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Mexico's Transition to Neo-liberalism

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The International Monetary Fund (IMF) is often accused of forcing countries to enact neo-liberal policies. As the international lender of last resort, it is to the IMF that countries turn when faced with extreme difficulties in their balance of payments or exchange rate stability. Since it was founded, the IMF has had the power to make its financial assistance conditional upon certain economic policy reforms. In the last twenty years, the IMF has made increased use of these powers; meanwhile, the IMF has embraced the neo-liberal policies of the Washington Consensus. Not all countries that have needed IMF assistance wanted to enact these policies, and many critics have alleged that the IMF has used its position to compromise national sovereignty. In 1982, facing an economic crisis, Mexico announced that it would have to place a three month moratorium on repayment of its massive external debt, beginning what came to be known as the Debt Crisis in the developing world. This crisis left the country in need of IMF assistance. For the twelve years prior to the crisis, Mexico had been governed under a statist-populist regime whose policies differed significantly from those required by the IMF as a condition of its aid. I began my investigation of the Mexican transition to a neo-liberal regime expecting to find that the IMF was largely responsible for the shift. However, closer investigation revealed that the shift was primarily generated internally.

While there was international pressure on Mexico to alter its policies, in this paper I will argue that the shift was primarily caused by the failure of the statist-populist model and by changes in the domestic balance of power between classes. In order to stem the impending debt crisis, President Jose Lopez Portillo (1976-1982) had taken a number of dramatic steps in 1982. In February, the peso was devalued. In August dollar denominated bank accounts were forcibly converted to pesos at an unfavorable rate, evaporating large amounts of middle class savings. In September the banking system was nationalized. These steps left the middle classes and the business sector in shock, and the government--and the statist-populist regime--lost all credibility in their eyes.

When the crisis struck, many believed it was a problem of liquidity, not solvency: that Mexico's economy was capable of generating enough income to repay the debt, but did not have enough dollars in the short term to make the external payments due in dollars. The political fallout that ensued was, in contrast, a crisis of solvency, of governing legitimacy. The Partido Revolucionario Institutional (PRI), having ruled Mexico for decades, lost its support among the middle classes and business classes, support that was crucial to its maintenance of power. A radical shift was required if the PRI was to continue its rule. It took form in the neo-liberal policies of Miguel de la Madrid Hurtado (1982-1988) and the IMF program. The middle classes and the business sector rejected the statist-populist system of government in favor of neo-liberal policies, and they carried sufficient economic and political weight to require a change.

The International Monetary Fund

The International Monetary Fund, founded at the Bretton Woods Conference in July of 1944, was born of the economic problems of the first half of the twentieth century. In the aftermath of World War I, the economic links between the belligerent countries weakened. During the Great Depression, countries put up significant trade barriers. Most Western policy makers believed that the low levels of trade in the interwar years and low level of economic interdependence had contributed to the conditions that precipitated the Second World War. Thus, they thought rebuilding war ravaged economies and increasing world economic ties were important measures for preventing future conflagrations. Many familiar programs and institutions were created either partly or wholly as a result of this logic, including the IMF, World Bank, and the Marshall Plan.

In line with policy makers' concerns, the IMF's mandate was, in short, to facilitate the expansion of trade. This in turn required exchange rate stability and financial liquidity, primary concerns of the IMF to this day. Seeking stability of exchange rates, with some flexibility, a 'par value' system was implemented. All currencies would have a fixed-but-adjustable exchange rate with the U.S. dollar, which would in turn be pegged to gold. Each currency's par value would be allowed to fluctuate within boundaries of one percent of the fixed rate, or parity. Changing this fixed rate required consent of the IMF, which could be contingent upon a country meeting certain conditions.[1] The IMF also made available to countries conditional financial assistance in maintaining the existing rate. In the first decades of the IMF's existence, these conditions, typically mild, consisted mostly of fiscal and monetary adjustments the IMF deemed necessary to maintain parity, and sometimes a reduction in the barriers to trade--tariffs, quotas, etc.

By the late 1960s, this system had developed a number of problems. The 1970s was a period of difficulty and uncertainty, both in the international economy and at the IMF. Following the lead of the United States, most industrialized countries switched to some form of a flexible exchange rate regime--effectively ending the Bretton Woods system--and none have required an IMF financial rescue since 1976.[2] More so than before, then, the IMF's clientele became developing countries exclusively. Meanwhile, in the 1970s commercial banks began lending larger amounts to sovereign states--mostly developing countries--further drawing clients away from the Fund. Mexico was among those countries that used private sector loans to fuel development and maintain equilibrium in its balance of payments. Despite attempts to tailor new facilities to developing country use, the IMF was in an uncomfortable position of reduced influence and relevance.

The IMF made adjustments to respond to this situation. In the late 1970s and early 1980s, the IMF made several attempts to increase the size of its resources. This required the consent of the largest economies; these countries insisted that the IMF make greater use of its powers of conditionality. In 1978 amendments were made to the IMF Articles that, among other things, increased the IMF's power to make its loans conditional. This was followed around 1980 by the development of the Washington Consensus, named after the location of its most aggressive proponents--the IMF, the World Bank, and the U.S. government, particularly the Treasury Department. The Consensus was based on neo-liberal ideology, including the neo-classical paradigm in economics, which had risen to prominence in policy circles in the late 1970s. Policies encouraged under the Consensus include the following: an emphasis on the market system as allocator of resources; elimination of wage and price controls, subsidies, barriers to trade and capital flows, and other policies that distort market signals; privatization of state-owned enterprises; and deregulation of economic activity.

These developments were followed by the debt crisis, which afflicted much of the developing world. The crisis was first acknowledged with the temporary suspension of interest payments by Mexico in August of 1982, with many countries following suit. Even before the extent of the crisis was fully understood, commercial banks ceased lending to developing countries at anything but unfavorable terms--typically short term loans at high interest rates.

[1] Harper, p. 96.
[2] Polak, p. 12.

Most countries were forced to turn to the IMF for assistance in meeting debt payments and maintaining their balance of payments and stability in exchange rates.

With the increased powers of conditionality granted it in 1978, the IMF was able to make its loans contingent upon meeting certain criteria. Most countries that fell victim to the debt crisis were in desperate need of IMF assistance and accepted the conditions, regardless of whether or not domestic policymakers found them palatable. Thus, the neo-classical policies called for in the Washington Consensus were implemented in many countries that otherwise would not have adopted them, or would have done so with less stringency.

Economic Ideas and Ideologies in Mexico

To understand the context in which the shift to neo-liberalism took place, one must examine the economic and political ideas and ideologies prevalent in Mexico at the time. Untangling economic ideology and economic 'reality' is difficult. However, it will be useful to examine the different ideologies that were influential in Mexico in order to better understand the actions of actors within the economy, and resulting changes in the economy.

A person's understanding of the world affects their decisions and actions. This holds true for economic decisions. The history, policy, theory, and 'reality' of an economy interact with each other in a complex fashion, and each actor in an economy (e.g. people, households, governments, businesses) has their own conceptions and understandings of these. These beliefs about an economy or economic policy, regardless of their accuracy, can fundamentally alter the economy. An example of this, one often seen in Mexico, is the phenomenon of capital flight. If the government implements a policy to redistribute income, it will be viewed by some as a step toward increasing domestic demand and by others as a step toward socialism. In Mexico, those believing the latter have in the past voiced their objection to redistributive measures through capital flight, which in turn affects the economy, including the viability of a program of redistribution. Examples of this type abound and are often complex.

In Latin America and in Mexico, two issues stand out as primary in debates regarding economic policy: first, should development strategy be outward oriented and export-led, or inward-looking and manufacturing-led; second, are markets effective resource and income allocators, or is it necessary for the state to play a significant role in allocation. In both cases the former position is associated with orthodox models of the economy and the latter position with heterodox models. However, there is clearly a great deal of gray area between these polar positions, and important modes of economic thought in Mexico (e.g. Keynesian) do not fit neatly into this framework. There exists no simple classification scheme of economic thought in Mexico.

'Orthodox' theories of the economy--classical, neo-classical, and monetarist--have been influential in Latin America and in Mexico, both with important internal factions and with powerful countries and international institutions, including the International Monetary Fund. Their primary feature is an emphasis on markets as allocators of resources and output--a country's natural resource endowment and comparative advantage in trade, in the context of free trade and free capital movements, will determine the most effective use of labor and capital and their appropriate rewards. Barriers to trade and capital flows, wage and price controls, and government subsidies all distort market signals and cause inefficient allocation of resources. The export sector is seen as a primary engine of growth in a developing economy. The role of the state is to develop and enforce the rules by which markets function, but to remain largely outside of the economic sphere. In the 1980s orthodox models took institutional form in the Washington Consensus.

Historically, countries in Latin America have often had large export sectors based on primary products. Manufactured goods tended to be imported rather than produced domestically. Much of Latin America, including Mexico, enjoyed strong economic growth under export-led economies from the 1880s to the Great Depression. While growth in Gross Domestic Product (GDP) was often high, the skewed distribution of wealth that typically occurred under these regimes often engendered social problems. In Mexico, this problem was one of the causes of the Mexican Revolution.[3] Subsequently, both of the World Wars created an export boom for Mexico, but availability of consumer goods and manufactured imports in general was reduced due to the focus of the industrialized economies on production of war goods. Between the wars, the Great Depression witnessed a perilous drop in world demand, crushing export markets for Mexico and other developing countries. In addition to causing recession throughout the economy, this reduced Mexico's ability to purchase imports. Thus, the period from 1914-1945 saw great volatility in the export sector and frequent unavailability of imports (see table 1). It was during this period that some economists began to note that Latin America faced declining terms of trade: the prices of its exports did not rise as quickly as the prices of its imports, leading to a decline in export purchasing power over time. Partly as a result of this, Latin American countries tended towards frequent balance of payments problems.[4]

Table 1: Volatility in the External Sector

Year	Exports/GDP	(Exports + Imports)/GDP
1928	31.4	47.7
1938	13.9	25.5

Source: Bulmer-Thomas, p. 195

Structuralism developed in part as a response to these dilemmas. Along with Dependency Theory, Structuralism is one of two economic paradigms that originated and developed largely in Latin America, both having gone on to have a significant influence throughout the world. Structuralists were among the first to note, and make an economic argument in favor of, industrialization in Latin America. Industrialization, essentially, consists of the accumulation of capital and technology and their deployment in an increasingly complex and productive manner. Joseph Love writes that, "Industrialization in Latin America was fact before it was policy, and policy before it was theory."[5] Impressed by these problems that had led to incipient industrialization, by the 1930s many Latin Americans had come to see industrialization as a desirable goal. In Mexico, this was reinforced by the desire on the part of many for economic modernization, an important force since the Porfiriato. The Structuralist school, which dominated the United Nations' Economic Commission for Latin America (ECLA), provided important theoretical justification for a sustained program of industrialization.[6]

[3] Meyer, p. 481-83.
[4] Love, p. 408.
[5] ibid, p. 395.
[6] ibid, p 393-423. Though the name 'Structuralism' was taken on in the context of the debate with Monetarists in

The Structuralists saw market-led development as inadequate and argued a need for a more active state. They proposed that Latin American countries pursue a program of Import Substitution Industrialization (ISI), the goals of which were to reduce imports and industrialize, with the purpose of alleviating the problems mentioned above. The state would encourage industry through a number of measures, including protective tariffs, credit subsidies, tax breaks, and the provision of cheap food in urban industrial centers. In theory, the program would progress through stages from light to heavy industry, targeting at each stage those goods that were previously imported. The desired result was an industrial base and decreased reliance in imports, alleviating balance of payments problems and the terms of trade problem.

As Structuralist thought was developing in the 1930s, the economic thought of John Maynard Keynes was rising to prominence. Keynes and his followers argue that the macro-economy does not necessarily tend toward full-employment equilibrium as orthodox micro-economic theory holds, particularly in the short run. Thus, a potential need exists for government to fix market failures through various economic levers. These policies can be grouped into the categories of monetary and fiscal. An example of monetary policy is the reduction of the interest rate to stimulate investment. An example of fiscal policy is increasing government spending to create employment and incomes. Such measures are short-term correctives, and in the long run the Keynesian model mirrors orthodoxy.

Antonio Ortiz Mena, secretary of the treasury from 1958-70, developed for Mexico a model of 'stabilizing growth' that was very influential in Mexico from 1958 to 1982. Mexico was to maintain fiscal and monetary restraint--keeping budget deficits low and the growth of the money supply in check. This would keep inflation low and the peso stable. Ortiz Mena believed that Mexico's low savings rate placed a constraint on growth and that borrowing to raise more funds for investment could increase growth. He believed Mexico would obtain high returns on its investments, increasing the GDP and enabling Mexico to pay back its loans as they came due.[7] In the 1970s there was a 'hyper-Keynesian' or 'Cambridge' Keynesian approach in Mexican policy circles. This school argued for a need for income redistribution. This would increase domestic demand by increasing the purchasing power of the poor, who have a higher propensity to consume. This in turn would raise profits and stimulate growth. The Mexican policymakers influenced by this school argued that Mexico had excess supply, and that domestic demand could be raised without causing inflation through matching increases in supply. Deficits and foreign borrowing were accepted as means for paying for redistributive measures.[8]

In all of the heterodox models of the economy some measure of state intervention is either allowed or encouraged, but they did not converge into agreement on just what the state should in fact do. Though elements of some reinforced each other, their proponents did not necessarily agree on economic policy. The Mexican policy making elite did not as a group conform to a particular doctrine. Further, as in any country, varying interests pulled economic policy making in different directions. According to James Cypher, Mexico's economic policy was "pragmatic, incremental, and nondoctrinaire." At times policies contradicted one another.[9]

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regards to the sources of inflation, the Structuralist departure from orthodoxy was inspired at least in part by observations of and reactions to Latin American problems with respect to terms of trade and differential productivity vis-à-vis the developed countries.

[7] Cypher, p 61.

[8] ibid, p 89.

[9] ibid, p 15.

Political Influences on Economic Policy

As in any country, Mexico's economic ideologies and practices are inextricably linked to its social and political ideologies and practices. Much of Mexico's political discourse calls upon traditions and themes of the Revolution of 1910. The Revolution brought an end to the Porfiriato, the period named after the *Jefe Maximo* who ruled Mexico from 1876-1910, Porfirio Diaz. Mexico had enjoyed political stability under Diaz for the first time since its independence from Spain in 1821, setting the stage for a long period of economic growth and incipient industrialization. Mexico's intellectuals and political leaders valued economic growth and modernization, and these became important social goals. Foreign investment was encouraged, and U.S. and European firms took advantage of Mexico's resources, including mineral wealth, oil, and cheap labor. However, inequality in the distribution of wealth and income, foreign control of domestic resources, and Diaz's insistence on running for reelection in 1910, among other factors, incited frustration, and in 1910, revolution.[10]

There were several factions that opposed Diaz, some of them with quite different agendas. Some of the Revolutionaries were moderate and sought only to replace the aging Diaz to advance their own agenda or to continue economic growth under a less authoritarian regime. More radical factions, led by Pancho Villa in the North and Emilio Zapata in the South, called for improvement of the lot of peasants and workers and even economic equality. In 1917 a Constitution was forged between these factions, each pressing different versions. The result was a document that attempted to live up to differing Revolutionary ideals and contained ambiguities. Though violence continued and many of the radicals were killed, including Villa and Zapata, the Constitution survived and the government that ruled under it had to attempt to build a consensus as a foundation on which to govern. In the short term this was often accomplished through repression of opposition, but attempts were made to solidify a social pact that could endure. The victors of the Revolution sought not only a stable government but also enduring control of Mexico. They attempted to incorporate all of the important social forces into their political party, which, after two name changes, is now known as the Partido Revolucionario Institucional (PRI).[11]

Several features of the Constitution warrant attention. Two ideals embodied in the document and the consensus that emerged from it in the 1920s and 30s were modernization and equality.[12] Both social rights and individual rights were recognized. The nationalist and populist spirit of the Revolution was blended with the liberal ideals and drive for modernization influential in the Porfiriato. The government was given a prominent role in the direction of the economy and to the executive branch was delegated much of the political power. Article 27 reserved for the state ultimate control of Mexico's land and mineral wealth. Article 123 recognized fundamental rights of labor and was used to justify minimum wages and limitation of hours. Article 3 mandated universal education.[13]

Fighting continued even after the implementation of the Constitution. Gradually, though, the leaders of the Revolution, now the leaders of the government, shifted from repressive means of control to the development of a stable and permanent social consensus. This project came to full fruition under Lazaro Cardenas, president of Mexico from 1934-1940. This was

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[10] Meyer, p. 481-83.
[11] Newell and Rubio, p. 41-71.
[12] Newell and Rubio, p. 34.
[13] ibid, p. 30-32.

accomplished in part by the perception that Cardenas, in contrast to his predecessors, was living up to the ideals of the Revolution. Invoking Article 27 of the Constitution, Cardenas nationalized the oil industry, an important event in the development of the Mexican national consciousness. As the industry was largely U.S. owned and operated, nationalization was seen as a victory against the 'colossus of the north' and a matter of pride for Mexico.[14] Subsequently many industries thought to be of particular importance were nationalized or created by the state. Nationalization, then, though it had important economic effects, was frequently a political and cultural decision. The Cardenas administration also represents the height of populism in Mexico, though the perceived need to spread the benefits of the Revolution to all Mexicans remains an important force in Mexico to this day. Cardenas organized the redistribution of significant amounts of land to peasants.

The PRI maintained its power in Mexico for several decades by formally or informally bringing each significant group into an alliance with the PRI and taking measures to delegitimize or repress groups that would not join. Peasants and labor were both organized into official unions and confederations of unions, the leadership of which was usually chosen by the PRI. Their incorporation into the governing consensus provided raw numbers of support and followed up on the more radical ideals of the Revolution, at least in name. The military, which had been a volatile political force in Mexico since the Revolution, was professionalized and depoliticized, and by the 1940s was not a significant player in the political arena. From the middle classes came most of the original Revolutionaries and the bureaucrats that followed them. Despite this power enjoyed by some individuals, the middle classes as a group did not have official connections to the PRI.

The business sector was not explicitly incorporated into the PRI either. The government set up Chambers of Commerce and Industry, but the business sector did not have channels of representation as direct as that of peasants and labor.[15] This was despite the role the business sector was called upon to play in the modernization of Mexico through economic growth and industrialization. The PRI itself was strongly associated with the goal of bringing about an industrialized country, including through state-led economic development.[16] Industrialists and businessmen, though not powerful or well organized in the wake of the Revolution, would play an increasingly important role in Mexican society.[17]

The PRI established firm political control of Mexico through the incorporation of diverse social groups and through the control and manipulation of national symbols and ideals. The latter was accomplished in part through extensive state involvement in the media. The PRI became synonymous with the government itself. The PRI, then, carried several banners of the Mexican social and political consciousness: nationalism, populism and economic equity, and economic modernization and industrialization; waving them all at the same time would prove difficult.

Import Substitution Industrialization

As far back as the Porfiriato, industrialization and economic modernization have been important goals in Mexico. The export volatility and loss of imports experienced between the

[14] Ross, p. 99.
[15] Newell and Rubio, p 46.
[16] Meyer, p. 614.
[17] Newell and Rubio, p 53.

World Wars reinforced Mexico's desire to develop its industrial base and increase its economic self-sufficiency. Like many Latin American countries during this period, Mexico implemented as the centerpiece of its development strategy a program that is now referred to as Import Substitution Industrialization (ISI). This was not an implementation of Structuralist doctrine, but a program derived from an eclectic mix of policy influences and a reaction to previous problems.

Under ISI a country attempts to reduce its need for imports and increase its manufacturing base. These goals reinforce each other, as developing countries typically import manufactured goods. Many policy tools can be utilized to accomplish this goal. Tariffs or imports quotas can be used to mitigate the impact of foreign competition. Credit subsidies and tax breaks can be used to encourage the development of domestic industries. An appropriate combination of these policies can, at least in theory, allow a country to substitute domestic production for those goods coming in from abroad.

Although not always the case in practice, in theory ISI entails a progression of development from light--low capital, low technology--industry to heavy industry. A country first makes investments in agriculture, particularly irrigation and transportation, and develops simple production techniques, especially industries for its primary products. As capital and technical prowess accumulate, intermediate goods and later capital goods are produced. These latter two phases are more difficult--bringing a country into competition with more developed countries and requiring significant investments in capital goods, most of which must be imported from abroad. In practice the lines between these phases are not clearly drawn.

Stabilizing Development[18]

Mexico was a founding member of the IMF and received the first IMF loan in 1948. In the first decade after World War II, Mexico required some IMF assistance to maintain the value of the peso, and in 1953 and 1954, there was further exchange rate difficulty and a substantial amount of capital flight. There were devaluations in both years, both of which were broadly opposed. This experience was traumatic for policymakers and contributed to the perceived need to maintain the exchange rate, even at high cost. Maintaining favorable external conditions was viewed as critical to the success of Mexico's strategy for economic development. From 1955 to 1975, the peso traded at 12.50 to the dollar. Mexico did not access IMF resources again until 1976.

The period 1958-1970 came to be known as the era of 'Stabilizing Development,' in which growth rates were high, inflation was low, and the exchange rate was stable (see table 1). The latter two of these were no small accomplishment for Latin American countries, and Mexico was heralded as a tremendous economic success.

Several factors contributed to this success. The administrations of both Adolfo Lopez Mateos (1958-1964) and Gustavo Diaz Ordaz (1964-1970) fostered good relations with the business sector and the latter leaned toward economic modernization versus equality. This pro-business appearance helped bolster investor confidence.[19] Fiscal deficits were kept to reasonable levels. The Banco de Mexico kept reserve requirements high, and the Banco transferred these funds to the Treasury, helping to finance the deficits.[20] Since they were easily financed, there was little pressure to increase tax revenues. Public and private investment were both high,

[18] *desarrollo estabilizador*
[19] Newell and Rubio, p. 108.
[20] Fitzgerald, p. 34.

expanding aggregate supply and helping to clear bottlenecks in the economy. External conditions were favorable. Through most of the period, growth and import demand were high, both worldwide and in the United States, Mexico's main trading partner. U.S. inflation was relatively low, especially compared to the 1970s, meaning imported inflation was low.

Table 2: Economic performance in the era of 'Stabilizing Development'

Year	Real GDP, % increase	Real GDP, % increase per capita	Wholesale Prices, % Increase	Consumer Prices, % Increase
1958	11.1	7.5	4.4	12.2
1959	7.2	3.6	1.1	2.5
1960	13.4	9.7	4.9	4.8
1961	4.9	1.5	0.8	1.9
1962	4.7	1.2	1.9	0.9
1963	8.0	4.4	0.4	0.7
1964	11.7	7.9	4.3	2.4
Lopez Mateos *Sexenio* Average (1959-64)	8.3	4.7	2.2	2.2
1965	6.5	2.9	2.0	3.5
1966	6.9	3.4	1.2	4.2
1967	6.3	2.7	2.9	3.0
1968	8.1	4.5	2.0	1.4
1969	6.3	2.7	2.5	3.5
1970	6.9	3.2	5.8	5.0
Diaz Ordaz *Sexenio* Average (1964-70)	6.8	3.2	2.7	3.4

Source: calculated from data in IMF, *International Financial Statistics Yearbook.*

1968 Crisis

Despite the successes of the period, many people in Mexico perceived that the benefits of Mexico's Stabilizing Development were not being properly allocated and that the political process was too oligarchic. Between 1958 and 1968, the distribution of income deteriorated in Mexico. The Gini Coefficient rose from .450 in 1958 to .526 in 1968 (see table 2).[21] In the same period, the share of income of the bottom seven tenths of Mexican society decreased (see table 3). The frustration over these shifts in income distribution was aggravated by the perception that the Diaz Ordaz administration favored modernization and the business sector over equality and peasants and workers.[22]

[21] The Gini Coefficient is a measure of the distribution of income. It ranges from 0 to 1, where 0 is perfect equality and 1 is complete equality.

[22] Newell and Rubio, p. 108

Table 3: Gini Coefficient

	1950	1958	1963	1968	1970	1975	1977	1983	1984	1989
Gini Coefficient	.516	.450	.527	.526	.496	.570	.496	.499	.429	.469

Source: INEGI, *Estadísticas Históricas de México.*

Table 4: Percent of income, by income group

Income group[a]	1958	1968
I	2.32	1.21
II	3.21	2.21
III	4.06	3.04
IV	4.98	4.23
V	6.02	5.07
VI	7.49	6.46
VII	8.29	8.28
VIII	10.73	11.39
IX	17.20	6.06
Xa	10.24	14.90
Xb	25.46	27.15
Total	100%	100%

Source: INEGI, *Estadísticas Históricas De México.*
a: Each income group contains ten percent of the population, with the exception of **Xa** and **Xb**, each of which contain five percent of the population. **I** is the poorest ten percent of the population. **X** is the wealthiest ten percent of the population.

As in several countries in 1968, a student movement protested the perceived abuses of their government. A generation had grown up with Pancho Villa and Emilio Zapata as heroes, and perceived a stark contrast between the Revolutionary ideals and Mexico's reality. Steeped in leftist rhetoric, this movement sought a more democratic political process and a more equitable distribution of income. As this movement was growing, the government was making preparations to host the Summer Olympics in Mexico City. The government wanted it to be a proud moment for the country. They viewed the student movement as an obstacle to that goal and dealt with it harshly to prevent embarrassment during the games. During a demonstration at Tlatelolco Square, police killed hundreds of people.

The Mexican people were stunned. Even part of the political elite was alarmed at the severity of the crackdown. The student movement and the crackdown brought to the forefront the increasing split perceived to exist between the national goals of modernization and equality. The students and leftists were objecting to the perceived authoritarian politics and pro-business orientation of the government. The political elite was split on how to handle the aftermath of the massacre. This was the first significant crisis of governing legitimacy since the Revolution.

Shared Development[23]

The crisis was met with a pledge of 'shared development' by the new president, Luis Echeverria (1970-1976). Echeverria asserted that growth could continue while the distribution of income was improved. He saw the state as an appropriate tool for accomplishing this agenda. Increased spending on services, including education, health, and housing, would help extend the benefits of development to more Mexicans. Reducing unemployment was to be a central policy goal, accomplished in part through increased public sector investment.[24] Echeverria matched the leftist rhetoric of the student movement with his own, and though his administration did little to curtail the advantages of the business sector, it was quickly dubbed leftist and populist.

Both Echeverria and his successor, Jose Lopez Portillo, employed a statist-populist model of political economy. In Mexico, both populist policies and the active involvement of the state in the economy trace back at least as far as the Revolution, so this was more a change in emphasis than a shift in political philosophy. Whereas the Lopez Mateos and Diaz Ordaz administrations were seen to favor modernization and pro-business policies, Echeverria and Portillo were perceived to favor equality and populist policies.

The business sector felt excluded from political dialogue under Echeverria. Just two weeks after his inauguration, in December of 1970, COPARMEX, an employers' confederation, accused the administration of failing to consult the business sector in the development of its economic plan, which was both an unprecedented act and charge. Subsequently, different factions within the business sector overcame their differences to form the Consejo Coordinador Empresarial (CCE), an organization that represents the business sector. The Partido Acción Nacional (PAN), a party that tends to draw support from the urban middle classes, did well in the 1973 mid-term elections, and 29% of voters abstained from the 1976 election.[25]

In addition to these political problems, a number of economic problems plagued the shared development regime. Although growth remained high, from 1970 to 1975, the budget deficit grew from 2 to 10 percent of GDP, inflation increased from 5 to 18 percent a year, and the current account deficit went from 3 to 5 percent of GDP. The peso became overvalued as Mexican inflation outstripped that of the US, but the exchange rate was maintained at 12.5 pesos to the dollar. Capital flight became a significant problem. By 1976 these problems had accumulated and snowballed, requiring a devaluation of the peso and an IMF financial rescue program. After this correction, many of the same problems plagued the Portillo administration and contributed to the 1982 crisis. Investigating these issues will contribute to an understanding of the failure of the statist-populist model and the shift to the neo-liberal model.

Agriculture

In the 1940s and 1950s, Mexico made large investments in agriculture. Increases in output and productivity were to be a cornerstone of the ISI program. The growing numbers of non-farm workers required increases in food output, and part of the ISI program to spur industry was an attempt to supply food at low prices, helping in turn to keep wage costs down. Furthermore, food exports would help finance necessary imports of intermediate and capital goods. Significant funds were directed into irrigation projects, transportation, and

[23] *desarrollo compartido*
[24] Enríquez, p. 29.
[25] Luke, p. 45-46.

mechanization. Commercialization was encouraged; the Revolutionary tradition of land redistribution and protection of the *ejido* was deprioritized. This project was largely successful and witnessed high returns in the 1950s.

The government food procurement agency, CONSUPO, controlled many agricultural prices and kept them low. Though this benefited urban workers and in turn their employers, it squeezed small farmers. Larger firms could adjust more easily and could access export markets as well, and there was a growing gap between agribusiness and the subsistence sector. The squeeze on small and subsistence farming, coupled with mechanization, left many in the countryside without employment or enough food and income. This contributed to the rapid urbanization that occurred in Mexico in the second half of the twentieth century (see table 4). This is turn, increased the expenditure burden on the government to provide urban social services.

Table 5: Urbanization

Year	Percent of population urban
1930	33.5
1940	35.1
1950	42.6
1960	50.7
1970	57.8
1980	66.3
1990	71.3

Source: INEGI, *Estadísticas Históricas de México*.

By 1965 success in agriculture began to taper off. Low prices deterred private investment, and the business sector tended to invest in livestock rather than crops because prices were higher in the former.[26] Investments in agriculture had constituted 18 percent of state investment in the period 1940-49, but this fell to 9 percent in the mid 1960s.[27] Agricultural output expansion fell below the rate of population growth in mid 1960s.[28] Food export revenues disappeared, and Mexico began to import more food.

An attempt was made to respond to this problem; new investments were made in the Echeverria and Portillo years, but the results were not adequate for a number of reasons. Some of the funds went into a growing bureaucracy supporting the agricultural sector rather than productive investments. The percent of net investment within gross investment declined because of depreciation of old investments and increasing use of mechanization (investments in which depreciated faster than other projects like irrigation). Cost cutting investments (versus yield increasing investments) took up a larger share of allocations than in the past. By the 1970s most arable land was in use; whereas previous investments in irrigation yielded large returns by increasing the amount of cultivated land, subsequent investments faced diminishing returns with respect to fixed land inputs.[29]

[26] Heath, p. 142.
[27] Fitzgerald, p. 30.
[28] Fitzgerald, p. 25.
[29] Heath, p. 143-145.

Industry

By the 1970s Mexico was suffering from a difficulty with ISI that many countries experienced: moving from substitution of light industry to substitution of intermediate and capital goods is difficult, requiring a great deal of investment, import of foreign capital goods, and skilled labor. For example, according to Clark Reynolds, between 1950 and 1960, in four industry sectors--textiles, wood and paper products, chemicals and plastics, and basic metals--the ratio of the value of import inputs to value of production increased.[30] The import requirements of import competing industries put pressure on the balance of payments--defeating part of the original *raison d'être* of the ISI program.

According to E.V.K. Fitzgerald, the business sector was unwilling to undertake the necessary investment to accomplish the next phase of ISI, "preferring the high profits of light manufacturing, real estate and tourism." Some orthodox economists argue that the extensive government investments 'crowded out' private investment. Whether or not this occurred, it is safe to argue that business sector investment was reduced by the weak level of business confidence that obtained in the face of the leftist rhetoric of the Echeverria administration--it 'crowded out' business sector investment. As the Echeverria *sexenio* progressed, more and more funds were diverted to investment abroad rather than direct domestic investment.

This placed a heavy burden on public investment in the continuation of the ISI program. Both the Echeverria and Portillo administrations attempted to allocate sufficient funds to accomplish this, and spending on economic investments remained high. This, of course, added to the pressure on the budget.

Fiscal Issues and Problems

Expenditures

Government spending increased significantly under Echeverria and Portillo. Some of the reasons for this have already been outlined. Much of it was due to the perceived need to respond to the crisis of 1968 with increased social spending. This came at a time when other factors were causing a need for more spending. The most significant of these were demographic trends. The population of Mexico exploded in the 1960s and 1970s (see table 5). This was accompanied by a significant trend toward urbanization (see table 4), which was caused in part by the changes in agriculture. High levels of unemployment and under-employment existed. This benefited the business sector, as an industrial reserve army was available for cheap employment in Mexico's burgeoning industry, but it left a large percentage of people in urban areas in poverty. Thus, there was a greater need for social services; meanwhile, the expense was greater per capita, as urban areas require more spending per capita than do rural areas.

These increases in social spending were matched by increases in economic spending. Both Echeverria and Portillo sought to further industrialization and create new jobs through public sector investments. As a part of this, the government incurred significant expense in the parastatal sector in the 1970s. Parastatals are state owned and operated enterprises, such as PEMEX, the state oil company. A large portion of government investment went into parastatals. These investments did not always pay off, for a number of reasons. The most important was that

[30] Reynolds, p. 229.

the government kept the prices of parastatal output low in order to subsidize the business sector, in part as a component of the ISI program. Another reason was that the government at times purchased failing business sector businesses and turned them into parastatals in order to help maintain employment levels.[31] Under Echeverria the number of parastatals increased from 86 to 740.[32] This expansion of government enterprises contributed to the perception of the Echeverria administration as leftist.

In 1971, the first year in which Echeverria implemented an economic plan, government spending was actually restrained due to a perceived overheating of the economy. The perception by 1972 was that the restraint had been too large, and that growth had suffered. This had the effect of reducing the weight of those in the administration calling for fiscal responsibility.[33] Afterwards spending increased sharply (see table 6).

Table 6: Population

Year	Population	% Increase over previous 5 years
1960	36,050,000	18.0
1965	42,690,000	18.4
1970	50,690,000	18.7
1975	60,150,000	18.7
1980	69,660,000	15.8
1985	77,940,000	11.9

Source: IMF, *International Financial Statistics Yearbook.*

[31] Fitzgerald, p. 34.
[32] Luke, p. 44.
[33] Fitzgerald, p. 40.

Table 7: Government Spending

Year	Central government spending, as % of GDP[a]	Parastatal spending, as % of GDP[b]	Total government spending, as % of GDP[c]
Average of period 1966-1970	11.47	13.79	25.27
1971	10.54	14.23	24.77
1972	11.90	12.16	24.06
1973	12.74	13.72	26.46
1974	13.77	14.69	28.46
1975	14.69	19.32	34.01
1976	15.43	16.68	32.11
1977	15.47	15.14	30.61
1978	15.70	16.20	31.90
1979	16.46	17.07	33.53
1980	17.54	18.09	35.63
1981	20.12	22.12	42.24
1982	30.04	12.66	42.70
1983	26.06		
1984	22.89		
1985	24.86		

Source:
a: calculated from IMF, *International Financial Statistics Yearbook*
b: calculated by subtracting Column 1 from Column 3
c: taken from Newell and Rubio, *Mexico's Dilemma.* p 279-281. This column does not include state or local government expenditures.

Revenue

Throughout the period under review, Mexico suffered from an inflexible and inadequate revenue structure. Most of the government's revenue collections came from indirect taxes--which are not elastic, meaning they do not increase as quickly as the growth of the economy. They are also regressive, meaning the burden of taxation falls more heavily on the poor than the rich.

In the era of stabilizing development, though the government always ran a deficit, increases in spending were roughly held to increases in revenue. In other words, the deficit as a percent of GDP remained more or less stable. This was not the case under Echeverria and Portillo. The public sector deficit increased in nearly each year of their respective terms (see table 7).

The economic elite was unwilling to accept an increased tax burden. Serious attempts at tax reform were blocked by the business sector in 1962 and again by the business sector and the Banco de Mexico (central bank) in 1972. The latter objected for fear that a tax increase would anger the business sector and cause capital flight. When his plan for tax reform failed, Echeverria failed to adequately adjust expenditures.

The difference was recovered by borrowing, both domestically and externally (see table 8). The primary source of deficit financing in the era of stabilizing growth--transfer of reserve requirements to the Treasury--was no longer adequate. Many of Mexico's policy makers did not believe that deficit spending was necessarily problematic. Indeed, some of them, influenced by Ortiz Mena or the hyper-Keynesian model, believed it to be necessary.

Table 8: Government Deficit

Year	Central government budget balance, as a percent of GDP[a]	Balance including parastatals, as a percent of GDP[b]
Average of Period 1966-1970	-1.73	-3.10
1971	-0.85	n.a.
1972	-3.00	-4.04
1973	-3.96	-5.56
1974	-3.81	-5.72
1975	-4.87	-8.70
1976	-4.67	-7.53
1977	-3.30	-5.18
1978	-2.70	-5.22
1979	-3.32	-6.25
1980	-3.13	-6.92
1981	-6.67	-14.71
1982	-15.54	-15.88
1983	-7.95	
1984	-7.11	
1985	-8.39	

Source:
a: Calculated from IMF, *International Financial Statistics Yearbook.*
b: Taken from Newell and Rubio, *Mexico's Dilemma*. p. 282-283

Table 9: Domestic and Foreign Borrowing

Year	Net domestic borrowing as a percent of GDP	Net foreign borrowing as a percent of GDP
Average of Period 1966-1970	1.52	0.42
1971	1.02	0.07
1972	2.41	0.44
1973	3.62	0.49
1974	3.10	1.30
1975	3.65	1.42
1976	3.68	1.84
1977	2.97	0.54
1978	2.78	0.30
1979	3.36	-0.23
1980	3.44	-0.07
1981	4.56	2.11
1982	13.04	2.42
1983	4.71	3.27
1984	5.18	1.99
1985	7.79	0.65

Source: Calculated from IMF, *International Financial Statistics Yearbook.*

The Balance of Payments

In both 1976 and 1982 the crises took shape in the form of balance of payments problems. Transactions across borders typically require that one party exchange its domestic currency for the currency sought by the other party. For example, to purchase cars from Ford Motor Company, a Mexican car dealer must pay for them in dollars, not pesos. If the Mexican government borrows dollars it must repay the loan in dollars. In both crises, Mexico did not have enough foreign currency to conduct its international transactions. In the most basic sense, it was because Mexico earned less foreign currency (from exports and capital flows into the country) than it needed to spend (on imports and capital outflow). The Banco de Mexico holds foreign currencies and buys or sells them as needed to keep international transactions flowing at the given exchange rate. These holdings of various currencies are referred to as reserves or reserve assets. In both crises, these reserves fell to extremely low levels, and the government had to undertake drastic corrective action to ensure the continuation of international transactions.

The Exchange Rate

The exchange rate is an important variable in the determination of levels of trade and capital flows. It determines the buying power of the peso versus another currency, and vice versa. Throughout most of the period 1970-1982, the peso was overvalued, hurting Mexico's balance of payments: an overvalued peso makes exports expensive to buyers in other countries and imports cheap to Mexican purchasers.

Mexico took pride in its currency stability. Public reaction to the devaluation in 1954 had been very negative, leaving policymakers with a bias towards maintaining the exchange rate, even at high cost. From 1954 to 1976 Mexico maintained its exchange rate at 12.5 pesos to the dollar. Inflation weakens the buying power of a currency, though, and Mexico's inflation outpaced that of the United States in the 1970s, weakening the peso vis-à-vis the dollar. According to Fitzgerald, using the wholesale price index as a guide, the peso was overvalued by 9 percent in 1970 and by 14 percent in 1975. By the consumer price index, the peso was slightly undervalued in 1970 and 27 percent overvalued in 1975.[34]

Export Sector

Mexico's export sector was weak in the 1970s for a number of reasons. As has already been mentioned, Mexico's agricultural exports weakened in the 1970s. The government was focusing its investments on the ISI program. Though import substitution does not necessarily conflict with the stimulation of exports, in practice the new industries had difficulty tapping export markets, and less funds were available for targeting improvements in the export sector. Mexico's main trading partner, the United States, exhibits a large amount of import volatility. When the U.S. economy goes into a recession, its imports are greatly reduced. This leaves the fate of Mexico's export success largely subject to forces beyond its control. The 1970s were a turbulent decade for the U.S. economy and, in turn, for Mexico's export sector. The crises in both 1976 and 1982 were exacerbated by a U.S. recession.

One response to these problems has been the development of export industries on the U.S. border, also known as maquiladoras, that process imported materials for export, with this occurring mostly to and from the United States. The sector was stimulated by tariff free status in the mid 1960s and a tax rebate scheme that started in 1973.[35] Though very small in the mid 1960s, this sector grew to account for two-thirds of Mexico's manufactured exports by 1980.[36]

This sector, which has increased in size and significance since the 1982 Debt Crisis, has some problems. First, a number of environmental and social concerns have developed regarding the sector. Second, while the static gains from trade in this sector can be large, it is not a dynamic source of growth in the economy: there are few linkages with other domestic businesses.[37] Third, most of the raw materials used in the maquiladoras are imported, negating part of the benefit of investments in the industry in terms of the balance of payments.

Import Sector

While Mexico's export sector faced these difficulties, imports were booming. The overvaluation of the peso made imports cheap in relative terms. Some food items had to be imported because of the failure of the agricultural sector to increase output in line with the increase in population. The attempt to expand the ISI program to intermediate and capital goods necessitated the import of large amounts of capital goods.

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[34] Fitzgerald, p. 44.
[35] Kim, p. 210.
[36] Kim, p. 209.
[37] Kim, p. 223.

In the 1970s growth and domestic demand were high in Mexico. While the ISI program stumbled, demand for intermediate and capital goods remained high--and what domestic industry failed to produce, Mexicans imported. In 1973 Mexico was still a net oil importer and suffered both the increased expense of oil and the inflationary aspects of the price hike.[38]

In the Portillo administration, import tariffs were reduced across the board (see table 9). This was in part a response to the criticism of orthodox economists and the business sector. With the overvalued exchange rate and high domestic demand, this led to a tremendous increase in imports. Imports increased three times in real terms from 1977 to 1981.[39]

Table 10: Average Import Tariff Rate

Year	Average Tariff
1964	9.66
1965	11.85
1966	11.61
1967	14.72
1968	11.54
1969	12.01
1970	14.91
1971	13.61
1972	13.04
1973	9.56
1974	9.13
1975	9.96
1976	9.09
1977	5.68
1978	5.76
1979	5.96
1980	4.94
1981	4.54

Source: Newell and Rubio, *Mexico's Dilemma*. p 296.

Capital Account

In addition to the difference between exports and imports, the balance of payments is influenced by the inflows and outflows of capital. Capital outflow occurs in different forms. Mexicans can exchange pesos for other currencies and purchase foreign assets or hold other currencies in foreign banks. Repayment of foreign debt must be made in the currency of the country from which funds were borrowed. Foreign investors can, with great ease, sell existing portfolio investments (e.g. stocks, bonds) or, with more difficulty, direct investments (e.g. factories). All of these transactions increase the demand for dollars sought for exchange with pesos.

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[38] Lustig, p. 20

[39] Kim, p. 212.

In the period under review, Mexican banks offered dollar denominated accounts. This meant that capital 'flight' could occur without funds leaving the country, through the simple exchange of pesos for dollars within Mexico. Middle class savers in particular made use of these, including sometimes to protect themselves from feared devaluations.

Both capital flight and use of Mexdollar accounts had deleterious effects beyond those on the balance of payments. They reduced the funds available for business sector loans (Mexdollar accounts had 100% reserve requirements). They also decreased the amount captured by the Banco De Mexico through reserve requirements and in turn reducing the amount transferred to the Treasury to finance the deficit--which contributed to the need for borrowing.[40]

Capital can also enter the country through the same mechanisms with the processes reversed. In Mexico in the period 1970-1982, external borrowing was a significant source of capital inflow (see table 8).

A number of factors influence the flow of capital into and out of a country. The expected return on an investment is an important factor. High interest rates or expected profit levels will attract capital to a country. Inflation mitigates these gains: the real interest rate, versus the nominal rate, must be considered in determining the impact on capital flows. Capital movements also occur for non-economic reasons, such as concerns about political stability or government policies. These factors could perhaps be summed up under the appellation 'investor confidence.' As mentioned, investor confidence was low during the Echeverria and Portillo administrations.

In the period under review, few or no obstacles to capital movements or currency conversion were in place in Mexico. Mexicans viewed these free movements as an economic right and curbing them would have been politically difficult if not impossible. At least as far back the Mexican Revolution, capital flight has been a mechanism by which the economic elite protected itself from instability and uncertainty or voted against policies it opposed.[41] Though the economic consequences are always potentially far-reaching, this phenomenon was often motivated or exacerbated by policy concerns outside of the economic arena. When economic crises did occur, capital flight often worsened and perpetuated them. Capital movements have become larger over time, increasing their significance.

The combination of a fixed exchange rate and free capital movements can become problematic. If it becomes clear that the exchange rate is out of alignment, a number of problems can occur. If the peso is overvalued, in time the government will have to either intervene to bring it back into alignment or devalue the currency. Fear of devaluation will encourage holders of pesos to exchange them for dollars or dollar assets. This will put further pressure on the peso, as demand for the dollar increases and demand for the peso decreases. This increases the need for devaluation, and the circle continues with even greater fervor. If this cycle grows out of hand, it may lead to a need to devalue, even if the currency could previously have been bolstered. Many developing countries have had this problem. In 1976 Mexico joined their ranks.

There were three main sources of pressure on the peso that led to crisis in both 1976 and 1982: the current account deficit, external debt service, and capital flight (see table 10). The first two of these are not particularly difficult to measure. Capital flight, though, is difficult to measure. The term is not synonymous with capital outflow, something that happens at all times in all countries. It refers to those capital outflows that occur in a time of crisis. As mentioned, it also contributes to crisis. It is difficult in practice to distinguish between 'normal' capital flows

[40] Luke, p. 44-45.
[41] Enríquez, p. 9.

and capital flight brought on by crisis. Table 10 gives measurements from two sources. One generic method of measuring capital flight is to use the 'errors and omissions' portion of the balance of payments as a proxy. This portion is used to offset the discrepancies in the statement, which is required to balance total inflows and total outflows--it reflects, as the name indicates, capital flows that were not measured. Thus, 'errors and omissions' is sometimes used as a proxy for capital flight because it captures irregularities. However, it should not be thought of as an accurate or complete measure. The fourth column gives capital flight estimates from an article by Edward Buffie and Allen Krause.

Table 11: Sources of currency pressure

Year	Current Account Balance as % of GDP[a]	External Debt Service as a % of GDP[b]	'Errors and Omissions' as a % of GDP[c]	Capital Flight Estimate[d], as a percent of GDP
Average of Period 1966-1970	-2.41		0.22	
1971	-2.13		0.19	
1972	-2.03		0.56	
1973	-2.56		-0.78	
1974	-4.00		-0.67	
1975	-4.59	2.82	-1.37	
1976	-3.84	4.08	-3.37	
1977	-2.26	6.36	0.0037	6.85
1978	-3.09	7.37	-0.14	1.14
1979	-4.06	8.35	0.48	1.13
1980	-5.78	5.15	-0.0022	2.00
1981	-6.70	4.45	-3.76	2.57
1982	-3.78	7.09	-4.07	3.95
1983	3.79	10.43	-0.65	4.82
1984	2.39	8.09	-0.55	-0.38
1985	0.61	6.93	-0.96	

Source:
a: Calculated from IMF, *International Financial Statistics Yearbook.*
b: Calculated from OECD, *External Debt Statistics.*
c: Calculated from IMF, *International Financial Statistics Yearbook.* A negative number indicates capital outflow.
d: Taken from Buffie and Krause, "Mexico 1958-86." A negative number indicates capital inflow.

1976 Crisis and Devaluation: 'Flotar Como una Piedra'[42]

Many of the problems outlined so far in this paper gathered momentum during the Echeverria administration and built to crisis proportions by 1976. The overvaluation of the exchange rate increased. The fiscal deficit ballooned and external debt increased--in turn increasing the burden of debt servicing. The current account deficit widened. Investor confidence--shaken by Echeverria's leftist rhetoric, the fiscal deficit, inflation, negative real interest rates after 1973, etc.--plummeted, and capital flight became an increasingly large problem (see table 10). Deposits in Mexdollar accounts increased, especially in 1975 when devaluation seemed immanent. Mexdollar accounts accounted for only 4 percent of total money stock in the early 1970s, but 15 percent of the money supply was contained in Mexdollar accounts by August of 1975.[43]

Echeverria resisted a devaluation. The PRI perceived that a devaluation would weaken support from labor and believed it needed strong labor support in the face of weakening business sector support. Further, Echeverria perceived the capital flight to be a temporary political problem that would go away. Reserves were maintained through external borrowing.[44] The objective in so doing was to finance imports and maintain debt servicing, but the effect was to also finance capital flight.[45]

By 1976 reserves had fallen to unacceptable levels, and it was clear that a large correction would be necessary. Echeverria bowed to pressure to leave incoming President Jose Lopez Portillo with a clean slate. The peso was allowed to float against the dollar, and it depreciated substantially. Mexico requested access to IMF resources, and an IMF stabilization program was negotiated and accepted.

The IMF argued that the devaluation alone was not enough to solve the balance of payments problem. The response of imports to a change in the exchange rate was less than that of exports. Both the elasticity effect--price adjustment--and the absorption effect--demand management--needed to be utilized. Aggregate demand had to be reduced to close the balance of payments deficit, primarily by reducing import demand and slowing inflation.

A number of other measures could have been taken. Import restrictions could have reduced or eliminated the current account deficit. Capital controls could have limited capital outflow. Exchange restrictions could have helped maintain reserve levels. None of these options suited the IMF. According to Fitzgerald, since the IMF "assumed that tax reforms, suspension of convertibility, control over capital movements and import controls are not politically feasible or economically desirable (as the IMF does), then the budget deficit is indeed the only variable open to government control." This does not mean, though, that government spending or external debt were the only causes of the balance of payments crisis and that reducing them yields a complete solution. The IMF preferred solutions consistent with orthodox economics and with its mandate to expand international trade.

The IMF requirements for access to its funds were not stringent in comparison to its subsequent programs in Mexico and elsewhere. The IMF required that by 1979 the public sector deficit be reduced to 2.5 percent of GDP, that public sector saving to rise to 5.5 of GDP, and that

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[42] After the 1976 devaluation in which the peso was allowed to float against the dollar, it was commonly said in Mexico that the peso "floated like a rock." Fitzgerald, p. 61.

[43] Luke, p. 74.

[44] Fitzgerald, p. 42.

[45] ibid, p. 46.

external borrowing to fall to 1% of GDP. No large spending cuts or privatizations were required. Despite the loose terms of credit, though, Mexico would soon cancel its IMF program.

Administering the Abundance

Jose Lopez Portillo started his administration as had Echeverria--scrambling for legitimacy, especially with the business sector and the middle classes. Within a year, though, Mexico and Portillo seemed to be sitting pretty. The devaluation slowed import growth. Exports had picked up--the US economy had revived and was importing more Mexican products.[46]

But the real change was oil. In the first year of his administration Portillo announced that the level of proven oil reserves and suspected oil reserves in Mexico had both increased substantially. This drastically changed Mexico's economic picture. Suddenly Mexico's concern was not to make difficult decisions on the distribution of scarce resources, but, as Portillo put it, to "administer the abundance."

Portillo attempted to use the oil revenue to accomplish what Echeverria had failed to do: bridge the apparent divide that had formed between, on the one hand, Mexico's business sector and the goal of modernization and, on the other, labor, peasants, and the goal of economic justice. Portillo responded to the business sector and orthodox critics in a number of ways. He initiated an "Alliance for Production" meant to elevate the role of business sector in the development strategy. It included lower taxes on reinvested profits.[47] Various tax incentives were offered for investment, including accelerated depreciation and tax credits for new investments. Real wage growth was held below output growth from 1977-1979. Mexico's import duties were reduced on the average (see table 9). Each of these policies added to the fiscal deficit.

Meanwhile, social spending also continued to increase (see table 6). Though oil revenues increased in each year of Portillo's administration, spending increased faster (see table 7). The difference, of course, was made up through borrowing. The increase in oil wealth was used to justify the increases in public indebtedness, including to foreign banks. Though in hindsight the extent of this indebtedness clearly grew to be unreasonable, at the time there seemed little reason for concern. Mexico's ratio of external debt to oil reserves fell from 32 percent in 1976 to 4 percent in 1982.[48] At the time it was believed that oil prices could only go up.

Growth was high during most of the Portillo administration, but a number of problems presented themselves (see table 12). As mentioned, the fiscal deficit grew to massive proportions. The rate of growth of the money supply increased substantially. Mexico continued to have difficulty with the transition in the ISI program to intermediate and capital goods and faced supply bottlenecks. These factors all contributed to high inflation rates (see table 12). Exports faced the same difficulties as during the Echeverria *sexenio*. With high aggregate demand, import demand was high. As Mexican inflation outpaced U.S. inflation during the *sexenio*, the exchange rate became increasingly overvalued. Thus, when import restrictions were reduced, imports skyrocketed--imports increased three times in real terms from 1977 to 1981, and substantial trade deficits persisted despite oil revenues. In the same period consumer goods increased from 6 percent of the import total to 12 percent.[49]

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[46] ibid, p. 53.
[47] Luke, p. 50-51.
[48] Luke, p. 41.
[49] Kim, p. 212.

The inflation problem was answered by an increase in reserve requirements. This limited private credit, leading to increased external financing by the non-bank business sector. External financing of imports was also attractive because of domestic inflation. This increase in external debt by the business sector increased the need for foreign exchange.

Table 12: Oil Prices and Production

Year	Average Price of Crude Petroleum on the World Market, $ per barrel	Index of Production of Crude Petroleum in Mexico
1970	2.11	25.2
1971	2.57	25.8
1972	2.80	27.3
1973	3.14	27.7
1974	11.22	31.7
1975	10.60	35.2
1976	11.83	38.6
1977	12.84	43.8
1978	12.95	50.4
1979	29.22	57.8
1980	35.48	71.0
1981	34.12	80.3
1982	31.38	98.7
1983	28.37	96.6
1984	28.25	100.4
1985	26.98	100.0
1986	13.82	96.2

Source: IMF, *International Financial Statistics Yearbook.*

Table 13: Economic performance under Echeverria and Portillo

Year	Real GDP, % increase	Real GDP per capita, % increase	Wholesale Prices , % increase	Consumer Prices, % increase
1971	3.4	-0.02	3.8	5.5
1972	7.3	3.7	2.7	4.9
1973	7.6	3.96	15.8	12.0
1974	5.9	2.3	22.5	23.8
1975	5.1	0.6	10.5	15.7
1976	2.1	-1.4	22.3	15.1
Echeverria *Sexenio* Average (1971-76)	5.23	1.52	12.93	12.83
1977	3.0	-0.6	41.1	29.0
1978	8.3	5.2	15.8	17.5
1979	9.2	6.2	18.8	17.5
1980	8.3	5.0	25.0	25.7
1981	7.9	5.4	24.2	28.0
1982	-0.6	-2.8	55.9	59.7
Lopez Portillo *Sexenio* Average (1977-1982)	6.01	3.07	30.13	29.57

Source: Calculated from IMF, *International Financial Statistics Yearbook.*

Déjà Vu All Over Again

Despite these problems, Portillo's economic strategy might have succeeded due to the sheer size of the potential oil wealth, but three unexpected events catalyzed a spiral that led to crisis: oil prices fell, U.S. interest rates increased, and capital flight of massive proportions took place.

The 1981 budget was planned with an expected 75 percent increase in oil exports at a 10 percent increase in dollar price on the previous year.[50] At the time it was believed that oil prices could only get higher. However, many of the major economies were in recession, reducing demand for oil. The volume of exports increased only 33 percent[51] and the dollar price actually fell (see table 10). This, of course, resulted in a large gap between expected earnings of dollars and actual earnings.

The U.S. was in recession from 1980 to 1982. Most observers expected the U.S. to lower interest rates to stimulate the economy. However, inflation was high, and the experience of the 1970s and the increased influence of monetarism both contributed to a bias toward taming

[50] Luke, p. 64.
[51] Luke, p. 64.

inflation, even at high cost. The Federal Reserve raised interest rates in 1981, even though this deepened the recession. This increased Mexico's cost of external borrowing and reduced exports. Domestically, interest rates also had to be raised to fight inflation and slow capital flight, increasing the cost of borrowing within Mexico.

Capital flight in 1981 and 1982 occurred on a crippling scale (see table 10). Use of Mexdollar accounts increased, and by the end of 1981, they accounted for 25 percent of the money supply.[52] Given the overvaluation of the peso, another devaluation was feared. Mexicans turned to dollars and dollar assets to protect themselves. As more capital left the country and external borrowing increased, there was greater pressure on the peso, and greater fear of devaluation. This, of course, spurred more capital flight. Mexico suffered from the same destructive cycle witnessed in the 1976 crisis. The business sector and the middle classes voted their pocketbooks--against the statist-populist regimes of Echeverria in 1976 and Portillo in 1982.

By February of 1982, it was evident that a crisis was at hand, and the peso was devalued by 40 percent. Interest rates and reserve requirements were raised to stem inflation. 5000 products became subject to price controls. New incentives to exports and tourism were announced and the prices of parastatal products were raised.[53]

Nonetheless, the response of the government was not adequate. The 1982 budget was supposed to bring down spending, but the deficit climbed again, in part because wages of public employees were raised. The February devaluation had the effect of increasing the expense of dollar denominated debt servicing, and the increase in interest rates had the effect of raising the cost of domestic borrowing by the government. Capital flight continued, both out of the country and into Mexdollar accounts. Foreign banks stopped lending to Mexico on favorable terms--loans were short term with high interest rates.[54] The perception that the government continued to mismanage the economy contributed to still more capital flight. The pressures on the peso were still significant, and Mexico could no longer sustain external borrowing to bolster reserves.

In August the finance minister announced a three-month suspension of repayment of principle on foreign debt. There was another devaluation that entailed the creation of a new two-tier exchange system. Mexdollar accounts were forcibly converted into pesos at an unfavorable rate, instantly erasing a substantial portion of the savings of the middle class. In September the government instituted foreign exchange controls and nationalized the banks.[55] These steps, of course, infuriated the business sector and the middle classes.

Analysis and Conclusions

Under Miguel de la Madrid Hurtado, Mexico shifted to a neo-liberal regime, which it has employed to the present day. The ISI program was abandoned, and the government shifted its focus to stimulating the export sector. The role of the government in the economy was significantly reduced. Many state-owned enterprises were sold. Government spending was reduced. The trade account was further liberalized, and Mexico joined GATT. Why did this shift occur?

In short, it was because of the rejection of the statist-populist model employed by the

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[52] Luke, p. 66.
[53] Luke, p. 68-70.
[54] Luke, p. 68-70.
[55] Luke, p. 68-70.

administrations of Echeverria and Portillo. Why, then, did the statist-populist model collapse? In the immediate sense, it was the debt crisis that killed the model. Thus, part of the explanation of the shift can be found in the reasons the debt crisis occurred.

One set of contributing causes for the crisis is that general economic conditions in the United States were unfavorable in the period 1970-1982 when compared with the 1960s and the rest of the 1980s. This had a large effect on Mexico because of the extent of its trade with the U.S. Growth in the United States was weak and erratic. In turn, Mexico's exports faced unfavorable conditions. U.S. inflation was higher than in the 1960s or the 1980s; Mexico imported it. Interest rates were unfavorable, particularly in the period immediately before the Debt Crisis.

In the 1970s Mexico faced political constraints on its economic policy that were more severe than in the past. Answering the 1968 crisis through an increase in social spending and public investment seemed to be a political necessity. At the same time, the Echeverria administration could not gather enough momentum to implement its plan to raise taxes in 1972, leaving a revenue gap that caused inflation, exchange rate instability, and increased debt, both internal and external. The budget deficit and its effects further undermined the support of the business sector and contributed to both capital flight and speculation against the peso; these latter two phenomena reinforced each other.

In addition to these problems, both administrations made many mistakes. Echeverria's strong leftist rhetoric may have helped to appease some of the frustrations that exploded in the 1968 crisis, but it weakened investor confidence significantly. Ironically, the Gini concentration actually increased under Echeverria (see table 2). This underscores the importance of perception with regard to economic policy: it was the leftist rhetoric, more so than a state program of redistribution (the opposite occurred), that dampened investment and led to capital flight. Portillo failed to distance himself from Echeverria's image and suffered the same problems.

Another significant mistake, which should actually be largely blamed on previous administrations, was the failure to slow population growth (see table 5). Any country's economy would have difficulty creating enough new jobs, producing enough food, and building enough schools, etc., to service Mexico's rate of population increase. In strictly economic terms, this was a tremendous blunder. In reality, of course, other factors have to be considered. The powerful Catholic Church, along with many Mexicans, objected to birth control. Not until 1972 did the government take steps to increase the use of birth control and family planning.[56]

Further, the oil wealth was not used effectively. According to Paul Luke, the problem was that the revenues generated from oil sales were thought of as income rather than wealth. The money was used for domestic spending. Though some of this spending went to economic investment, these funds were not focused on generating foreign exchange, in part because of the continued program of industrialization. Projects in the non-traded sector did not contribute to the current account. The overvalued exchange rate made investments in non-traded goods more profitable than traded goods.[57] An alternative would have been to focus on investments, both domestic and particularly in other countries, which could have generated foreign exchange on a steady basis.[58]

Portillo's choice to liberalize trade with an overvalued exchange rate led to a massive increase in imports and widening of the current account deficit. It is also clear that Mexico's

[56] Meyer, p. 689-90.
[57] Luke, p. 57-58.
[58] Luke, p. 42.

fiscal deficits and external borrowing were both too large. Whether or not one accepts deficit spending as an appropriate policy at times, Mexico stretched it to unreasonable levels.

These mistakes all contributed to the belief that the statist-populist model employed heterodox, or simply bad, economics. In the 1970s, orthodoxy had strengthened within the economics profession in the United States and in policy circles in many countries. The Washington Consensus was a product of this and became an ideological icon and weapon. Economic programs were categorized as either free or unfree, market led or statist, export oriented or import substituting, fiscally conservative or fiscally irresponsible, right or left, and, essentially, right or wrong. This coincided with trends towards technocratization in Mexico and academic training of Mexican leaders and bureaucrats in the United States.

Against this backdrop, the business sector and middle classes voiced their increasing displeasure through capital flight. This reduced the funds available for domestic investment and put pressure on the peso. Clearly the current account deficits and the servicing of external debt also put a great deal of pressure on the peso (see table 10), and, as discussed, policy mistakes contributed to these. It is important to note, though, that while much of the external debt was contracted for the purpose of bolstering external reserves, the practical effect was to finance capital flight. In other words, Mexicans were only able to exchange pesos for dollars so long as the government maintained sufficient reserves to continue to sustain such international transactions. Thus, much of the burden of debt servicing should in fact be attributed to capital flight--otherwise the significance of external debt itself is easily exaggerated. Capital flight (and the external borrowing that financed it) could have been stemmed through exchange or capital controls, but the government failed to do this--in part because of the existing influence of the business sector and middle classes. This financial voting procedure sounded the death knell of the statist-populist model and sounded the bugle call for the inauguration of neo-liberal policies.

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