Lecture 4
The Mexican Way

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As early as in 1976, when Latin America suffered another of its recurrent monetary and financial crisis, economic thinking in the region had begun to question excessive fiscal expansion and the Import Substitution Industrialization as sound growth strategies. Most economists thought that the ISI strategy was exhausted and it was indeed preventing LA countries to achieve the stability and growth that had enjoyed earlier.

By that time, Chile had started the economic reform we referred to last class. Nonetheless, this process did not take off in Mexico due to concurrent circumstances. On the one hand, large oil reserves were discovered and on the other hand abundant money in financial markets coming from the recycling of the Petrodollars made it easy to get external financing.

Most Latin American leaders became convinced that Latin America should seek macroeconomic stability and trade openness after the 1982 Mexican debt crisis fueled a long and painful stagflation process.

President De la Madrid took office on December 1st, 1982. His Administration made great efforts to cut government expenditures and to open the economy. Notwithstanding, in the period 1982-1987 inflation remained high and exports did not increase enough to become the engine of growth. At that point, the cause behind the persistent stagflation process seemed clear. Since 1982 Mexico had been transferring abroad as much as 5% of its GDP, in net terms.

In order to be able to generate such large Current Account Surplus in its Balance of Payments Mexico kept the domestic currency deeply devalued, which in turn led to a very low investment rate. The continue devaluation of the domestic currency fueled inflation, which remained persistently high. A high exchange rate would supposedly foster exports; however, the low investment rate set a limit to that process, along with insufficient productivity increases.

By 1985, a similar attempt by the Bolivian Government to continue transferring abroad a significant proportion of its GDP while trying to satisfy simultaneously domestic social demands had ended in Hyperinflation. To stop it, Victor Paz Estenssoro's Government had to introduce a reform program, which included the suspension of payments on the debt, which, by the way, started to be the recommendation that Jeffrey Sachs and other scholars started to make to the indebted nations of Latin America.

It was at this time that Mexico started to seek the restructuring of its external debt. The process should contemplate both capital and interest lessening and longer maturities.

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As part of the program, Mexico started a privatization process that would help it obtain the resources needed to afford its internal debt. But that was not enough to reverse the net transfer of resources abroad, which in turn was the key to strengthen the currency and to increase the rate of investment.

By that time, Wall Street and Washington favored debt-equity-swaps as a method to cut external debt and at the same time foster private investment in indebted countries. Nonetheless, Mexico rejected the idea on the grounds that it would fuel inflation because the Mexican Central Bank would have to issue domestic currency in exchange of the debt being swapped.

Mexico looked for an alternative solution. It proposed a scheme to restructure the debt based on external support. In 1989, the US Administration accepted such a scheme. To the best of my knowledge, this is how the "Brady Plan" was designed and launched.

The "Brady Plan" produced a double positive effect on the Mexican economy. On one hand, it would allow Mexico to lessen significantly its debt burden. On the other hand, Mexico was able to attract foreign savings. As a matter of fact, in 1988 it transferred resources abroad equivalent to some 5.7% of GDP, whereas in 1989, the transfer was very close to zero. This trend strengthened during the following years reaching the inflows of foreign savings a significant 8% of GDP in 1994.

The openness of the economy and prudent macroeconomic policies undertaken by the De la Madrid Administration, along with the successful restructuring of the debt accomplished by Salinas de Gortari Administration during the first year in office contributed to restore the confidence in the Mexican economy. Thus, the foreign currency drain stopped, and the stagflation inertia that had dominated the period 1982-1987 was curbed.

Salinas's initial success against stagflation made it possible to gain the political and public support needed to undertake the process of economic reform implemented later on. I believe that his initial success drew the attention of the US and contributed to its willingness to negotiate NAFTA.

How "orthodox" was the Mexican Stabilization Plan?

The Mexican stabilization plan implemented in December 1987, which was called "The Solidarity Pact", was not the standard IMF stabilization recipe. As a matter of fact, initially the IMF did not give its support. On the contrary, we could classify the plan as a "heterodox" one. A heterodox plan along the lines of those implemented in Argentina and Brazil in 1985, which by 1987 had failed to curb inflationary inertia.

The most important difference between the Mexican Solidarity Pact and the Argentine Austral Plan and the Brazilian Cruzado Plan was rooted on Mexico's emphasis on accompanying heterodox economic measures with prudent macroeconomic policies and the openness of the economy.

Lessons learned from Chile and Bolivia's previous experiences indicated that those two ingredients were the key to the sustainability of stabilization policies in the long run. Those elements had been absent in both Argentina and Brazil's plans.

I already mentioned that my stay in Cambridge from 1974 to 1977 gave me the opportunity to follow quite closely the Chilean and Bolivian experiences, as I was close to those who would design and implement the economic reforms in those countries. The same comment applies with regards to Mexico. One of my best Mexican friends at that time was Pedro Aspe. So, through him I could follow very closely the Mexican experience.

Pedro Aspe was in Cambridge attending his PhD at MIT at the same time I was attending my PhD at Harvard. We and other Latin American students had discussed extensively about our countries. No question about that, Chile was a case in point because it had started to implement its economic reform package by that time.

In writing our respective PhD dissertations, Pedro and I, analyzed the stagflation process that our countries were suffering. Argentina was going through the traumatic experience of another Military Cup. The Peronist Administration, which had been elected in 1973, was ousted from power in 1976 by the Military Junta amidst economic chaos. In 1976, Mexico suffered its first serious financial crisis since 1940 and the first devaluation of the Peso after 22 years.

From 1978 to 1987 Pedro and I stayed in touch and well informed of what was going on in both countries. I was the Director of a think tank in Argentina, the IERAL from the Mediterranean Foundation, whereas Pedro was faculty at the ITAM in Mexico City. He was starting his political career. He first served at the Institute of Statistics and then at the Secretariat of Planning and Budget.

In July 1987, Pedro Aspe invited me to participate in the Conference on Structural Change and Modernization in Mexico and the World, which took place in Mexico City. I remember that during the first day of the Conference, we shared the panel with Martin Feldstein from Harvard University, Rudiger Dornbusch from MIT, Carlos Salinas, who was the Secretary of Planning and Budget at that time, and President De la Madrid Hurtado.

The speeches given at that Conference were later on compiled in a book, which was published in Spanish by the Fondo de Cultura Economica. They reflect clearly that there was a "Latin American Consensus" at that time. Such a Consensus received the support of academicians such as Rudiger Dornbusch from MIT and Jeffrey Sachs from Harvard, whose economic ideas were rather different from those championed by Wall Street and Washington. As a matter of fact, regarding the debt problem, both Dornbusch and Sachs suggested that Mexico would never overcome stagflation and achieve macroeconomic stability and economic growth if it did not stop the net transfer of resources, which in turn was determined by its foreign debt.

I recall that I described the typical Latin American economic organization as "Capitalism without a Market and Socialism without a Plan". I advanced my interpretation of the kind of economic reform that was needed to overcome the debt trap, and suggested that a new set of rules of the game was necessary along the lines of those implemented by Chile and Bolivia. This interpretation was widely supported, in particular by Latin American attendees.

At that Conference, President De la Madrid and future President Carlos Salinas de Gortari subtly unveiled that they were about to launch what in December 15 would be presented as the "Solidarity Pact." The "Solidarity Plan" was a plan of stabilization and growth, which curbed inflation and allowed Mexico to undertake deep economic reforms. I believe that the best description of such a plan has been provided by Pedro Aspe and is included in the Syllabus. It is the Chapter 1 of Pedro Aspe's book The Mexican Way. Additionally, the most detailed description of the negotiations that preceded the Brady Plan and NAFTA has been offered by Carlos Salinas de Gortari in his book Mexico: the Policy and Politics of Modernization, which is also included in the syllabus.

What did go wrong?

I have no doubt that the most radical economic changes of recent Mexico took place during the six years of Carlos Salinas de Gortari Administration. Successive Administrations tried to solve the most urgent problems at hand but were unable to introduce other reforms or reverse the reforms already in place.

Miguel Angel Centeno, in the first edition of his book Democracy within Reason: Technocratic Revolution in Mexico, published in 1993 admires Salinas' skills to obtain both PRI and population support in the difficult internal and external negotiations that institutionalized the economic reform. In its second edition, published in 1996, he includes a Post-script in which he tries to make sense of what happened in 1994 and 1995. He says: "The ultimate irony of the Salinato is that it was partly brought down by mistakes right out of a final exam for intermediate macroeconomics."

Although I do not agree with this conclusion, I included this reading in the Syllabus for a reason. Most of the analysis produced by the economic thinking in relation to the Tequila crisis endorses the previous simple explanation. I think that the available political and economic analysis simplistically find the causes of the crisis in basic macroeconomic mistakes the Mexican authorities supposedly made. From my point of view, this explanation of the crisis does not address what to me was the fundamental mistake made by Mexico during the transition from the Salinas to the Zedillo Administration. The mistake was to use US support to prevent a default on the debt rather than using it to prevent the extreme devaluation of the Peso. My point is that the mismanagement of the economic and political relationship between Mexico and the US is key to understand both the Tequila crisis and the relative lack of action characteristic of the Administrations that followed Salinas'.

Nonetheless, before analyzing the causes and consequences of the Mexican Crisis of 1994-1995, it will be useful to analyze more closely the role that Washington played in relation to the implementation of the economic reforms in Latin America. This is the topic of our next class when we will discuss "The Washington Consensus and US Leadership."