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8 Populism and Economic Policy in Mexico, 1970–1982

Carlos Bazdresch and Santiago Levy

8.1 Introduction

Economic historians will probably look back at the 1970s in Mexico as a puzzling period during which the "miracle" of the 1950s and 1960s was slowly transformed into the "debt crisis" of the 1980s. The figures are quite dramatic. From 1954 to 1970, average annual GDP growth was 6.8%; the corresponding figure for inflation 3.5%. By the end of 1970 the ratio of foreign debt to GDP stood at 16.2.[1] The period was also marked by improving real wages: urban (rural) wages grew by 4.6% (4.7%). The next 18 years witnessed a dramatic reversal of these events: from 1971 to 1988 GDP growth averaged 4.1%, inflation 43%, urban (rural) wages 0.1% (2.0%);[2] the foreign debt/GDP ratio stood at 77.5. Equally important, the standard deviations of the growth and inflation rates during the former period are 0.019 and 0.04; the corresponding figures for the latter period are 0.03 and 0.39. Macroeconomic performance was not only less satisfactory during the latter period, it was also more erratic.

This paper centers its attention on the period 1970–82, which we label one of "populist macroeconomic policies." These macro policies stand in contrast to those implemented during the "stabilizing development" of the 1960s and the attempts at macroeconomic stabilization that followed since 1983. Our purpose is not to provide yet another critique of the policies followed during that time. Rather, our aims are two: one, to understand the origins of these

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1. The figure relates to long-term debt only.
2. The data for wages refers only to the period 1970–82; see table 8.1 below.

policies in Mexico and, two, to explain their economic effects. As the rest of the papers in this volume attest, the history of Latin America—and Mexico is no exception—is full of "populist episodes," and so we wish to ask not only what these episodes consist of, but why they occur and what their short- and medium-term effects are.

The term "populist" is used to refer to different regimes. Thus, the Cárdenas presidency in Mexico is termed populist, but so is the Peronist regime in Argentina and the Vargas regime in Brazil. More recently, and despite substantial differences with past experiences, the term populist is also applied to Allende's regime in Chile, Echeverría's and López Portillo's presidencies in Mexico, and García's in Peru. The ideological differences among these regimes are large, as is the international context in which they take place. Perón is considered to originate in the "military right," while Allende was "on the left." Cárdenas was consolidating the postrevolutionary regime in Mexico; Allende intended to build socialism in Chile.

If the term "populist" had a precise meaning it could clearly not be used to account for such diverse historical circumstances. Thus, its use as an analytical category is both risky and dangerous; it may generate more heat than light. And yet, language may not betray us completely: there are some similarities in these experiences.[3] In economic policy they relate to the profligate use of public expenditures, the intensive use of price controls, systematic overvaluation of the exchange rate, and uncertain policy signals with depressing effects on private investment. In politics they relate to the regime's reliance on the support of workers' and peasants' organizations, which generally puts the regime in conflict with the country's private sector. But, with the exception of Allende's Chile, these conflicts are rarely absolute; moreover, the private sector seems to survive them more often than the governments that provoke them. These similarities, nevertheless, are insufficient to distinguish populist from nonpopulist regimes. Many other governments share the characteristics just mentioned. And the distinction, surely, cannot be made ex post on the basis of which regimes succeeded and which did not; populism should not be a portmanteau category to describe any set of inconsistent policies. The question remains, Why does the adoption of a set of policies that many governments use sometimes lead to the populist label? What is really meant by such label?

3. Sheahan (1987, p. 316) writes that: "Populism is not merely the name for a disorder, but instead a fairly systematic manifestation of widely shared popular objectives. . . . But some features are certainly common: dislike of the traditional elite dominance, of foreign investment and influence, of erratic and unfair market-determined prices for necessities, and of any appeal to the need for overall restraints on spending on social programs. In the Latin American version they have all favored activist governments committed, at least verbally, to protection of workers and of wages, to industrialization, to nationalism, to policies of cheap food for urban consumers, and to favors for worthy groups as the norm and goal of good government. Rejection of efficiency criteria and of concern for macroeconomic balance became *principles*, not accidental byproducts" (emphasis in the original).

We organize the paper in four sections. Section 8.2 analyzes the origins of populist policies in Mexico. Section 8.3 looks at the period of stabilizing development. While it has been extensively analyzed before, we nonetheless review it briefly, as it provides the background for the period under study. Section 8.4 describes the populist episodes of 1970–82, dividing them, as seems natural in the Mexican context, into the six-year presidential terms (or *sexenios*) of Echeverría (1970–76) and López Portillo (1977–1982). Section 8.5 provides an assessment of populist policies along with concluding remarks.

8.2 Populist Economic Policies

After 1910 Mexico experienced a long and violent revolution with strong nationalistic and popular overtones. The revolution took some time to consolidate into a stable government, but by the end of the 1930s this task was accomplished by President Cárdenas through pacts with various popular organizations, chief among them the peasants' confederation (Confederacion Nacional Campesina, or CNC) and the workers' central trade union (Central de Trabajadores de Mexico, or CTM).[4] Through these pacts the government traded protection for the social interests represented by these organizations in exchange for political support. This network of alliances, coupled with the previous emergence of a single political party (Partido Revolucionario Institucional, or PRI), maintained social peace for a long time, while at the same time keeping political power firmly in control of the government.

Naturally, the leaders of the revolution were very critical of the previous regime. Among many criticisms, two stood out: (*i*) the extreme misery in which the majority of the population lived and (*ii*) the unwillingness or inability of the government to remedy this situation.[5] Two ideas derived from these criticisms were to play a major and persistent role in the emerging system. First is the idea that the country's growth should not occur at the expense of basic popular rights. In practice, this was interpreted to mean that bounds should be imposed on the operation of markets; limits to land ownership, protection of workers from the vagaries of the labor market, and preclusion of foreign participation in the exploitation of natural resources. The second idea is that the government should be responsible for, and have the power to, impose the desired outcome.

Thus, far from having only to "regulate trade and commerce and provide social peace," the government born out of the Mexican Revolution had to be activist, "protecting" the lower-income classes and, more generally, pursuing distributive justice. Economic growth became one of the central raisons d'être

4. See Meyer (1974), Ianni (1983), and Cordoba (1974) for further analysis of the Mexican political system and the Cardenist period.

5. Some argued, in addition, that the prior constitution—that of 1857—imposed too many restrictions on the government to act in economic matters.

of the government, as its political legitimacy derived from its ability to raise the standard of living of the population. To insure that growth had the desired characteristics, the government had an explicit mandate, enshrined in the constitution,[6] to intervene in the economy. This was manifested in various forms—first through land redistribution, and second in the control of fiscal and monetary policy.[7] Among other manifestations are, third, through the creation of public enterprises in manufacturing, transportation, banking, and other areas; fourth, through price controls for selected commodities; and fifth, through interventions in foreign trade and investment, labor legislation, credit policy, and the like. All this, in turn, had two key implications: first, the government would be the central actor or protagonist in the economic life of the country. Second, the government would take the role of referee or mediating agent, balancing the conflicting demands of workers, peasants, and entrepreneurs. And government, in the Mexican context, meant the executive branch, as a strong presidential regime was another key characteristic of the political arrangements set by the 1917 Constitution.

With growth as a priority, the government had to develop a special alliance with entrepreneurs (or the private sector), as the latter controlled the supply of capital and entrepreneurial ability. And, while the private sector was formally out of the PRI, the government nonetheless created the conditions for it to flourish: fiscal policy, labor laws,[8] trade protection, and other instruments were chosen to enhance the profitability of private investment. In exchange, the private sector would not directly challenge the government's monopoly on political power. Still, the private sectors' support for the government was less forthcoming than that of workers' or peasants' organizations. At the root of the arrangement lay a fundamental asymmetry: while workers and peasants were not, on the whole, internationally mobile, the opposite was true of capital. Hence the greater bargaining power of the latter group vis-à-vis the government.

A necessary condition for the government to perform effectively its role as leading agent of growth and referee of social conflict is that it be powerful. Economic policy, broadly defined, would be a pillar of this power. Thus, the principle emerged that economic policy could—and, when necessary, should—be used in the pursuit of the government's political goals. These goals could be distributive, though this was not always the case. But regard-

6. See in particular Article 27 of the Mexican Constitution, where reference is made to the "Rectorship of the State" in economic affairs.

7. The Central Bank—Banco de Mexico—was founded in 1925, but was not designed to function as a truly autonomous institution. The director of the bank is either confirmed or appointed by the president, who has the power to renew his term in office. The director is responsible to the Board of Governors headed by the minister of finance.

8. We note, however, that there were at times important differences between the formal labor laws and their implementation. Although the letter of the law placed great emphasis on workers' rights, these were at times suppressed by a combination of trade union corruption and outright repression.

less of whether government interventions had distributional intentions, they always had a parallel goal: to strengthen the political power of the government through its control of economic activities. Many forms of government action therefore had this double role. The *ejido*, for example, was a mechanism to distribute land to peasants and impose bounds on land ownership, but it was also an institution that tied the loyalties of *ejidatarios* to the government.[9]

The large role given to the government in the economy, as well as the limits imposed on the free operation of markets, created an inherent conflict between the government and markets; this conflict reflected a deep-seated distrust in market operation.[10] We see two reasons that account for it. First, we know that, for given preferences and technology, income distribution is strongly determined by the size and distribution of productive assets.[11] In Mexico's case the distribution of productive assets has been highly concentrated. Thus, the undiluted action of market forces, barring any government action, would probably generate a very skewed distribution of income. This outcome would be incompatible with the ideals of the revolution: too much economic power would be concentrated in few social groups.

Second, distributional problems aside, the requirements for market forces to produce efficient outcomes are very strong; incomplete markets for risk, costs, and asymmetries in the availability of information, increasing returns, and other nonconvexities imply that market equilibrium are Pareto-suboptimal.[12] Although not articulated in this language, it is probably the case that these factors played a large role in the thinking of some revolutionaries, who felt the need for mechanisms to achieve more equitable and efficient outcomes than what the markets of that time delivered; it was believed that the government could do better.[13] Thus, the set of laws and regulations that gave

9. For example, neither *ejidos* as a whole nor individual *ejidatarios* are allowed to offer land as collateral, thus limiting any access to credit from private sources; credit is offered to the *ejido* as a whole by public-sector institutions.

10. Sheahan (1987, p. 319) has put the matter aptly: "The low popularity of free-market economics in Latin America is not evidence that radicals have misled the people: the majority of the public is probably no more confused about what they want and why than the rest of us are. It is rather that the conviction runs deep that market-oriented economic strategies are likely to maintain special privilege, work adversely for the poor, impede industrialization, and strengthen foreign influence."

11. This point has generated some misunderstandings. For instance, Cordera and Tello (1989, p. 82) think neoclassical theorists claim that "the free interplay of market forces . . . would insure the *best and fairest* distribution of income between the various classes that participate in the production of goods and services" (our translation and emphasis). In fact, no such claim is made.

12. A long tradition in development economics—associated with the names of Rosenstein-Rodan, Hirschman, Scitovsky and others—can be interpreted as dealing with these issues. See Stiglitz (1988) for a modern rendition of the arguments and Bardhan (1988) for a particularly illuminating discussion of alternative approaches to development economics. We note, as Bardhan does, that "the differences between the more sophisticated versions of alternative approaches, even though substantial, are narrower than is generally perceived" (Bardhan 1988, p. 40).

13. From a welfare-theoretic point of view, of course, the presence of market failures is a necessary but not sufficient condition to justify government intervention. For the latter, it is necessary to show that, given the government's information and administrative capacity, such inter-

power to the government to intervene in the economy had, aside from the political considerations mentioned above, a separate origin.

As many historians have pointed out, not all revolutionaries were in favor of this role for the government. A subset of them argued that Mexico's growth should be based on the development of markets and free enterprise. Hence, the Constitution of 1917 embodies these two visions. From this difficult cohabitation inconsistent laws and policies have emerged on more than a few occasions. For our purposes, however, the key point is this: given Pareto suboptimal equilibriums and skewed distributions of productive assets, the issue is not whether the government will intervene, but with what policies. Risking oversimplification, we distinguish two types of interventions. On the one hand are those that try to alleviate market failures or improve the distribution of income by means that do not interfere with price signals but pay attention to the resulting incentive structure.[14] On the other are those—which we label *populist*—that implicitly or explicitly disregard resource constraints, the informational content of prices, and the reaction of agents to the incentive structure and attempt to replace markets by direct government allocations.

The combination of three conditions creates the background for populist policies in Mexico: (1) an activist government born out of a revolution with a mandate to intervene and a desire to do so to pursue its political goals; (2) market failures and distributional considerations that create a need for government intervention; and (3) the appeal associated with interventions that suppress markets or try to allocate by other means. Thus, the potential for populist interventions is a phenomenon rooted in the political institutions dominant in Mexico since 1917.

It should be clear from this description that populist interventions should not always be seen as the response of "the constrained referee of social conflict" to inconsistent demands by various social groups. This view ignores the second objective of government's intervention in the economy: that is, to remain in political control. Even when distributional conflict is not at center stage, governments may engage in populist policies if they believe that by doing so they can diminish the political power of certain groups. In contrast to what Dornbusch and Edwards (1989) and Sachs (1989) argue is the case for Latin America, in Mexico the primary cause for populist policies has not always been social pressures arising from inequality.

Of course, interventions by governments never take a pure form: in almost every regime there is a mix of market-oriented and populist policies. This creates a need to make a distinction between populist policies and populist

vention will increase welfare. Put differently, it is necessary to show that those responsible for designing and implementing government policy have the ability (and incentives) to make credible and consistent (social) welfare improving interventions.

14. By incentive structure we mean here the set of current and expected future relative prices (and possibly quantity constraints) that agents, given the information at their disposal, use to make their economic decisions.

episodes. We argue that populist economic episodes occur when populist policies come to the fore and, more particularly, when the mix of macroeconomic policies tilts strongly in the populist direction. Thus, all regimes have "populist features" in the sense that to some extent they all engage in populist policies. A combination of political circumstances, external shocks, and individual personalities determines when populist policies cease to be *pecata minutia* and instead dominate the bulk of macroeconomic policies taken by the government, that is, when populist episodes occur. Of these three, political circumstances occupy a central role: the government might find it expedient to resort to populist policies to accommodate the demands of certain groups, to increase its legitimacy, to solve a political crisis, or to bypass or postpone structural reforms. Alternatively, the government may implement a particular populist policy in an attempt to reassert political control. External conditions also matter, however, as access to external borrowing, and/or terms of trade shocks, and/or swings in the rate of growth of the world economy have important domestic repercussions. An elastic supply of foreign credit is a precondition for a large buildup of debt. A government tempted to populist actions might find them irresistible in the event of a positive terms of trade shock. Conversely, a negative terms of trade shock coupled, say, with an inelastic supply of foreign credit might preclude a government from engaging in populist policies, even if it was predisposed to do so. The government in Mexico plays the leading role in the economy; it does not control external events. Finally, personalities also matter, particularly in the short run, given the strong concentration of political power in the executive branch.

Thus, given the potential for populist policies that is always present, populist episodes result from the interaction of a complex set of events. Because these policies can yield short-run benefits, there is always a temptation to engage in them. Because they do favor certain groups (although not necessarily, nor always, the poor), they create political constituencies that support and encourage them. Because their implementation may at times be easier or politically more viable (e.g., raising revenues through the inflation tax or foreign borrowing rather than through a tax reform), governments may opt for them. And because there might be a belief that they can alter the distribution of power in the society, governments may at times feel that they have no other option than to resort to them.

In Mexico's postrevolutionary history there have been two main populist episodes. The first occurred during the Cárdenas administration (1934–40), a period during which (*i*) land redistribution was extensive, (*ii*) the corporatist nature of the political system was consolidated, (*iii*) large numbers of public enterprises were formed, and (*iv*) oil resources were nationalized. The second populist episode occurred during the presidencies of Echeverría and López Portillo. These two episodes are very different, and it is probably misleading to use the same adjective to refer to both. In any case, we emphasize that, in this paper, we deal only with the second one. Before we turn there, however, one additional remark is necessary.

While governments in Mexico have great leeway to intervene in the economy, they are all bound to follow, at least in principle, the ideology of the Mexican Revolution. This ideology emphasizes, among other things, the notions of economic nationalism and a mixed economy (Cordoba 1973). But these notions are sufficiently vague to allow for various interpretations, giving governments enough space to stress this or that particular interpretation of the mixed economy, or of economic nationalism, as the conditions of the time require. Nevertheless, specific economic policies cannot be implemented without recourse to some economic justification. When governments follow orthodox macroeconomic policies, their rhetoric emphasizes fiscal prudence. In these circumstances governments borrow freely, but selectively, from orthodox economic theory. Conversely, when populist policies are implemented, the rhetoric emphasizes nonorthodox approaches. Governments in Mexico are not committed to (nor do they strictly follow) a narrowly defined economic philosophy. In our view, it is misleading to identify populist economic policies with a specific school of economic thought, whether Marxist, structuralist, or otherwise. Rather, these ideas are pragmatically invoked when it is necessary to justify a particular action taken by the government in pursuit of its political interests. To the extent that structuralist ideas do not emphasize the relationship between budget deficits and inflation, for instance, these ideas are welcomed, nay solicited, by the government to justify its use of deficit finance. (Whether budget deficits do or do not cause inflation is a separate matter.) And while Marxist and/or structuralist ideas can be invoked and incorporated into the populist rhetoric, they are rarely applied in a pure form. It is futile to look for consistency between, say, structuralism and the economic policy of a particular regime. This implies, in turn, that the analysis of populist economic policies is not synonymous with the analysis of a particular school of thought. Economists might place great emphasis on purity of thought, consistency, and rigor. Mexican governments have been historically less inclined to do so and have consumed theories and ideas from a wider menu.

8.3 A Glimpse at Stabilizing Development

Stabilizing development—the period running from the mid-1950s to 1970—was characterized by very low inflation and nominal exchange rate stability. After an initial interlude of mildly falling real wages in the mid-1950s, the next decade experienced the opposite phenomenon: real urban (rural) wages rose, on average, 6.6% (6.7%).[15] In addition, real per capita

15. Data on real wages in Mexico should be interpreted with caution, as different sources give different results; see Gregory (1986) for further discussion.

growth was positive and steady. Such a simultaneous occurrence of events had never been experienced before, nor has it been observed since.

The core element of macroeconomic policy was the control of inflation, a sine qua non for exchange rate stability in an economy with full capital mobility. Low inflation was basically produced by tight control of public finances; small budget deficits were financed with moderate growth of external borrowing (cf. tables 8.1 and 8.2). Small budget deficits, in turn, were the outcome of tight fiscal expenditures, not high taxes.[16] Tax policy was instead used to promote private investment and grant subsidies to selected sectors and commodities (energy, food, transportation) via the pricing policies of public enterprises. Low inflation and low inflationary expectations along with credible exchange rate policies induced asset holders to invest in domestic assets, both physical and financial. A savings rate growing jointly with positive domestic real interest rates increased substantially the degree of financial intermediation during the period.[17] The same was true of private investment in real capital. Capital flight—a phenomenon that would plague the economy in later years—was mostly absent. In addition, the international environment was also conducive to growth.

The orthodox management of aggregate public finances, the exchange rate, and interest rates contrasts with the nonorthodox management of many other aspects of economic policy. First, protective trade policies associated with import substitution industrialization resulted in a strong "domestic bias" of the trade regime. Industry grew behind a combination of import permits, quotas, and tariffs. The trade regime did increase the share of industry in GDP, but also induced tariff-jumping direct foreign investment and inefficiencies in industries where the domestic market was insufficient to exploit economies of scale. It also created opportunities for rent-seeking activities, and it was a major factor (together with tax and credit regulations) in the creation of oligopolistic industrial structures; the resulting increases in price-cost margins probably had a regressive effect on income distribution.

Second, agricultural growth slowed considerably as the extensive margin was reached and the easy irrigation projects completed (Yates 1981). This, together with price controls on key agricultural goods, food, housing and transport subsidies for the urban workers, and protective tariffs on industrial products, altered the terms of trade in favor of the urban-industrial areas.[18] Growth had, in the language of Lipton (1977), a strong "urban-bias." Third, the pricing policies of public enterprises in key areas of oil, electricity, trans-

16. Hansen (1974, p. 114) argues that, when account is taken of all sources of government revenue (including social security taxes), Mexico's tax effort in 1965 ranked among the lowest of Latin American countries, with a total tax coefficient of 10.4%, compared to Brazil's 30.4%, Chile's 25.8%, and Argentina's 18.9%.

17. The ratio M3/GDP increased from 0.28 in 1960 to 0.51 in 1970.

18. For example, the real price of corn and wheat fell by 6.4% and 22.8% between 1960 and 1970; see Secretaria de Agricultura y Recursos Hidralicos (1983).

Table 8.1 **Basic Macroeconomic Indicators**

Year	GDP Growth Rate[a] (%)	Per Capita Growth Rate[a] (%)	Inflation Rates		Total Foreign Debt[b]	Real Wage Indices[c]		
			WPI for Mexico City (%)	CPI for Nation (%)		Rural[d]	Urban[d]	Minimum
1955	8.5	5.2	13.4	. . .	. . .	37.8	39.5	. . .
1956	6.8	3.6	5.1	. . .	. . .	37.0	39.0	. . .
1957	7.6	4.3	3.9	. . .	. . .			. . .
1958	5.3	2.0	4.7	. . .	. . .	36.4	37.7	. . .
1959	3.0	−.2	.9	. . .	. . .			. . .
1960	8.1	4.7	4.9	. . .	. . .	43.8	42.8	. . .
1961	4.9	1.6	1.3	. . .	. . .			. . .
1962	4.7	1.4	1.7	. . .	. . .	52.9	52.6	. . .
1963	8.0	4.6	.4	. . .	. . .			. . .
1964	11.7	8.2	4.5	. . .	. . .	62.6	54.9	. . .
1965	6.5	3.1	1.6	. . .	. . .			. . .
1966	6.9	3.5	1.5	. . .	. . .	67.7	70.3	. . .
1967	6.3	2.9	2.7	. . .	. . .			. . .
1968	8.1	4.7	2.2	. . .	. . .	75.4	77.5	. . .
1969	6.3	2.9	2.5	. . .	. . .			. . .
1970	6.9	3.5	6.0	5.2	8.63	79.1	81.1	83.6
1971	4.2	.8	3.7	5.3	9.22			79.2
1972	8.5	5.0	2.6	5.0	10.08	81.6	83.6	89.8
1973	8.4	4.9	16.0	12.0	12.74	. . .[e]		84.3
1974	6.1	2.8	22.4	23.8	16.68	90.2[f]	92.5	92.3

1975	5.6	2.4	10.4	15.2	22.71			93.7
1976	4.2	1.2	22.4	15.8	29.45	95.1[g]	98.9	104.2
1977	3.4	.5	41.2	28.9	32.34	99.8	102.5	103.5
1978	8.2	5.2	15.7	17.5	36.40	100.0	100.0	100.0
1979	9.2	6.1	18.3	18.2	41.12	103.5	99.2	97.9
1980	8.3	5.4	24.4	26.3	49.03	103.1	92.3	91.0
1981	8.8	6.3	24.5	28.0	74.35	101.7	95.1	92.5
1982	−.6	−2.9	56.1	58.9	92.41	100.1[h]	87.3	88.6
1983	−4.2	−6.3	107.3	101.9	93.78	89.7[i]	78.2	67.9
1984	3.6	1.4	70.3	65.5	96.65	. . .	. . .	63.3
1985	2.5	.4	53.6	57.7	96.57	. . .	. . .	62.5
1986	−3.7	−5.9	88.4	86.2	100.99	. . .	. . .	57.2
1987	1.5	−.6	135.6	131.8	107.47	. . .	. . .	53.6
1988	1.1	−.8	103.3	114.2	100.38	. . .	. . .	47.1

Sources: GDP and inflation rates: Indicatores Economicos, Banco de Mexico; for rural and urban real wage indices, 1955–83, Gregory (1986); for minimum real wage index, 1970–88; CIDE, Economia Mexicana; for total foreign debt: Macroasesoria, Inc.

[a] 1955–80 in 1970 prices; 1980–88 in 1980 prices.

[b] In billions of U.S. dollars.

[c] 1978 = 100.

[d] 1954–75 data are two-year averages.

[e] In the period between 17 September and 31 December 1973, the index for rural and urban minimum wages is 86.2 and 88.3, respectively. In the period between 1 January and 7 October 1974, the index for rural and urban minimum wages is 87.3 and 89.4, respectively.

[f] Effective 8 October 1974 to 31 December 1975.

[g] In the period between 1 October and 31 December 1976, the index for rural and urban minimum wages is 104.5 and 107.3, respectively.

[h] In the period between 1 November and 31 December 1982, the index for rural and urban minimum wages is 92.8 and 80.9, respectively.

[i] In the period between June 1st and December 31st, 1983, the index for rural and urban minimum wages is 77.0 and 67.2, respectively.

Table 8.2 **Indicators for Public Finance (% of GDP): Consolidated Public Sector**

	Revenues		Expenditures				
Year	Total	Oil	Total	Current[a]	Capital	Interest	Financial[b] Deficit
1965	18.0	. . .	18.8	. . .	. . .	. . .	.9
1966	17.3	. . .	18.4	. . .	. . .	. . .	1.2
1967	17.5	. . .	19.7	. . .	. . .	. . .	2.4
1968	17.7	. . .	19.6	. . .	. . .	. . .	2.2
1969	18.1	. . .	20.0	. . .	. . .	. . .	2.2
1970	18.9	. . .	22.4	. . .	. . .	. . .	3.8
1971	18.4	3.0	20.5	14.6	4.3	1.6	2.5
1972	18.7	2.8	22.9	15.4	5.7	1.8	4.9
1973	20.2	2.6	25.8	17.0	7.0	1.8	6.9
1974	21.1	3.4	27.0	17.9	7.2	1.9	7.2
1975	23.2	3.3	31.9	21.0	8.6	2.3	10.0
1976	23.8	3.3	32.0	20.7	8.0	3.3	9.9
1977	24.6	3.8	30.0	19.3	7.6	3.1	6.7
1978	25.9	4.5	31.4	19.5	8.7	3.2	6.7
1979	26.7	5.6	33.0	19.5	9.8	3.7	7.6
1980	26.9	7.3	33.5	19.8	9.6	4.1	7.5
1981	26.7	7.3	39.7	21.4	12.9	5.4	14.1
1982	28.9	9.9	44.5	25.1	10.2	9.2	16.9
1983	32.9	14.2	41.0	20.7	7.5	12.8	8.6
1984	32.2	13.0	38.8	20.7	6.7	11.4	8.5
1985	31.2	11.5	39.2	21.1	6.1	12.0	9.6
1986	30.3	9.0	44.8	21.5	6.0	17.3	16.0
1987	30.6	9.8	45.0	19.5	5.6	19.9	16.1
1988	29.8	7.5	39.0	17.9	4.4	16.7	12.3

Sources: Data for 1977–88; Indicadores Economicos, Banco de Mexico; data for 1965–76; Direccion General de Planeacion Hacendaria, SHCP; Financial deficit, 1965–70: Gil Diaz and Ramos (1988).

[a]Excluding interest payments.

[b]The financial deficit includes also "financial intermediation" expenditures, so that it is not equal to the difference between total revenues and total expenditures.

portation, and food were used not only as mechanisms to promote private investment and turn the terms of trade against rural Mexico, but also as signaling devices for inflation control: insofar as these prices were nominally constant inflationary expectations would be reduced and the credibility of the exchange rate enhanced. Nevertheless, the resulting structure of relative prices induced distortions in the use of intermediate inputs and indirectly channeled subsidies to high income groups.[19] Fourth, price controls were also

19. Levy (1988) develops a model to trace through the effects of public-sector prices on the distribution of income, showing that generalized price subsidies are a very expensive way of helping the poor, as these subsidies spill over into higher income groups that consume a significant share of the subsidized products.

applied to important commodities produced by the private sector. Thus, the nominal prices of wheat, corn, tortillas, bread, and sugar, as well as of urban transport, electricity, and other services were left unchanged throughout the sixties. This aimed at reinforcing the nominal stability of prices, but produced a rigid structure of relative prices and, at times, squeezed profit margins in some private firms.[20] Stability of nominal prices, particularly the exchange rate, were almost an end in itself. Yet a fifth characteristic is associated with public expenditures. A low tax coefficient made little room for social expenditures (see table 8.3). Serious deficiencies in the provision of health and education ensued precisely at a time when the rate of growth of population was accelerating. This phenomenon, together with a highly skewed distribution of income,[21] was an important ingredient of the political crisis that was under gestation toward the end of the 1960s.

In sum, stabilizing development brought about sustained growth, but a gamut of structural problems lurked behind the screen of price and exchange rate stability: agricultural stagnation, inward-biased industrialization, regional disparities and urban bias, and insufficient attention to income distribution and poverty. The strategy generated growth, but at increasingly higher costs. As the period came to an end, trade and exchange rate policy were turning more incompatible, real wage increases in excess of productivity growth threatened price stability, while restrictive government expenditures generated social problems. Even those responsible for economic policy during the period emphasized the fragility of the macroeconomic balance, and the difficulties of recuperating it if it was ever lost.[22] Thus, it is fair to say that, in 1970 the economy was in need of reform, although the reforms required were mostly microeconomic in nature. And while this can be said with the benefit of hindsight, a clear awareness of the difficulties inherited did not exist at that time.

20. A side effect of this policy would be the need to 'nationalize' private firms that could no longer produce profitably at the given prices. This was, for example, the case for sugar mills.

21. It is difficult to make comparisons in the pattern of income distribution overtime, as the Lorenz curves for the years for which income-expenditure surveys are available cross. After making various corrections and using alternative measures of inequality, Aspe and Beristain (1984b, p. 54) conclude that: "Whatever measure of inequality is observed and whatever indicator of relative position is used, whether income or expenditure, the main conclusion . . . is that the income distribution structure of the country remained basically unaltered between 1950 and 1977." Note that while income shares have been mostly time invariant, at any point in time the distribution is highly unequal. For 1977 we find that the poorest decile of the population earned 1.2% of all income, while the richest received 42% (Aspe and Beristain 1984b, p. 38). On the other hand, during stabilizing development: (*i*) the absolute income levels of the lowest deciles increased and (*ii*) grew faster than during any other period. Thus, while income inequality was pronounced, there were substantial improvements in the welfare levels of the poor; poverty and inequality are distinct phenomenons.

22. Ortiz Mena, finance minister during the period 1958–70, and generally recognized as the chief architect of stabilizing development, pointed out the need for policy changes in his classic article published at the end of the period (see Ortiz Mena 1970).

Table 8.3 **Indicators for Public Finance (in Constant Prices)[a]**

Year	Total Revenues	Growth Rate (%)	Oil[b]	Growth Rate (%)	Total Expenditures[c]	Growth Rate (%)	Current	Growth Rate (%)	Capital	Growth Rate (%)
1965	57,236				57,236					
1966	58,827	2.8			59,847	4.6				
1967	63,270	7.6			66,523	11.2				
1968	69,158	9.3			72,284	8,7				
1969	75,236	8.8			78,148	.1				
1970	83,967	11.6			90,631	16.0				
1971	85,093	1.3	13,789		87,314	−3.7	67,463		19,850	
1972	93,920	10.4	14,005	1.6	105,867	21.2	77,506	14.9	28,362	42.9
1973	109,759	16.9	14,264	1.8	130,393	23.2	92,337	19.1	38,056	34.2
1974	121,674	10.9	19,403	36.0	144,773	11.0	103,195	11.8	41,578	9.3
1975	141,243	16.1	20,134	3.8	180,901	25.0	128,187	24.4	52,715	26.8
1976	151,086	7.0	21,111	4.9	182,435	.8	131,883	2.9	50,553	−4.1
1977	161,926	7.2	24,724	17.1	177,225	−2.9	127,138	−3.6	49,874	−1.3
1978	184,657	14.0	32,134	30.0	201,423	13.7	138,935	9.3	61,879	24.1
1979	207,575	12.4	43,577	35.6	229,854	14.1	151,692	9.2	75,932	22.7
1980	236,835	14.1	64,384	47.7	263,445	14.6	174,115	14.8	84,487	11.3
1981	252,968	6.8	69,392	7.8	329,119	24.9	202,711	16.4	122,124	44.5
1982	272,178	7.6	92,936	33.9	341,249	3.7	236,558	16.7	95,609	−21.7
1983	293,771	7.9	127,055	36.7	256,029	25.0	184,531	−22.0	66,824	−30.1
1984	292,864	−.3	118,687	−6.6	373,035	45.7	183,521	−.5	61,284	−8.3
1985	295,932	1.0	109,343	−7.9	263,231	−29.1	199,990	9.0	57,384	6.4
1986	279,066	−5.7	82,669	−24.4	260,157	−1.2	197,689	−1.2	55,319	−3.6
1987	277,729	−.5	89,270	8.0	228,822	−12.0	176,696	−10.6	50,419	−8.9
1988	270,738	−2.5	68,400	−23.4	202,748	−11.4	162,764	−7.9	39,522	−21.6

Sources: Data for 1977–88: Indicadores Economicos, Banco de Mexico; Data for 1965–76: Direccion de Estadisticas Hacendarias, SHCP.

[a]Current price data is deflated by the GDP implicit price index (1970 = 100).

[b]Does not include tax revenue from PEMEX.

[c]Does not include interest payments.

8.4 Populist Economic Episodes

8.4.1 The Echeverría Regime

Change was the distinctive feature of Echeverría's presidency. Foreign policy took a more active role and tilted in favor of Third World interests (Green 1977). The political management of the country changed: political reforms, which continue to this day, were initiated (Middlebrook 1986). Political style and rhetoric were different.[23] Economic policy also changed. The cautious approach to macroeconomic management was abandoned as the government began to use public expenditures and other instruments more aggressively. Why did economic policy change paths? What objectives were being pursued? What was accomplished by the change?

To understand Echeverría's motives we must begin by recalling the political crisis that characterized Mexico in 1970 and its connection to the 1968 student-led protests and subsequent repression. Two factors were dominant: (1) the erosion of the government's political legitimacy and (2) the possibility of a guerrilla movement developing at a time when leftist ideology was significantly more important in Latin America than it is today. These two factors placed the need for political action at the top of the agenda; economic problems took a secondary role. Echeverría signaled throughout his election campaign his wish for a negotiated solution to the political crisis; his desire for eschewing repression stemming, at least in part, from a desire to avoid increasing the role played by the military.

A politically moderate government like the Mexican one sought a negotiated solution to the political crisis. This was difficult since a new element was present: to incorporate the left into the political system real concessions had to be made, yet at the same time it was important that the actions taken by the government not give the impression that the country would turn socialist, given fears of alienating the right. These factors reduced the government's space for finding a solution. Yet, barring some members of the private sector, a consensus appeared that the political crisis should be tackled by more "state activism." This "return to the state" was strongly advocated by the leftist-leaning intellectuals whom Echeverría had recruited from the national university (UNAM), and other places, into his circle of advisers. These intellectuals had long criticized the government for "betraying" its popular and revolutionary origins and surrendering to capitalism for the sake of rapid growth. More state activism, however, was also advocated by other economists not identified with leftist ideologies.[24] These economists coincided with those on the

23. The rhetoric was different not only in its emphasis, but also in its amount: observers hesitated between labeling the president a demagogue or a preacher (Cosio Villegas 1973).

24. For example, D. Ibarra, L. Solis, V. Urquidi, and even Ortiz Mena recommended an increase in public expenditures in order to most effectively meet the various social needs. And while they also advocated the simultaneous need for increasing government revenues, the general message was for more state intervention (see Ibarra et al. 1972). One should also recall that the

left in signaling unequal income distribution, or at least widespread poverty, as a central problem.

In short, at the beginning of the Echeverría regime, informed opinion favored stronger use of the government's capacity to intervene in the economy to reduce poverty, increase public investment in areas where private investment was not forthcoming, and reduce the importance of foreign firms. Among the many promises that Echeverría made in his inaugural speech two stood out: political reform and changes in economic policy to reduce poverty. The announcement of political reform was accompanied by a clear message: the government would lean in the direction of those who advocated a more democratic and open system; the "apertura democratica" signaled substantial change. The same was not true of economic policy; while reducing poverty and income inequality were announced as objectives, the *means* by which this would be attained were not clearly specified. Thus it was announced that low inflation and nominal exchange rate stability remained as targets along with real wage increases. The mixed economy and the "nationalist" businessman were praised, but stern criticisms were made of the business community. And while affirming that "free enterprise can only render fruit if the government has sufficient resources to coordinate the fulfillment of the great national objectives," Echeverría's inaugural address made no references to taxes.

The promise of reduced income inequality, therefore, was and was not an important goal of the unspecified changes in economic policy. It was important to the extent that it was obviously desired. It was unimportant to the extent that there was a simultaneous promise that everything, or almost everything, would remain the same. The abundance of promises suggests that the government intended to neither commit itself to a particular policy, nor waive its right to any policy. Today, with the benefit of hindsight, what Echeverría had in mind appears clear: that economic policy should henceforth obey the needs of the government, not those of the private sector. Put differently, Echeverría had a new attitude to economic policy, not a new solution to the problems of policy. So we find here tinges of populism or, if you will, evidence of a "voluntaristic" attitude toward the economy: willing change without providing solid means for it. In any event, after more than a decade of stabilizing development, the government's leading role in the economy took a new turn in 1971: shared development had arrived.

The world economy also changed in important ways in the early 1970s. Two such changes were important for Mexico. One, higher world inflation contributed, through import prices, to increase domestic inflationary pressures. Two, the 1973 oil shock enlarged substantially the country's access to international finance, as the world capital markets sought outlets for the large

substantial economic literature criticizing import substitution industrialization appeared later on (e.g., the influential OECD study by Little, Scitovsky, and Scott 1975). The benefit of hindsight makes many things obvious now, not then.

petrodollar deposits. Private capital flows became a more important source of external savings.[25]

Shared development inherited a stable macroeconomic environment with unstable microeconomic foundations. Microeconomic reforms, however, were not on the agenda. Although 1971 experienced a deceleration in growth, it was more the result of the standard slowdown in spending associated with a change in administration than of tight fiscal policy aimed at holding back inflation and reducing a growing trade deficit. The stated aims of policymakers were to preserve price stability and the fixed exchange rate, while at the same time augmenting social spending and accelerating growth to increase employment.[26] The government took the lead in promoting such growth, and in 1972 substantially increased both public expenditures and domestic credit: the former increased by 21.2% in real terms in that year, the latter by 7.9%. Yet the key fact about the expansion of government spending was that it occurred in the absence of a significant tax reform.[27] While at the beginning of the administration the sales tax rate was increased by 1%, this was insufficient to cover the added spending. (Later on, at the end of 1972, serious consideration was given to a fiscal reform that would increase income taxes. But the private sector threatened with large capital flight. This, in turn, could threaten the constancy of the nominal exchange rate, something that Echeverría thought he had to defend as a sign of continuing stability and continuity with stabilizing development.) In addition, public enterprise prices—which in Mexico must be thought of as an integral part of fiscal policy—were not changed until 1973, and only increased in nominal terms. And while real public enterprise prices lagged behind, an ambitious program of expansion in public enterprises was begun.[28] The deterioration in public finances followed soon (see table 8.2).

Strong aggregate demand expansion continued in 1973 and 1974, triggered again by deficit spending. With little slack after strong growth in 1972, part of this expansion began to be reflected in prices: the inflation rate increased from 5% in 1972 to 12% in 1973 and to 23.8% in 1974, significantly in excess of world inflation.[29] Two effects followed immediately. One, as figure 8.1

25. As opposed to the past, however, these flows took the form of commercial bank lending rather than bonds or equity investments. Thus, the distribution of risk changed.

26. An influential report that appeared at that time (Grupo de Estudio del Problema del Empleo [GEPE], n.d.) argued the existence of a substantial problem of unemployment and underemployment in the country, of the order of 40% of the labor force. See Levy (1979) for a discussion of the employment figures in Mexico and Gregory (1986) for a critique of the GEPE figures and an alternative view of the functioning of the labor market.

27. Tax policy was an issue of contention between Echeverría and the private sector from the very beginning. In December of 1970 Echeverría sent a small tax reform to Congress (a 1% increase in the sales tax rate). The then leader of COPARMEX, an association of private-sector businessmen, called on the president to say that this was not the way policy was done, and that tax matters had to be negotiated directly with the private sector.

28. For example, between 1970 and 1972 the real price index for transportation fell by 3%, while that of gasoline and oil by 8%.

29. As measured by the United States WPI. The relevant inflation figures for that country were 3.1%, 9.1%, and 15.3% for 1972, 1973, and 1974, respectively.

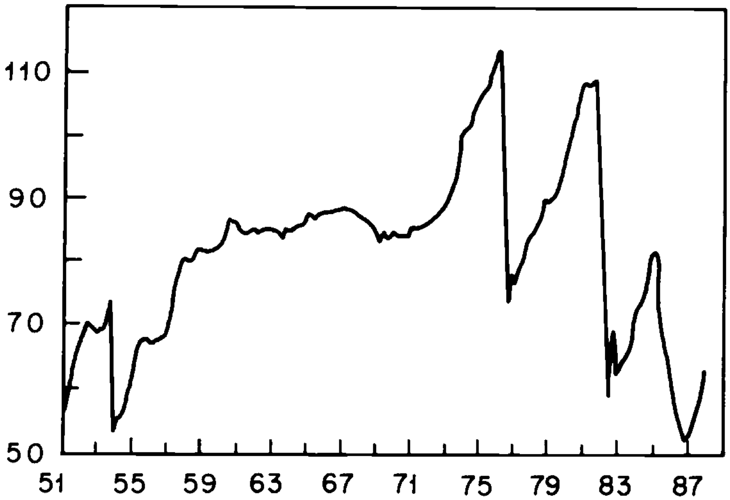

Fig. 8.1 Real exchange rate index (1980 = 100)
Source: Dornbusch (1988).

shows, the real exchange rate started to appreciate as the policy of fixing the nominal exchange rate was maintained. Two, as inflation rates exceeded domestic nominal interest rates, the growth of financial intermediation observed during the 1960s began to reverse itself.[30]

The expansion of aggregate demand also had an impact on the current account. This deficit increased from 0.2% of GDP in 1971 to 3.7% of GDP in 1974 due to the excess of domestic expenditure over income and the progressive overvaluation of the exchange rate that began to erode the service component of the current account. These two elements could be tied directly to the government's fiscal stance. A third element, in addition, reflected the long-term structural stagnation of agriculture, which began to exert its toll as significant imports of foodstuffs and grains appeared in 1971. The changed world environment, however, modified the nature of foreign borrowing obtained to cover the current account deficits. Now resources came mostly from private banks rather than multilateral institutions, with shorter maturities and variable interest rates.

As of 1972 the government exercised its leading role with a set of macroeconomic policies that departed from those of the past 15 years. As macroeconomic policies changed, so did the government's rhetoric, which had to respond to a private sector witnessing negative domestic real interest rates and a progressive overvaluation of the exchange rate. The notions of fiscal prudence

30. The ratio M3/GNP reached a peak of 0.53 in 1972 and then steadily declined to 0.46 by 1976. Real interest rates for the last four years of the Echeverría *sexenio* were: −5.5, −12.3, −2.0 and −33.4; see Solis (1981).

Table 8.4 Allocation of Public Social Spending

	% of Public Expenditure		% of Public Investment			
Dates and Administration	Education	Health	Social Welfare	Education	Health	Agricultural Development
1934–40, Lazaro Cárdenas	12.5	2.9	9.6	1.0	1.2	17.6
1940–46, M. Avila Camacho	9.9	3.6	11.1	.2	2.4	17.3
1946–52, Miguel Aleman	7.8	3.2	13.5	3.0	3.1	19.8
1952–58, A. Ruiz Cortines	8.7	3.1	14.6	2.6	1.5	13.6
1958–64, A. Lopez Mateos	11.4	3.6	24.1	2.7	7.3	9.9
1964–70, G. Diaz Ordaz	13.2	3.1	24.7	4.8	4.9	11.0
1970–76, L. Echeverría	19.4	4.5	22.2	6.6	4.3	17.3
1976–82, J. Lopez Portillo	7.7	1.1	9.5	2.6	3.1	18.5

Source: Aspe and Beristain (1984a, p. 26).

and financial orthodoxy no longer served, so official rhetoric began to rely more on "nonorthodox economics."[31]

On the other hand, other aspects of economic policy remained much the same as during the stabilizing development. Three merit special attention. One, trade policy: the anti-export bias of the trade regime was maintained despite the fact that fiscal incentives for exports were introduced. No attempt was made to liberalize imports. In fact, as the current account deteriorated, the government responded with more stringent import controls, further strengthening the anti-export bias of the trade regime. Two, regional policy: to the credit of the administration, an effort was made to channel more resources to the rural areas (see table 8.4). But while the share of agriculture in total public investment increased from 13.4% in 1970 to 17% in 1974, policies that increased the attractiveness of urban areas continued. Services like water and transportation in Mexico City continued to be highly subsidized, transferring resources from the rest of the country into the relatively richer capital city. In addition, the administration launched an ambitious housing program for urban workers (INFONAVIT). All in all, the urban bias of the prior regime continued (Moore 1984). Three, the exchange rate: although there were strong disagreements in this regard, it was finally decided that the policy of keeping a fixed nominal rate would continue, despite expansive fiscal policy and its effects on the trade deficit. It is important to point out that the Central Bank supported the fixed exchange rate policy, though perhaps for different reasons than those held by the government.

Negative domestic real interest rates, progressive overvaluation of the real

31. At the beginning of 1973 the minister of finance (Margain) resigned as a result of differences of opinion with regards to economic policy.

exchange rate, and growing foreign indebtedness were clear signs of the unsustainability of the policy stance. As expectations of an eventual change in policy amplified, capital flight began. And although this could be construed as a political response to the changed rhetoric, it was perhaps more simply the natural response of asset holders who realized that the option value of liquid capital abroad, corrected by the expected devaluation, would exceed the profitability of new investments in domestic physical capital or in peso-denominated deposits. In consequence, despite the fact that the economy was growing relatively fast and bottlenecks appeared, and that fiscal incentives for private investment were granted,[32] the latter did not respond as expected. The incentive structure had changed, and even if the government was unwilling to see its deleterious effects, the same was not true of other agents.

At the same time, public investment increased (cf. tables 8.5 and 8.6) and, along with it, the degree of public intervention in the economy: while a total of 83 major public enterprises were created between 1952 and 1970, the equivalent number for the period 1971–76 was 108 (Aspe and Beristain 1984a).[33] The government also expanded significantly the areas in which it operated. And while arguments could easily be found to justify these actions,[34] we interpret them as the pragmatic response of the government in pursuit of its political interests rather than as a conscious decision to take over the role of the private sector as the main producer of goods and services (or to take the "commanding heights" of the economy). Such a short-term pragmatic response, nevertheless, had important implications: the larger role of the government as producer and investor imposed further burdens on its already overstretched finances and administrative capacity.

To put it differently, we argue that by 1973–74 events had acquired a dynamic of their own. Rather than following a tightly preconceived plan, the government pursued its own objectives through what we might label as "the path of least resistance": a mix of foreign borrowing and inflationary finance. Once this process began, however, it created a vicious circle. Willy-nilly, larger budget deficits and increasing devaluation expectations slowed private investment.[35] At the same time, the political objectives of the government

32. Tello (1979, p. 205) quotes an ex-president of COPARMEX (an association of business employers) as follows: "One can assert that few regimes as this one [Echeverría's] have been more concerned with promoting private initiatives. In just three years, more decrees, laws and regulations promoting entrepreneurial activity have been passed than during the whole of the prior *sexenio*" (our translation). In addition, Sigmund (1984) argues that the law regulating direct foreign investment, introduced in May 1973, requiring a majority of Mexican participation in all new foreign ventures enhanced the strategic position of Mexican vis-à-vis foreign investors.

33. Many of these enterprises, however, were quite small, and included a large number of funds and special trusts with little economic impact.

34. Flores de la Pena, who was minister of national patrimony during the Echeverría regime, argues that the Mexico public investment is preferable to private (1976, pp. 35, 41, and 51).

35. See Lizondo (1983) on the behavior of future prices for the Mexican peso during that time. In terms of the slowing of private investment, this was particularly the case after 1974; with the exception of that year, the rates of growth of private investment were lower than those of public investment for the period under study (see table 8.5).

Table 8.5 **Total Investment (in Constant Prices)**[a]

Year	Total	Growth Rate (%)	Public	Growth Rate (%)	Private	Growth Rate (%)
1960	38,606.0		. . .		. . .	
1961	38,965.9	0.9	. . .		. . .	
1962	39,840.5	2.2	. . .		. . .	
1963	45,085.5	13.2	. . .		. . .	
1964	54,857.9	21.7	. . .		. . .	
1965	57,047.3	4.0	. . .		. . .	
1966	62,616.5	9.8	. . .		. . .	
1967	69,861.5	11.6	. . .		. . .	
1968	76,731.5	9.8	. . .		. . .	
1969	82,016.9	6.9	. . .		. . .	
1970	88,660.6	8.1	29,249.9		59,410.7	
1971	87,142.2	−1.7	22,451.2	−23.2	64,691.0	8.9
1972	97,805.8	12.2	31,484.4	40.2	66,321.4	2.5
1973	112,227.7	14.7	43,938.2	39.6	68,289.5	3.0
1974	121,095.8	7.9	45,009.6	2.4	76,086.2	11.4
1975	132,316.1	9.3	54,732.9	21.6	77,583.2	2.0
1976	132,909.6	0.4	50,597.2	−7.6	82,312.4	6.1
1977	123,986.5	−6.7	47,212.4	−6.7	76,774.1	−6.7
1978	142,799.3	15.2	62,122.2	31.6	80,677.1	5.1
1979	171,714.2	20.2	72,753.3	17.1	98,960.9	22.7
1980	197,364.5	14.9	84,870.3	16.7	112,494.2	13.7
1981	228,975.0	16.0	103,930.7	22.4	125,044.3	11.1
1982	190,526.0	−16.8	84,289.7	−18.9	106,236.3	−15.1
1983	136,644.0	−28.2	53,928.4	−36.0	82,715.6	−22.1
1984	145,427.0	6.4	56,142.4	4.1	89,284.6	7.9
1985	156,846.0	7.8	56,641.2	.8	100,204.8	12.2
1986	138,341.0	−11.8	48,576.4	−14.2	89,864.6	−11.6
1987	137,476.0	−.6	43,830.5	−9.8	93,645.5	4.3

Sources: SPP, National Accounts.
[a]In millions of 1970 pesos.

called for a larger role in the economy. But as the government stepped up public investment, it would further deteriorate its financial position, closing the circle: private investors would see growing fiscal deficits together with larger foreign borrowing as unambiguous signals of the unsustainability of the macro configuration, and would wait for events to change with their capital safely tucked away abroad.

The historically high inflation rates of 1973–74 began to permeate economic life. Investors hedged in foreign assets and real estate; the length of contracts shortened: as of 1973 minimum wages were to be set annually, as opposed to the biannual convention. Trust in the currency, which can be thought of as a public good, eroded. The public tried to avoid the inflation tax as a process of currency substitution increased the share of dollar-denominated deposits in the total obligations of the financial system from 17%

Table 8.6 Total Investment (% of GDP)

Year	Total	Public	Private	Year	Total	Public	Private
1955	15.5	. . .	. . .	1972	19.0	6.1	12.9
1956	17.7	. . .	. . .	1973	19.3	7.5	11.8
1957	17.9	. . .	. . .	1974	19.9	7.5	12.3
1958	15.7	. . .	. . .	1975	21.4	5.0	12.4
1959	15.2	. . .	. . .	1976	21.0	8.2	12.9
1960	16.0	. . .	. . .	1977	19.6	7.8	11.8
1961	14.8	. . .	. . .	1978	21.1	9.5	11.6
1962	14.7	. . .	. . .	1979	23.4	10.3	13.2
1963	15.7	. . .	. . .	1980	24.8	10.7	14.1
1964	16.2	. . .	. . .	1981	26.4	12.1	14.3
1965	16.6	4.9	11.7	1982	23.0	10.2	12.8
1966	16.9	5.2	11.7	1983	17.5	6.6	11.0
1967	18.2	6.5	11.7	1984	17.9	6.6	11.3
1968	18.2	6.5	11.8	1985	19.1	6.5	12.5
1969	18.3	6.6	11.7	1986	19.4	6.5	12.9
1970	20.0	6.6	13.4	1987	18.9	5.5	13.4
1971	18.0	4.6	13.3				

Sources: Data for 1965–69: Economia Mexicana en Cifras, NAFINSA (1986). Data for 1970–87: Cuentas Nacionales, SPP.

in 1970 to 40% in 1976 (Solis 1981). In addition to the figures on the current account, these were all clear signs of the need for stabilization. And, indeed, such a program was announced: as of 1975 monetary policy became more restrictive and a tighter fiscal stance was signaled.[36] In fact, and despite the absence of a fiscal reform, fiscal revenues began growing quite rapidly due to improvements in the tax collection system (see table 8.2). But this increase arrived too late; public expenditures by then were growing even faster.

The stabilization program did not go far. Efforts at inflation control were pursued through, once again, the "path of least resistance": the exchange rate was kept nominally fixed and controls on imports increased, while price controls were tightened on key commodities provided by public enterprises: the resulting implicit subsidies further fed the fiscal deficit. In addition, government spending was not cut, although its rate of growth did slow somewhat (see table 8.3): it was argued that inflation would be cut by "increasing supply" with more public investment in key bottleneck areas, without recognition of gestation lags, or of the fact that the immediate effect of investment is to increase demand. The inflation rate fell slightly in 1975, but rose again in 1976. As tables 8.2 and 8.7 show, neither the budget nor the current account deficit showed any improvement.

36. The private sector's beliefs about the viability of Echeverría's economic program were also influenced by announcements made in 1975 of the discovery of large oil deposits in the south of Mexico. These discoveries would facilitate access to foreign borrowing, which was needed to finance the growing trade deficit. Although capital flight continued, it did not accelerate at that time, an event that gave Echeverría's program an additional breath of life.

Table 8.7 Indicators for the External Sector (% of GDP)

Year	Total Exports (goods & nfs) % GDP	Oil Exports/ Total Exports	Total Imports (goods & nfs)	Current Account Deficit	Current Account Deficit (in Millions of U.S. Dollars)
1955	16.6	. . .	17.2	1.1	−1.7
1956	15.9	. . .	17.9	2.5	183.1
1957	13.2	. . .	16.8	3.9	359.9
1958	12.0	. . .	14.9	3.3	385.5
1959	11.6	. . .	13.2	2.1	232.1
1960	9.7	. . .	11.9	3.2	419.7
1961	9.7	. . .	10.8	2.3	343.7
1962	9.8	. . .	10.2	1.6	249.6
1963	9.5	. . .	10.1	1.6	226.1
1964	8.8	. . .	10.0	2.4	444.7
1965	8.8	. . .	9.7	2.0	442.9
1966	8.6	. . .	9.2	1.8	477.8
1967	7.9	. . .	9.2	2.5	603.0
1968	8.1	. . .	9.5	2.7	775.4
1969	8.7	. . .	9.4	2.2	708.4
1970	7.7	.3	9.7	3.0	1,187.9
1971	7.6	.1	8.7	.2	928.9
1972	8.1	.1	8.8	1.9	1,005.7
1973	8.4	.0	9.5	2.4	1,528.8
1974	8.4	.4	10.6	3.7	3,226.0
1975	6.9	7.2	9.6	4.2	4,442.6
1976	8.5	7.2	9.9	3.3	3,683.3
1977	10.3	11.7	10.2	2.0	1,596.4
1978	10.5	16.5	11.0	2.6	2,693.0
1979	11.2	25.0	12.5	3.6	4,870.5
1980	10.7	47.5	13.0	5.0	10,739.7
1981	10.4	53.1	12.9	6.0	16,052.1
1982	15.3	62.7	10.3	.5	6,221.0
1983	19.0	53.6	9.4	−3.9	−5,418.4
1984	17.4	49.7	9.6	−2.6	−4,238.5
1985	15.4	47.1	10.3	−1.3	−1,236.7
1986	17.2	25.3	12.6	.4	1,672.7
1987	19.7	28.3	12.6	−3.1	−3,966.5

Sources: Indicadores Economicos, Banco de Mexico, and Cuentas Nacionales, SPP.

Various reasons explain why the efforts at stabilization in 1975 failed. At the technical level there were obvious flaws in trying to "cover up" inflation via higher subsidies and an overvalued exchange rate. But this probably misses the point. The Echeverría administration did not believe in the need for stabilization. To seriously attempt to do so would require undoing many of the policies (and rhetoric) of the previous years, since the political inertia of the administration—and the personal prestige of the president—was built on the idea of an expanding government with social and infrastructure investments. Reversing that inertia was politically difficult. Moreover, as the basis of political support for the government (or the president?) eroded within the private sector and some of the middle classes were hurt by inflation, it turned to the organized urban working class for political support. Spending cuts and a real devaluation would not enhance its standing there. The government had cornered itself into an inconsistent set of demands.

Two factors determined the final denouement of this process. One, Mexico's ample access to international finance. Two, the absence of any institutional mechanism in the Mexican political system that could counterbalance, in the short run, the power of the government. The accommodating variable to the inconsistent set of demands was foreign borrowing: the foreign debt almost doubled between 1974 and 1976. This was not borrowing to accommodate a temporary downturn in the terms of trade. Rather, it served to finance the large public-sector deficits and, increasingly, capital flight, as the government engaged in a forlorn attempt to "defend" the currency. The process came to a halt in September 1976, when the exchange rate, which had been nominally fixed since 1954, was devalued by 59%. Faced with no alternatives, with depleted reserves, with inflation of 22%, a foreign debt of $29.5 billion (U.S. dollars) and rather strained relations with the private sector,[37] the Echeverría administration terminated with an agreement with the International Monetary Fund (IMF).

8.4.2 The López Portillo Regime

The repair of strained relations between the government and the private sector was the first order of business for the new administration. The Alliance for Production was announced as the new accord under which all social groups would participate in the process of economic recovery and political healing (under the tutelage of the government, comme il faut). The rhetoric changed accordingly: fiscal prudence was (shortly) in vogue again. Thus, macroeconomic policy for 1977 was quite orthodox. As table 8.1 shows, GDP growth for that year was the lowest in decades, barely above population growth. Economic contraction was engineered by classical means: real public expenditures and the real money supply fell by 4% and 2%, respectively. The current account improved by over $2 billion, given a sharp drop in imports and a mild recovery of exports (see table 8.7).

Macro policy was carried out under the auspices of the IMF and, as a distinguishing characteristic, brought along changes in trade policy. Imports, 100% of which were subject to permits by the end of 1976, were to be liberalized.[38]

37. In what could perhaps ex post be seen as a precedent-setting action, the president also nationalized large tracts of land in the northern state of Sonora. The next *sexenio* would end with a similar action but on a larger scale with the nationalization of the domestic banking industry.

38. It is difficult to determine to what extent the change in trade policy at that time was perceived as permanent, so as to induce investments in the exportable sectors. Import liberalization

In addition to the intended removal of the domestic bias of the trade regime, other reforms were initiated later on. Tax policy was changed, and a value-added tax replaced the cascading system of indirect taxes; additional adjustments to corporate and personal income taxation followed, although the special tax treatment granted to agriculture and transportation continued (Gil Diaz 1984, p. 18). We can speculate: perhaps if oil had not been discovered the Mexican economy might have returned to the macro policies of stabilizing development, but with the added lesson that the structural reforms of taxation, trade, and regional policy could be postponed no longer. Oil, however, was discovered; it changed all. With the benefit of hindsight we can see the unfortunate event: a temporary terms of trade improvement in a commodity that had recently been discovered to be in abundant supply turned the government's attention away from structural reforms.[39]

López Portillo and his advisers believed that oil offered "financial self-sufficiency" (*autodeterminacion financiera*) and a historical opportunity to carry out a "structural transformation" of the economy; the task of the *sexenio* was not to shy away from such opportunity.[40] The government, in its role as leader, wanted a great leap forward and would, simultaneously, attack many problems: from the development of the capital goods industry to the elimination of poverty and malnutrition, on to the enlargement of the country's infrastructure, the promotion of tourism, and the achievement of self-sufficiency in energy and basic grains. And together with the financial resources to do so, the government felt, implicitly, that it also had the administrative capability to carry it out.

There was nothing truly novel in the government's taking such a gigantic role in the economy. As discussed, the foundations for substantial government participation in the economy were laid in the institutional arrangements of the 1930s. But there is a second factor that furthered this process connected, if we may say so, with a political culture that also sees the government *as a provider.* And oil, in this culture, removed any reasons why the government should not provide. The outburst of public spending was not the outcome of a single individual intoxicated by a terms of trade shock: it was also produced by a set of institutions that simultaneously placed great expectations on what the government should provide and few restraints on the nature of its intervention in the economy.

López Portillo and his advisers not only wanted a large public sector; they

proceeded by replacing quantitative restrictions and permits by tariffs, but the process was reversed later on.

39. Many observers, of course, saw this danger; e.g., Solis (1980, pp. 59–72).

40. "Either we exploit the oil right now, today, without further delays and infantile fears and use it to be truly self-sufficient and sovereign—given, of course, what our forces and intelligence allow—or soon we will be sorry for not being up to the historical moment that we are living"; from the speech given by Diaz Serrano, the general director of PEMEX, on 18 March 1978 (our translation).

also wanted an economy that would be immune to the vagaries of private investment. An objective of policy would be to build a public sector capable of producing its own inputs,[41] or at least capable of generating the foreign exchange required to buy these inputs, without running the risk of being "blackmailed" by the private sector. This rather odd idea of quasi self-sufficiency was partly motivated by fears that toward the end of the *sexenio* the government might face the same kind of economic blackmail (capital flight) experienced by Echeverría.[42] In a separate vein, others welcomed the growth of the public sector as a step in the direction of socialism (Tello 1987).

During the first two years of the oil boom, 1978 and 1979, macroeconomic policy was characterized by strong expansion of aggregate demand, triggered by government expenditures. As table 8.3 shows, the latter grew 13.7% in real terms in 1978 and 14.1% in 1979 (and continued to grow at high rates through 1981). Yet inflation, at rates of around 18% for those two years, was not accelerating. This was due partly to the opening of the economy, which allowed excess demand to spill more easily into imports. But three additional effects were also present. First, agricultural production had a much better performance, growing on average 4.5% during the López Portillo *sexenio* versus 2.6% during Echeverría's; this reduced some of the inflationary pressures that this sector had caused over the last decade.[43] Second, private investment responded quite positively to the government led expansion in aggregate demand: it grew by 5.1% in 1978 and by 22.7% in 1979. The official rhetoric was different; but, in addition, a domestic market growing at around 8% annually offered large profit opportunities at a time in which devaluation risks were perceived as minimal given the expected volume of foreign exchange earnings coming from oil. Third, a policy of "price contention" based on controls on nominal wages and public enterprise prices was followed, based partly on a (self-serving) belief of complete independence between the inflation rate, on the one hand, and aggregate demand and the budget deficit on the other.

A second oil shock in late 1979, associated with turbulence in the Middle East,[44] provided a sense of euphoria and affected the psychology of the coun-

41. A careful reading of the Plan Nacional de Desarollo Industrial reveals the objective of building a public sector less dependent on private investment for its inputs.

42. López Portillo, as any other politician, could mainly explain the events at the end of 1976—capital flight and the run on the banks—in terms of a carefully premeditated aggression on the part of organizations acting on behalf of the private sector.

43. The relationship between food supply and inflation is an old theme in Latin America. The issue is more generally related to the income redistribution that must occur when demand expands under an inelastic supply. One of the earliest analysis of this problem was by the Mexican economist Noyola, who argued that inflation was the result of a "social stalemate" where no group was willing or could be forced to absorb an income loss (see Bazdresch 1984). More recently, Cardoso (1981) shows how, under a passive money supply and markup pricing in the manufacturing sector, an inelastic supply of food can generate an inflationary process.

44. In 1979 the Shah of Iran was dethroned; the associated uncertainty produced a temporary increase in the world price of oil; see fig. 8.2.

try, and perhaps the president. (In fact, the president expressed the view that the country's economic problem was "the management of abundance.") The second oil shock further undermined fiscal discipline as well as attention to relative prices. Two factors then account for a substantial increase of the fiscal deficit. One, very large projects were undertaken by the government in infrastructure, health and nutrition, and productive public enterprises. Among these, the Mexican Food System (SAM, Sistema Alimentario Mexicano) deserves mention as a very ambitious effort to reduce poverty and improve nutrition of lower income groups, while at the same time raising incomes of the rural poor through guaranteed prices for basic grains. The second factor concerns the price contention policies for public enterprises which, as noted earlier, resulted in huge subsidies.

And while government revenues, principally from oil, grew substantially, the growth in expenditures—as table 8.2 and 8.3 show—was dramatic. Such growth further enlarged the range of sectors where the government intervened in the economy, provided ample opportunities for graft, and generated large inefficiencies given the speed with which resources were being spent. But more important from a short-term macroeconomic viewpoint, it generated unprecedented deficits in the fiscal and current accounts (tables 8.2 and 8.7). The latter account also reflected real exchange rate appreciation, as the rate of crawl of the nominal exchange rate was lower than that of prices (fig. 8.1). Tourism and border transactions lost competitiveness; merchandise exports actually fell in real terms. The current account deficit jumped from $2.7 billion in 1978 to $16 billion in 1981, a sixfold increase. Such an explosive growth of the current account deficit was met by foreign borrowing. Despite the positive terms of trade shock, the foreign debt increased from $36.4 billion in 1978 to $74.4 billion in 1981.

Circumstances began to change in 1981 and did so very rapidly. Economic policy was tied to the price of a single commodity. The short-run effects of real exchange rate misalignment and budget deficits could be ignored as long as oil resources kept growing. When the oil market weakened in mid-1981, there was a realization that the increase in the price of oil could be just a temporary phenomenon (fig. 8.2). This, together with the sheer magnitude of the underlying macroeconomic disequilibriums and the perspective of change that naturally arises when the administration comes to an end, rapidly changed the economic outlook.[45] Expectations adjusted rather quickly as the sustainability of current policies came increasingly into question; capital flight began in sizable magnitudes. The timing of events was politically unfortunate; capital flight began at the moment when the López Portillo presidency was ending, with only a few months remaining in the complicated process of naming a

45. This is an important side effect of a political system like the Mexican one, where presidents are barred from reelection. As the end of the *sexenio* approaches the current administration may fail to internalize fully the medium-term effects of economic policies, thus shortening the planning horizon for other agents.

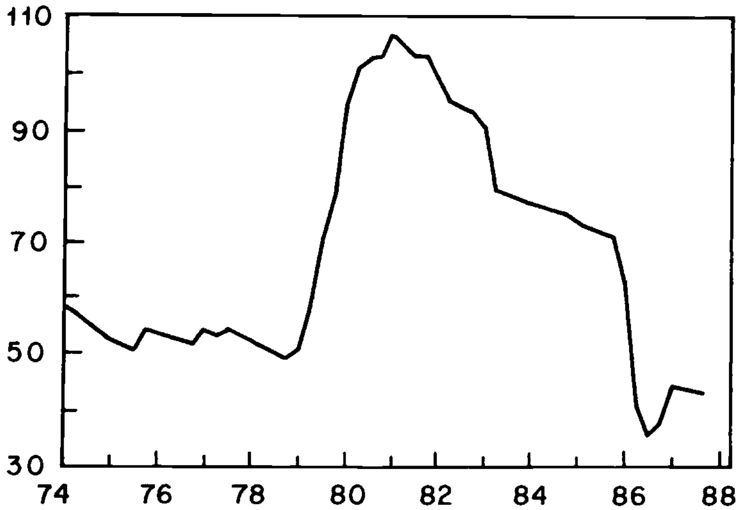

Fig. 8.2 Real oil price index (1980 = 100)
Source: Dornbusch (1988).

successor. The president faced the very situation he hoped to avoid: a negative vote of confidence by the private sector.

An appropriate response to dramatically changed circumstances was lacking. The need for adjustment was not in dispute in mid-1981: the oil boom was over and it was time to restore balance to the key macro variables, principally the fiscal stance of the government and the real exchange rate. But the measures taken were patently insufficient to deal with the magnitude of the crisis: the rate of devaluation of the peso was accelerated somewhat, and most of the import controls which had been removed since 1977 were reimposed.[46] As it occurred towards the end of the Echeverría regime, an attempt was made to solve macroeconomic imbalances with a patchy combination of trade policy adjustments and noncredible commitments to reduce expenditures.[47]

46. The situation at the time generated a debate centered on whether spending cuts. a real devaluation, or import controls were called for (see, e.g., Eatwell and Singh 1982). From our point of view, the essence of the problem was a fiscal imbalance which, given private savings and investment, was reflected as a current account deficit. In addition, the exchange rate appeared overvalued, and there was little evidence of excess capacity (Eatwell and Singh 1982 show average rates of capacity utilization in the manufacturing sector of over 95%; no data for the nontradable sectors is presented). Import controls would not help with the problem of exchange rate overvaluation; by cutting a source of supply, they would increase inflationary pressures. Moreover, it can be shown that even in a model that allows for markup pricing and excess capacity, import controls in general need not improve the trade deficit, while they will reduce the real wage (see Levy 1987). In addition, the use of trade policy to correct macroeconomic imbalances seemed inappropriate: it reversed the signals for investment in the exportable sector and probably generated an additional surge of imports as consumers anticipated higher obstacles to importing.

47. In particular, different members of the cabinet at that time were expressing divergent opinions on the nature of the crisis and the appropriate policy response. The underlying message was that the executive branch was not under full understanding and control of the process.

The government's response to the crisis was based on various considerations. First, to them it was not obvious that the fall in the price of oil was not a temporary phenomenon. Until they were convinced that this was not so, there was an understandable reluctance to change direction. In addition, the fact that, at least through the second half of 1981, foreign commercial banks continued to lend to Mexico could also be interpreted as a sign that they also saw the fall in the oil price as temporary. Second, there was perhaps a hope that, as in 1976, the American government would come to the rescue.[48] And while clearly these factors played a role, it is equally true that the political voluntarism so characteristic of the Mexican political system strongly pushed it against any major attempt at stabilization.

The ensuing response to the lack of serious adjustment and the uncertain policy signals devastated the Mexican economy. Massive capital flight was the private sector's response to the unsustainable policies. Yet at the same time, and in the face of a strong speculative attack against the currency, the government decided against any major jump in the exchange rate, maintaining the slow rate of crawl. Devaluation and stabilization were seen as equivalent to a surrender to its enemies, as these measures implied a substantial revision of the government's growth strategy. Such backing down of the powers-to-be was an unacceptable situation for any political authority.

Access to foreign borrowing played again a key role, but with a vengeance. Incredibly enough, in a single year, 1981, the country's foreign debt increased from $49 billion to $75 billion, with the bulk of the increase occurring during the last six months of the year. Most of this debt was contracted with private banks, with relatively short maturities, and with variable interest rates, just when world interest rates edged upward and monetary policy tightened in the United States. Après moi, le deluge.

The remainder of the López Portillo administration was characterized by intensely acrimonious relations between the government and the private sector. Policy was determined by the need to reduce a fiscal deficit of major proportions, in a context where the external conditions were now working against Mexico: world interest rates were increasing and the oil market weakening. At the same time, the supply of foreign resources turned inelastic as foreign creditors realized the magnitude of Mexico's obligations and its deteriorated economic conditions. This combination of events implied that foreign borrowing was procyclical with the price of oil, precisely the opposite of what should occur had there been any attempts at consumption smoothing.

Faced with the need to change policy, the government needed a new rheto-

48. We can only speculate why the initial response of the American government to Mexico's crisis, particularly during the first half of 1982, was different to that of 1976. Perhaps this was due to the differences in administration (Carter vs. Reagan); perhaps to the fact that in this occasion the crisis was of a much larger magnitude (involving other Latin American countries); perhaps also the response was due to the previous differences in foreign policy between Mexico and the United States, particularly over Nicaragua. It was only later, in August 1982, when there was a risk of substantial default with direct repercussions on the large American commercial banks, that the American government became fully involved in the crisis.

ric. It reluctantly had to adjust, but was not quite willing to hear the prescriptions of orthodox macroeconomic management. As events unfolded since mid-1981, the government turned, as it had done in the past, to those segments of the bureaucracy attuned to a heterodox perspective. But the magnitude of the crisis left almost no room for maneuver, and actions followed accordingly: toward the end of 1981 some public-sector prices were raised; in early 1982 the government ran out of reserves and could no longer support the exchange rate, generating a nominal devaluation of 470%.[49] All imports were subject to controls, and the rate of growth of public expenditures was reduced from 25% in 1981 to 3.7% in 1982. Nominal wage rates were also increased. Later a system of dual exchange rates was announced.[50] Subsequently, in a much-debated action, the president introduced exchange controls and nationalized the domestic banking industry. With depleted reserves, an inflation rate of almost 100%, a decline in real GDP of 0.5%, a public-sector deficit of almost 18% of GDP and a foreign debt of $92.4 billion dollars the *sexenio* ended, just like the previous one, by signing a stabilization program with the International Monetary Fund.

8.5 Concluding Observations

The sketch of macroeconomic events during 1970–82 presented above provides a background against which some further remarks on the nature of "populist economic policies" in Mexico can be made. We begin by noting some important differences between the two *sexenios*. First, and most obviously, López Portillo's was blessed with a much larger import capacity. In addition, since oil was publicly owned, the revenue position of the government was substantially improved. The underlying circumstances were very different.

Second and more important, the motives behind policies were different. Echeverría's main objective was to solve a political crisis: larger government participation and a reassertion of control of the economy were seen as the medium through which the crisis would be solved. This implied an almost unavoidable conflict between the government and the private sector. In contrast, at least through the first half of López Portillo's *sexenio*, policy could be characterized simply as an attempt to "please all," rather than a situation where the interests of the private sector and the government were in conflict. Thus, urban workers (or at least their unions) were pleased since even though the real wage fell slightly, employment grew at above-average trends; the middle classes were pleased by price subsidies and an overvalued exchange rate; the bureaucracy was pleased by the greater influence it derived from the

49. The nominal exchange rate had discrete jumps at various times during 1982. The figure in the text is obtained by comparing the December 1981 to December 1982 exchange rate.

50. Given the emphasis of this paper, and space constraints, we just list here the major events during that time. A fuller analysis of the crisis can be found elsewhere (see Taylor 1985 and Bazdresch, n.d., for contrasting views).

larger involvement of the government in the economy; the private sector was pleased by an overvalued exchange rate and the sizable profits that could be made in the domestic market; and rural Mexico was beginning to be pleased through large increases in employment, infrastructure investments, and SAM. It was only after the crisis erupted, when pleasing all was no longer feasible and the situation appeared explosive, that actions that attempted to reassert political power and control (exchange controls and bank nationalization) were taken.

A third difference relates to rhetoric. Echeverría's was quite militant, with entrepreneurs being the object of continuous criticisms. In contrast, during most of López Portillo's regime, the atmosphere of acrimony and political crisis that characterized shared development subsided significantly. Of course, after the crisis erupted in mid-1981 López Portillo's rhetoric changed dramatically (and rapidly), illustrating the little association that exists between the ideological proclivities of the president in turn and populist policies: populist policies are not a monopoly of "leftist-leaning" presidents (assuming such a term is meaningful in Mexico).

Differences between the two populist episodes notwithstanding, we emphasize that, on the whole, they did not result from incompetence, nor from the fact that either president did not have technically trained economists among their trusted advisers. This does not mean, of course, that some specific populist policies cannot result from mistakes, or from misunderstandings of the nature of markets or of the type of interventions that can increase welfare. Economics is not an exact science, and there is plenty of room for error and differences of opinions. In addition, ideology matters; sometimes the rejection of the distributional implications of undiluted markets leads some economists to reject tools of analysis that emphasize the allocative role of prices; paraphrasing Sheahan (see n. 3 above), rejection of efficiency criteria becomes a principle.[51]

But there is a wide gap between, on the one hand, individual populist policies that may arise from policy mistakes and, on the other hand, the systematic violation of economywide budget constraints and the persistence of government interventions against the logic of markets. While certainly mistakes matter (and are difficult to correct given inertia, vested interests, and prestige), the appearance of populist episodes under very different circumstances shows that other factors play a more central role. Our argument is that populist *episodes* are, at heart, the results of circumstances where policymakers be-

51. We note also that in rejecting tools of analysis that emphasize the importance of markets, policymakers create a vicious circle: the measures introduced end up strengthening monopolies and distorting prices further, then proving, ex post facto, that markets lead to undesirable outcomes. As an example, consider the issue of industrial policy. Many analysts have pointed out the oligopolistic structure of some sectors of manufacturing, with obvious welfare costs. Yet at the same time the same analysts will recommend import controls and other trade barriers that, among their many effects, certainly promote oligopolistic concentration in industry (see Cordera and Tello 1989, pp. 36–37).

lieve that their political goals can only be achieved by interventions that restrict the operation of markets and increased the degree of state intervention. From Echeverría's perspective, how else but with a return to the state was he going to convince left-wing intellectuals to abandon violent means? From López Portillo's perspective, how else but with exchange controls and bank nationalization was he to "punish" the private sector for capital flight and reassert the primacy of the government in the economy?

We posit that while distributional considerations are important (given the government's role as "referee of social conflict"), populist episodes are a reflection of a deeper phenomenon: the underlying weakness of governments who engage in populist policies because, so to speak, they have no other cards to play. Under our interpretation, therefore, populist episodes in Mexico occur when the government engages in "last-resort" policies that it believes will strengthen it. These policies can be deficit finance that results partly from pursuing some distributional objectives and partly larger influence through a greater presence and control of economic activity (as was most often the case with Echeverría); but they can also be policies that have no direct distributional objective but rather try to tilt the balance of power in favor of the government (as was the case with López Portillo's bank nationalization).

From a strictly technical point of view, the case against populist policies is simple and overwhelming: because they ignore the reaction of agents to the incentive structure, and the underlying resource constraints, they cannot be sustained. And, moreover, when the short-term economic benefits that they can potentially yield are exhausted, the unavoidable correction that follows has economic costs that erode the initial economic gains; in present value terms, populist policies are welfare reducing.

But policies must be evaluated by their ability to reach their underlying objectives. If populist episodes occur partly as a result of the weakness of the government, an important metric (though not the only one) for evaluating them must be their effectiveness in strengthening the government or solving the political crisis which was their initial raison d'etre.[52] Thus, as shown in section 8.4, there is no doubt that Echeverría's and López Portillo's regimes faired badly in the economic front; the dynamic equilibrium which had been so carefully preserved during stabilizing development was lost.[53] But during Echeverría's regime there were some notable improvements in the political front. Though hesitantly, the door was opened for extensive political reforms, political repression became a thing of the past, a potentially dangerous guerrilla movement was diffused, freedom of the press was established. With the beginning of the dismantling of the closed corporate political system of the

52. From this perspective, orthodox economists who criticize populist governments on the grounds that the same distributional objectives that those governments claim to pursue can be achieved at lower cost and/or by more efficient means, while technically correct, may be missing the point.

53. To this day, policymakers are still struggling to lower the inflation rate and raise the growth rate; those who signaled the dangers of breaking macroeconomic equilibrium were basically right.

fifties and sixties, Mexico initiated a transformation toward a politically plural society. Echeverría was a key element in this process.

With López Portillo the situation is also mixed. There was a substantial political reform that consolidated Echeverría's initial moves toward a less repressive state; political parties on the left were legalized. This certainly strengthened civil society. On the other hand, and perhaps paradoxically, López Portillo's populism failed to reach its political objectives, as the huge debt buildup, the bank nationalization, and the exchange controls did not strengthen but instead further weakened the government. Strength cannot derive from the inheritance of a huge public debt, a financial sector that escapes government control as banks reduce their importance as financial intermediaries, while foreign exchange transactions continue unabated.[54] And while distributional considerations were obviously not the motives for these actions, it is clear that (*i*) the poor people in Mexico did not benefit from them,[55] and (*ii*) the poor have borne, at least in absolute terms, the economic costs of the unavoidable adjustment to the large macroeconomic disequilibriums.

We thus find that populist policies, aside from their obvious economic shortcomings, generally fail to strengthen the government. And, after the populist episode comes to an end, the economic incentives required to increase private investment are larger, as investors require higher returns to compensate for the observed uncertainty and higher risks. The use of economic policy to pursue the short-term political interests of the government is hence doubly costly; not only do the episodes end in a need for macroeconomic stabilization, but the underlying increase in generalized uncertainty acts like a tax on new investment, which depresses the prospects for long-term growth.

Given their undesirable welfare consequences, how can populist episodes be avoided? The answer is complex, but we feel that two elements must play a dominant role. First, civil society—the set of nongovernment institutions that together with the central government bureaucracy shape the nation—

54. Proponents of exchange controls (see Tello 1987) argued that controls would give more "degrees of freedom" to economic policy by delinking the domestic interest rate from the foreign and allowing the government to pursue more aggressive tax reforms without the fear of capital flight. The nationalization of the banks was then required to help implement the said controls (while at the same time reducing the political power of the "financial sector"). As one of us has argued elsewhere, however, these arguments are unconvincing (Bazdresch 1985). Given Mexico's proximity to the United States, exchange controls would not serve to reduce the mobility of capital. As a result, if domestic savings were to be kept in the domestic financial system, exchange controls would not succeed in delinking the domestic rate of interest from the world rate of interest. It is not obvious, moreover, how proponents of exchange controls would set domestic interest rates even if the economy was closed to capital movements; the point here is that the interest rate is an intertemporal price that plays a key role in distributing consumption through time and cannot be set independently of agents preferences.

55. Moreover, some policies associated with the bank nationalization were certainly regressive. While the nominal exchange rate was set at 70.00 pesos per dollar, a special exchange rate of 50.00 pesos per dollar was instituted for firms with dollar-denominated debts (so as to "protect" the productive apparatus). This created the need for significant subsidies to cover the losses by the Central Bank on this type of operations. But, clearly, not many poor people had dollar-denominated debts.

must be strengthened. The government has, at present, too much room for arbitrary actions (either repressing the population as did Diaz Ordaz or suddenly nationalizing the private banks as did López Portillo). To some extent, the protagonistic role played by the government must be diminished. Upon reflection, it should be clear that strengthening civil society will, in turn, strengthen the government, because the latter will then have a legitimate mandate from the former to carry out reforms. And while a "strong" government is an operationally difficult concept, we mean by this a situation where the government has, among other things, the ability to decree and enforce reasonable tax structures, to develop institutional settings where conflicts are settled by law, and where there is no need to make unsustainable promises or engage in special deals with specific groups to obtain legitimacy and support. If populist episodes occur when governments have no further cards to play, then strong governments might not feel the need for populist policies or may be able to correct them before they produce long-term damages. But, more important, under a strengthened civil society governments will not have the possibility to lead the country into populist economic episodes.

The second element concerns the social perception about market-oriented policies. The fact that societies allow governments to pursue policies that systematically go against the logic of markets reflects the fact that they are not fully convinced about their benefits. As we have argued, there are substantial reasons why this has been so in Mexico. We are convinced that, on the whole, market-oriented policies are desirable and beneficial; there seems to be no other mechanism to produce an efficient allocation of resources. And yet, while markets do produce relatively more efficient outcomes than direct government allocations, efficiency is not enough. Market outcomes must also be distributionally acceptable.

Developing a social consensus in favor of market-oriented policies is also important. To do this, not only must the benefits of markets become clear, particularly the associated distribution of income, but the conditions under which markets do indeed produce better outcomes also requires elucidation: markets have desirable properties under a certain set of conditions. At the same time, however, we must also come to realize that while certain market outcomes may not be Pareto efficient, this need not imply that the situation can be improved by government action. It is necessary to understand that, given problems of bounded rationality, availability of information, and incentive compatibility, there are limits to what government interventions can achieve, even if well-intentioned.[56] In addition, the implicit connection that is made between markets and privilege must disappear.[57]

56. A case in point is the market for credit. It is now generally understood that credit rationing may arise even in contexts where the interest rate is free to vary (Stiglitz 1988). But the root of the problem is a moral hazard problem arising from the fact that information is asymmetric and costly. This type of informational failure, however, cannot generally be solved by governments.

57. Language is revealing about this problem in Mexico: the term *private sector* (or, misleadingly, entrepreneurial sector) generally denotes large firms in manufacturing and finance and is

Market-oriented policies will produce benefits when they are perceived by all agents to be permanent. There is now a substantial body of literature to show that noncredible or unsustainable market reforms may reduce welfare and, in doing so, reduce the reputation of markets. From a different perspective, imposing a market-oriented outcome may, to some extent, be sowing the seeds for a latter populist episode. The permanency of market-oriented policies is thus directly linked to the social consensus behind them. If the latter is developed, the associated economic outcome, while obviously not a Pareto optimum, is likely nonetheless to be better than the current situation. But, of course, a Pareto optimum, or anything coming closer to that, might not be what society desires. The arguments of the "social welfare function" might include elements other than physical goods. Society has the right to choose an alternative set of policies—as long as it is aware of the associated economic costs of those policies.

But the lesson from all this must be obtained by looking not only at Echeverría's and López Portillo's regimes, but also at stabilizing development. Stabilizing development can be criticized for paying scant attention to political development. Echeverría probably tried to redress the balance by focusing on political development, although in doing so he, in turn, paid scant attention to economic constraints. Neither strategy, in the end, was permanent. So the lesson is simply that societies cannot develop under either a purely economic or political track. One cannot focus only on one set of variables at the expense of the other, and perhaps Mexico has been suffering, since at least the 1950s, from wide swings in a pendulum that goes from concentration in economic matters at the expense of political development to concentration in economic development at the expense of politics. Populism is, from this perspective, just one of the two types of errors that policymakers can fall into.

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evocative of privilege and elite. In turn, the term *social sector* (or, misleadingly, popular sector), denotes an amorphous collection of agents (some rural workers, small vendors, and self-employed in the urban areas) and is evocative of destitution and poverty. Yet there is nothing more private (or social) in the activities of a large oligopolistic firm producing, say, fertilizers, than in an individual vendor in the streets of Mexico City selling, say, candy. Presumably both agents (entrepreneurs?) maximize profits and respond to current and expected relative prices. And while there are obvious differences of size, access to credit, tax obligations, etc., policies can either improve the functioning of markets for both (removing barriers to entry in fertilizers to lower price-cost margins and, say, granting credit to the street vendor) or, alternatively, suppress them (nationalizing the fertilizer producer, say, and giving a government-guaranteed job to the street vendor). The dichotomy private-social sector is not analytically useful but generates a background against which populist policies, regardless of their medium-term effects, seem immediately (we hesitate to use the term) "popular."

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Comment Enrique Cárdenas

Bazdresch and Levy's paper is a well-structured and researched piece that deals with the economy's development from the late 1950s until the crisis of 1982. The authors also review briefly the immediate postrevolutionary years and emphasize the role of the revolutionary ideology as the seed of subsequent populist periods that have repeated themselves sporadically. However, they review very deeply the policies of the Echeverría (1970–76) and López Portillo (1976–82) administrations.

The first part intends to demonstrate that the revolution ideology created a

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strong, interventionist, and large state with the power to influence and direct economic activity. In my view, although this is true to some degree—the 1917 Constitution that emanated from the revolution included many economic articles along those lines—the Mexican state "developed" its instruments of economic policy at about the same time as most other countries: during the 1930s. Indeed, in the 1920s, the Mexican government had as its only policy expedient the import tariff to affect relative prices; by the mid-1930s, the recently created Central Bank began to function as a real monetary authority, and fiscal policy began to be implemented very cautiously to counteract economic recessions. But all this was happening at the same time in all the major Latin American countries. Indeed, it is usually argued that the Great Depression throughout Latin America and elsewhere was the major force behind the idea of an interventionist government. This was not only through economic policy; the general atmosphere pointed in that direction.

The authors also consider that in contemporary Mexico there were two episodes of populist polices: Cárdenas and Echeverría—López Portillo. I have no doubt that they are right, but I would only mention that Cárdenas was careful not to ignore the macro constraints that his successors did. During the most expansionist years of the Cárdenas period, the fiscal deficit was about 1% or 2% of GDP. During the Echeverría period the deficit reached 10% of GDP, while during the López Portillo administration, the fiscal deficit reached a peak of almost 17% of GDP. Naturally, Echeverría and López Portillo would love to be placed in the same package as Cárdenas, but I do not think that should be the case.

With regard to the stabilizing development period, the authors follow the mainstream, noting that fiscal discipline was the reason that inflation and the nominal exchange rate were stable during those years. I firmly believe they are right, but that this was a necessary, but not sufficient, condition for such an outcome. New research has recently shown that the absence of foreign shocks also played a significant role in that respect. That is to say, "stabilizing development" was possible because the government was well disciplined in its finances *and* because there were no external shocks that disturbed the economy during that period.

Their approach to analyzing the 1970–82 years is by reviewing the various economic policies undertaken by those regimes. The authors conclude that these governments adopted populist policies to reach high-priority political objectives that, moreover, could not be reached through market-oriented interventions. They arrive at this conclusion by saying that Echeverría had no other choice than to increase the role of the state in the economy if he wished to attract the support of leftist intellectuals. However, when they review that period, they imply that the failure of Echeverría, as measured by the 1976 crisis, was largely due to his lack of fiscal discipline as well as to the pernicious interplay of foreign economic shocks, such as the oil embargo and high international inflation rates. This fact, with which I personally agree, points to a major ingredient of populist policies. It is true that they are pursued for political reasons of high priority, which tend to benefit a specific social group, sometimes at the expense of another. But what is equally true and important is that a populist regime is not willing to pay the whole cost of its policy. Echeverría, for instance, decided to redistribute wealth and enlarge the size of the state by spending resources that he actually did not have and *was unwilling to make the fiscal reforms that would provide such funds*. If he had done so, there would be a discussion on ideology (having a large vs. a small state) and not a discussion on populism. The consequence of that decision had disastrous effects, as Bazdresch and Levy well point out, which could have been avoided or at least could have served to turn the public's attention to the basic underlining factor: the weak structure of the economy.

Such an unwillingness to "pay the price" is also a reflection of a basic ingredient of populist policies: The utmost concern for the short run as opposed to the long term. Naturally, political objectives usually imply, at the end, the aim to control power. In modern regimes, holding power (and political prestige) is a concern for just a few years, especially in a nonrenewable six year term that the president serves in Mexico. In other cases, such a term is even shorter. Consequently, political objectives are usually concerned with the short term, and therefore populist policies are also usually concerned with immediate impact. That is why it is not difficult to understand why populist regimes are not prepared to pay the whole price and tend to overlook the macroeconomic constraints that any economy faces.

In the case of Echeverría, if he had made the fiscal reforms needed to pay for the additional expenditures required to pursue his political objectives, it is possible to speculate that the crisis would have arrived anyway, probably later. It would have come, however, not because of fiscal indiscipline but because the structure of the economy remained weak, uncompetitive, and highly vulnerable to external economic shocks, which were particularly strong in the 1970s.

López Portillo's populism, I believe, is of a different sort. He was blessed with the oil boom and a tremendous inflow of foreign exchange. At first the government thought that it had finally overcome its endemic financial constraint that the scarcity of hard currency imposes on the balance of payments. During its first years, the López Portillo regime simply wanted to distribute wealth that was pouring from the oil revenues, not necessarily redistribute it. José López Portillo's populism was for the poor and the rich. There was so much wealth that it seemed that there was enough for everybody. All enjoyed inexpensive public goods and services, cheap dollars, and extensive subsidies at all levels. It was like manna coming from heaven, but it became the virus of a "Dutch disease" type of macroeconomic problem. The sudden inflow of vast amounts of dollars distorted relative prices and increased income. The result was a growing import bias and high domestic rates of inflation, which exerted pressure on the balance of payments, given a fixed exchange rate policy. Consequently, the economy's structure became even weaker and more vulnerable to any type of shock.

It should be mentioned that, during López Portillo's regime, a segment of the government tried to enter the GATT in an attempt to force the economy to become more efficient and competitive. The impact of the Dutch disease was beginning to be felt, and concern was expressed in terms of the disastrous macroeconomic outcome if the status quo were maintained. The refusal to join GATT was a reflection of a generalized feeling of self-sufficiency, not only in the executive branch but also in most of the private sector. At the same time, there was no government recognition of the fact that the economy was becoming weaker.

Actually, it can be speculated that, if the price of oil had continued to climb as was forecasted by most analysts at the time, and assuming that overall macroeconomic policy would have continued the way it was, the Dutch disease would have become a cancer and a larger segment of the society would become a *rentier* class, very much in the same way the Spaniards in the sixteenth century were affected by the gold and silver inflows from their American colonies. Income was growing much faster than actual productivity, and the relative price increase of domestically produced goods with relatively open imports inhibited domestic investment on productive activities. To allow such a situation, with the concomitant impact in public finances and the budgetary deficit, was another form of populism. To make people believe that they were rich (because they truly believed it) when they actually are not is a certain way to spoil one's future.

The authors rightly argue that in order to "immunize" a country against populist policies it is necessary to strengthen the role of the civil society and to create a social consensus in favor of economic policies that do not clash directly with the logic of markets. They also indicate, with good reason, that it is important that institutions should be created in order to prevent a government from ignoring macroeconomic constraints. I would simply extend this thought to mention that governments and the "social consensus" alike must not forget that it is impossible to obtain something from nothing, that one cannot indefinitely consume more than what one produces, that a country cannot live from borrowing forever. Perhaps this is the most painful lesson that Mexico has learned from the recent economic crisis, a lesson that is now shared by the government and the common people alike. This is another kind of immunization, at least for one generation, I hope; that is, just having the disease.

Indeed, the prolonged crisis and the more recent opening of the economy to foreign competition has had a tremendous impact on people's mentality. Apparently governments learn and people also learn. In my opinion, there is a growing and widespread feeling today, at least among the middle and upper classes, that one has to be more productive and competitive in order to enjoy a better life, that it is no longer possible to spend beyond one's means indefinitely.