reducing the total number by around two-thirds.³¹ Through these actions, De la Madrid laid the groundwork for Mexico's democratic transition—given the precarious situation of the party and global tendencies, any future leaders would find it untenable to continue with a domestic political regime that ran in complete opposition to the economic principles it was embracing.

Crafting NAFTA

The idea of a free trade bloc encompassing Canada, Mexico, and the United States had been around for over a decade before Salinas, former U.S. President George H.W. Bush (1989-1993), and former Prime Minister of Canada Brian Mulroney (1984-1993) signed the finalized agreement in 1992. In 1986, the U.S. administration under President Ronald

³¹ Juan Carlos Moreno-Brid and Jaime Ros, *Development and growth in the Mexican economy: a historical perspective* (Oxford University Press, 2009).

Reagan, one of the staunchest supporters of global free trade³², made calls for the negotiation of a free trade agreement between the U.S. and Mexico as the only viable solution to Mexico's recurring sovereign debt troubles, which by then had reached USD 98 billion.³³

Perhaps considered overly optimistic, the transition in Mexico's economy from 1986 to 1993 was drastic. As discussed earlier, the De la Madrid and Salinas administrations undertook economic reforms of a neoliberal current with a speed that surprised even the most optimistic of policymakers and analysts. Beyond the gradual removal of non-tariff barriers to trade, including quotas and license requirements for imports, tariffs were slashed from 100 to 50 percent under GATT rules, and then unilaterally reduced further to a maximum of 20 percent. By the early nineties, controls on foreign investment for a majority of industries had nearly disappeared.³⁴ This meant that when Salinas officially requested a start of negotiations to establish a free trade agreement with the United States, the corresponding Bush administration, very much ideologically aligned with the previous president's views on liberalization, was only too keen to begin negotiations as soon as possible to reduce all barriers to trade with its southern neighbor.³⁵

The main changes to Mexico's trade policy as a result of NAFTA were as follows:

³² Alfred E. Eckles, "Ronald Reagan and the New Age of Globalization," in *Reagan's Legacy in a World Transformed*, edited by Jeffrey L. Chidester and Paul Kengor, by Brian Mulroney, 11-23, Cambridge, Massachusetts; London, England: Harvard University Press, 2015.

³³ Edward L. Hudgins, "A U.S. Strategy to Solve Mexico's Debt Crisis," Report, Washington, D.C.: The Heritage Foundation (1986).

³⁴ Gustavo Vega Cánovas, "La política comercial de México en el sexenio 1994-2000: crisis financiera y recuperación económica," *México y Estados Unidos: La economía política del Libre Comercio* (pp. 351-402), El Colegio de México: 354.

³⁵ Baer, M. Delal. "North American Free Trade." *Foreign Affairs* 70, no. 4 (1991): 139.

1. *A gradual removal of all barriers to trade, tariff and non-tariff, to the two-way flow of products.*

Prior to the implementation of NAFTA, U.S. products in Mexico faced, on average, a 10 percent tariff, compared to the average 2.07 percent tariffs for products travelling in the opposite direction. Two years into the progression of tariff elimination, the means had fallen to roughly 3 percent and under 1 percent respectively.³⁶ These were of special note for the textile, auto, and agricultural industries, where tariffs placed on U.S. imports into Mexico were as high as 20 percent in the automotive industry.³⁷

2. *Liberalization and standardization of trade in services.*

Through the agreements on the topic of service trade, a common framework was laid out for issues such as investment, transnational sales, and nondiscrimination of products. Notably, the framework of NAFTA allowed Mexico an exception to the aforementioned rules in petroleum exploration and extraction, allowing Mexico to keep its moneymaker, Pemex, away from its momentum towards complete market liberalization indefinitely.³⁸ Instead, Salinas focused on a “modernization” of the entity and its operations,³⁹ a move which was little more than internal restructuring which prevented the industry from expanding in productivity through the advantages of liberalization.⁴⁰

³⁶ Executive Office of the President, *Study on the Operation and Effects of the North American Free Trade Agreement*, July 1997: 6-7.

³⁷ Business Roundtable, *NAFTA: A Decade of Growth*, The Trade Partnership, (Washington, D.C., 2004): 30-33.

³⁸ M. Angeles Villarreal and Ian F. Fergusson, *The North American Free Trade Agreement (NAFTA)*, CRS Report No. R42965 (Washington, D.C.: Congressional Research Service, 2017): 12.

³⁹ George Philip, “The Political Constraints on Economic Policy in Post-1982 Mexico: The Case of Pemex,” *Bulletin of Latin American Research* 18, no. 1 (1999): 45-47.

⁴⁰ Rogelio López -Velarde, “Mexico's New Petroleum Law: The Internal Reforms at Pemex and the North American Free Trade Agreement,” *The International Lawyer* 28, no. 1 (1994).

3. *Provisions protecting IP rights, promoting foreign investment, and establishing arbitration systems for trade-related disputes.*

Given that many of these issues were innovative—TRIPS would only be cemented into international trade framework two years later with the ratification and entry into force of the WTO—NAFTA essentially provided a framework for the new trade that would take place among the three countries to be tightly regulated and promote inclusive development across the three-member states.

Immediately after the treaty's entry into force, however, economic discipline troubles put Mexico into a tough situation which would prevent the treaty from seeing results for another 5 years.

The Mexican Peso Crisis of 1994

One of the most prolific crises in recent history, and one with global repercussions, affecting both the developing and the developed world, was the Mexican Peso Crisis of 1994. Arguably, the cause of the crisis itself stemmed from a single policy decision. Commonly known as *el error de diciembre*, its results were dictated primarily by its timing and the immediate response by the government and market actors. The decision to allow the controlled devaluation of the peso, however, was not without its merits. Monetary and fiscal policy leading up to December 1994 necessitated the very decision which academics, and even the outgoing president, condemned as the genesis of the crisis. At the time, however, experts who defended the policy decision argued that the Mexican economy would recover after a mild

recession caused by the devaluation. The question this work aims to answer is how political factors in the run-up to the 1994 presidential election deepened the effects of the devaluation, causing a full-fledged crisis requiring a bailout to the tune of USD 52 billion and with repercussions felt in the developing world for nearly a decade after.

Salinas assumed the presidency after a highly fraught election in 1988. In an effort to repair his reputation following the debacle of the election, his administration embarked on a series of ambitious neoliberal reforms which aimed to achieve three goals. First, the opening of the Mexican market to international competition and a shift to export-oriented industrialization; second, the privatization of virtually all sectors of the economy—with the notable exception of the energy sector—and; third, macroeconomic stability through restraint in monetary and fiscal policy. To the surprise of many, and the pleasure of Wall Street, his administration successfully reined in inflation, spurred economic growth, and stabilized the Mexican economy with such swiftness that experts and academics revived the term “the Mexican miracle”, reflecting the optimism of foreign actors, private and public, with regards to Mexico’s path to development. Inflation fell precipitously, from the record highs of the late 1980s, to under 8 percent in 1993; in two years, foreign reserves, a key sign of economic stability, grew from virtually zero to USD 6.3 billion in 1989, and had reached just under USD 30 billion by January 1994.⁴¹ Confidence in the Mexican economy was so strong that, between 1990 and 1993, Mexico captured fully one fifth of net capital flows to developing countries—no less than USD 104 billion over the course of four years. The signing of NAFTA

⁴¹ Guillermo A. Calvo and Enrique G. Mendoza, "Petty Crime and Cruel Punishment: Lessons from the Mexican Debacle," *The American Economic Review* 86, no. 2 (1996).

in January 1994 and the country's admission into the OECD in May of the same year cemented the belief that Mexico was poised to become a developed economy by the turn of the millennium, and not without reason.⁴²

In spite of aggressive investor presence, by early 1993 there were serious signs that the macroeconomic policy decisions, fiscal and monetary, which had resulted in rapid growth, were unsustainable. Inflation, while drastically lower than it had been six years prior, was still above target. This posed a problem for the fixed-nominal rate-based stabilization, which led to a real appreciation of the peso because it did not account for a higher domestic rate of inflation. The sheer size of capital inflows was another problem—large foreign demand for Mexican securities placed heavy upward pressure on the value of the peso⁴³. Economists had suggested that a nominal devaluation of the peso, which had moved from a fixed peg, to a crawling peg, to an adjustable band, was a necessary step to correct this overvaluation.⁴⁴ If left to be corrected naturally, the process would be long and painful, with years of low growth and high unemployment eventually depreciating the real currency to match the nominal exchange rate.⁴⁵

The overvaluation of the currency played an important role in the widening of the country's current account deficit, which is the first of the reasons why the impact of the crisis was so deep.⁴⁶ Mexico's economic history since the Revolution of 1910 largely consisted of a

⁴² Shalendra Sharma, "The Missed Lessons of the Mexican Peso Crisis," *Challenge* 44, no. 1 (2001): 57.

⁴³ Nora Lustig, "The Mexican Peso Crisis: The Foreseeable and the Surprise," Brookings Institution (June 1995): 5.

⁴⁴ Calvo and Mendoza: 170.

⁴⁵ Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization, Reform, and No Growth," *Brookings Papers on Economic Activity* 1 (1994): 271-6.

⁴⁶ Pierre-Richard Agénor, "Market Sentiment and Macroeconomic Fluctuations under Pegged Exchange Rates," *Economica, New Series* 73, no. 292 (2006): 579-604.

closed economy, a development strategy based on import-substitution industrialization, and growth primarily driven by government spending. The liberalization reforms taken on the by the Salinas administration were seen as a move in the right direction, and heavily praised by Bill Clinton at the signing of NAFTA. The domestic public's perception to them, however, was much less enthusiastic. Mexicans believed the country's trade liberalization regime to be a temporary opening with the aim of accessing foreign capital to spur growth and were not confident in the regime's permanence. This belief encouraged people to import "while they could". Because capital flows kept pouring into the country, Mexico could maintain this current account deficit for a while, accumulating foreign reserves, but deepening the deficit as they went.⁴⁷ Due to a prolonged, low level of domestic savings, any shocks to the flow of capital would cause an imbalance in consumption, which proved to be accurate after the crisis. Between 1994 and 1996, real income fell by 23 percentage points which then led to a 19 percentage-point reduction in consumption.⁴⁸

An additional cause for concern was the proportion of capital flows to Mexico which came in the form of portfolio investment. As mentioned before, Mexico captured over USD 100 billion in net capital flow between 1990 and 1993. However, USD 61 billion of that total was in the form of portfolio investment; less than USD 17 billion came in the form of FDI.⁴⁹ The problem with stock market investments is that they are highly liquid, and as easily as they move into a country during periods of investor optimism—as they did during

⁴⁷ Nora Lustig, "The Outbreak of Pesophobia," *The Brookings Review* 13, no. 2 (1995): 46.

⁴⁸ David J. McKenzie, "The Consumer Response to the Mexican Peso Crisis," *Economic Development and Cultural Change* 55, no. 1 (2006): 146.

⁴⁹ Sharma: 58.

the last three years of the Salinas administration—they move out of a country at the slightest sign of a panic. This distinction is one of the crucial points in formulating sound economic policy, especially as it relates to capital attraction. For increased productivity, an industry must be able to take advantage of positive cash flows and inject them into the economy in the form of real wage growth or added value.⁵⁰ In the aftermath of the December devaluation, the Mexican Stock Exchange (BMV) took a nosedive, depleting the country of the necessary flow of dollars, and forcing the Mexican government to act.⁵¹

Upon arrival in Los Pinos, Ernesto Zedillo Ponce de León removed Pedro Aspe from the helm of the Secretariat of Finance and Public Credit (SHCP). He replaced the former leadership of the country's financial institutions with his own team of economists, led by Jaime Serra Puche, to deal with the mounting balance of payments problem and the overvalued peso, both of which were brought on by his predecessor's policies. On December 20, 1994, less than a month after his inauguration, the Zedillo administration announced the widening of the exchange rate band to correct the latter of the two issues, moving the upper limit from MXN 3.47 to MXN 4.00 to the U.S. dollar.⁵² Zedillo, a career economist with experience in exchange-traded funds (ETFs) in Banxico, had recommended the devaluation while working as an adviser to the Salinas administration. Under normal circumstances, the relatively modest increase (15.3 percentage points) to the upper limit of the exchange rate band would have been inconsequential, incurring a mild recession and a speedy recovery, driven by renewed export

⁵⁰ Rabin Hattari and Ramkishan S. Rajan, "How Different are FDI and FPI Flows?: Distance and Capital Market Integration," *Journal of Economic Integration* 26, 3 (2011).

⁵¹ Calvo and Mendoza: 171.

⁵² Sharma: 59.

growth and domestic production. However, 1994 was marred by a series of scandals and news of national importance that put a strain on the government's ability to weather the slow in capital flows.⁵³ While delaying the devaluation of the peso an entire year, Salinas burned through over USD 20 billion in foreign reserves in an effort to maintain the value of the peso artificially high to sustain the country's current account deficit.⁵⁴ In doing so, he effectively spoiled the potential for the work of his *sexenio* to bear fruit.

Economic stabilization and growth

As a result of the Mexican Peso crisis, profound changes to policy were implemented to reduce the risk associated with investment in Mexico during the Salinas period. Prior to 1994, poor fiscal management led to an overdependence on unfulfillable guarantees to attract foreign capital. Moreover, industry was under regulated, crony capitalism dominated the relatively young private sector, and the country's monetary policy was largely aimed at keeping the peso attractive for foreign investors, whatever the cost.

Tequila on an empty stomach

Prior to 1994, Mexico's banking sector which had only been privatized in the three years leading up to the crisis, was ill-regulated and excessively exposed to risky investments. The National Banking Commission (CNB) was understaffed, lacked the information

⁵³ Ibid.

⁵⁴ Joseph A. Whitt, Jr., "The Mexican Peso Crisis," *Economic Review* 8, 1 (January/February 1996).

technology necessary to adequately gather data on the banks, and did not have the legal authority for effective oversight of the banking industry.⁵⁵ As a result, a considerable share of loans outstanding issued by the newly-privatized institutions were non-performing.⁵⁶ Salinas' administration knew this: the privatization of banks had been speedy with loose guidelines for the payment of the winning bids, meaning some payments were made by borrowing from the same institutions they were purchasing. In spite of this, Banxico established a contingency fund known as *Fobaproa* (Banking Fund for the Protection of Savings) through which it committed itself to guaranteeing all bank liabilities excluding subordinate debt.⁵⁷ The administration knew this was the country's economic Achilles' heel— given the scale of deposits in private banks, Banxico would be unable to maintain the system afloat if the sector collapsed.

On the topic of the peso's value, the government's general economic strategy was to treat any adverse shocks to the economy as a temporary obstacle to be "sterilized" through government borrowing.⁵⁸ In part, this meant maintaining the value of the peso stable vis-à-vis the dollar and keep interest rates from climbing.⁵⁹ Towards 1994, this stability in the peso's nominal exchange rate was a source of confidence in the market's stability. Because of the scale of capital inflows, the peso quickly appreciated. In spite of this, exports continued to grow, an

⁵⁵ Stephen Haber, "Mexico's experiments with bank privatization and liberalization, 1991-2003," *Journal of Banking and Finance* 29 (2005): 2332.

⁵⁶ Lustig, "Life is not Easy."

⁵⁷ Michael W. Mackey, *Report of Michael W. Mackey on the comprehensive evaluation of the operations and functions of the Fund for the Protection of Bank Savings 'FOBAPROA' and the quality of supervision of the FOBAPROA program, 1995-1998*. Stanford University: unpublished paper, July 1999.

⁵⁸ Jeffrey Sachs et al., "The Collapse of the Mexican Peso: What Have We Learned?" *Economic Policy* 11, 22 (April 1996): 16.

⁵⁹ Nora Lustig, "Life is not Easy: Mexico's Quest for Stability and Growth," *Journal of Economic Perspectives* 15, 1 (2001): 92.

indicator used as evidence that the peso was not overvalued. Economists however, argued the contrary, and deemed the imbalance a threat to the country's growth. Notably, Rudiger Dornbusch and Alejandro Werner wrote and spoke extensively about the overvaluation of the peso, and the threat that it posed on the economy when, inevitably, the peso was subjected to a corrective devaluation.⁶⁰ These concerns were rooted in a current account deficit to the tune of 7 percent of GDP.⁶¹

Arguably, however, the most dangerous policy decision was the decision to begin issuing dollar-denominated instruments of sovereign debt, the infamous *tesobonos*. As FDI soared in the early nineties following large-scale privatization, the peso remained fixed to the dollar in an effort to keep inflation low. In spite of this, the real appreciation of the currency paired with the entry into force of NAFTA meant that domestic savings were nearly non-existent, and investors began to suspect that the Mexican economy was not stable enough for long-term investment. To combat the threat of large-scale capital flight, the government pushed for foreign investment to shift to dollar-denominated debt. The hope was that the issuance of *tesobonos* would instill confidence in the government's control of the situation. Just in 1994, the share of Mexico's outstanding sovereign debt denominated in dollars rose from 6.4 percent at the beginning of the year to nearly two-thirds of total debt by August.⁶² This was yet another unsustainable burden on the country's foreign reserves which would ultimately lead to capital flight and the risk of a sovereign default.

⁶⁰ Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization, Reform, and No Growth," *Brookings Papers on Economic Activity* 1 (1994): 271-6.

⁶¹ International Monetary Fund data.

⁶² Lustig, "Life is not Easy."

Following the debacle of 1994, the Zedillo and his posse of technocrats developed a concise objective for the country's economic policy which would inform specific decisions on monetary policy, budgeting, and efforts to reform various sectors of the economy. As defined in the General Criteria for Economic Policy for the year 2000, the administration's economic strategy consisted of three main pillars of policy implementation: fiscal and monetary prudence, the strengthening of the country's financial system, and the push for structural changes to the national economy.⁶³ In terms of monetary policy, the main adjustment was the release of the peso's pegged exchange rate. Along with this, the reorientation of the central bank's mission toward the use of monetary policy to target inflation expectations. In financial sector, the decade following the crisis saw a shift in policies to curb lending, diversify risk, instill a sense of confidence in the banks' solvency through capital reserve requirements, and shift the burden of deposit guarantees from Banxico to the individual institutions. The structural changes would have come slowly—a constitutional reform package approved in 2014 was the latest in the series of policy instruments aimed at restructuring the Mexican economy to take advantage of its growth potential.

Curbing monetary policy

One of the first actions taken by Zedillo's administration was an agreement known as *el Pacto* through which the government and leaders of every sector of the Mexican economy

⁶³ Secretaría de Hacienda y Crédito Público, *Criterios Generales de Política Económica para el 2000*, presentado ante la LVII Legislatura del Congreso General de los Estados Unidos Mexicanos para facilitar el examen de la Iniciativa de Ley de Ingresos y del Proyecto de Presupuesto de Egresos de la Federación para el ejercicio fiscal 2000, México, D.F. (2000).

agreed to do their part to stabilize the Mexican economy which was on the edge of a financial crisis. As a part of the *Pacto*, the government agreed on the need to release the crawling band to a full floating exchange rate regime. During the negotiations, however, it was widely thought that a sudden release would only further scare the exchange market. To avoid such a shock, the Exchange Commission decided to widen the band by 15 percent, effective 20 December 1994.⁶⁴ Within 48 hours, foreign investors had pulled USD 5 billion out of the country dragging the value of the peso down as they went. On 22 December, Banxico announced it would release the peso's peg, which immediately caused a further depreciation in the value of the peso to the tune of 15 percent, reaching MXN 5.70 to the dollar by 27 December—a loss of more than 40 percent of the peso's value against the dollar in the span of a week.⁶⁵

In the aftermath of the crisis, analysts in academia as well as the business sector agreed that a pegged exchange rate was little more than an opportunity to draw foreign investment under the guise of stability at the expense of the central banks.⁶⁶ Ultimately, the real appreciation of a currency undermines the peg, the value cannot be maintained, and the government is held liable when capital flees.⁶⁷ An additional problem to be resolved with the peg's release was conflation of confidence in the Mexican economy with confidence in the

⁶⁴ Banco de México, *Informe Anual 1994*, rendido al Ejecutivo Federal y al Congreso de la Unión en cumplimiento de lo dispuesto en fracción III del artículo 51 de la Ley del Banco de México, México, D.F. (1995): 41-42.

⁶⁵ Sharma: 60; Whitt: 14.

⁶⁶ Sharma: 66.

⁶⁷ Rudiger Dornbusch, "The Folly, the Crash, and Beyond: Economic Policies and the Crisis," in Edwards and Nairn, ed., *Mexico 1994: Anatomy of an Emerging-Market Crash*, (Washington, D.C.: Carnegie Endowment for International Peace, 1997).

sustainability of the peg. Mexico was only able to maintain the level of debt it did prior to 1994 because of the relative safety of *cetes*—peso-denominated debt instruments.⁶⁸

As outlined by Banco de México in its 1995 Annual Inform, the monetary strategy in place for the remainder of Zedillo’s *sexenio* was notable for the shift in emphasis toward the anchoring of inflation expectations. However, the bank pointed out that using monetary policy to combat inflation was not a goal in itself: rather it defined it as “an indispensable condition” to reach the state’s transcendental goals of sustainable and equitable economic growth.⁶⁹ That is, the peso’s purchasing power must remain stable in order to focus on strategies to promote growth in an environment of certainty. The floating exchange rate remains a core part of Mexico’s economic policy. While the economy is no stranger to volatility, especially in light of external shocks that may affect investor sentiment,⁷⁰ the restrained use of monetary policy has been successful in keeping the value of the peso from nosediving as it did at the end of 1994 (with the 2008 Global Financial Crisis being a notable exception)⁷¹.

New rules for the financial sector

Recovery from the crash did not take long: by the third quarter of 1995, seasonally-adjusted GDP was already positive.⁷² The USD 52 billion rescue package orchestrated by the

⁶⁸ Whitt: 11.

⁶⁹ Banco de México, *Informe Anual 1995*, rendido al Ejecutivo Federal y al Congreso de la Unión en cumplimiento de lo dispuesto en fracción III del artículo 51 de la Ley del Banco de México, México, D.F. (1996): 65.

⁷⁰ M. Angeles Villarreal, *The Mexican Economy After the Global Financial Crisis*, CRS Report No. R41402. Washington, D.C.: Congressional Research Service, 2010.

⁷¹ Bank of Mexico data, 2017.

⁷² Instituto Nacional de Estadística, Geografía e Informática (Inegi data).

Mexican government, the IMF, and the U.S. Secretary of the Treasury allowed the government to stay on schedule with interest payments to its creditors, assuage investor fears, and focus its energy on pulling the country out of its performance slump.⁷³ Once indicators began pointing towards a recovery, the government began taking steps to regulate and reform internally, starting with the banking industry.

The lax regulation enjoyed by the newly-privatized domestic banks played a key role in weakening the financial sector. Among the most salient issues with the regulatory environment was the degree to which the institutions were lending to individuals and companies with ties to the bank's management. These loans had higher default rates and banks that held these loans tended to engage in even more related lending in an effort to stay afloat at the onset of investor panic.⁷⁴ These connections were not required to be disclosed. Additionally, accounting standards which were not required to follow international guidelines hid the banks' real degree of exposure by understating nonperforming loans. Lastly, as became evident following the onset of the crisis, the legal framework to deal with the banks which were going under was lacking, and often times allowed culpable directors to simply walk away. Following the crisis, Congress and the Zedillo administration worked to implement reforms that would address these concerns.

The first part of the reforms aimed at incentivizing self-imposed market discipline by institutions of credit. This included the 1999 Law for the Protection of Bank Savings. With

⁷³ James M. Boughton, "Tequila Hangover: The Mexican Peso Crisis and Its Aftermath," in *Tearing Down Walls: The International Monetary Fund 1990-1999*, 455-496 (Washington, D.C.: International Monetary Fund, 2012).

⁷⁴ Rafael La Porta, Florencio Lopez-de-Silanes, and Guillermo Zamarripa, "Related Lending," *The Quarterly Journal of Economics* 118, 1 (2003).

its implementation, Fobaproa was dismantled and replaced by the Bank Savings Protection Institute (IPAB). Unlike its predecessor, IPAB capped deposit insurance at about USD 130,000 per individual, per IPAB protected institution.⁷⁵ Later, in 2003, the CNBV (born of the merger of the CNB with its securities counterpart), on the question of information disclosure, established regulations to normalize the reporting of investment, derivative, and financial performance information, as well as information about internal control and risk.⁷⁶ Additional reforms included revisions to the regulation of accounting practices to follow international standards, the establishment of regulation to ensure sufficient liquidity by banks with foreign liabilities, and reforms to corporate governance, which gave shareholders legal grounds to be aware of, and thus responsible for, the decisions taken internally.

On the side of the framework in which banks operated, bankruptcy and insolvency legislation were given a lot of work. The *Ley de Quiebras y Suspensión de Pagos* (Bankruptcy and Payment Suspension Law) was scrapped and replaced with the *Ley de Concursos Mercantiles* (Commercial Bankruptcy Law) in May of 2000. The most notable development as a result was the establishment of an independent institution, *Ifecom*,⁷⁷ an autonomous agency of the Federal Judiciary Council, to address bankruptcy protection claims more efficiently than previously. Moreover, laws were amended to prioritize the interest of the creditors in insolvency disputes,⁷⁸ preventing the processes from dragging out and encouraging institutions

⁷⁵ Ley de Protección al Ahorro Bancario, nueva ley publicada en el Diario Oficial de la Federación 19-01-1999, última reforma publicada DOF 10-01-2014.

⁷⁶ Comisión Nacional Bancaria y de Valores, “Disposiciones de carácter general aplicables a la información financiera de las instituciones de crédito,” 2003.

⁷⁷ Ley de Concursos Mercantiles, nueva ley publicada en el Diario Oficial de la Federación 12-05-2000, última reforma publicada DOF 10-01-2014.

⁷⁸ Código de Comercio, nuevo código publicado en el Diario Oficial de la Federación 13-12-1889, última reforma publicada DOF 13-06-2014.

to expand credit.⁷⁹ Moreover, strict regulations were established for banks to take preemptive action should capital inadequacy symptoms arise.⁸⁰

All of these changes which have taken place as late as a decade after the crisis, have served to strengthen the financial sector in Mexico. There certainly remains ample room for improvement—competition remains low and access to credit is restricted because of excessive cautiousness, stringent regulations, and a combination of mistrust of and lack of familiarity with financial institutions. However, the general view is that the country’s macroeconomic fundamentals as well as the strength of its private industries have solidified since the crisis. These achievements were in no small part the result of the fiscal, monetary, and regulatory discipline—self-imposed and external—which Mexico pursued in the short- and medium-term following its close encounter with sovereign default.

⁷⁹ Ley de Instituciones de Crédito, nueva ley publicada en el Diario Oficial de la Federación 18-07-1990, última reforma publicada DOF 17-06-2016.

⁸⁰ José J. Sidaoui, *The Mexican financial system: reforms and evolution 1995-2000*, BIS Papers, No. 28, 19 (August 2006): 286-287.

IV. Current policies and economic outlook

Expectations for growth

Unlike the growth seen in the decade following the Tequila Crisis, Mexico's economic performance in the last six years has been underwhelming at best. When compared to the rest of the emerging markets, Mexico's growth tracks more closely the OECD average annual rates. Since the passing of 13 reforms aimed at tapping into the economy's potential, growth has remained sluggish, oscillating between 2 and 3 percent annually. In spite of this, international organizations and academics alike keep a positive outlook for Mexico's growth. In the last two years, realized growth has exceeded Banxico and the IMF's forecasts by as much as half a percentage point. Policymakers and academics point to this as proof of the country's solid macroeconomic fundamentals and strengthening resilience. Moreover, the U.S. Presidential Election of 2016, the threat of a trade war with the country's largest trading partner, the uncertainty generated by the continuing security issues internally, and corruption scandals notwithstanding, Mexico's economy continues to expand. Recent reforms have started to bear fruit in the form of an expanded credit market, increased competition in domestic industries for the benefit of consumers, and the entry of the private sector into high-value activities in the energy sector. Additionally, high value-added exports are an increasingly large portion of the country's gross domestic product, as domestic and foreign investment continues to expand with a focus on domestic industry and original research and development (R&D).

Looking at labor and population statistics, the current *sexenio* has been noteworthy in its commitment to labor formalization, a key factor in the country's lag in productivity. Official unemployment figures for those aged 15 and up have fallen to 3.13 percent at the end of 2017, the lowest level seen since 2006.⁸¹ Moreover, in the first 5 years of the administration, the private sector has added a record of 3,461,055 new formal jobs.⁸² This brings the total proportion of people employed in the informal sector to 26.8 percent of employed persons at the end of 2017. However, the figure is not without qualification: 56.8 percent of employed persons aged 15 and up participate in informal employment.⁸³

The general situation of the economy, however, remains one of uncertainty and tepid growth prospects. Rising inflation has been answered by hikes to the overnight interbank lending rate by Banxico, reaching 4.69 percent in January of 2018. This means that the expansion of private credit is likely to level off in 2018. On the public front, the Peña Nieto administration has undertaken an far-reaching fiscal consolidation project aimed at rebalancing the government's finances by expanding tax revenues and curtailing public spending. Additionally, the general elections in July of 2018, where a populist, protectionist platform leads in the polls, has generated enough uncertainty to keep growth expectations for 2018 at a meager 2.24 percent—below the OECD average of 2.36 percent, and far below the prospects for similar countries such as Colombia (2.91), Turkey (4.91), and Indonesia (5.16). The forecast for 2019 is only 9 basis points higher.⁸⁴

⁸¹ Inegi, 2018.

⁸² Paulo Cantillo, "Este año, récord en empleo formal, reporta el IMSS," *Excelsior*, 3 December 2017.

⁸³ Inegi, 2018.

⁸⁴ OECD, 2018.

Policy performance 2012 – 2018

The beginning of the current administration’s activity was marked by a boost in confidence from the private and international audiences following Mexican politics. President Peña Nieto’s platform, focused largely on the country’s economic development, drew applause from international observers who commended the government’s commitment to reforms to improve the country’s trade liberalization and degree of economic participation. Indeed, between 2013 and 2016, Mexico led the OECD countries in reform activities, implementing just under 50 percent of the policy recommendations set for by the organization in the *Going for Growth* report—a wide margin over the organization average of 30 percent. Among the most welcome reforms were the fiscal reform, and those of the energy and telecommunications sectors.⁸⁵ The reforms, however, have delivered mixed results.

In 2013, in the first volume of its annual economic outlook report, the OECD suggested that the reforms would “raise sustainable long-term growth prospects.”⁸⁶ At the time, the more important concern for observers and domestic policymakers alike was the retention of core levels of inflation at or below target.⁸⁷ Investors expected a rise in inflation as a result of an economic boom following the reforms’ implementation. This upturn in inflation expectations did not much affect medium-term growth prospects. The same year, GDP growth forecasts by investors surveyed in December by the central bank predicted slow growth for

⁸⁵ OECD, “Mexico,” in *OECD Economic Outlook, Volume 2013 Issue 1*, (Paris: OECD Publishing, 2013).

⁸⁶ *Ibid.*: 142.

⁸⁷ *Ibid.*

2013 (survey average of 1.3 percent), followed by a sharp jump to 3.41 percent in 2014, 3.97 for 2015, and 4.14 for 2016(!).⁸⁸ Even then, Banxico reported additionally a concern over the country's economic context as a result of the implementation of the fiscal reform, the country's public security problem and, most importantly, the expectation that foreign demand would slow (as it has) along with a global economic downturn.⁸⁹ The effects of the global economic slump have evidently had a greater impact on realized growth. Paired with the political risks associated with the US election in 2016 and the current renegotiation of NAFTA, growth has far underperformed vis-à-vis expectations at the beginning of the *sexenio*.

Since its implementation, the telecommunications reform has been among the most successful. The reform was aimed primarily at breaking the duopoly that the Spanish conglomerate Telefónica and Carlos Slim's América Móvil exercised on the market—while only 44 percent of the population has access to fixed-line telephone service, compared to a 94 percent penetration of mobile providers.⁹⁰ As far as market competition is concerned, as of 2017, Telcel remains the largest mobile provider, concentrating 64 percent of the market. However, this represents the smallest market share for the company in the last two years. AT&T, on the other hand, closed the year with over 15 million subscribers (representing 13 percent of the market), nearly double those reported at the end of 2015. Average revenue per user just in 2017 fell about 10 percent, suggesting the increased competition continues to place downward pressure on prices, which will ultimately benefit the customers and incentivize

⁸⁸ Banco de México, *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Diciembre de 2013*, (Ciudad de México: Banco de México, 2013): 6.

⁸⁹ *Ibid*: 14.

⁹⁰ Instituto Federal de Telecomunicaciones, *Anuario Estadístico 2016*, (México City: IFT 2017).

business to further invest in expanding access.⁹¹ However, the reform also included provisions to entirely phase out analog systems, a move which succeeded in fully digitalizing all TV signals nationwide. However, this process, like much of the implementation of the reforms, was riddled with accusations of corruption. An investigation by *The Wall Street Journal* surfaced claims of bribery, extortion on behalf of government officials, and mismanagement of funds in the acquisition of the digital systems provided by the government.⁹² Other reforms have been less successful to different degrees, ranging from insufficient results, to deadly riots following the implementation.

The fiscal reform, one of the most controversial for relying heavily on those who already contributed in the largest amounts to the government's budget,⁹³ was nonetheless one of the most successful.⁹⁴ Given the precipitous drop in oil prices since the beginning of the current administration, the increase of over 3.4 percentage points between 2013 and 2016 in tax revenues as a percentage of GDP helped the government maintain a balanced budget,⁹⁵ a hallmark of public finances in Mexico since the crisis of 1994. The downside to a balanced budget, however, is that it by definition implied either high taxes to subsidize broad government services to the community, or it presupposes a severe lack of public spending. In Mexico's case it is the latter. As pointed out by Manuel J. Molano, Deputy Director General of IMCO (*Instituto Mexicano para la Competitividad*), this lack of investment has precluded

⁹¹ Teleconomía, 2018.

⁹² Santiago Pérez, "Mexico's TV Giveaway Spawns Questions," *The Wall Street Journal*, 28 September 2016, <https://www.wsj.com/articles/mexicos-tv-giveaway-spawns-questions-1475103213>

⁹³ Enrique Campos Suárez, "La reforma fiscal, la reforma huérfana en campaña," *El Economista*, 15 February 2018.

⁹⁴ OECD, *Towards a stronger and more inclusive Mexico: an assessment of recent policy reforms*, (Paris: OECD Publishing, 2017): 7.

⁹⁵ OECD, *Revenue Statistics: 1956-2016*, (Paris: OECD Publishing, 2017): 50.

Mexico's capacity to develop high-skill industries to the degree that Korea or Turkey, for instance, have been able to do in the same period of time.⁹⁶ This suggests that fiscal reform will be a continuing topic of interest for the following administration, and a priority if the government is to seriously commit to investing in domestic growth.

The landmark reform for the Peña Nieto government, however, has been the Energy Reform. Oil production in Mexico had been on a steady decline since 2004.⁹⁷ The reform was a multifaceted piece of legislation which included the liberalization of oil prices, leaving them at the mercy of the markets; the entry of private enterprise into virtually every aspect of energy production, from petroleum exploration, extraction, transport, refining, and the sale of the product and all its derivatives. On the electric energy side, private firms can now compete in the production and distribution of electricity, and the participation in the development of renewable energy has been subjected to a similar process of bidding, open to the private sector, as the petroleum industry did. While remaining (more) autonomous public entities, Pemex and CFE will have to compete on equal grounding with private corporations and international conglomerates.⁹⁸ As a result, the U.S. Energy Information Administration expects oil production in Mexico will again begin to increase by 2018.⁹⁹ In spite of the expected benefits to public resources, as well as the important role the reform has played in the current administration's publicity, the reform will likely not bear significant fruit until considerably in

⁹⁶ Eric Martin and Nacha Cattán, "The U.S.-Mexico Wage Gap is Actually Widening Under Nafta," *Bloomberg Businessweek* (November 28, 2017).

⁹⁷ U.S. Energy Information Administration, *International Energy Statistics*, 2018.

⁹⁸ David Penchyna Grub, "Reforma Energética y Desarrollo Industrial: un modelo democrático para México," in Arturo Oropeza García, coord., *Reforma Energética y Desarrollo Industrial: Un compromiso inaplazable*, (Mexico City: Universidad Nacional Autónoma de México/Instituto de Investigaciones Jurídicas, 2015).

⁹⁹ OECD, *Towards a Stronger and More Inclusive Mexico*: 17.

late into the next administration. What may come even later are the reductions in government waste and money lost to embezzlement within the giant, that have plagued Pemex in recent years, which are estimated to have cost the firm—indeed, Mexico—nearly USD 12 billion between 2003 and 2012.¹⁰⁰

Insulating Mexico from the U.S.

As mentioned earlier, one of Mexico's most important weaknesses are the country's reliance on the United States as a consumer of its exports and the threats associated with U.S. monetary, fiscal, economic, and foreign policy decisions as they relate to Mexico and the bilateral relationship between the two. A look at the impact of the 2008 Global Financial Crisis on Mexico shows some of the weaknesses in Mexico's contemporary relationship with the United States. Several policy decisions as well as trends in Mexico's commercial relationship with the global markets compounded to make Mexico the single most affected country in the developing world.¹⁰¹

One of the most notable liabilities in Mexico's trade policy has been its heavy dependence on demand from the United States' internal market.¹⁰² While trade liberalization practices have successfully incentivized foreign investment and the free flow of goods, the large

¹⁰⁰ Gabriel Toledo Guerreo, *Corruption in the Mexican Energy Industry: Recommendations and Proposals*, (Washington: Wilson Center/Mexico Institute, 2016).

¹⁰¹ Gerardo Esquivel, "Mexico's Recovery from the Global Financial Crisis", in *Unexpected Outcomes: How Emerging Economies Survived the Global Financial Crisis*, edited by Carol Wise, Leslie Elliott Armijo, and Saori N. Katada, Brookings Institution Press (2015): 185.

¹⁰² Juan Pablo Soriano, "Dilma Y México: Altibajos En Una Relación Indispensable Para América Latina / Dilma and Mexico: The Ups and Downs of a Crucial Relation for Latin America", *Revista CIDOB D'afers Internacionals*, no. 97/98, CIDOB (2012): 140.

majority of this has been carried out with the United States. It is true that Mexican commercial policy has focused on a diversification of both its commercial offer and its network of trade. As of today, Mexico has reached a total of 24 free trade or economic integration agreements signed with other countries or country groupings, as well as participation in three of the most important multilateral organisms.¹⁰³ And yet, as of 2016 (the latest available data from the World Bank), out of Mexico's exports, valued at USD 373.9 billion, a troubling 81.03 percent (or USD 302.9 billion) went to the United States, up from the 80.3 percent consumed by the U.S. in 2014. More importantly, the number has hardly changed since the beginning of neoliberalism in Mexico. After 1994 and the signing of NAFTA, the percent of the country's exports which headed to its northern partner only grew, peaking at 88.4 percent in 1999, dropping a couple of points, only to rebound to 88.5 percent in 2005.¹⁰⁴

While the numbers have indeed dropped since, an eight-point drop in the amount of exports which go to the United States still leave that market with the lion's share of the country's trade balance, and a dangerous liability in situations such as the one presented during the 2008 GFC. By the middle of 2009, Mexico's trade balance had fallen by nearly 35 percent annually owing to the fall in U.S. demand. That year, GDP contracted by a formidable 6 percent, the largest market contraction in modern Mexican history since the 1994 Peso Crisis.¹⁰⁵

Beyond situations of crisis, the political situation in the United States since 2016 have served as evidence that demand and the monetary policy emanating from the Fed are not the

¹⁰³ ProMéxico, 2018.

¹⁰⁴ World Bank, 2016.

¹⁰⁵ Esquivel: 182-185.

only impact the U.S. can have on Mexico. If the bilateral relationship had been friendly until the 2016 election cycle, it has since become clear that policymakers in Mexico cannot count on that being the case. As consequence, the Secretary of the Economy, Ildefonso Guajardo, has been one of the most visible personae in Mexican politics in 2017. Despite not being in the running for this year's presidential election, Guajardo has taken the role of the chief negotiator for Mexico on numerous fronts as a means to diversify Mexican trade. While Secretary of Foreign Affairs Luis Videgaray Caso has led the NAFTA renegotiations for Mexico, the Secretariat of the Economy has team laying the foundation for stronger ties to Europe, Asia, Latin America, and the CTPP.

In the Old World, Mexico is close to concluding a significant update to the EU-Mexico FTA, which will aim to add an IP section, including a subsection outlining geographical indication protection for Mexican goods in Europe and vice versa.¹⁰⁶ Given the importance of intellectual property protection for European firms seeking to expand into developing markets, the promise of legal protections from Mexico could signal an added boost of trade and investment from the region, which already includes Mexico's second largest FDI source, Spain.¹⁰⁷ Additionally, the access to the European market for Mexican agricultural goods is lauded as one of the most logical alternatives for the same exports currently directed at the U.S.

¹⁰⁶ Secretaría de Economía, *Consulta sobre Indicaciones Geográficas en el marco de la Modernización del TLCUEM*, Secretaría de Economía, August 2017.

¹⁰⁷ Ana Carolina Garriga, "Inversión extranjera directa en México: comparación entre la inversión procedente de los Estados Unidos y del resto del mundo," *Foro Internacional* 57, no. 2, (abril-junio, 2017).

On the Pacific front, since the collapse of the TPP negotiations due to the U.S. pulling out of the treaty, have already implemented a near-identical agreement with the exclusion of 22 provisions which the U.S. had forced in. The Comprehensive and Progressive Agreement for Transpacific Partnership was signed by the 11 members on 8 March of this year and will enter into force a short two months after at least six states ratify it.¹⁰⁸ The treaty raises the number of countries with whom Mexico has free trade arrangements to 52, keeping it at the helm of free trade globally.¹⁰⁹ Encompassing 13.5 percent of global GDP, both the participating countries and observers have commented on the potential success of the treaty in expanding trade between some of the largest emerging markets.

In addition to transoceanic negotiations, Mexico has been busy at work developing closer relationships with Latin America. The Pacific Alliance, in force since 2012, has included Australia, Canada, New Zealand, and Singapore as Associated States to further integrate the current members—Chile, Colombia, Mexico, and Peru—to its counterparts around the Pacific. With respect to Argentina and Brazil, expansion of the Economic Complementation Agreements (ACE) which aim to eventually reduce all tariff barriers to trade between Mexico and the two South American giants, is expected to be completed by June of this year as well.¹¹⁰

All of these fronts combined, it is clear that the Mexican government has taken to heart the necessity to diversify its trade balance to steer away from dependence on the U.S. On the other hand, there is a long way between goals and the reality, and Mexico is in a difficult

¹⁰⁸ A.F., “What on earth is the CPTPP?” *The Economist Explains*, 12 March 2018.

¹⁰⁹ Eduardo Sánchez and Ildefonso Guajardo, *Signing the CPTPP is a fundamental part of the legacy of the Government of President Peña Nieto in commercial matters*, press release: Office of the President of Mexico (*Presidencia de la República*), 13 March 2018.

¹¹⁰ María Alejandra Rodríguez, “Diversificación comercial acapará primer semestre,” *El Economista*, 9 January 2018.

position because of the physical proximity to the U.S. and the large proportion of Mexican immigrants and their descendants who now live in the U.S., which make it difficult to take a 180-degree turn. All things considered however, there is certainly room for improvement in terms of global connectivity and economic diversification.

Arrested productivity

Researchers as well as international organizations alike have been steadfast in their identification of weak productivity as one of the country's most important challenges today. Productivity has stagnated since 1990, growing only 4.5 percent in the span of 23 years¹¹¹ and, as of 2017, remains at USD 18.80 per hour worked, giving Mexico the lowest rate of productivity of all OECD countries.¹¹² The reasons for this are varied: since the beginning of the economic liberalization of the 1980s, the increase in Mexico's economic competitiveness has been beneficial primarily to the accumulation of wealth for the primary producers. While wages and productivity grew alongside each other prior to 1976, since then, the participation of wages in the country's GDP composition has fallen to 18.9 percent. Manufacturing and exports, on the other hand, have increased to represent nearly two fifths of the country's GDP.¹¹³ This separation of wages doubles its effect on productivity when compounded with the stagnation of the minimum wage. Within Latin America, Mexico boasts the second highest level of productivity (following Chile) but the third lowest minimum wage (only Bolivia and

¹¹¹ Juan Carlos Moreno Brid and Stefanie Garry, "El rezago del salario mínimo," *Nexos*, 1 February 2015, <https://www.nexos.com.mx/?p=24115>.

¹¹² OECD data.

¹¹³ World Bank, 2017.

Nicaragua rank lower).¹¹⁴ Additional obstacles to the growth of productivity to levels comparable to the rest of the OECD countries include labor informality, the existing tax burden on individuals and corporations, wage stagnation, bureaucratic hurdles to enterprise, as well as the inefficient allocation of foreign direct investment.

Employment informality

As discussed above, informally employed individuals in the Mexican economy present an overbearing participation among the employed population. However, the way in which it is defined is important in providing a way to address it. The distinction between the informal sector and informal employment is a crucial one. The ILO's Office of International Labor defines the informal sector as the grouping of units of production (read: businesses) not registered under a country's legal framework.¹¹⁵ In the case of Mexico, this means that the business is not an official entity under the Tax Administration Service (SAT), and its employees are not beneficiaries of the *Instituto Mexicano del Seguro Social* (IMSS), the national institute responsible for providing health services and social protection to all private-sector employees in Mexico. However, the size of the informal sector in the country underestimates the total number of persons who are informally employed. This figure also includes people who are indeed earning wages, often times employed by a formal enterprise, but who are not subject to a contract or employment agreement which provides them with access to IMSS benefits and

¹¹⁴ Moreno Brid and Garry, 2015.

¹¹⁵ International Labor Office, *Measuring informality: A statistical manual on the informal sector and informal employment* (Geneva: International Labor Organization, 2013).

leaves them outside the country's official employment framework. Among Mexican workers, only 26.8 percent are employed in the informal sector. However, this ignores the fact that over half of the country's economically active population is not entitled to social security and other benefits as a part of their labor contracts, even when they are indeed employed by formal firms or organizations. The high degree of informal employment in the formal sector suggests there are other avenues to increased productivity growth beyond the creation of formal jobs. Within the formal sector itself, there needs to be an implementation of reforms or more stringent regulations to prevent loose employment arrangements which allow employers to fill positions with undercompensated workers. Such arrangements provide an additional loophole for firms to sidestep tax expenses. This, in turn, continues to keep tax revenues below potential given the size of the economy, further constraining the government's capacity to invest in growth.

Employment informality, in all of its flavors, presents one of the biggest obstacles to productivity. Workers have little in the way of legal protection against employers, who can use this to widen profit margins at the expense of the workers. The broadest section of the informal sector consists of micro-enterprises, which are the least productive of all OECD countries. This means that the high-degree of informality is keeping a sizeable proportion of the country's human capital and physical resources away from more productive industries.¹¹⁶ Wages are further reduced from spending on social services—in particular, those which are typically provided by the IMSS. Additionally, escaping informal employment can prove difficult, given the disconnect between workers coming from an informal job and the skills or experience often required by the formal labor market. This ensures that, in addition to an obstacle to

¹¹⁶ OECD Structural Business Statistics, 2017.

productivity, informality becomes a trap for those who have been forced into it to support themselves.¹¹⁷

An additional challenge to portraying an accurate picture of labor informality in the Mexican economy is the exclusion of agricultural workers from the criteria that make up either the informal sector or informally employed persons.¹¹⁸ Given the importance of the agricultural industry for large swaths of the country's population as well as the high degree of marginalization among agricultural workers, the criteria to define the phenomenon of informality makes even the broadest definition of the term insufficient to quantify the scale of *real* informality in the economy.

Foreign direct investment allocation

One of the most important sources of capital for any developing country are cash flows from foreign direct investment (FDI). As mentioned in the previous chapter, capital from FDI is a much more stable and permanent source of investment for a country than portfolio investment. Unlike the latter, FDI is employed in value creation processes, producing benefits for both the sender country as well as the host country. Even before NAFTA's ratification, FDI has been flowing relatively consistently into Mexico, providing an additional source of income to sustain the country's running current account deficit.¹¹⁹ However, the shape FDI has taken once it arrives in Mexico, as well as the industries targeted by foreign capital providers

¹¹⁷ OECD, *Towards a stronger and more inclusive Mexico*: 6.

¹¹⁸ Ibid.

¹¹⁹ OECD, 2018.

when investing in the country, have changed dramatically over the last half century. Mexico's first sign of opening to foreign investment was the establishment of *maquiladoras* across the country's northern states, primarily concentrated along transportation routes leading into the United States. The primary purpose of *maquiladoras* was to turn materials into finished products for consumption or further assembly in the U.S. Over the course of the years, and especially since Mexico's economic opening, FDI has morphed into a way of providing capital for the growth of domestic industry, and today is an important source of financing for projects ranging from petroleum extraction to aerospace engineering, to digital architecture design, to domestic and foreign auto industry development and production.

Important factors in determining the outcomes associated with FDI are the institutional and legal frameworks in place to regulate it, as well business and investment incentives for investors, the characteristics of the target industry, and the available infrastructure, technological, and human capabilities to maximize the capital productivity of the investment.¹²⁰ All of these have to work in tandem to ensure that FDI is not limited to extractive industries which have a negligible impact on the host country's GDP.¹²¹ This has become particularly difficult following the Uruguay Round of 1994 and the negotiations that produced the agreements necessary to establish the WTO. In these negotiations, developing countries were prohibited from using several policy tools which would facilitate the country's ability to meet its objectives for the FDI captured.¹²² For Mexico, much of the framework was

¹²⁰ Nagesh Kumar, "Intellectual Property Protection, Market Orientation and Location of Overseas R&D Activities by Multinational Enterprises," *World Development* 24, 4 (1996).

¹²¹ Sanjaya Lall and Kishore Rao, "Indonesia: Sustaining Manufactured Export Growth," report developed for the Asian Development Bank, (Manila: Asian Development Bank, 1995), pp. 40-42.

¹²² David Romo Murillo, "Derramas tecnológicas de la inversión extranjera en la industria mexicana," *Comercio Exterior* 53, 3 (marzo de 2003): 231.

developed during the last fifteen years of the XX century—NAFTA, the reversal of nationalistic policies, IP protection, and the loosening of regulations for technological transactions has led to private, foreign investors being at the helm of investment in Mexico. So much so, that as late as 2001, Mexico still captured as much as 35 percent of FDI inflows into Latin America.¹²³

Several recent studies have suggested that FDI indeed has a broad, positive impact on key economic indicators, notably, real GDP and the country's balance of trade. Moreover, there is evidence that there is significant impact on domestic investment as a spillover from FDI entering the country.¹²⁴ When firms financed by foreign capital enter the market, investment from domestically financed firms spurs to better compete against the new players.¹²⁵ While the domestic benefits are broad, however, it is important to note that these benefits are not universal. As explained before, the proper framework to promote productive investment must be in place to ensure the benefits are shared between the capital provider and the host country. Additionally, even with the proper framework in place, FDI can only have significant spillover when the gap in technology between firms operating directly on foreign capital and domestic firms is narrow enough that the spread of knowledge—vertically or horizontally in the form of domestic sourcing, cooperation agreements, mergers, imitation or demonstration—happens organically.¹²⁶

All of this is suggestive of a continued strengthening of the economy, given the country can continue to attract investment in the scale it has up to this point. That task, however, has

¹²³ Ibid: 231.

¹²⁴ Brian Aitken, Gordon H. Hanson, Ann E. Harrison, "Spillovers, Foreign Investment, and Export Behavior," *Journal of International Economics* 43, no. 1-2 (1997).

¹²⁵ Garriga: 319-20.

¹²⁶ Romo Murillo: 240.

become evidently a more challenging one in recent years. Since reaching a high-point in 2011, FDI in Latin America has fallen consistently—by 2016, FDI in the region stood at USD 167.2 billion, 16.9 percent lower than the USD 206.9 billion received five years prior. Mexico, in particular, has been hard hit by the fall in FDI. Today, the country continues to receive 19 percent of the region’s inflows—less than half of Brazil’s share (47 percent). However, on a year-to-year basis, FDI in Mexico from 2015 to 2016 fell by 7.9 percent.¹²⁷

As it relates to low productivity, FDI presents a nuanced picture. On the one hand, research into the factors of location for FDI firms converges on the idea that Mexico is an attractive destination for its proximity to the United States, the sizeable domestic market, and the attractive wage level as a cost-saving strategy. Indeed, the states capturing the largest share of FDI have historically been Mexico City (formerly, the Federal District), home to a fifth of the country’s population, and the states sharing a border with the U.S.¹²⁸ Paired with the positive effects on indicators and the possibility of economic spillover, further accommodating domestic economic policy to attract larger amounts of FDI to the rest of the country would seem like a reasonable strategy to pursue.

Wage stagnation

Arguably, the most challenging obstacle for Mexico’s economic prospects is wage stagnation across the board. Since the ratification of NAFTA, Mexico’s daily minimum wage

¹²⁷ Economic Commission for Latin America and the Caribbean, *Foreign Direct Investment in Latin America and the Caribbean 2017* (Santiago, Chile: United Nations 2017).

¹²⁸ Jacob A. Jordaan, “Agglomeration and the Location Choice of Foreign Direct Investment: New Evidence from Manufacturing FDI in Mexico,” *Estudios Económicos* 27, no. 1 (January-June 2012): 72-73.

has been 8.6 percent that of the United States, when adjusted for historical exchange rates.¹²⁹ Despite near annual increases to the national minimum wage, purchasing power remains more or less identical to what it was 20 years prior. On the measure of real income, with the exception of highly specialized professionals in globally interconnected industries—e.g., aerospace, information technology, and finance—workers across the country at all income levels have seen a decrease in their real wages since 2006, the only G-20 emerging economy to have seen such a trend.¹³⁰

After the full liberalization of trade, U.S. firms have taken advantage of Mexico's low wages to outsource production and widen profit margins. On Mexico's side, policymakers who advocated for the benefits of the treaty for the country largely focused on large FDI inflows and increased foreign demand as the primary aims of the country's commercial opening. As time has passed, however, it has become evident that this is not sufficient. Because policy has largely ignored the domestic front, public and domestic private investment in Mexico has been disappointingly low, in part due to low credit-access, and thus wages across the board have remained insufficient.¹³¹ In addition, if foreign firms are attracted to the country *because* of low wages, the reliance on large, foreign investment inflows suggests FDI could be an obstacle to, more than simply a distraction from generalized increases in income. Domestic producers are incentivized to keep wages low to remain an attractive location for foreign production.

¹²⁹ Banco de México data, 2018.

¹³⁰ International Labor Office, *Global Wage Report 2016/17: Wage inequality in the workplace* (Geneva: International Labor Organization, 2016): 105, Appendix I.

¹³¹ Martin and Cattán.

Current economic outlook

In the context of the current political and economic atmosphere, resilience has become Mexico's hallmark.¹³² If fiscal restraint has hurt the government's ability to encourage investment and spur growth through public spending, credit rating agencies have certainly looked upon Mexico with kind eyes as a result of it. Even amidst the threat of a partial reversal of the achievements of the energy reform should López Obrador succeed in July's elections,¹³³ as well as the aforementioned renegotiation of NAFTA, ratings agencies have largely maintained a stable outlook for Mexico's ability to fulfill its debt obligations. Nonetheless, Fitch has advised caution in light of financial volatility which may come as a result of the electoral process.

Inflation expectations remain anchored, even after the December departure of the governor of the Bank of Mexico. While realized inflation has spiked in the past year, it is again on a downward trend, and there is little doubt of the central bank's commitment and ability to keep it at sustainable levels. However, above-target inflation remains an obstacle to domestic consumption growth. In 2018, domestic demand is expected to grow only 1.7 percent, suggesting wage growth is not enough to make up for the rise in prices and boost spending.¹³⁴ Moreover, to keep inflation under wraps, the central bank has had to push interest rates to levels which have placed a strain on private investment.¹³⁵ Lending remains low, in spite of the

¹³² Ignacio Fariza, "Fitch alerta de 'volatilidad financiera' en México por el proceso electoral," *El País*, 16 March 2018.

¹³³ Alejandra Canchola, "AMLO, a favor de independientes," *El Universal*, 19 March 2018.

¹³⁴ OECD, "Mexico" in *OECD Economic Outlook, Volume 2017 Issue 2*, (Paris: OECD Publishing, 2017): 199.

¹³⁵ Banxico, 2018.

expanded access to capital. However, the realization of investment commitments following the auctioning of lucrative energy sector contracts are expected to foster growth in the next few years.¹³⁶

¹³⁶ OECD, “Mexico” (2017): 200.

V. Policy case assessment

Diffusion theory

The Washington Consensus, and by extension economic neoliberalism, has long been the golden standard of developmental economics from a Western perspective, even after it was partially disavowed by its original author. The consensus is built on the theory of a convergence of ideologies toward a common set of reform areas which in turn are expected to realize a country's economic potential. The main critics of the Washington Consensus pointed out that, to a large degree, the points of the consensus were being imposed on the countries rather than chosen through rational economic analysis. Irrespective of their origin, it is generally true that as more and more countries saw quantifiable benefits from the implementation of policies in line with the consensus, other countries around them increasingly adopted policy agendas that mirrored those of the former.¹³⁷

This spread of similar policies is the core of the theory of policy diffusion. Rather than an imposition of a policy agenda, as the critics of the Washington Consensus would argue, the theory of diffusion suggests that as a state implements policies or structures which are successful in achieving a stated goal, neighboring—or distant, but metrically similar—countries will implement policies and structures which mirror that strategy. Diffusion, then, suggests that

¹³⁷ Williamson, (2003): 1475-6.

neoliberalism has been less a purposeful effort of policy-alignment and rather an organic policy-adoption process based on rationality.¹³⁸

An additional dimension to policy diffusion theory is the model introduced by Charles Tiebout in 1956 of competition among local government jurisdictions. Notably, his model suggested that the formation and change over time in policy in a certain jurisdiction was impacted by the relative success of policies elsewhere and a desire to imitate success, but also by a sense of competition for residents.¹³⁹ In Tiebout's domestic model, policymakers contend for spending and tax revenue from residents who have free movement. Extrapolating the concept of competition in policy diffusion to the international level, a contest for foreign direct investment and the creation of business to promote local spending may be motivating factors in how policy is developed *with relationship* to that of other countries.

To develop a comprehensive and substantive set of policy recommendations for Mexico, then, requires case assessments of different economic policies which may provide a roadmap for Mexico beyond 2018. Of particular interest are policies which have been implemented in countries with comparable economic conditions, aimed at addressing the primary areas of concern outlined in the previous chapter. These case assessments will take into account the stated goal of the policy, the implementation process, and the short- and long-term impact of its implementation on the economy as measured by the appropriate indicators.

However, analyzing the potential impact of international and domestic policy models cannot be done uniformly. For the purpose of assessing the success of any policy, it is important

¹³⁸ Charles R. Shipan and Craig Volden, "Policy Diffusion: Seven Lessons for Scholars and Practitioners," *Public Administration Review* 72, no. 6 (2012): 788.

¹³⁹ Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, no. 5 (1956).

to distinguish between those which have been implemented in Mexico—successfully or not—and those which can potentially be replicated, but which nevertheless were implemented in a different context. This contextualization allows for the assessment to address potential weaknesses arising from exogenous factors in an *economic* policy model adapted from an authoritarian regime, for instance.

Domestic policy cases

In approaching examples of domestic policy, there are two main questions to answer: (1) which policies have been the most successful in bringing about the desired outcome? And (2) what about the policy itself or the framework for implementation differentiated it from less successful policy endeavors? The selection of cases to consider will provide a response to the former, and the cases themselves will answer the latter.

Financial re-regulation and related reforms

Among the most important items of Mexico's domestic policy agenda in recent history, and one with resounding economic repercussions, was the strengthening of regulations surrounding the financial sector following the crisis of 1994. As outlined in chapter I, the sudden hemorrhage of portfolio capital from the Mexican Stock Exchange following the onset of investor panic in December of that year strained domestic banks beyond their operational breaking point. To stay afloat, management at several financial institutions chose to engage in related lending, a practice virtually inseparable from loan default because of the lack of proper

due diligence at issuance. When the institutions did go under, there was little prosecution for reckless management, and the depositors bore the burden of the bankruptcies.

Banks were able to do this because of the severe regulatory void in the financial sector following the privatization of the sector in the three years prior. At the time, there were no standardized financial reporting requirements, no requirements to disclose the interests of the banks' management, and no requirements to report on internal control and risk. On the legal side, the extant Bankruptcy and Payment Suspension Law was not far-reaching enough to adequately punish culpable directors, nor was it paired with effective institutions which could uphold the letter of the law. As a result, engaging in moral hazard became commonplace among the leadership of the financial sector. Finally, the Salinas administration was not a mere victim of unscrupulous financial directors. In many ways, it was the deregulation of the early 90s and the administration's refusal to act against the private sector—for fear of unnerving foreign capital providers—that allowed for these conditions to remain the status quo. While the privatization had been rife with irregularities, the government had an unofficial policy of turning a blind eye to the sector. At the same time, to induce confidence in an industry it knew well to be unstable, Banxico legitimized the banks and their activities by guaranteeing virtually all banks' liabilities through *Fobaproa* with funds it knew well were no longer there.

To a large degree, the weaknesses in the financial sector were one of the primary drivers of investor panic in the run-up to December of 1994. While the issuance of *tesobonos* and the political shocks of the year contributed to the country's weakened financial position, the private banking sector had grown large enough to drag down the country's entire economy with it if it failed. For this reason, regulating the sector and introducing strict standards,

comprehensive oversight, and severe legal consequences for noncompliance of norms were central to stabilizing the country's macroeconomic foundation in the years following the crisis.

The package of policies enacted in the aftermath of the crisis was aimed at tackling three main axes as defined by José J. Sidaoui:¹⁴⁰

1. Stabilizing the economy as quickly as possible to avoid a relapse,
2. Realigning the structure of incentives for negligent or perverse behavior within the banking industry, and
3. Strengthening the legal and regulatory framework so ensure the execution of the law regarding the financial sector.

Financial re-regulation has been primarily aimed at addressing the second axis. These policies have been remarkable in the speed with which they have produced change in the economy. Especially considering the haste in which they were passed. With a government composed overwhelmingly of highly-educated technocrats, Zedillo's administration and the federal dependencies during his *sexenio* were swift in implementing policies they considered prudent for the situation. Even since the beginning of political alternation with Fox's electoral victory in 2000, the dependencies of the Secretariat of Finance continue to be staffed by economic and finance professionals whose primary objective is the stability of the Mexican financial system.

While the package as a whole addressed several deficiencies in the practices of industry participants, a majority of the standards and requirements introduced through the package

¹⁴⁰ José J. Sidaoui, *The Mexican financial system: reforms and evolution 1995-2000*, BIS Papers, No. 28, 19 (August 2006): 279-287.

were basic regulations that addressed the core failings of the financial system when banks were privatized in the first half of the decade. These included logical capital adequacy rules, “prudential” regulation to ensure private bank liquidity, an adoption of international accounting standards, the establishment of limits on deposit insurance, and the elimination of limits to foreign ownership in the industry.¹⁴¹

However, two of the policies included in the package have been paramount in improving economic conditions in Mexico since then. The first was the separation of the National Banking Credit Information Service (*Senicreb*) from its role as a credit bureau. Rather, the institution, a public registry maintained and managed by the federal government through the Secretary of Finance and the Bank of Mexico, is relegated to gathering information for the government to maintain oversight over the industry without much intervention. At the same time, the new legal framework allowed the private sector to participate in the gathering and dissemination of credit information through the creation of private credit information associations (*sociedades de información crediticia, SICs*).¹⁴²

The second policy which has yielded considerable results was the implementations of norms for corporate governance in financial institutions. Among these norms was the issuance of an entire document titled “General Dispositions Applicable to the Financial Information of Credit Institutions, officially encoded into law by Congress in 2005.¹⁴³ At its latest amendment, enacted on 14 March 2018, the disposition is made up of 786 pages of legislation

¹⁴¹ Ibid, 283-286.

¹⁴² José Luis Negrín, “Mecanismos para compartir información crediticia. Evidencia internacional y la experiencia mexicana,” Banco de México, Dirección General de Investigación Económica, documento de investigación No. 2000-05 (December 2000).

¹⁴³ Sidaoui: 283.

in five titles, two of which outline the exact financial information that must be disclosed by each institution and the regulatory reports that each institution operating in the private credit market in Mexico must undergo. Moreover, the document outlines the way in which the information can and should be presented, and even includes clauses regulating valuation and the use of information as a tool of financial behavior.¹⁴⁴ Even beyond the regulatory framework regarding which activities can be carried out legally, the value of this section of the document is clear.

Transparency, in private as in public matters, is key in preventing perverse behavior. Moreover, transparency is the key to competitiveness, a positive attribute in either the political or economic development of a country. Peter Drucker in 1985 outlined the importance of competition in the development of a healthy environment of innovation and entrepreneurship.¹⁴⁵ The correlation has only been reinforced since. Moreover, informational asymmetry is one of the most important hindrances to optimal decision-making. From a financial consumer perspective, reducing that asymmetry has in other cases contributed to a generalized fall in prices and granting financially “unsophisticated” investors access to financial markets—some academics suggest that indeed, the purpose of financial regulation is in fact a tool in the redistribution of wealth.¹⁴⁶ Even if redistribution is not the primary goal of policies to improve transparency, the argument gives weight to the value of such policies for social wellbeing. On the other hand, transparency in the private sector can have serious implications

¹⁴⁴ Secretaría de Hacienda y Crédito Público, *Disposiciones de Carácter General Aplicables a las Instituciones de Crédito*, publicadas en el Diario Oficial de la Federación 02-12-2005, modificadas por última vez 14-03-2018.

¹⁴⁵ Peter Drucker, *Innovation and Entrepreneurship*, New York: Harper and Row (1985).

¹⁴⁶ Paul M. Healy, Krishna G. Palepu, “Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature,” *HBS: Journal of Accounting and Economics* 31 (2001): 412.

for corruption which, as mentioned earlier, is one of the biggest challenges still facing Mexico today—disclosure of key financial information, as well as details regarding contractual ties of a person, moral or physical, to another through financial transactions bring to light potential conflicts of interest among policymakers, deterring the incentive to pursue dishonest projects with public resources. Furthermore, the implementation of requirements which compel financial institutions to disclose information to the general public ensures that a public agency or dependency will be unable to abuse its monopoly on financial information control its dissemination for private gain.¹⁴⁷

All around, the passage of several new pieces of legislation, the establishment of competent bodies to tighten the regulatory environment, and the continued commitment to transparency in financial reporting have introduced a high degree of trust in the financial industry. The public and private sectors alike have taken note of the continuous improvement to the framework of the financial system since 1995. These developments have led to a stable and highly liquid financial market which acts as a counterweight in situations where financial instability is introduced through external shocks.¹⁴⁸

A perfect float

Mexico's floating exchange rate regime, established following the release of the peg after the December Error, has been one of the hallmarks of Mexican economic policy in recent

¹⁴⁷ Veselin Vukotić, "Transparency in the economy of Montenegro," *SEER: Journal for Labour and Social Affairs in Eastern Europe* 4, No. 2 (July 2001): 78.

¹⁴⁸ Remarks by Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Mexico Financial Day 2011 CEO Roundtable, New York (2011).

economic history. On the one hand, it is a policy that was modelled in stark contradiction to what Williamson proposed in the Washington Consensus. In fact, by the time the original article was written, there was a general agreement that a successful exchange rate regime would have to be either a peg strictly defended (read: currency boards), or a full float with no monetary intervention other than for the purpose of anchoring inflation expectations.¹⁴⁹ On the other, the regime has been notorious for being the foundation of Mexico's macroeconomic stability. Despite some criticism in the last two years following the peso's nosedive following the U.S. election of 2016, domestic analysts agree that the regime should not be reversed to defend the value of the peso from further devaluation. This agreement has been twice notably contravened in recent years.

In December of 2014, faced with the crash in oil prices and given the government's continued reliance on crude sales for the bulk of the federal budget, the Exchange Commission—an organism composed of the Secretary and Under-secretary of Finance, a second under-secretary of the Finance Ministry, the Governor and two board-members of the Bank of Mexico—announced daily auctions of up to USD 200 million in foreign reserves with a minimum price of the prior day's exchange rate plus 1.5 percent. As expressed by the press release, the intention of the policy was to ensure liquidity if necessary in the exchange markets in periods of high financial volatility.¹⁵⁰ In March of 2015, the Commission announced that the government would offer an additional USD 52 million daily with no price minimum.¹⁵¹

¹⁴⁹ Williamson, 1476.

¹⁵⁰ Banco de México, *La Comisión de Cambios adopta medidas preventivas para proveer liquidez al mercado cambiario*, comunicado de prensa (12/08/2014).

¹⁵¹ Banco de México, *La Comisión de Cambios adopta medidas preventivas adicionales para proveer liquidez al mercado cambiario*, comunicado de prensa (03/11/2015).

While the express reasoning was to hedge against market volatility, the underlying reasoning is clear. An accelerated devaluation of the currency puts in doubt the central bank's ability to curb inflation and undermines the government's ability to service foreign currency-denominated debt—two factors which were at the heart of the crisis of 1994. The daily auctions of USD 200 million were discontinued in November of the same year, and the remaining USD 52 million-a-day auctions ran through February of 2016.¹⁵²

Even then, the logic behind the implementation of FX auctions as a short-term tool to combat volatility was well-grounded in the country's macroeconomic doctrine of monetary policy restraint. While the intervention in exchange markets was indeed aimed at defending the peso's value, it was not to support an artificially high value of the currency, but rather to combat upward inflationary pressures that could have had serious impacts on real incomes for the economy at large. Moreover, the International Monetary Fund sanctioned the policies—the SDR 62.4 billion credit option extended to Mexico as a part of the fund's reform in lending for the purpose of crisis prevention in 2009 was renewed in 2017, reinforcing the country's record of stability and fiscal discipline, as well as the expectation that the country will maintain such policies.¹⁵³ As a way of providing additional reassurance that the government was committed to monetary restraint, Banxico hiked the reference rate by 50 basis points after an unannounced meeting, surprising markets and curbing speculation on the peso's value. The value of the peso was up just under 3 percent after the announcement.¹⁵⁴

¹⁵² Anthony Harrup, "Bank of Mexico to Suspend Some Dollar Auctions," *The Wall Street Journal* (19 November 2015).

¹⁵³ International Monetary Fund, *Mexico: Arrangement Under the Flexible Credit Line and Cancellation of Current Arrangement—Press Release and Staff Report*, IMF Country Report No. 17/355 (November 2017).

¹⁵⁴ Miguel Gutiérrez and Michael O'Boyle, "Mexico unleashes surprise rate hike to smoke out peso speculators," *Reuters* (17 February 2016).

The second instance of an intervention in foreign exchange markets, however, came shortly after on 21 February 2017, with the announcement of the offering of as much as USD 20 billion in currency hedges. Banxico asserted that FX reserves would not be used—instead, the policy relies on the auctioning of contracts of non-deliverables.¹⁵⁵ The mechanism is relatively simple: the government offers to pay a price above the spot market rate on the day of the exchange for a notional amount (which is never in fact paid, hence the term “non-deliverable”) and then auctions the contract. Interested buyers will agree to receive less than the maximum price offered by Banxico, and the payment is made in pesos, thus propping up demand for and the value of the currency.

In addition to successive hikes to the reference rate, the central bank has been refocusing its strategy on such non-monetary policy to curb both inflationary expansion and avoid sharp plunges in the value of the currency. In October, contracts worth USD 4 billion were added to the currency hedge offerings.¹⁵⁶ Finally, in December of 2017, Banxico announced an additional USD 500 million would be sold beginning on the last week of the 2017 fiscal year.¹⁵⁷ Between the initial announcement in February and the expansions of the policy in October and again in December, the peso steadily had steadily regained ground against the dollar, only to start regressing after the beginning of NAFTA’s renegotiation. The impact, however, has been unequivocally stabilizing: after each announcement, the peso’s fall

¹⁵⁵ Michael O’Boyle, “Mexico to offer up to \$20 billion in forex hedges to aid battered peso,” *Reuters* (21 February 2017).

¹⁵⁶ Anthony Harrup, “Mexico Moves to Shore Up Peso With Increased Dollar Hedges,” *The Wall Street Journal* (25 October 2017).

¹⁵⁷ Miguel Gutiérrez, “Mexico steps up currency hedge auctions to ease pressure on peso,” *Reuters* (26 December 2017).

has been reversed and stabilized, and has been on a generalized upward trend since the beginning of 2017 with the exception of the aforementioned drops.

Moreover, unlike the policies implemented in 2014 and 2015 that depleted reserves, this type strategy ensures the government's ability to service debt obligations while controlling for volatility in the market at the same time. This has proven to be one of the biggest strengths in maintaining the country's solid fundamentals. As of April of 2018, foreign reserves held by the central bank remain at around USD 173 billion, more than enough to confidently service the country's external debt, which clocked in at just over USD 200 billion in February.¹⁵⁸

Transparency in public documents has played an important part in the confidence that has been extended to the country's public administration. In spite of chronic low confidence in public service and a generally grim panorama, the country's commitment to fiscal and monetary responsibility—partially as a result of having a highly-trained army of experts in the Secretariat of Finance and Banxico—has been at the center of much of the discussion surrounding the future of the U.S.-Mexico trade relation. On a broader level, credit ratings as well as international organizations have highlighted the relative strength with which the country has weathered the highly uncertain environment which surrounds virtually every aspect of the Mexican economy.

¹⁵⁸ Bank of Mexico data, 2018.

Foreign policy cases

As this paper turns to consider policy beyond the scope of Mexico's complex economic dynamics, foreign cases are evaluated in line with the understanding of diffusion theory as a series of choices to maximize capital attraction. For each case, this means that policy impact will be assessed based on any changes in the country's position relative to countries with which it competes for capital attraction and business formation.

With this in mind, it is important to review Mexico's economic context to find comparable cases. Unlike most developing countries, Mexico is closely linked to the political and economic developments of countries far beyond its economic situation—it has been for a long time. It was the first developing country to gain admission to the OECD, back in 1994, and has only expanded its role as regional power since then—the G8 acknowledged its role as a global leader at the establishment of the Heiligendamm Process in 2007¹⁵⁹ and has become a household name in global climate change negotiations, serving as a bridge between the Global North and South on several key international policy areas.¹⁶⁰ Today, a billion dollars' worth of goods cross the country's border with the United States on a daily basis, and the country has signed FTAs with 46 countries, making it one of the countries with the highest access to international trade.¹⁶¹

¹⁵⁹ Timothy Myatt et al., "Outreach 5' Country Objectives Report: 2007 Heiligendamm Summit," G8 Research Group – Oxford (7 June 2007).

¹⁶⁰ Bernadette Hobson, "Mexico, a global climate change leader," *The Hill* (21 December 2016); Guy Edwards et al., "A New Global Agreement Can Catalyze Climate Action in Latin America," *Global Views*, Policy Paper 2015-03, (Washington: The Brookings Institution, 2016).

¹⁶¹ Secretariat of the Economy, 2015.

Even so, Mexico remains a middle-income country, and the odds of that changing are less than optimistic. Since the implementation of the *Progres*a, *Oportunidades*, and *Prospera* antipoverty programs—in 1994, 2000, and 2015 respectively—the federal government has spent just shy of MXN 825 billion on their running.¹⁶² During the same period of time, the national poverty rate, as shown in the table above, the poverty rate has increased slightly, falling near the end of the Fox administration, in 2006, only to rebound over the past two administrations.

Using these nuances as search parameters, then, few countries are comparable in terms of economic context. However, an assessment of the policies implemented by these countries targeted at the same issues that face Mexico in 2018 should deliver more valuable insights into the characteristics of policies which may be successful in addressing the underlying obstacles to growth. To that end, the paper evaluates policies implemented in South Korea (officially, the Republic of Korea) and an array of policies implemented in Central and Eastern European (CEE) transition economies (largely, the former republics and satellite states of the Soviet Union). For the case of the former, the analysis focuses particularly on the relationship between the state and the country's industrial development, and its policies directed at allocating investment capital. In the case of the CEE states, the focus will be on actions implemented to attract foreign investment as well as the lessons learned from the countries' experiences with attempting to expand access to capital.

¹⁶² Secretariat of Finance and Public Credit, 2017.

The ROK's ROI

The case of South Korea (officially, the Republic of Korea) is a particularly interesting one, if nothing else, for the immense amount of parallels with Mexico's own history. As with Mexico, potential was never lacking in Korea. Since the country's partition after the end of the Second World War, the southern half of the peninsula has had its eyes set on greatness. With the arrival of General Park Chung-hee, those aspirations quickly began to materialize.

Unlike the "perfect dictatorship" that Mexico lived under the PRI's 71-year hold on power, however, Park's ambition had tangible results on the health of the Korean economy across the board. A violent coup d'état led Park to power in 1961; between the following year and 1985, nearing the end of military rule in Korea, per capita GNI rose from USD 101.60 to USD 2,032.00, (an average of 13.9 percent annual growth) while overall GNI growing at an *average* pace of 8.3 per annum.¹⁶³ These figures far outperform Mexico's moderate 5.9 percent annual growth over the same period of time, 2.9 percent of which accounts for population growth rather than increases in productivity.¹⁶⁴

However, the political contexts of the two countries were very similar. Park's dictatorship ended with his assassination in 1979, and his successor, Chun Doo-hwan served as elected President of Korea between 1980 and 1988 after having arrived in power through a coup of his own. However, the elections of 1988 led Roh Tae-woo, a technocrat with democratic ambitions for Korea, to the presidency, ushering in the beginning of Korea's

¹⁶³ Minho Kuk, "The Governmental Role in the Making of Chaebol in the Industrial Development of South Korea," *Asian Perspective* 12, No. 1 (Spring-Summer 1988): 107.

¹⁶⁴ World Bank data, 2018.

democratic transition.¹⁶⁵ These events closely track the timeline of the PRI's loss of its hold on power over the course of the 1980s. With the arrival of Ernesto Zedillo to Los Pinos in 1994, Mexico's own democratic transition began bearing fruit around the same time as Korea's did.

On the economic front, the countries share even more remarkable similarities. Like a flawless encore to Mexico's 1994 performance, Korea took one of its heaviest hits during the 1997-98 Asian Financial Crisis. And the two crises revealed the same structural problems in each country's respective financial systems: a woeful lack of regulation, overleveraged banks (as well as private enterprise), and lending and corporate activities plagued with nepotism and favoritism. The result, for both countries, was a realization that the financial environment needed to be strengthened for continued growth and participation in global markets. As a result, the early 2000s saw complete transformations in the two countries' regulatory and legal frameworks.

However, the continued credit expansion and business promotion that Korea experienced as a result of a stronger financial system was not replicated in Mexico. On the contrary, an already small credit market became even more restrictive to the general public and the acquisitions of Mexico's largest banks by foreign financial conglomerates served to reinforce the idea that liberalization was tantamount to expatriation of the country's capital. In spite of the similarities between the two, the country's diverging trajectories had been laid out nearly thirty years prior with the establishment of the *chaebol* during Park's regime. The foundation of economic growth in Korea was widespread and officialized crony capitalism.

¹⁶⁵ Marcus Noland, "South Korea: The Backwater that Boomed," *Foreign Affairs* 93, No. 1 (January/February 2014).

Chaebol (literally, a wealth clique) are a uniquely Korean phenomenon: they are the inordinate concentration of Korean capital in the hands of a few wealthy families which control massive conglomerates in highly productive industries, ranging from automobiles (Hyundai Group), to high-tech products (Samsung and LG), to petrochemical and energy production (SK Group). Their ascent was associated with political connections with the ruling elite during the Park dictatorship. As a result, chaebol received benefits, as a part of a concerted national strategy, that would enable them to be the economic engine of the country. These included a preferential trade regime, subsidies funded with public monies, tax breaks, below-market-rate loans, and in many instances the legal institution of a monopoly in a particular sector.¹⁶⁶

If the success of the chaebol model instituted by the Park regime is unquestioned, there is considerable nuance to how and why these companies were successful. As mentioned before, the most important piece of the strategy was the monopoly on information held by the Korean government and their ability to distribute public resources as would best take advantage of the capital. Moreover, the reason Korea was able to transform the entire economy and virtually every industry in the span of 25 years was the it did was the complete control that the government still exercised on finance and the distribution of private ownership. Last, but not least, Park's most notable policy to bring about the desired change in Korea was the deliberate depression of wages until the industries were productive enough to raise wages in a competitive fashion.¹⁶⁷

¹⁶⁶ Noland (2014).

¹⁶⁷ Hagen Koo, "The State, Industrial Structure, and Labor Politics: Comparison of Taiwan and South Korea" in Michael Hsiao Hsin-huang et al. eds., *Taiwan: A Newly Industrialised State*, Taipei: Department of Sociology, National Taiwan University, 1989.

The key finding in the Korean case, however, is the eventual transfer of the directive powers held by the authoritarian regimes of the 1970s and 1980s into the hands of private capital. As external pressures increased and private ownership of the largest proportion of the Korean economy developed networks and business beyond the Korean shores, firms were less keen on centrally-planned economic policy.¹⁶⁸ As a result, these firms were instrumental in redirecting the path that Korea undertook. While to a degree it was these unrestrained market forces that led to the damage that the Asian Financial Crisis brought upon Korea, it was the same priorities of the market and the upward pressures on wages which contributed to a rapid recovery in the economy.

While Mexico has already made the transition into democracy, the resonance of this is unmissable for Mexican readers. One of the most important outcomes of liberalization was the acceleration of the PRI's decline and eventual loss of power. In any situation where actors external to the central decision-making bodies begin to accumulate capital (both financial as well as political), they pose a threat for the unilateral direction of developmentalism. It should therefore be the priority of future administrations to protect social wellbeing and incentivize responsible business practices. At the same time, they should remain conscious that, in a democratic society with a liberal economy, public policy can only set a frame or a lane, if you will, within which economic developments will unfold, but always driven and subject to free market forces.

¹⁶⁸ Kuk (1998).

Beating the West at its own game

Since the fall of the Soviet Union, the former soviet republics and the Union's satellite states have undergone a political and economic transformation at a speed that has drawn the attention of academics and policymakers worldwide. The Eastern European countries, since 1998, have been in a race against time to implement reforms, including pension privatization and ultra-low corporate tax structures, that place them far ahead of their Western counterparts on the liberalization spectrum.

While the European Union has long used accession as a carrot for countries in the periphery to adhere to social and economic policy more in line with Western ideology, EU conditionality does not explain the pace of reforms in the CEE states on the economic front. In fact, in several instances, the reforms adopted went beyond the social policy norms that many in Brussels sought to see expanded to the eastern end of the continent.¹⁶⁹ Support for the policies came from the World Bank, the OECD, and USAID, using the Chilean experience in similar reforms nearly two decades prior as an example to follow.¹⁷⁰

The degree to which such policies were implemented, however, proved to be the determining factor in the country's recovery following the Russia Crisis of 1998. As is the case with Mexico, CEE countries required investment in infrastructure, which was underdeveloped in nearly all states. The countries that saw the greatest FDI flows following the beginning of the recovery were states which had since the earlier half of the decade undertaken drastic

¹⁶⁹ Bob Deacon, "Easter European welfare states: the impact of the politics of globalization," *Journal of European Social Policy* 10, No. 2 (2000); Zsuzsa Ferge and Gábor Juhász, "Accession and social policy: the case of Hungary," *Journal of European Social Policy* 14, No. 3 (2004).

¹⁷⁰ Mitchell A. Orenstein, "Out-liberalizing the EU: pension privatization in Central and Eastern Europe," *Journal of European Public Policy* 15, No. 6 (2008).

measures to privatize industry and the financial sector. However, the policies that truly made a difference were those that fundamentally reformed the framework for business operations in the countries. Countries which committed to such reforms were rewarded with rapid growth driven by FDI allocation according to market forces and exports to the EU.¹⁷¹ Especially active in implementing these reforms were the Baltic States, which adapted rather quickly and grew rapidly even after the GFC.

The question for the case of CEE states is what compelled them to implement such actions. According to economists, two main reasons stand out. First, the intense competition that countries in Eastern Europe, the Balkans and the Baltic sea found themselves in following the collapse of the Soviet Union. Given the sudden emergence of more than ten new countries, all with similar conditions for investment, countries strove to differentiate themselves from the competition. From a perspective of diffusion theory as described by Tiebout, this conclusion is in line with rational policy actors in the region. This explains why a country might go well below the recommended corporate tax rate. Low cost of business incentivizes the establishment of global firms in the countries, which in turn provide a near permanent source of foreign financing and labor opportunities.¹⁷² Indeed, since the implementation of these tax structures in CEE countries, literature surrounding the corporate tax rate has addressed its impact on the availability of similar capital in neighboring countries, suggesting that a country's decision to lower taxes incentivizes reductions to the homologous rate nearby. While the topic remains a

¹⁷¹ James Roaf et al., "25 Years of Transition: Post-Communist Europe and the IMF," *Regional Economic Issues Special Report*, Washington, D.C.: International Monetary Fund (October 2014).

¹⁷² Hillary Appel, "The Race to the Bottom? Corporate Taxes and the Competition for Capital," in *Tax Politics in Eastern Europe: Globalization, Regional Integration, and the Democratic Compromise*, Ann Arbor: University of Michigan Press (2011): 63-68.

hotly contested one, a line of thought in European economics suggests that the Union should spend less time criticizing CEE states for the incentives to capital attraction. Rather, this current suggests, EU corporate tax policy should fall in line with CEE schemes to equalize capital dispersion throughout the continent.¹⁷³

The second reason is an amalgamation of political, fiscal, and social factors. Following the collapse of the Soviet Union, the public in most CEE states had a generally negative perception of most policy associated with the communist experiment. Publicly-funded pension plans were among these. At the same time, a wrecked political environment dominated by weak competing parties and little commitment to public policy meant that leaders in most countries' governments were looking to reduce the responsibilities of the state and devolve, where possible, the provision of social goods to the private sector. Last, from a fiscal perspective, cash-strapped governments in the region, aware of the political and social benefits to removing pensions from state control, acted additionally to reduce the burden of supporting the retired—and therefore underproductive—on the public budget.¹⁷⁴

By measuring GDP per capita levels in the CEE economies, the difference between countries that implemented aggressive liberalizing strategies—that is, Poland, Czechia, and the Baltic States—and those which did not—primarily in the Balkans and the former Soviet Republics—is evident.¹⁷⁵ The results of the policies are clear—the “shock therapy” of the 1990s was conducive in a speedier restoration of income levels to what they were prior to the collapse

¹⁷³ Friedrich Heinemann, Michael Overesch, and Johannes Rincke, “Rate Cutting Tax Reforms and Corporate Tax Competition in Europe,” Centre for European Economic Research Discussion Paper No. 08-028 (2010).

¹⁷⁴ Orenstein: 903-905.

¹⁷⁵ World Bank data, 2017.

of the Soviet Union, and countries that implemented such reforms on average performed better than countries with gradual liberalization strategies.¹⁷⁶

In spite of the marked difference in short-term performance, however, it is important to note that the ability of a country to remain on this track is highly dependent on whether or not policies are accompanied by institutionalization and regulation for the proper functioning of a market economy.¹⁷⁷ This distinction is crucial in any effort to adapt the reformist spirit embraced by the countries in this case. As it applies to Mexico, any policies or generalized strategies proposed which involve aggressive reform or liberalization in any sense—for instance, the auctioning of exploration and extraction contracts for a newly opened petroleum industry—have to first consider whether or not the necessary institutions exist to ensure optimal market performance.

¹⁷⁶ Roaf et al.: 24.

¹⁷⁷ Martha de Melo et al., “Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies,” *World Bank Economic Review* 15, No. 1 (2001).

VI. Policy recommendations

The research conducted and laid out in the previous chapters aims to present Mexico's reality, contextualize the particularities of the country's economic position through a historical analysis, and evaluate potential future strategies by reviewing domestic and foreign policies that highlight the strengths and weaknesses of each. Keeping in mind the country's economic history as outlined in Chapter I, given the challenges identified in Chapter II, and based on the policy assessment conducted in Chapter III, this thesis presents several policy recommendations that fall into two broader policy goals that the government should keep in mind as the country moves beyond 2018: (1) achieving generalized productivity growth which will be the backbone of economic gains as the country's demographic panorama shifts, and (2) moderating the country's excessive dependence on the United States to reduce volatility associated with U.S. domestic policy developments.

Generalizing productivity growth

The first of these is the country's low productivity problem. Since 1994, at-large productivity has grown by 4.5 percent—an average 0.2 percent annual rate that has quashed the country's ambitions of taking advantage of the untapped human and capital resources identified by myriad international observers.¹⁷⁸ As indicated by the country's population growth estimates, the country's demographic expansion will not be enough to continue to

¹⁷⁸ Moreno Brid and Garry (2015).

sustain economic growth. Without sizeable improvements to productivity, growth will not be able to remain above 2 percent in the medium run.¹⁷⁹

Naturally, given the magnitude of the problem, the following policies are not meant to be sufficient in overcoming the challenges posed by productivity stagnation. However, the following three policies should serve as a basis upon which future administrations can build to address any changes in the country's outlook without losing sight of the main drivers of economic stability and growth.

Progressive increments to the minimum wage

In addressing the low productivity that has hindered the country's growth, the obvious first step is dealing with stagnant wages, more specifically, the minimum wage. While exports have grown substantially since NAFTA's implementation, the country's labor output, measured in the wages of workers in every industry, has been shrinking as a proportion of GDP. In 2016, labor represented roughly 36.6 percent of Mexico's product (compared to ratios closer to 60 percent of GDP for the rest of the G20 countries)¹⁸⁰. This suggests that the country is highly dependent on its exports and thus more vulnerable than comparable countries in an economic recession. It seems evident that wages need to grow faster than GDP for this to be amended.

¹⁷⁹ Eduardo Bolio et al., "A tale of two Mexicos: Growth and prosperity in a two-speed economy," *McKinsey Global Institute* (March 2014): 6.

¹⁸⁰ UN data, 2018.

While the minimum wage is not universally applied—informal employment agreements are not subject to the federal disposition—the figure serves as a benchmark to which formal businesses can compare their compensation and pay raises. Consequently, the decision to maintain wages so far below the minimum living wage has had repercussions. Among Mexico’s economically active population, a large proportion of those who earn above the minimum wage have their salaries tied to the daily minimum—it is not uncommon to find labor contracts, as well as payment of any number of federal and state obligations, defined in terms of minimum wages rather than in monetary terms for the purpose of standardization.¹⁸¹ Changes to the minimum wage, then, or maintaining the current level, would not only affect the base wage earners. Therefore, an adjustment to the federal minimum wage is in order. And the magnitude of the adjustment is of particular interest.

Mexico’s current daily minimum wage, in effect since 1 December of 2017, sits at MXN 88.36. At nominal exchange rates, that translates to USD 4.84. The minimum wage level cannot be compared to the corresponding figure in the U.S.—cost of living is vastly different between the two countries. However, even when compared to its peers in the rest of Latin America, Mexico comes in last.¹⁸² On the lower end of the spectrum, Colombia’s monthly minimum clocks in at USD 278.73 (COP 781,242.00); slightly ahead is Brazil with a minimum USD 287.94 (BRL 954.00) since the beginning of 2018. Closer to the higher end, minimum wage earners in Chile are legally entitled to USD 455.93 (CLP 276,000.00).

¹⁸¹ INEGI, “Determinan para 2018 valor de Unidad de Medida y Actualización (UMA),” *INEGI*, comunicado de prensa no. 007/18 (9 January 2018).

¹⁸² For the sake of comparison, minimum wage values are presented in USD at nominal exchange rates on 2 April 2018, on a monthly wage basis, as calculated by most countries in the region.

In Argentina, with the highest minimum wage in the region, they can claim USD 470.88 (ARS 9,500.00)—and the Argentine Congress has already approved a hike to ARS 10,000 in July of 2018. In Mexico, when translated to monthly terms, the minimum wage for a 48-hour workweek is a meager USD 116.23 (MXN 2,120.64).

Previous literature, however, suggests that rapid increases to the minimum wage will have a damaging effect on the achievements in labor formalization and employment.¹⁸³ That being said, most literature on the effects of minimum wage hikes was based on data from advanced economies. An in-depth empirical study by Campos Vázquez, Esquivel, and Santillán Hernández on the impact of the homogenization of minimum salaries in 2012 paints a more nuanced picture of the effects of such an adjustment to the Mexican context.

In advanced economies, wage elasticity is significantly negative: in general, hikes to the minimum wage are followed by a reduction in unskilled labor. Even in situations where there is no evidence of an immediate decrease in the rate of labor occupation, demand for labor falls over time, which negatively impacts the economy.¹⁸⁴ The counterargument is that minimum wage increases—even progressively—tend to succeed in boosting growth by increasing consumption. Additionally, other research has found that the differences in labor demand is less closely correlated to wages as was previously thought.

If the idea of rapid economic growth coming as a result of hikes to the minimum wage has been disproved by several studies, the reality remains that the minimum wage is indeed a

¹⁸³ David Neumark and William Wascher, “Minimum Wages and Employment,” *Discussion Paper Series No. 2570*, Institute for the Study of Labor, (January 2007).

¹⁸⁴ Raymundo M. Campos Vázquez, Gerardo Esquivel, and Alma S. Santillán Hernández, “The impact of the minimum wage on income and employment in Mexico,” *CEPAL Review* 122 (August 2017).

necessary protection for workers in sectors with a highly elastic labor demand and fierce competition because of excessive supply. The principle behind the institution of a minimum wage, from a social policy perspective, is that no person should, while working a full-time job (as defined by the respective jurisdiction), find themselves unable to afford the basic cost of living for them and their family.¹⁸⁵ The reality of the situation, however, suggests that the policy is not fulfilling its goal. Even with the December 2017 increase, the minimum wage is not sufficient to afford the basic consumer goods basket as defined by INEGI's national consumer price index.¹⁸⁶ According to *Coneval* (National Council for Social Development Policy Evaluation), the threshold of wellbeing sits still seven pesos higher, at MXN 95.24; the country's preëminent employers' association, Coparmex, has lobbied to have the minimum wage pegged to Coneval's threshold wage.¹⁸⁷

Following the review of the aforementioned study, it seems plausible to induce further increases to the minimum wage to ensure it fulfills its objective of providing sustenance to a family. As shown in the study, the 5.4 percent increase in real wages as a result of the homogenization of the minimum wage across regions produced no significant negative effects on either hourly wages nor on employment. On the contrary, labor income grew for those directly impacted by the hike, and employment, if anything, became more stable, strengthening the desire to remain in the formal sector. More importantly, the homogenization

¹⁸⁵ Ley Federal del Trabajo, art. 90.

¹⁸⁶ INEGI data, 2018.

¹⁸⁷ El Informador, "Inflación y canasta básica 'devoran' alza al salario mínimo," *El Informador* (22 November 2017).

of standards actually changed the incentive structure for self-employed Mexicans and workers in the informal economy to transition to formal employment.¹⁸⁸

To address the problems associated with the low minimum wage, this thesis proposes the implementation of a progressive policy to raise the minimum wage to competitive levels over the course of six years. The proposal suggests quarterly increases of 4.25 percent to the minimum wage, pushing the daily minimum to MXN 240.00 after twenty-four quarters. Taking the evidence from the homogenization of wages as a basis for comparison, such moderate increases should succeed in raising the living standards for minimum wage earners, increasing the incentives to transition to or remain in the formal sector, while avoiding effects on employment by spreading out the rise in cost of labor over the course of six years.

More broadly, this proposal achieves three objectives:

1. *Fulfilment of the purpose of the minimum wage in accordance with federal labor law.*

According to Coneval, the baseline wage to keep a person from extreme poverty today sits just above MXN 95 a day. However, that figure represents the wage required for one person's basic necessities. In six states, a majority of *households* earn no more than two daily minimum wages¹⁸⁹, which today translates to just over USD 5,450 when adjusted for the cost of living. It is imperative that the wage afford a sufficient standard of living for those families. With the implementation of this thesis' proposal—and assuming stability in the growth of purchasing power adjustment—at the end of six years a household earning two daily

¹⁸⁸ Campos Vázquez et al.: 226.

¹⁸⁹ INEGI data, 2010.

minimums would see their annual income, adjusted for purchasing power, rise to roughly USD 13,600.¹⁹⁰

2. Real wage growth for the lowest earners above general inflation.

Agustin Carstens, the former Governor of Banxico, has cautioned against drastic increases to the minimum wage as proposed by labor groups, warning that such changes would put excessive upward pressure on inflation, which if left unchecked could eat up any wage increases at all earning levels. However, Carstens's Banxico is notable for having kept inflation expectations well anchored at 3 percent, and over the course of the last administration, core inflation has remained in line with expectations. The proposed increase supposes an 18.11 percent annual rise in the nominal minimum wage—when adjusted for headline inflation forecast for 2018, the real increase in the minimum wage falls to 13.07 percent per annum.¹⁹¹ This would aid in countering the generalized drop in real wages seen since 2006, which has affected labor product and GDP at large. Additionally, increases at that scale for the lowest earners in the formal sector would incentivize formalization, raising the productivity levels of the economy as a whole by reducing the large fall in productivity seen in traditional (read: informal) enterprises since 1990.¹⁹²

3. Improved access to financial products, capital, and increases to domestic savings.

With relation to the other goals of the policy strategies outlined here, a higher level of earnings and the expansion of the formal sector of the economy would suggest that a greater share of the population would be able to access financial products. Paired with a loosening of

¹⁹⁰ OECD data, 2018.

¹⁹¹ Bank of Mexico data, 2018.

¹⁹² Bolio et al.: 7.

the financial sector's credit requirements, the increase in the minimum wage could translate into expanded access to capital. If implemented responsibly—which can be achieved through financial literacy programs—this could incentivize households to use credit to increase household investment and allow for the expansion of domestic savings.

Reallocation of FDI and public social spending

As mentioned before, Mexico has long been a darling of international investors looking for healthy returns in a relatively safe emerging market. Over the last two decades, foreign direct investment in Mexico, however, has seen a transformation in terms of the object of capital received from external sources. Prior to NAFTA, and even in the early years after its implementation, FDI by and large was used for the development of a manufacturing industry that would allow the sending countries to outsource parts of their own production processes to lower costs, creating wider profit margins and economic growth for the sending country. Today FDI flows have increased substantially—FDI received in 1999 from all countries was about equal to that originating only in the U.S. in 2017—and is aimed at production and development for foreign business looking for lower costs for high-skilled labor and lower barriers to trade, as well as for domestic businesses which take advantage of foreign funding for projects ranging from digital design, to agricultural innovations, to investments in infrastructure.

However, a surface evaluation of Mexico's economic situation suggests that twenty years and half a billion dollars later, FDI seems to have been particularly unsuccessful at jumpstarting growth. A closer look into the object of FDI and the results achieved by

individual sectors reveals a more nuanced picture of the impact of foreign capital on growth. Firms in dynamic and competitive industries such as manufacturing (e.g., Bombardier, General Motors, Nissan, Audi), finance and insurance (e.g., BBVA's Bancomer, CitiBanamex, Santander, AXA Group), and telecommunications (AT&T) have continuously represented over two-thirds of the FDI captured by Mexico. In other sectors, however, foreign capital is lacking. Rodrigo Aguilera argues that the cause is clear: lack of competition in several industries and uncompetitive wages that inhibit domestic spending.¹⁹³

One of the most successful examples of reforms working to increase competitiveness, lower consumer prices, and improve the general quality of the service has been the telecommunications industry since the passing of the 2013 reform on the matter. The telecommunications sector component of the national consumer price index recorded a 28.5 percent fall in prices for the industry since reform. At the same time, the government's intervention to compel the domestic duopoly (Mexican giant América Móvil and Spain's Telefónica controlled 92 percent of the mobile market as of 2010¹⁹⁴) was not met by a retraction in infrastructure and service expansion investment by the two—the two firms followed the dispositions set forth by the IFT in allowing AT&T to use the existing infrastructure while it developed its own. As of 2017, AT&T commands a 15.09 percent market share¹⁹⁵ but has already surpassed Telefónica as the second most profitable of mobile operators.¹⁹⁶ This growth highlights the necessity for reform in less productive industries.

¹⁹³ Rodrigo Aguilera, "Mexico's Foreign Investment Problem," Berggruen Institute: *The World Post* (2015).

¹⁹⁴ GSMA Intelligence, 2016.

¹⁹⁵ AT&T Annual Investor Report, 2016.

¹⁹⁶ El Economista, "Mercado de telecomunicaciones de alto valor registra poco avance en México," *América Economía* (4 February 2018).

The recent reforms in the energy and financial sectors should bring positive outcomes to the share of FDI in those sectors as well. However, the key question going forward, with respect to FDI, is how to ensure that the benefits of foreign capital in any given industry or firm can be spread to the rest of the economy. Importantly, the framework for foreign investment has to be addressed to ensure that, while high-capturing industries such as manufacturing and technology continue to be the object of foreign capital injection, less attractive industries—but industries with a high potential for growth nonetheless—are also targeted. Through the review of successful policies implemented in Mexico it became clear that the most successful in achieving their stated goals were those which addressed deficiencies in public strategy, spending, and the framework that affects the business environment in the country. So, the government's objective should not be to compel foreign capital providers to provide FDI on an equal basis to all industries and all regions by force. Nor should it take a strategy whereby FDI grows but it remains concentrated in one industry.

Changes to the legal framework, reduction in bureaucratic processes and the elimination of non-tariff barriers to trade, and the strengthening of IP protections have facilitated investing in the country. Consequently, the goal of future policy is to further incentivize FDI in Mexico to attract higher amounts of capital, and to ensure that said investment spills over into the rest of the economy. To that end, the recommendation that I put forth in this thesis is a strategy of structural incentives for investment in industries with a large potential for development, where large amounts of capital may mean the difference between productivity and the lack thereof.

Reorganization of the legal framework surrounding land use in the primary sector

Land reform in the early XX Century placed large swaths of land, known as *ejidos*, under communal control to redistribute the country's property and allow for individual wealth creation. A century later, however, the sector is stagnant and communal lands are among the least capital productive subsectors, owing largely to a lack of infrastructure, low technological incursion, and poor resources. So much so that 41.2 percent of youth from *ejidos* across the country leave the community in search of better economic opportunity, some to the U.S., some to urban centers, but some others even to other rural areas to work in private agricultural industry.¹⁹⁷

Considering that 102 million hectares, 53.4 percent of the Mexican territory, are held in social possessions, ensuring they become productive is paramount for the soundness of the primary sector. To that end, the government should undertake a substantial reform to facilitate the transfer of land to private buyers, domestic or foreign. The entry of FDI into the industry will be critical in bringing about the technological improvements necessary to make the sector more productive.

Agroindustry is capital-intensive by nature,¹⁹⁸ irrespective of technology acquisition. However, by injecting into the industry the capacity to adapt new technologies, efficiency will be optimized and the yield from available capital will be higher, transforming the industry to the benefit of workers in the sector and its contribution to GDP.

¹⁹⁷ J. Carlos Morett-Sánchez and Celsa Cosío-Ruiz, "Outlook of *Ejid*os and Agrarian Communities in Mexico," *Agricultura, Sociedad y Desarrollo* 14 (January-March 2017).

¹⁹⁸ Pavel Ciaian, Jan Falkowski and D'Artis Kancs, "Productivity and Credit Constraints: A Firm-Level Propensity Score Evidence for Agricultural Farms in Central and Eastern European Countries," *Acta Oeconomica* 62, No. 4 (December 2012).

Coöperation among state and federal governments to attract capital

As in the United States, Mexico's government is organized as a federalist state whereby responsibility is shared among the federal government in Mexico City, the mayor and city council of the former, and the 31 state governments across the country. Since the advent of democratization, there has been a subtler trend in domestic politics towards the increased importance of local leaders in formulating policy for each state.¹⁹⁹

State governments should take advantage of the reduced preponderance of the federal executive to be more active in pursuing policies for the benefit of the state. At the same time, leaders at both levels of government should strive toward increased coöperation, especially as it relates to economic policy. As the representative for all 31 states and Mexico City, the federal government is constrained in acting with aggressive policy in any given region by the considerations of the impact that may have elsewhere. Moreover, policy coming out of Mexico City has to promote national inclusion. The state governments, on the other hand, have more leeway in pursuing more focalized projects, and should indeed pursue them. Take, for instance, the suspension of a government contract awarded to a Sino-Mexican consortium to build a high-speed train connecting Mexico City and Querétaro. If the reasoning of the suspension suggests improvements on the matter of corruption, the cancellation of the contract leaves the government with an obligation for reparations to China Railway Construction Corporation

¹⁹⁹ Rodolfo García del Castillo, "Los gobiernos locales en México ante el Nuevo Federalismo," *Política y Cultura* 7, (Fall 1996).

(CRCC) and the rest of the consortium.²⁰⁰ If the federal government found itself unable to continue with the project bid as awarded, there is no reason why the governments of the interested states should have been unable to coordinate to go through with the project.

The proposition here is that states take the initiative to promote policies to attract foreign investment, either through public procurement for infrastructure projects, public spending to position the state as a competitive destination for market expansion, and the cooperation with other state governments. For the federal government, this would mean furthering the principles of the tax reform for participatory budgeting, whereby monies in the public treasury are less concentrated at the federal level—after all, local governments, both state and municipal, are better aware of the needs of their jurisdictions and better equipped to address the problems if given the resources.²⁰¹

This will prove important because, as state governments become more capable of managing these relations and defining policy direction locally, the federal government will have to—and will be more effective in—concentrating national policy towards an equal distribution of investment and a sustained and balanced level of growth. This means that even in 2018, National Palace can and should prioritize improvements to the standard of living of indigenous communities in Oaxaca, a state marred by low investment, low quality of life indicators, and violence, over investments in infrastructural updates in Nuevo León, a state

²⁰⁰ Comisión Especial para Revisar el Proceso de Licitación, Emisión de Fallo y su Cancelación, para la Construcción del Tren México-Querétaro, “Informe de Resultados,” *Gaceta Parlamentaria*, No. 4234-I (13 March 2015).

²⁰¹ Andrés Ruiz, “La importancia del gobierno local,” *Revista Paradigmas*, Forbes México (23 April 2014).

that already has income and standard of living indicators comparable to those of Mediterranean Europe.

Reorientation of public spending priorities toward infrastructure and social investment

Along similar lines, a pressing question for Mexico today is how to increase productivity while taking advantage of the leaps achieved in tertiary education and the high levels of professionalization in the Mexican labor market to increase wages across the board. As outlined above, the redirection of private investment towards productive industries across the country has to take into account the competitive advantages associated with the resources—natural, human, and capital—that define each geographic region. An important differentiating factor among the country’s states and regions is the quality of human capital available, and thus, the kind of FDI it receives. In recent years, economic activity at the national level has been slow, but the trend is not uniform. In 2016, with annual growth rates above 5 percent, the states of Aguascalientes (9.5), Quintana Roo (7.6), Colima (5.7), Sonora (5.6), Sinaloa (5.5), and Chihuahua (5.1) demonstrated the dynamism associated with the country’s economic panorama. With the exception of Quintana Roo, where the dominant economic activity is tourism, all states are highly industry-dominated, have high rates of educational attainment, and a high degree of connectivity with the rest of the world.²⁰² This has to do, to a large degree, with the focus these states have placed on higher education.

²⁰² INEGI data, 2017.

The federal government should make a concerted effort to shift public expenditure priorities to focus on social areas that have been demonstrated to correlate with the attraction of capital and economic performance. This includes greater spending on publicly-funded scholarships for lower-income families, improvements to public education systems (see below the example of the University of Guadalajara), and credits to low earning families to enable spending on household wellbeing, increase domestic spending, and grant access to better healthcare services without a detriment to educational or career development.

Credit expansion

The business of gathering and distributing credit information is a lucrative one, albeit one that depends heavily on the availability of information to gather and distribute. With the modification in the framework regulating the gathering and sharing of credit and financial information in 1996 as a part of the stabilization strategy, three private SICs were established. However, by 1998, two of the three had ceased operations. As of March of 2018, there are again three SICs registered with the securities commission, but only two operate independently, one of which has operated continuously since 1996.²⁰³ While three is a typical number of SICs for any country, the information they provide is limited—Buró de Crédito serves as the in-country technical partner for both Dun & Bradstreet²⁰⁴ and Transunion de México²⁰⁵, meaning they possess the same information that businesses provide to Buró de

²⁰³ Comisión Nacional Bancaria y de Valores.

²⁰⁴ Dun & Bradstreet, S.A.

²⁰⁵ Transunion de México, S.A. de C.V.

Crédito. But unless there is a marked expansion of the availability of credit in the country, the finance industry will not need more information than the three of these firms can provide.²⁰⁶

One of the biggest challenges for the continued expansion of both the role and the breadth of information maintained by credit bureaus is the size of Mexico's credit market. Unlike other emerging markets, available credit is severely limited in Mexico. According to the national financial inclusion survey in 2015, only 44 percent of adults in the country owned a bank account²⁰⁷—by comparison, 63 percent of Chilean adults, 68 percent of Brazilian adults, 70 percent of South African adults, and 78 percent of Thai adults had accounts in formal financial institutions.²⁰⁸ Moreover, as a percentage of the country's economy, Mexico again lags behind the rest of the region: as of July of 2016, Mexico's domestic private credit represented 35 percent of GDP, abysmal when compared to Brazil's (62 percent of GDP) or Chile's (112 percent of GDP).²⁰⁹ As outlined by the World Bank's *Financial Capability in Mexico* report of 2013, there is a significant relationship between the type of employment a person has and their knowledge of—and therefore, access to—financial products. People who are employed in the informal sector, who also tend to have lower levels of educational attainment, are more prone to financial strain, which is then addressed through informal borrowing.²¹⁰ This is related both to deficiencies in education about formal financial products and to the risk associated with the precarious nature of informal employment.

²⁰⁶ Negrín.

²⁰⁷ Comisión Nacional Bancaria y de Valores, Inegi, *Encuesta Nacional de Inclusión Financiera 2015*, CNBV.

²⁰⁸ World Bank, 2014.

²⁰⁹ World Bank, 2016.

²¹⁰ World Bank, *Financial capability in Mexico: results from a national survey on financial behaviors, attitudes, and knowledge*, World Bank Report No. 82134 (November 2013).

If Mexico is known to a large degree for its important agricultural tradition, productivity in the sector has long been lackluster. The sector's share of the country's GDP has fallen from 3.6 percent in 1993 to 3.1 percent in 2016. In theory, NAFTA's implementation should have allowed the sector to boom. While it is indeed true that Mexican agricultural products easily found demand in the U.S. and Canada following the treaty's ratification, the sector's relevance in national production has fallen primarily as a result of its productivity problems. As evidenced by the CEE case, agriculture is by nature a capital-intensive industry, requiring a greater share of capital than it contributes to GDP. In the case of Mexico, these disparities are exacerbated by the low degree of technological incursion in the industry and the legal framework that surrounds large swaths of land in several of the country's most fertile regions. As a proportion of internal debt in the private sector, the agricultural industry accounted for credit totaling MXN 70 billion in 2016.²¹¹ The same year, net private sector debt clocked in at MXN 8.16 trillion—the entirety of credit extended to the industry represented 0.8 percent of private sector credit.²¹² By way of comparison, during the same year, just shy of 7 million Mexicans were employed in the primary sector, a full 13.28 percent of the country's economically active population.²¹³ It is worth noting that only 2.5 percent of these loans were past due, suggesting that, if the availability of credit is near non-existent for the sector, financial institutions have been assiduous in evaluating potential borrowers' risk. This being the case, the low degree of nonperforming loans lends itself as evidence that

²¹¹ Alma Martínez, Alfredo Salgado, and Samuel Vázquez, "Tendencias recientes del sector primario en México," *Observatorio Económico México*, BBVA Research (17 March 2017): 16.

²¹² World Bank data, 2017.

²¹³ INEGI data, 2017.

regulations to develop a sound financial system have been successful. In addition, smaller firms, especially those with a traditional product or service offering, tend to find themselves without the capital to increase productivity because of barriers to financial products.²¹⁴ Removing these barriers will be crucial in ensuring that they are better able to compete with well-financed competition.

However, easing restrictions on access to credit is a double-edged sword. While broader access to financial products is essential in increasing household savings and the accumulation of wealth, a laxer financial regulatory environment incentivizes perverse behavior. The degree of related lending during the crisis of 1994 served as evidence of this from a supplier perspective. However, the same is true for demand-side behavior.

The Great Financial Crisis of 2008 was detonated, in part, by a mortgage default crisis, the result of an accelerated expansion of the credit market for homeowners in the U.S. Given the access to technologies which permit near-constant developments, innovations in the finance sector which would allow for higher returns on investment in largely unregulated instruments can be the apple to tempt unsophisticated or negligent investors. The result of such practices without controls are clear—the securitization of subprime mortgages played an important role in the collapse of the banking system, as financial institutions that invested heavily in mortgage-backed securities took heavy losses and found themselves insolvent.

As outlined in the previous chapter, Mexico's financial sector is still relatively young, and the degree of stability it has achieved is largely a result of the strengthening of regulations and the legal framework surrounding the industry. The objective of policies to expand credit

²¹⁴ Eduardo Bolio et al.: 13-14.

access should not undermine this environment. For the secondary and tertiary sectors of Mexico's economy, the primary challenge as it relates to credit is ensuring that capital provided to industries increases productivity. This cannot be achieved through public policy, as each firm will have to determine a strategy to optimize productivity through an evaluation of its own position, internal strengths and weaknesses, and external opportunities and threats. Instead, policy at the federal level should target the expansion of credit to the primary sector of the economy, to small- and medium-sized enterprises (*pequeñas y medianas empresas* or *pymes*) with high growth potential, and to individuals working independently seeking to enter the formalized economy. To that end, policy to ease access to credit should have a dual focus as outlined below:

On one front, the continued strengthening of the financial sector through legal protections for creditors, periodic evaluation of financial mismanagement and perverse business practices, and granting further independence to the CNBV and other regulatory organisms. All of these things working in tandem will provide the industry further resilience and establish the Mexican financial sector as a stable, attractive, and advantageous option for foreign financial institutions looking to enter the credit market.²¹⁵ Mexico's financial sector is already highly competitive,²¹⁶ however, and interest rates in the private sector are largely determined by the benchmark rates set by Banxico. As in other complex financial markets, the result of intense competition is often the development of new investment and credit products

²¹⁵ Deloitte, "Taxation and Investment Mexico 2016: Reach, relevance and reliability," Deloitte Touche Tohmatsu Ltd. (2016).

²¹⁶ Stijn Claessens and Luc Laeve, "What Drives Bank Competition? Some International Evidence," *Journal of Money, Credit and Banking* 36, No. 3, pt. 2 (2004).

for potential customers outside the sector's traditional client base. In the case of Mexico, there is already a growing number of microlenders beyond the formal financial institutions that extend credits to small, informal businesses and individuals in tight financial circumstances. Easing regulation to allow these firms to enter the formal credit market would expand opportunities for these customers to then access more complex financial products. At the same time, it expands the size of the industry and, by bringing these microlenders into a well-regulated framework, avoids the economic losses associated with their being outside the formal economy.

The second front, and the more crucial one, is the expansion of those opportunities to the public. While access to credit can be improved through deregulation in the sector, the idea of changing the direction of policy in the financial sector seems unwise. As is, the continuous progression of formal protections in the sector is what has given foreign investment the confidence to enter the market. Two efforts by the public, however, can increase the degree to which capital is available to a broader proportion of society.

First, efforts to improve financial literacy may prove crucial in inducing trust from the public in the banks—much of which was lost following the debacle of 1994. This is especially important when paired with the recommendation to increase education. Mexico's challenges are in a large part founded on insufficient knowledge or education.

Second, financial infrastructure has to be expanded. Alexander Herman and Alexander Klemm, in an IMF Working Paper on financial deepening in the country, pinpoint the country's credit problem on the supply side. Notably, however, credit shortage is not a result of a problem in turning deposits into credit, but rather a low level of deposits as well. Their

empirical studies suggest that banking infrastructure and a low degree of physical access to financial products are behind the shallow financial depth in the country.²¹⁷ Addressing both of these dimensions should produce the necessary expansion of credit through organic means. This ensures that the industry remains solid and performs well, avoiding perverse financial practices regardless of the size of the credit portfolio in the country.

Lowering barriers to formalization

In the case of the Asian Tigers in general, and looking particularly at the Korean case, the main driver of growth since the end of state-led economic planning has been the increase in wages in high-tech industries. This was driven by the preponderance of the export industries in the Korean economy and the fact that wages were largely determined by the revenues produced by these industries. Moreover, in such firms, productivity tends to be high and grow rapidly. In the case of Mexico, this is especially true—modern firms, irrespective of their size, productivity per annum has averaged 5.8 percent since 1999. Traditional, informal businesses, on the other hand, had average productivity *decreases* of 6.5 percent during the same period of time.²¹⁸ The reason behind this drastic difference has to do with low access to capital in traditional enterprises described above paired with high capital requirements and low capital yield. With the high costs associated with formalization, however, the incentive for businesses and individuals is to remain put. This dichotomy illustrates the need for a new strategy for business creation and formalization in Mexico.

²¹⁷ Alexander Herman and Alexander Klemm, “Financial Deepening in Mexico,” IMF WP/17/19 (2017).

²¹⁸ Eduardo Bolio et al.: 2.

Among the most important policy goals identified here, then, is the creation of incentives for domestic private capital formation in high-growth industries. As an example, Guadalajara, capital of the western state of Jalisco, stands among the most devoted local governments in the country. The government of the state too has had a considerable hand in this transformation as Government Palace, together with the city of Guadalajara, have been investing aggressively into a project to transform the city into a hub for technological innovation—in 2013, the two committed MXN 220 million into the project. By 2016, the state government had committed an additional MXN 150 million, matched by another MXN 300 million by Mexico City. The state’s 2018 budget tagged yet another MXN 150 million for the project.²¹⁹ The developments in the city captured international attention and, in 2015, the Inter-American Development Bank (IABD) announced it would too commit USD 500,000 to the project. The Digital Creative City, as the planned development is called, is aimed at attracting new and existing firms, both foreign and international, in the creative and technology industries.²²⁰

At the same time, they have invested heavily in the state’s public university system to make graduates competitive candidates for foreign firms looking to outsource or expand internationally. The University of Guadalajara is Jalisco’s public, higher education system, which operates in a manner similar to the University of California system in the U.S. It includes six campuses spread across the Guadalajara metropolitan area with different academic concentrations and nine regional campuses across the state which make up one of the most

²¹⁹ Secretaría de Infraestructura y Obras Públicas data, 2018.

²²⁰ Coordinación de comunicación institucional, “Ciudad Creativa Digital de Guadalajara ingresa a red de la UNESCO,” PROMEXICO Press Release No. 96/2017 (1 November 2017).

respected and best performing academic systems in the country. And it has been recognized for its push to develop a more competitive educational offer in high-tech academic areas internally, and a more tech-savvy environment in the state through the sponsoring of several global-scale events.²²¹

As a result of this investment orientation, Guadalajara, heart of the Mexican Silicon Valley, as Jalisco has come to be known, has now become home to over 300 startups since 2014, receiving hundreds of millions in VC investment. And some 600 well-established firms, including international giants such as Intel, Oracle, HP, IBM, and Dell, all have offices in the city and surrounding suburbs.²²² Because domestic companies and startups compete with foreign firms for talent, wages have risen substantially in the sector. Even if an average employee earns less than they would in the U.S., average wages for high-tech employees in the city sits at USD 1,916.42 monthly, nearly 6 times the average wage of USD 330 monthly.²²³

However, this is a very localized case. Moreover, not all jurisdictions have the same capital and revenue that Jalisco does. And while there should be increased investment in these sectors, caution should be exercised to avoid curtailing funding for successful programs targeted at poverty alleviation and public services. Consequently, this kind of public investment reorientation has to be adjusted, as the state cannot simply choose to spend more on growth. Moreover, the aim here is to replicate successful cases in local jurisdictions at the federal level. Even then, the government cannot direct private capital as it sees fit. South Korea

²²¹ Forbes Staff, "Inicia Talent Land en Jalisco, la feria de tecnología mas grande del país," *Forbes México* (2 April 2018).

²²² Adam Popescu, "Is Mexico the next Silicon Valley? Tech boom takes root in Guadalajara," *The Washington Post* (14 May 2016).

²²³ Matt Kendall, "When it Comes to Tech Salaries, Mexico Offers Far Better Value than the US," *Nearshore Americas* (27 February 2018).

presents a unique case in that, during the country's period of high growth, the government was an authoritarian regime untied to commercial interests. Rather, they were able to manage the economy very effectively and move public funds as they saw fit. Without advocating for a democratic regression in a country which has fought so hard for democratization, the best way to achieve this is to incentivize through deregulation and tax breaks as opposed to further spending. To that end, two policy points should be pursued to incentivize business formation and formalization without the need to resort to multi-million-peso budgets.

The federal government is already well underway on the first—the reduction of entry costs to the formal economy. In 2016, the legislation governing corporations, *Ley General de Sociedades Mercantiles*, was amended to simplify the registration of a business before the Secretariat of the Economy, introducing a new category: *sociedad por acciones simplificada* (simplified limited liability company).²²⁴ The registration can now be done online, a process that lasts as little as three hours, and there are no fees associated with the process. Prior to reform, the average fees associated with formalization were about MXN 30,000, more than the annual income of a minimum wage earner *already* in the formal sector.²²⁵

The second part of this, and the proposal I recommend, is the institution of a progressive tax rate for incorporated businesses. Given the drastic differences in the sizes of firms, and the reality that 48 percent of the country's employed population works in firms no larger than 19 people in size, a reduction in the tax burden on these firms is key in further

²²⁴ Ley General de Sociedades Mercantiles, nueva ley publicada en el Diario Oficial de la Federación 04-08-1934, última reforma publicada DOF 24-01-2018: 43-45.

²²⁵ ASEM, “¡Entró en vigor la ley para crear empresas en un día y sin costo!” Asociación de Emprendedores de México (15 September 2016).

incentivizing preëxisting firms operating in the informal sector to formalize.²²⁶ Paired with new access to capital, a raise in minimum wages, and the low entry costs associated with formal registration, the ability to broaden profit margins thanks to a lighter tax burden should be an added incentive to operate in the formal sector. These policies would push individuals to enter more competitive markets in search of higher returns. This invariably will lead to increases in productivity, if for nothing more, the higher wages produced and the ability to generate greater revenue as a formal business.

Crafting a global strategic vision

The second broad policy goal included in the country's economic strategy should be weaning Mexico's economy from U.S. consumer demand. As has been remarked by virtually everyone, from politicians to the private sector, one of Mexico's biggest sources of risk is the country's excessive dependence on trade with its North American neighbors. Mexico's exports make up a third of the country's economic production—with over four fifths of those exports going to the U.S. and Canada, a full quarter of the Mexican economy depends directly on the performance of the former two.²²⁷ On the investment side, the U.S. provides 44 percent of the country's FDI.²²⁸ This kind of overexposure proved catastrophic in 2009, when the financial crisis in the U.S. led to a contraction of GDP to the tune of 6 percent in Mexico. Therefore, and in light of Mexico's current trade predicament with NAFTA's renegotiation up in the air,

²²⁶ ILO data, 2017.

²²⁷ World Bank data, 2018.

²²⁸ Secretaría de Economía, 2017.

it is urgent that the government focus its efforts on cushioning the potential blow that negative developments across the border may have on Mexico.

While the policies outlined in this section are less dependent on unilateral action by the federal executive, they should nonetheless be taken into serious consideration in determining the orientation of Mexico's economic policy as well as general foreign policy going forward.

A Latin American Union?

Since the advent of independence in the region, Latin America has been disconnected. In spite of being one of the largest regions globally with broad cultural, economic, and historical ties, close coöperation has not come easily. A long history of revolution after revolution, followed by foreign interventions, military dictatorships, civil dictatorships, commercial protectionism and divergent political ideologies made for a largely balkanized Latin America for the better part of history.

In recent years, that has changed drastically. The second half of the last century saw the formation of a large number of regional organizations aimed at fostering cultural, commercial and political ties among countries in the region. The most notable of these has long been Mercosur, a free-trade zone, customs union, and free-movement zone that encompasses 72% of South America—an area three times the size of the European Union. And the bloc had EU aspirations since its inception. Like the latter, Mercosur adopted a common framework for customs beyond the member states, all restrictions to the movement

of goods and people were lifted, and for a time, there was considerable support for the establishment of a common currency.²²⁹ To a large degree, Mercosur was long united by political ideology—member countries were governed by successive left-of-center governments until the political shifts that have occurred in the last three years. With right-of-center governments now in control of Brazil and Argentina, political observers suggest that the unity of the bloc may be faltering.²³⁰ Notably, Shannon K. O’Neil, Senior Fellow at the Council on Foreign Relations suggests that changes in Buenos Aires’ outlook, marked by a recent trade agreement with Chile, as well as the economic downturn in Brazil may signal an opening for the two to seek new trading partners beyond the bloc.

Mexico should take advantage of this opportunity to expand its footprint with the world beyond its southern border. In the near future, a key component of Mexican diplomacy should be a concerted effort towards Latin American integration. Considering that South America’s GDP at nominal rates, even excluding Venezuela given the country’s current situation, is expected to rise to above USD 4 trillion by 2019, Mexico should strive to better integrate itself into the region. The direction of the next administration will be crucial for this: with right-of-center administrations in Brazil, Argentina, Chile, Peru, Colombia—the five largest economies on the continent—and Paraguay, fostering greater economic inclusion should be a priority. Moreover, given the cultural and historic ties in the region, there is ample potential for inclusion beyond a removal of trade barriers.

²²⁹ Claire Felter and Danielle Renwick, “Mercosur: South America’s Fractious Trade Bloc,” *Backgrounder*, Council on Foreign Relations (26 December 2017).

²³⁰ Ernesto Londoño, Shasta Darlington, and Daniel Politi, “‘World Upside Down’: As Trump Pushes Tariffs, Latin America Links Up,” *The New York Times*, 18 March 2018.

While Mercosur has seen a general decline due to ideological fragmentation, cooperation with Argentina and Brazil to revive the organization through expansion might yet bear fruit. In the bloc's first twenty years of existence, total trade grew from just under USD 200 billion in 1994 to over USD 800 billion by 2014.²³¹ The expansion of the common market to include Mexico, and foreseeably, the countries of the Pacific Alliance, would bring along free trade agreements with 52 countries worldwide, making the potential customs union among the four countries one of the most attractive markets for global trade.

A Caribbean belt and the Pan-American road

Along similar lines, another potential axis for integration is Mexico's immediate vicinity: Central America and the Caribbean. Already the Caribbean looks to Mexico for FDI flows: after Chile, Mexico is the region's second largest source of FDI from Latin America.²³² Expanding that presence would give Mexico an additional platform to expand trade beyond the Western Hemisphere, by using the Caribbean as a jumping board to the Middle East. At the same time, assertive foreign policy in the region may be key in asserting Mexico's position as a stalwart for democracy. The unequivocal position taken by the Secretariat of Foreign Affairs with respect to the political crisis in Venezuela was noted for demonstrating a departure from prior diplomatic doctrine, and a welcome vocal commitment to rule of law and democracy in a region where the two seem eternally in peril.²³³ And the government has taken

²³¹ UNCTAD data, 2016.

²³² CARICOM, "Looking Towards Mexico for Foreign Direct Investment," CARICOM Regional News (11 December 2015).

²³³ Anthony Esposito, "Venezuelan crisis takes center stage at OAS meeting in Mexico," *Reuters* (20 June 2017).

note of this: following the country's condemnation of political oppression in Venezuela, the administration has taken an active role in stepping in to the region to supply oil to the members of Petrocaribe, a mechanism to supply the essential resource to the region.²³⁴ This may force Havana to look to Mexico City for cooperation on political issues, raising the possibility of Mexico being the force behind the spread of democracy to the half-a-century-old dictatorship.

However, in regard to Central America, the countries' close ties to Mexico are undeniable, given that the entire region once belonged to Mexico, Panama excluded. Their physical proximity is an additional asset for Mexico. Given the asymmetry in the scale of Mexico's economy in comparison to its southern neighbors, Mexico should take a page out of the U.S.'s handbook and use carrots to influence policy in the region. By pulling the region into a well-defined sphere of influence, Mexico positions itself not only as a regional actor in Latin America, but as the primary speaker for the smaller countries sandwiched between Northern America and a distinct South America. Additionally, pursuing a leadership role in Central America opens a physical path to the rest of Latin America.

The most important takeaway from such policy, however, is the benefits that Mexican investment in infrastructure development in Latin America would provide for the receiving countries as well as for Mexican enterprise. Today, a key reason why Mexico finds itself isolated from the rest of the region is the lack of physical connectivity. The Pan-American highway is to this day incomplete because of the impossibility in crossing the rainforest in Panama. However, greater investment in the region would circumvent many of these issues, further

²³⁴ Assessments, "Mexico Sees an Opportunity in Venezuela's Struggles," *Worldview*, Stratfor (29 August 2017).

fostering intraregional trade and economic development that does not depend on demand for commodities or manufactured exports in the U.S. or China.

VII. Final Thoughts

Mexico has been on a continuous process of democratic and economic consolidation for the past three decades. This process is expected to continue over the course of the next three. Several economic analyses of the state of global affairs, in diplomatic and economic terms, coincide in the country's growth trajectory. By 2050, PricewaterhouseCoopers estimates Mexico will grow to be the world's seventh largest economy—behind China, India, the U.S., Indonesia, Brazil, and Russia, and ahead of every other advanced economy.²³⁵

As highlighted by a Goldman Sachs Working paper on the state of the world economy in 2050, however, these are projections of the best estimates for growth based on the *current* state of affairs.²³⁶ And recent crises around the world as well as the all-too-familiar tune of a “Mexican Miracle” demonstrate the possibility that these estimates are completely undermined by political turbulence, natural disaster, or societal forces. This highlights the importance of the policy recommendations comprehended in this thesis. For Mexico to continue down a successful path of economic growth, increased market complexity, reduction in social inequalities, and democratic consolidation, steps need to be taken to defend the state's strategy against political and social forces which seek to undermine the progress achieved to date.

This should not be taken to represent support nor repudiation for any candidates in the upcoming federal election, nor the parties they represent. As stated in the introduction of

²³⁵ Pwc, “The Long View: How will the global economic order change by 2050?” *The World in 2050*, PricewaterhouseCoopers (February 2017).

²³⁶ Jim O'Neill and Anna Stupnytska, “The Long-Term Outlook for the BRICs and the N-11 Post Crisis,” *Global Economics Paper No. 192*, Goldman Sachs Global Economics, Commodities and Strategy Research (4 December 2009): 21.

this work, the purpose of this undertaking is to provide a framework upon which any given administration—and ideally, those that come in 2024 and beyond—may build to create a national economic strategy.

As outlined throughout the work, in looking towards the future, Mexico's focus should be expanding its strategic horizon. To date, federal policy has largely been framed in relation to Mexico's internal economy and its relation to the U.S. Going forth, this will not be enough. More will need to be done on the diplomatic front to lay the foundation of a globally-oriented policy outlook, but the executive dependencies and agencies of federal, state, and municipal governments should be prepared to incorporate a more internationalist stance in developing policies at all levels.

Critics of Mexico note that, in spite of the optimism presented by PwC, Goldman Sachs, and the like, the country faces virtually insurmountable challenges in becoming a global power in any real sense. The preponderance of security problems in national- and international-level discussion, the high degree of corruption which permeates all levels of government and public service, social inequalities tied to historical imbalances, stigma rooted deep in the Mexican psyche, and the self-servient nature of domestic politics, and the list goes on. These are real and complex challenges, to be sure, and ones that will take more than simple political will to overcome. But there's an ocean between that and stating that the future of the country is doomed, and that Mexico is destined to never be great.

Examples abound of the perseverance and drive that distinguish Mexicans. For a country of backward-thinking farmers, Mexican genius Guillermo González Camarena delivered color television to the world. For a country of misery and lack of means, Mexico

produced two of the greatest artists in a generation in the form of Frida Kahlo and Diego Rivera. And for a bastion of religious fanatics and regressive social norms, Luis Ernesto Miramontes developed the first oral contraceptive, advancing the rights of women worldwide from a laboratory in Mexico. And there is nothing to say that in the coming years, Mexico will not be able to materialize each of these issues. The key is being prepared to take advantage of any breaks in the status quo. As happens in Mexico as in the rest of the developing world, opportunities are often times overlooked at the critical moment to act. Instead, issues are addressed once they reach a boiling point, and even then, planning is rarely done with a vision to the long-term concerns associated to the actions. My hope is that this thesis serves as a preparatory schema, putting the foundation in place to enable the country to take advantage of those breakthroughs. In this way, the country will be better prepared to deal with shock, positive or adverse, and extract the most from any situation and repurposing it for the achievement of a long-term plan.

And what is the plan? Standing in between Mexico and a primary position on the global stage are myriad challenges. However, the Roman Empire was not built in a day, the Spanish Empire was once little more than a feudal crown in Moorish lands, and the United States began as a smattering of coastal colonies. The plan is to develop a long-sighted vision and work incessantly towards the achievement of that goal. If Rome, Castile, and the American Colonies could do it, why not Mexico?

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