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of the Mexican Economic Growth Strategy**

Robert A. Blecker (American University)

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Center for Economic Policy Analysis
New School for Social Research
80 Fifth Avenue, Fifth Floor, New York, NY 10011-8002
Tel. 212.229.5901 • Fax 212.229.5903
<http://www.newschool.edu/cepa>

NAFTA, THE PESO CRISIS, AND THE CONTRADICTIONS OF
THE MEXICAN ECONOMIC GROWTH STRATEGY

Robert A. Blecker*
Department of Economics
American University
Washington, DC 20016 USA
Phone (202) 885-3767
FAX (202) 885-3790
E-mail blecker@american.edu

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Prologue: The Outbreak of the Peso Crisis

At the end of 1993, Canadians, Americans, and Mexicans were all assured that passage of the North American Free Trade Agreement (NAFTA) would guarantee rapid economic progress in Mexico at minimal cost to (and even with some small gains for) the United States and Canada (see, e.g., Hufbauer and Schott 1992, 1993; Lustig, Bosworth, and Lawrence, eds. 1992; U.S. International Trade Commission 1991, 1993; U.S. Congress, Congressional Budget Office 1993). Critics countered that NAFTA was likely to have negative effects on employment and wages, at least in the U.S. and Canada (see, e.g., Koechlin and Larudee 1992; Faux and Lee 1992; Stanford 1993). But to this author's knowledge, only one observer predicted as early as 1993 that the United States government would soon end up responsible for bailing out the Mexican financial system from an impending crisis:¹

The continued current account deficit will sooner or later require a devaluation of the Mexican peso. When that happens, short-term and speculative capital will flee. This will surely burst the speculative bubbles in real estate and finance, if they haven't burst before.... [NAFTA] is a formula for creating future demands that the U.S. taxpayer bail out the Mexican banking system in order to save the assets of major financial institutions. (Faux 1993, p. 11)

While at the time such a prediction may have appeared to be mere scare talk on the eve of the NAFTA vote in the U.S. Congress, in retrospect it was one of the few predictions about the post-NAFTA era that has clearly turned out to be accurate.²

NAFTA had hardly gone into effect on January 1, 1994, when the whole house of cards began to wobble. First, the Zapatista uprising in Chiapas called attention to the profound and worsening inequalities and marginalization in Mexico that had been obscured by all the talk of Mexico joining the ranks of the industrialized nations. Second, the assassinations of ruling party

presidential candidate Luis Donaldo Colosio and party chief José Francisco Ruiz Massieu made the 70-year old, one-party Mexican state seem suddenly unstable. Third, the Mexican trade deficit ballooned to unsustainably high levels, fueled by artificially cheap imports due to an overvalued currency and bolstered by election-year government spending. As nervous foreign investors began to reduce their investments in Mexico (and domestic capital flight resumed), net capital inflows were no longer sufficient to finance the huge excesses of net imports, and the Banco de México began to hemorrhage foreign exchange reserves in an ultimately futile effort to keep the peso from depreciating. In place of H. Ross Perot's "giant sucking sound" of jobs leaving the United States and going to Mexico, what was heard in 1994 were two other "giant sucking sounds": first, an enormous inflow of cheap consumer goods imports into Mexico; and second, a massive outflow of speculative "hot money" fleeing the country.

Massive intervention to support the peso continued throughout the last days of the administration of Carlos Salinas de Gortari, long enough to ensure the election of the substitute candidate of the ruling Institutional Revolutionary Party (PRI), Ernesto Zedillo Ponce de León (who holds a Ph.D. in economics from Yale University). With foreign exchange reserves dwindling rapidly, the new Zedillo administration was forced to devalue the peso a few days before Christmas, 1994. Initial efforts to manage the devaluation were quickly abandoned and the peso was allowed to "float" — although "sink" might be a more apt expression. International investors went almost overnight from being naively confident about the Mexican economy and financial markets to being unduly gloomy. As a result, the peso fell much faster and farther than the Zedillo administration had expected: its nominal value in U.S. dollars fell by over one-third (from \$0.29 to \$0.19) in just ten days at the end of 1994 and by more than one-half (to about \$0.13) by the end of 1995.³ With the collapse of the peso, Mexico's barely-suppressed inflation

quickly revived, not an unexpected development after a large devaluation in such an import-dependent country.

As the peso depreciated, the Mexican government was caught in a serious bind, since its large issues of dollar-denominated bonds called “*tesebonos*” had to be serviced in U.S. dollars, and without continued injections of foreign exchange the government could be forced to default. When Mexico’s initial efforts to halt the peso’s skid and reassure foreign investors failed, the administration of U.S. President Bill Clinton stepped in and proposed a \$40 billion loan package to bail out the Mexican government. Although Congressional opposition prevented passage of this proposal, the Clinton administration used existing exchange-rate stabilization funds to make a smaller package of \$20 billion of loans and loan guarantees available to Mexico, coupled with additional aid from multilateral institutions such as the International Monetary Fund (IMF).

Devaluing the peso did halt the immediate problem of the drain of foreign exchange reserves, and the international loans and loan guarantees did help to arrest the peso’s decline. But in order to win back the “confidence” of foreign investors and to staunch the soaring inflation at home, the Zedillo administration introduced stringent austerity policies, including fiscal contraction, monetary tightening, and credit restraints. While the balance of payments improved and default on Mexican government debt was avoided, the cost of all these policies to the “real” domestic economy was a devastating depression. Real gross domestic product plummeted by 7 percent in 1995, the largest single-year decline registered in Mexico’s modern history. By October 1995, open unemployment rose to about 3.3 million workers, or 8.9 percent of the labor force — about double the level of two years earlier, when NAFTA was adopted — and underemployment was much larger.⁴ Although accurate, representative figures on real wages for 1995 are still hard to come by, at least one source (Arroyo 1995) reports real wage decreases of

about 20 percent for most industrial sectors in the first three quarters of the year — with probably larger decreases for marginalized workers in the “informal” sector. Final figures on real wage decreases for 1995 could be on the order of 30-40 percent, and whatever the decrease is it starts from a base that was still considerably below the pre-debt crisis level. Just as in the aftermath of the 1982 debt crisis, the jobs and living standards of millions of already poor Mexicans were sacrificed to protect the investments of the very people, domestic and foreign, whose imprudent speculative activity had precipitated the crisis itself.

1. Introduction: Alternative Perspectives on the Mexican Crisis

The preceding summary of the events of the past two years suggests a series of questions. What went wrong? Why did the Mexican economy collapse so quickly after NAFTA’s passage, and what does the present crisis mean for Mexico’s future? Is the timing of the crisis in the first year of NAFTA merely an unfortunate coincidence, or is there a relationship between these NAFTA and the financial collapse? Is the post-devaluation crisis just a temporary setback, requiring only minor policy adjustments to get the country back on track? Or is the present crisis a sign of deeper problems in the direction of Mexican economic policy?

According to the U.S. and Mexican governments, the leading international financial institutions, and most orthodox economists, there is nothing fundamentally wrong with the economic liberalization policies that Mexico adopted in the late 1980s, including the free-trade strategy that culminated in NAFTA.⁵ On the contrary, it is argued that these policies are essential to Mexico’s long-term growth, and the economic crisis of 1994-95 in Mexico is merely the result of some short-term economic mismanagement — especially the mistaken decision to defend the

value of the peso in 1994 rather than allow it to depreciate sooner, as well as the election-year deficit spending by the outgoing Salinas administration. From this perspective, the political assassinations, guerrilla uprisings, and even the exchange-rate crisis itself are seen as exogenous “shocks” that have put some bumps on the road to an otherwise bright future for a liberalized, market-oriented Mexican economy. At most, it may be conceded that “Mexico’s political and economic stress reflects long-lasting economic change” that is both necessary and desirable (Gould 1995, p. 33). This view admits that further political reforms are needed to defuse the Zapatista threat and to eliminate corruption and violence within the government, and that prudential regulation of Mexico’s emerging financial markets could help to avoid excessive short-term capital inflows (see McKinnon 1995).⁶ Although the short-term stabilization measures (devaluation, fiscal contraction, and real wage cuts induced by inflation) will be unfortunately painful, in this view, Mexico should soon be back on the path to sustainable economic growth fueled by renewed capital inflows and enhanced exports.

One has to grant some validity to parts of this “Washington consensus”⁷ view of Mexico. First, Mexico’s pre-1980s development path based solely on import substitution *was* untenable in the long run, at least in the form in which it was implemented. Some degree of greater export-orientation and efforts to enhance domestic efficiency were both inevitable and desirable. And second, there can be no question that political upheavals and policy mismanagement contributed to the timing and severity of the post-1994 crisis in Mexico. But it is a far cry from these reasonable propositions to the conclusion that all is fundamentally well in Mexico, and that all that is needed is a more thorough implementation of the same general policy direction in which Mexico is already going.

This paper will argue that the present economic crisis reflects much deeper weaknesses in the overall policy trajectory that Mexico has been following since the mid-1980s. It will be argued here that the current economic growth strategy of the Mexican government is internally inconsistent and inherently flawed. There are two parts to this argument: the contradictions between Mexico's trade and macro policies, and the flaws in the trade policy strategy itself.

To summarize the first argument, Mexico has still not found an "engine of growth" to replace the dynamic of the old import-substitution regime, which was driven by the expansion of the internal market for domestically produced manufactures. Macroeconomic policies have been targeted mainly to containing inflationary pressures, and while the precise means for doing this have varied (from using the exchange rate as a "nominal anchor" and tolerating its real appreciation in 1988-94, to relying on fiscal and monetary contraction from 1995 to the present), they have all had the same effect, which is to put severe demand-side constraints on domestic growth. Lacking an internal stimulus to growth, Mexico has tried to rely on foreign investment and export promotion. But foreign investment and trade cannot serve as "engines of growth" when either exchange-rate policies or domestic macro policies are operating at cross-purposes. At best, the current set of policies (with a devalued currency and depressed domestic spending) may allow for increased export growth and an improved trade balance, but is unlikely to promote rapid expansion of the domestic economy or to permit shared benefits of export-led growth for the vast majority of Mexicans.

The driving motivation behind all of the recent twists and turns in Mexico's macro-economic policies has been the desire to suppress the high inflation that developed in Mexico in the 1980s. But the root of this inflation lies in an unresolved distributional conflict, sparked by the real wage cuts and increased inequality and poverty felt in the aftermath of the 1982 debt

crisis (see Lustig 1992). There is no way out of the unfavorable macro-policy trade-offs currently facing the Mexican government unless this conflict is resolved, one way or another. The current policies seem designed, perhaps unintentionally, to resolve the distributional conflict by permanently weakening the Mexican working class and forcing labor to accept a lower share of national income. The implicit expectation is that Mexico can then embark on a path of what might be called “profit-led growth,” in which heightened inequality and reduced labor incomes at home cease to be obstacles to aggregate economic expansion driven by high profitability for foreign capital and reliance on export markets. Whether such a growth path can actually succeed in Mexico is a question that will be explored further below.

A cornerstone of the Mexican economic strategy under both Salinas and Zedillo has been the emphasis on trade liberalization. As noted before, some degree of increased openness and export-orientation was probably unavoidable in Mexico. But this leaves open the question of whether the type of trade liberalization strategy that Mexico has pursued, both independently and through the NAFTA initiative, is likely to achieve the kind of gains from international trade and investment that the country hopes to obtain. One obvious issue concerns the timing of these initiatives. Much previous experience in Latin America suggests that it is potentially disastrous to attempt a trade liberalization or export-promotion strategy at a time when macro policies are promoting large capital inflows and the currency is appreciating in real terms (see, e.g., Agosin and French-Davis 1993, Ros and Skott 1995). Unfortunately, the Mexican government failed to learn from these previous experiences.

But a deeper issue concerns the confusion of trade and investment *liberalization* with the adoption of an *outward-oriented strategy* in the mainstream analysis. The East Asian experience shows that these two are far from equivalent, and that the most successful cases of the latter

strategy have taken place under the *aegis* of extensive government regulation and intervention, including both import protection and export subsidies (see, e.g., Amsden 1989; Wade 1990; Smith 1996; Shapiro and Taylor 1990, Amsden, Kochanowicz, and Taylor 1994). The East Asian countries contained the problems that have beset Mexico by maintaining strict capital controls and tight import restrictions throughout the early stages of their export-promotion drives. They never opened themselves up to the whims of financial speculators or the temptations of unrestrained imports, and they kept their exchange rates at levels that made their exports price-competitive abroad. To be sure, fiscal and monetary policies were conservative, but they were not allowed to become a brake on the growth process itself. And all of this required a degree of state intervention and economic micro-management that Mexico has largely foresworn through its international commitments under NAFTA. The Mexican strategy of trade liberalization opens up the economy to potentially huge increases in imports before domestic producers have time to adjust to the new competition, and does not guarantee that export growth takes place in the areas that are most beneficial to the long-run development of the domestic economy. In addition, NAFTA explicitly prohibits Mexico from using most of the types of strategic industrial and trade policies that proved so successful in the East Asian newly industrializing countries (NICs).

The connection between the macroeconomic and trade policies goes beyond mere issues of timing and consistency to some very core issues in economic policy analysis. Mainstream economists maintain a relatively strict dichotomy between micro and macro levels of analysis, which translates into viewing trade and macro policies as separate and independent levers of economic management. In the orthodox view, trade policies should be designed based on criteria of allocative efficiency, while macro policies are supposed to be used to maintain the fullest possible utilization of resources that is consistent with price stability. One implication of this view

is that trade policies can and should be designed “as if” there is full utilization of resources, while macro policy is left to pursue achievement of the latter (nowadays usually defined in terms of a presumed “non-accelerating inflation rate of unemployment” or NAIRU).

A very different perspective emerges from the “structuralist” approach to development, which incorporates the insights of Keynes and Kalecki applied to developing countries (see, e.g., Taylor 1983, 1991; FitzGerald 1993). According to structuralist theory, a country’s international trade and investment relations condition its overall macroeconomic performance in regard to objectives such as price stability, full employment, aggregate growth, and income distribution. Full utilization of resources is not guaranteed either by automatic adjustment mechanisms or by macro policies that target price stability. The effects of trade liberalization may differ depending on whether the economy is at or below full utilization,⁸ especially in terms of whether resources that become unemployed in import-competing activities do or do not find alternative uses where they are more productive. In addition, the effects of current account deficits matched by net capital inflows are very different in a situation of underutilized capacity compared with a situation of full utilization — a point of special relevance to Mexico, as we shall see.

Policies toward international trade and investment affect aggregate demand, not only via their direct effects on the trade balance (net exports), but also through their effects on income distribution and industrial structure, which can indirectly influence consumption and investment expenditures. From this perspective, one has to ask whether a particular international trade strategy is making it easier or harder for a country like Mexico to maintain full utilization of resources and to achieve desired rates of economic growth. In fact, as we shall see, the Salinas government understood that NAFTA was part of a growth strategy, not merely a policy to

enhance micro-level efficiency in resource allocation. The question is whether this growth strategy can work and, if so, at what social cost.

The rest of this paper is organized as follows. Section 2 briefly reviews how the Mexican government came to adopt the combination of macroeconomic and trade policies that led up to the peso crisis of 1994-95. Section 3 then details the evolution of Mexico's external accounts since the late 1980s and shows how the balance-of-payments disequilibrium that emerged in 1994 was the more or less inevitable result of the trade and macro policies then in place. Section 4 investigates the growth dynamics of the Mexican economy, based on a structuralist analysis of the country's efforts to switch to an export-led growth regime. Section 5 concludes with some thoughts on alternative policy options for Mexico in the final years of the twentieth century.

2. Mexican Economic Policy from the Debt Crisis to NAFTA⁹

From the 1940s through the 1970s, the dominant economic strategy in Mexico (as in most other major Latin American nations) was import substitution (IS) — the use of public policy interventions to promote the domestic production of formerly imported manufactured products for the internal market. This strategy had a growth dynamic of its own, resting on the virtuous circle of an expanding internal market for manufactured goods, increasing investment in production for the internal market, and the rising incomes of producers (including workers and managers as well as firm owners) in the heavily protected and subsidized manufacturing sector. But that growth dynamic was self-limiting for a variety of well-known reasons, including its tendency to generate a highly concentrated pattern of income distribution (which ultimately restricted the growth of the internal market), the creation of large rents through the pervasive use

of quantitative restrictions (which promoted corruption and other forms of “rent-seeking”), and the failure to develop competitive exports (which, coupled with continued dependency on foreign capital, technology, and intermediate goods, led to chronic balance of payments difficulties).

In the early 1970s, Mexican President Luis Echeverría Álvarez tried to forestall the collapse of the import substitution regime through massive public expenditures financed by foreign debt — a policy that collapsed with the devaluation crisis of 1976 (see Reynolds 1978). In the late 1970s, the government of José López Portillo tried to postpone the inevitable adjustments through the exploitation of oil reserves in an era of high oil prices — the revenue from which was used to leverage yet more debt. Rising interest rates, falling oil prices, and a U.S. recession were the main external “shocks” that put an end to that strategy in the early 1980s. By August 1982, Mexico announced that it could no longer service its huge external debt, and the “debt crisis” was underway.

The various measures adopted by the Mexican government in the wake of the debt crisis have been ably documented elsewhere (e.g., by Lustig 1992; Cline 1994) and need only be summarized briefly here. The Mexican government drastically cut its fiscal deficit and began to run budget surpluses by the late 1980s. State enterprises were privatized and decades of heavy government regulation (including restrictions on foreign trade and investment) were relaxed. This combination of austerity and liberalization made Mexico the darling of the international financial community, which in turn agreed to roll over the existing debt (usually by converting interest to principal and thus increasing the long-term debt burden) and eventually offered some modest debt relief under the U.S.-sponsored Brady Plan of 1989. At the same time, these policies caused drastic cuts in the standard of living for ordinary Mexican families. Real wages fell by between 30

and 50 percent, depending on the measure used, and overall economic growth completely stagnated leading to increased unemployment, poverty, and migration.

Table 1 provides some perspective on recent macroeconomic performance in Mexico. From 1965 to 1980, Mexican GDP grew in real terms at an *average annual* rate of 6.5 percent, with inflation averaging about 13 percent per year. This growth took place under the much-maligned *ancien régime* of protectionist IS policies. Although some of that growth in the 1970s was propped up by foreign debt and oil revenue, as mentioned earlier, and there was a rising trend of inflation in the latter part of this period, the IS period as a whole (including also the “miracle years” of the 1950s and early 1960s, when growth was similar and inflation lower) looks very good in retrospect compared with what came after it. From 1980 to 1986, GDP growth fell to an average annual rate of only 0.4 percent, while inflation soared to an average of nearly 64 percent *per year*. With population growing at a 2.2 percent annual rate at that time, this represented a real decline in the Mexican standard of living. Indeed, as Figure 1 shows, real per capita gross national product (GNP) in Mexico has never recovered to the peak levels experienced before the 1982 debt crisis. Undoubtedly, per capita GNP was artificially inflated during the oil boom years of 1979-81, but even if one ignores those years it is clear that per capita GNP growth completely stagnated in the 1980s and 1990s and is still well below its pre-1979 historical trend.

In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT) and committed itself to unilaterally reduce its formerly severe restrictions on imports of most industrial products. Over the next few years, Mexico eliminated the use of import permits, cut tariff rates dramatically (and made them more uniform), and relaxed its restrictions on direct foreign investment (see U.S. International Trade Commission 1991, ch. 1). Mexico did not give more explicit incentives or subsidies for export, but the devaluations of the peso in 1982-83 and 1986-

87 (see Figure 2) helped to boost exports by making Mexican goods more competitive, while the emergence of excess industrial capacity in a depressed economy induced Mexican firms to seek external sources of demand (see Agosin and Ffrench-Davis 1993). Still, the economic recovery that took place in the late 1980s was quite disappointing by historical standards, with growth rates that did not reach 4 percent until 1990 (see Table 1), and did not suffice to pull Mexican real wages and average living standards back to where they had been before the debt crisis.

It was in this context that the NAFTA proposal emerged. What President Salinas hoped to achieve through the NAFTA was to stimulate the renewal of growth that all of Mexico's stabilization policies, structural adjustments, and domestic reforms (including trade liberalization) in the 1980s had failed to achieve. According to the most authoritative study of Mexico's recent economic reforms,

When foreign investment did not respond with the expected vigor to the Brady-type debt agreement and the far-reaching economic reforms, the [Mexican] government had to find new ways *to entice the capital inflows required for economic recovery and sustained growth*. Policies able to increase the expected rate of return on investment and boost private sector confidence were essential. A free trade agreement with the United States belonged to this category for two reasons in particular. An FTA would ensure future access to the U.S. market, and ensure the durability of Mexico's open economy strategy. (Lustig 1992, p. 134, italics added)

A report by the U.S. Congressional Budget Office (CBO) makes the same point:

The key to this [development] strategy is for Mexico *to attract and productively absorb foreign capital*. In addition to making Mexico more attractive for U.S. investors (because of the investment provisions of the agreement), NAFTA reduces doubts that other foreign investors may have about the permanency of Mexico's economic reforms—that is, it helps to lock in those reforms and so reduces the risk involved in investment. (U.S. Congress, Congressional Budget Office 1993, p. xiii)

Thus, the purpose of NAFTA was primarily to give the Mexican economy the growth stimulus that had been missing since the demise of the IS regime. This stimulus was supposed to

come from massive inflows of direct foreign investment (DFI) that would enhance Mexico's export capabilities and generate an export-led boom.¹⁰ NAFTA would guarantee that Mexico's primary export market — the United States — would never be closed to Mexican exports. Mexico thus sought to avoid one of the primary obstacles to export-led growth, which is the threat of increased protectionism in export markets. NAFTA also laid out a welcome mat for foreign investors by guaranteeing respect for their property rights and freedom from regulations in Mexico. Thus, the Mexican government understood something that most of the neoclassical trade modelers missed: that the primary objective of NAFTA was to attract investment and impart a growth stimulus, not to liberalize trade *per se* (especially in a situation in which trade barriers had been lowered substantially already).¹¹

But the Achilles Heel of this strategy was the fact that trade policy was expected to “grow the economy” (to use President Clinton's unfortunate phrase) at the same time as domestic macroeconomic policies and international financial policies inimical to industrial growth were in place. It was as if the Mexican government was expecting foreign businesses to come in and press the economic accelerator at the same time as the government's policies in other areas were holding down the brakes. In addition, the trade strategy was internally inconsistent from the perspective of stimulating aggregate demand, since the opening to imports tended to counteract the expansionary effects of the export growth. In fact, growth never really got off the ground in the early 1990s, as both Table 1 and Figure 1 show. The Salinas administration had one great policy success, which was bringing inflation down from about 131 percent in 1987 to about 7 percent in 1994. Yet the very success of this policy sowed the seeds for its own subsequent failure through its implications for the value of the peso and Mexico's external accounts, as we shall see in the next section.

3. Trends in the Mexican Balance of Payments and Exchange Rate

The evolution of Mexico's international transactions since the late 1980s is shown in the Mexican balance of payments data in Table 2. Mexico's exports more than doubled from \$27.6 billion in 1987 to \$60.9 billion in 1994, while its imports *more than quadrupled* from \$18.8 billion to \$79.3 billion. The Mexican current account balance, which also includes trade in services, net interest payments, and unilateral transfers not shown separately, fell from a small surplus of \$4.2 billion in 1987 to a deficit of \$28.8 billion by 1994, representing almost eight percent of Mexico's gross domestic product (GDP) at that time.

Between 1990 and 1993, the growing current account deficits shown in Table 2 were actually exceeded by even more rapidly rising net capital inflows (direct investment and portfolio investment combined), leading to overall balance of payments surpluses that enabled Mexico to increase its foreign exchange reserves to almost \$25 billion by the end of 1993. Direct investment inflows reached about \$4-5 billion annually in 1991-93, while net portfolio investment inflows skyrocketed to \$28.9 billion by 1993. In those years, the intervention of the Banco de México was primarily to *keep the peso from rising too much* in response to the massive inflows of funds.

The widening of Mexico's trade deficit and the increased inflows of foreign capital were, of course, two sides of the same coin. But it is worth understanding the precise policies that not only made imports rise faster than exports, but also made portfolio investment rise so much faster than direct investment, and even led to overall payments surpluses for several years. The unilateral reductions in Mexico's import barriers in 1987 naturally led to a release of pent-up demand for imported consumer goods. At the same time, the Mexican government began serious efforts to control the country's runaway inflation, as well as to entice back the "flight capital" that

had left the country in the 1980s (estimated to have reached \$79 billion, or 73 percent of the external debt of \$108 billion, by 1987, according to Pastor 1989). These efforts included tight monetary policies that drove up real interest rates and thus made Mexican financial assets very attractive to both foreign and national investors (especially at a time when interest rates in the U.S. were generally falling). As a result, a lot of “hot money” came into Mexico’s “emerging financial market” in the early 1990s.

This same set of policies caused the Mexican peso, which had been devalued after the 1982 debt crisis and reached a record low real value in 1987, to begin appreciating again (see Figure 2). As part of its anti-inflationary campaign, the Mexican government restricted the rate of nominal depreciation of the peso to below the differential in inflation rates between Mexico and the United States. This policy of using the exchange rate as a “nominal anchor” kept the prices of imported goods from rising in peso terms, which helped to contain Mexican inflation, but also made imports artificially cheap for domestic consumers at the same time as import barriers were falling. As the peso began to appreciate again in real terms after 1987, import growth raced ahead of export growth (as shown in Table 2), thus putting a drag on overall Mexican growth.

By 1993, the peso had appreciated by 76.2 percent over its 1987 value in real terms, compared with the U.S. dollar. As a result of this sharp real appreciation of the peso, the export-led growth boom that Mexico was anticipating from its liberalization efforts could not materialize. As Figure 2 shows, the peak real value of the peso in 1993 was somewhat below its previous peaks in 1975 and 1981, but the resulting current account deficit (shown in Table 2) was nonetheless enormous due to the greater openness of the Mexican economy in the 1990s. And while the Mexican financial markets were booming in the early 1990s, real economic growth continued to be disappointing as the rising trade deficits kept the Mexican economy from

expanding at an adequate rate. By 1993, the Mexican economy was again stagnating, with a growth rate of barely 0.6 percent (see Table 1, above). Total manufacturing employment was actually falling, from a cyclical peak of 2.5 million jobs in 1990 to 2.3 million in 1993 (Arroyo 1995, p. 20), in spite of the creation of some new jobs in the export-oriented *maquiladora* sector. This was followed by a temporary recovery fueled by election-year government spending in 1994, when real GDP grew by 3.5 percent, before the collapse of 1995 when real GDP fell by 7.0 percent.

The financial side of the Mexican balance of payments took a distinct turn for the worse in 1994. While the trade and current account deficits continued to increase, and there was a significant increase in DFI to \$8.0 billion in the first year of NAFTA, portfolio investment inflows took a nosedive. Indeed, as explained in the notes to Table 2, the drop-off came precipitously in the fourth quarter of the year, when a net *outflow* of portfolio investment of \$5.5 billion was registered. This sudden withdrawal of funds left Mexico with a huge and rapidly exploding overall payments deficit that reached \$17.7 billion by the end of 1994. By the end of the third quarter, Mexican foreign exchange reserves had already been drained by \$9.5 billion compared with nine months earlier. These reserves then fell by another \$10.1 billion in the fourth quarter alone, leaving Mexico with only \$6.1 billion of reserves by the year's end (when the devaluation finally occurred). An earlier devaluation by the outgoing Salinas administration could have helped to some extent, especially by lessening the drain of foreign exchange reserves and the consequent need for a U.S. bailout. Nevertheless, it is doubtful that the reversal of the portfolio investment inflow could have been avoided altogether once the speculative bubbles in the Mexican asset markets had burst.

The huge net capital inflows into Mexico in 1991-93 were the source of much enthusiasm among NAFTA supporters before the agreement was approved. The enthusiasm was two-sided: on the one hand, it was thought that the net capital inflows into Mexico would be the catalyst for renewed growth there; on the other hand, it was argued that the corresponding net capital outflows from the United States would generate job-creating trade surpluses for the latter.

With regard to the Mexican side, it is clear from the data in Table 1 that the hoped-for growth boom never materialized in the early 1990s. A large part of the explanation lies in the huge trade deficits for the same years shown in Table 2. But why did the corresponding large net capital inflows not stimulate growth? Net capital inflows, which augment domestic saving, impart a growth stimulus if and only if an economy is operating with full utilization of resources. In this case, the inflow of foreign saving finances domestic investment that otherwise could not take place, without reducing domestic consumption. Otherwise, in the presence of excess capacity, the Keynesian paradox of thrift takes hold and the increased net foreign saving (trade deficit) depresses domestic output and employment. This appears to be what happened in Mexico.

Of course, a sufficiently large investment stimulus could possibly outweigh a trade deficit, leading to a net increase in aggregate demand. In fact, gross domestic investment (measured as a percentage of GDP) did rise steadily in Mexico between 1986 and 1992, albeit starting from a very depressed base, as shown in Figure 3. This increase in the investment share amounted to about 5 percent of GDP. But the current account worsened by a larger proportion, about 6 percent of GDP, over the same time period, and by another 2 percent of GDP by 1994, while the investment share declined in 1993-94 compared with 1992.¹² Thus, the rising current account deficits eventually overtook the increased investment share, and this occurred precisely when Mexican growth was slowing down in the early 1990s (see Table 1). The fact that the rising

current account deficits were not matched by continued increases in the investment rate is not surprising since, as Table 2 makes clear, most of the net capital inflow that financed the current account deficit consisted of portfolio capital rather than DFI.

With regard to the United States, Table 3 shows the evolution of bilateral U.S.-Mexican trade and capital flows over the period 1987-95. From 1987 to 1992, the bilateral merchandise trade balance swung from a deficit of \$5.7 billion to a surplus of \$4.9 billion. The bilateral surplus then shrunk to \$0.6 billion in 1994, before plunging to a record deficit of \$15.4 billion in 1995 after the peso was devalued and Mexico's economy collapsed.¹³ Some American economists hailed the rising bilateral trade surpluses with Mexico in the early 1990s as evidence that the opening up of the Mexican economy was having an expansionary, job-creating effect on the U.S. economy. Especially, Dornbusch (1991) and Hufbauer and Schott (1992, 1993) staked their predictions of net job creation in the United States due to NAFTA on the assumption that this agreement would induce further increases in U.S. trade surpluses with Mexico (financed by increased net capital outflows from the U.S. to Mexico).

Hufbauer and Schott in particular projected an increased U.S. trade balance with Mexico of \$9 billion by 1995 (from the deficit of \$2.4 billion in the base year of 1990 to a projected surplus of \$6.6 billion in 1995), as a result of "NAFTA and related reforms," which would create 171,400 net new U.S. jobs. Thus, Hufbauer and Schott were off by about -\$22 billion, representing (by their own logic) over 400,000 less American jobs than they had predicted.¹⁴ Although this discrepancy does not come close to the most hysterical claims of millions of jobs being at risk under NAFTA (e.g., Choate 1993, who saw six million jobs "at risk"), it is rare that any prediction by policy analysts has been so quickly and conclusively falsified.¹⁵

The argument that the U.S. trade surpluses with Mexico of the early 1990s would continue to grow under NAFTA ignored the special circumstances affecting the trade data for the early 1990s. These circumstances included above all the real appreciation of the peso, which we have seen was unsustainable. In addition, the U.S. economy went into a recession in 1990-91 from which the initial recovery was unusually sluggish. As U.S. demand growth was weak at that time, it is not surprising that U.S. imports from Mexico grew slowly in 1990-91, and then increased much more rapidly in 1992-95 when the U.S. economy recovered. Furthermore, Mexican economic growth was moving inversely with U.S. growth in this period. With Mexican growth peaking in 1990 and then falling through 1993 (as shown in Table 1, above), it is also not surprising that the growth of U.S. exports to Mexico accelerated in the early 1990s and then slowed down by 1993.

Comparing the data in Tables 2 and 3 also reveals an important but usually neglected fact.¹⁶ That is, while Mexico was experiencing a vast and growing overall trade deficit in 1990-94, the U.S. accounted for only a small and shrinking portion of this deficit — in spite of the fact that the U.S. is by far Mexico's largest trading partner and accounts for about three-quarters of the latter's trade. This suggests that the net job-creating effects of the Mexican trade deficit were largely felt in other countries that were exporting to Mexico, not in the U.S. Presumably, these were mainly East Asian export powerhouses such as Japan, Korea, and Taiwan, as well as the European Union. It is possible that the trade-diversionary effects of NAFTA could reverse this pattern to some extent, by giving U.S. producers preferential access to the Mexican market. But thus far, the trends have gone in the other direction. As Thea Lee writes,

Even the most basic of pro-NAFTA predictions, that the United States would enjoy more exclusive access to Mexico's market, turned out not to be true. While it is true that Mexico buys about 70% of its imports from the United States, it is

also relevant—although often not mentioned—that Mexico sends over 80% of its exports to the United States. This imbalance has grown over the past few years, indicating that Mexico has an increasingly limited export destination but a broadening base of import suppliers. Mexico appears to be turning into an export platform for European and Asian companies interested in selling in the U.S. market. (Lee 1995, p. 12.)

4. The Internal Contradictions in the Mexican Economic Strategy

This section considers in more depth the obstacles that have thus far impeded Mexico's efforts to "take off" on an export-led growth trajectory through market-opening policies. As discussed in the introduction, these obstacles fall into two categories: contradictory macro-economic policies and inconsistencies in the trade strategy itself. Let us now examine each of these in more depth, in light of the structuralist approach to development discussed earlier.

On the macroeconomic side, while the precise policies have changed (and have not always been applied consistently), there has been one overriding objective that has led to a persistent anti-growth bias in macro policies: the efforts to combat the high inflation rates that developed during the 1980s. Under the social pacts of the late 1980s, inflation was supposed to be held down by the combined effects of workers limiting their nominal wage increases, the government maintaining a slowly depreciating crawling peg of the peso (in nominal terms), and businesses practicing price restraint (induced in part by exposure to greater international competition and aided by enhanced efficiency due to deregulation). This heterodox anti-inflationary policy succeeded, but only (as we have seen) at the cost of engendering a real overvaluation of the peso and growing external disequilibria. Now, the Mexican government has switched to a more orthodox line of attack, by relying on old-fashioned monetary restraint and fiscal austerity, which

operate by reducing aggregate demand. Although these policies help in correcting the external disequilibria, they simultaneously counteract the demand-side stimulus from the greater external competitiveness due to the devaluation of the peso. In effect, the macro policy package adopted by the Zedillo government in 1995 has displaced the chief constraint on growth from the external trade imbalance to contractionary domestic policies.

Structuralist economists (e.g. Taylor 1991) are accustomed to seeing chronic inflationary pressures primarily as the manifestation of an unresolved distributional conflict between workers and firms, and secondarily as a result of “imported inflation” through rigid dependence on imports of intermediate goods and basic consumption goods — although these economists also recognize that monetary expansion is necessary to “validate” inflation based on conflicting income claims.¹⁷ From this perspective, the key to reducing inflation permanently is an “incomes policy” that effectuates a class compromise over income shares (or other distributional targets) and allows moderation of nominal wage demands and price increases. More rapid productivity growth also helps to reduce the conflict between workers’ and firms’ targets for income distribution.

In fact, the heterodox policy package embodied in the Salinas-era pacts included an implicit incomes policy and an effort to raise productivity, which succeeded in bringing inflation down from over 100 percent to under 10 percent in six years between 1988 and 1994. This policy package failed not because of domestic conflicts, but rather because of the inconsistency between the use of the nominal exchange rate as a lever for holding down prices of imports as a means of suppressing inflation and the need to maintain a stable real exchange rate in order to remain internationally competitive and achieve external balance — a problem that was exacerbated by the fact that Mexico liberalized its trade regime at the same time as it adopted this anti-inflationary package. Since the peso devaluation, workers have been forced to keep their end

of the bargain by restraining nominal wage increases, while the lid has been taken off price increases as firms have been allowed to pass through the increases in their import costs. The result has been a severe squeeze on real wages and a sharp reduction in labor's share, starting from levels that were already depressed below their pre-debt crisis norms (see Arroyo 1995 and Boltvinik 1995). In place of the heterodox pacts, there is a new, implicit "incomes policy," which consists of using increased unemployment to induce Mexican labor to accept further reduced real wages and a lower share of national income.

This brings us to the connection between income distribution and economic growth, which is central to all "alternative" paradigms of growth modeling (see Harris 1978; Marglin 1984; Dutt 1990). Traditionally, it has been thought that developing countries are best described by dualistic models in which there is full utilization of capacity in the "modern" or capitalist sector (see, e.g., Kalecki 1976). In the terminology of alternative growth theory, this suggests the use of either a "neo-Marxian closure" in countries where surplus labor (in the sense of Lewis 1954) keeps real wages rigid, or else a Kaldorian "neo-Keynesian closure" in countries where surplus labor has been eliminated (e.g., South Korea and Taiwan) and there is full employment with a flexible real wage. However, none of these models seem to fit Mexico since the 1970s very well.

Since the exhaustion of the IS model in the late 1960s, as discussed in section 2 above, Mexico has faced chronic difficulties in maintaining an adequate level of effective demand to fully utilize its capital stock and to employ the rapidly growing labor force in productive, modern-sector jobs. To be sure, these difficulties have sometimes been overcome, but only through unsustainable means such as deficit spending financed by foreign loans in the early 1970s and taking advantage of the oil boom in 1979-81. The mid-1980s were years of chronically depressed aggregate demand, and the post-1987 recovery never led to robust growth for the reasons already

discussed. Therefore, as argued by López G. (1995), it makes more sense to treat the Mexican economy as one characterized by excess industrial capacity, and to represent it by a neo-Kaleckian model in which capacity utilization is variable and output is demand-constrained.¹⁸

Over the past two decades, research in the neo-Kaleckian framework has identified a number of conditions that determine whether a redistribution of income from wages to profits tends to be expansionary or contractionary in a demand-driven economy. The earlier models (e.g. Harris 1974; Asimakopulos 1975; Rowthorn 1982; Dutt 1984; Taylor 1985) tended to show that economic growth¹⁹ was necessarily wage-led, and hence that a higher profit share led to economic stagnation. However, later work (e.g. Blecker 1989; Taylor 1991; You 1991; Marglin and Bhaduri 1990; Bhaduri and Marglin 1990) showed that this conclusion rested upon a number of strong assumptions, and that violations of these assumptions could cause growth to be profit-led even in a demand-driven economy with excess capacity. Fundamentally, there are three main factors that determine whether an economic system characterized by excess capacity is wage-led (“stagnationist”) or profit-led (“exhilarationist”):

- *Underconsumptionism.* The greater is the difference between the saving rates out of profit and wage income, the more likely such a system is to be wage-led. Narrowing the gap between these two saving rates makes the system more likely to be profit-led.²⁰
- *The investment function.* A strong accelerator effect (usually modeled as the response of the desired accumulation rate to the utilization rate) makes a system more likely to be wage-led. In contrast, a strong profitability effect (the response of the desired accumulation rate to the profit share) makes a system more likely to be profit-led.²¹

- *International competitiveness.* Exposure to strong international competition implies that rising wages (adjusted for productivity) tend to reduce net exports, thus slowing growth; this tends to make the economy more likely to be profit-led since a wage cut (or a devaluation) is expansionary. Insulation from competitive pressures, either through protectionism or other means, makes a wage-led outcome more likely.²²

In this framework, one could characterize the present direction of Mexican economic policy as implicitly attempting to foster the conditions for profit-led growth.²³ This characterization is based on two considerations. First, the emphasis on promoting manufactured exports and attracting DFI in export-oriented industries implies a delinking of investment demand from the growth of the internal market — i.e., a weakening of the domestic accelerator effect.²⁴ Given the globalization of production and mobility of technology, investment in labor-intensive manufacturing operations is driven primarily by labor cost differentials among different “newly industrializing countries” (NICs). This implies a strong profitability effect on investment demand for a country like Mexico that is competing with East Asian NICs and Caribbean and Central American nations for DFI or outsourcing by multinationals. Second, trade liberalization makes the national economy more open to foreign competition, both in the internal market (where imports now compete more freely with domestic consumer goods) and in external markets (where exports must compete with the products of other low-wage NICs as well as with domestic products in the industrial countries). Thus, trade liberalization intensifies the competitive pressures that can foster a profit-led growth regime.

Based on these considerations, it would seem that the current policy of cutting wages (both in purchasing power and in relative share) and raising profit margins could potentially

succeed in placing the Mexican economy on a trajectory of sustained profit-led expansion. Among other things, a profit-led growth regime makes it easier for a country to absorb productivity growth,²⁵ which Mexico is trying to foster via its micro-level structural reforms (e.g., privatization of firms and liberalization of trade). While in a stagnationist, wage-led economy productivity growth only widens the gap between actual and potential output, in an exhilarationist, profit-led economy productivity growth can actually stimulate aggregate demand thereby offsetting the labor-saving bias of the technical changes being introduced. However, other factors still mitigate against the success of such a strategy.

In the first place, underconsumptionist effects probably remain very strong in Mexico, and if anything may have been strengthened by the extreme concentration of income and wealth as well as the increased poverty of workers since the 1980s. As real wages have been cut again and again, workers are driven closer to (or below) the margin of survival²⁶ and their ability to save — never very high in the first place — is consequently reduced or eliminated. At the same time, financial liberalization has encouraged saving by the wealthy, and especially the channeling of these savings into domestic stock and bond markets rather than into capital flight abroad.²⁷ A redistribution of income from wages to profits (or, more generally, to property income including interest and rents) thus still has a significant underconsumptionist impact, requiring very strong gains in investment demand and net exports to have a net expansionary effect on aggregate demand.

Second, with regard to investment, the current set of policies is by no means uniformly stimulative. To be sure, the fact that Mexican wages have been cut roughly in half in dollar terms since 1994 makes Mexico a much more attractive location for DFI and outsourcing. But several factors cut the other way. Continued economic and political instability in Mexico (e.g., the new

guerrilla uprising in Guerrero) may depress corporate “animal spirits,” or what is more conventionally called “the state of business confidence.” In spite of all the NAFTA guarantees of property rights, foreign investors must perceive greater “country risks” in a nation going through so much turmoil. Also, the tight monetary and credit policies adopted in the wake of the peso crisis have raised interest rates to astronomical levels in Mexico. One need not believe in the importance of neoclassical investment models emphasizing the “cost of capital” to recognize that high interest rates can crush investment demand; aside from raising the cost of borrowed funds, high interest rates also exacerbate financial fragility à la Minsky (1986) by raising “cash commitments” for debt service and are also associated with quantitative credit restraints (credit rationing) in a tight money environment. Indeed, the large debts accumulated by Mexican firms before the 1994 devaluation crisis have become an obstacle to renewed expansion. However, this factor is clearly more of a binding constraint on domestic firms than on multinational enterprises (MNEs), which have greater access to foreign sources of funds.

Third and finally, although domestic accelerator effects are undoubtedly weakened by the export orientation of the economy, investment demand in Mexico is now linked more strongly than ever to the growth of demand in Mexico’s principal export market — the United States. In the long run, Mexican exports to the U.S. can only grow at the same rate as the U.S. economy, which is now being held to about 2.5 percent per year by deliberate policy of the Federal Reserve Board of Governors under Chairman Alan Greenspan (and with the blessing of most neoclassical macroeconomists, who share his commitment to maintain a NAIRU of nearly 6 percent). In the short run, of course, Mexican exports can grow faster than this, by taking market share away from other NICs or from U.S. domestic producers, but in the long run Mexican export growth will be constrained by the growth of the U.S. market if the latter continues to be the main target

of Mexican exports. As a result, one may expect a short-term boom in export-oriented DFI in Mexico in the next few years, as MNEs take advantage of the NAFTA reductions in U.S. trade barriers and the devaluation of the peso, but this boom will subside once the growth of Mexican exports to the U.S. slows down. By the logic of the accelerator model, a slowdown in U.S. market growth would then cause an absolute decline in Mexican investment insofar as the latter remained oriented mainly toward production for the U.S. market.

The upshot of all these factors is that, even if the current policies induce a substantial amount of new DFI in export-oriented industries, this is likely to be offset to a considerable extent by weakness of domestic investment in Mexico especially on the part of nationally-owned firms without recourse to foreign sources of funds (although capital market liberalization may ease this constraint to some extent). In the long run, continued growth of investment in Mexico (both DFI and national) will depend more on the growth of the internal market, but this is likely to be restrained by the underconsumptionist effects of the regressive redistribution of income effected by the current policy regime. As a result, Mexico seems unlikely to go all the way to becoming an “exhilarationist” economy. Nevertheless, the changes in the Mexican investment function and trade relations discussed above could still transform Mexico’s growth regime from what Marglin and Bhaduri (1990) call a “cooperative stagnationist” regime to a “conflictive stagnationist” one. In the former case, a redistribution of income toward labor boosts all key macroeconomic indicators: employment, capacity utilization, capital accumulation, and even the realized rate of profit (since firms gain more from higher utilization of capacity than they lose from a lower profit margin on goods sold, or profit share of value added). But in the latter case, capital accumulation and the rate of profit become positively related to the profit share, while employment and utilization remain inversely related. For Mexico, what this means is that the country could end up

with aggregate growth indicators that look good even though workers would continue to suffer high rates of unemployment in the modern sector (thus putting continued downward pressure on industrial wages, as well as adding to the stresses in the “informal” sector and increasing migration pressures).

The problems that emanate from Mexico’s emphasis on exports to the U.S. market bring us back to the overall direction of Mexican trade policy. Certainly, the strategy of focusing on the U.S. market has its appeal to Mexico. Proximity alone dictates that the U.S. market will always be Mexico’s largest. The United States has generally been the most open major industrialized country to NIC exports of manufactures, certainly more so than Japan and even compared with Europe. To be sure, the United States has created managed trade regimes and has utilized its “fair trade laws” extensively to protect significant domestic industries. Nevertheless, U.S. imports have grown very rapidly since 1980, beyond what can be explained by relative prices and income effects alone, and the persistent U.S. trade deficits have provided a net stimulus to other nations (see Blecker 1992a, 1992b). Although Mexico cannot be faulted for wanting to gain a larger piece of the action in the U.S. market for manufactured exports from the NICs, still any strategy of putting all the eggs in one basket is inherently risky.

In order to obtain the preferential access to the U.S. market granted by NAFTA, Mexico was forced to agree to a liberalized trade and investment regime that maximizes advantages for U.S. and other foreign MNEs, rather than for Mexican development objectives. The combination of NAFTA with a devalued peso is likely to deepen Mexico’s existing status as a locus of labor-intensive production activities (such as assembly of electronics equipment and parts production for automobiles) within the emerging “global factory.” Mexico is thus exploiting its “comparative advantage” in low-wage manufactures, which in turn requires Mexico to allow a

high Marxian “rate of exploitation” of its labor force (i.e., gross profit margin on value added) in order to attract DFI or outsourcing away from other possible locales.

To be sure, the East Asian NICs have all gone through stages of emphasizing low-wage, labor-intensive manufactures, and many of them (e.g., Thailand and China) are still heavily dependent on such production for export. But the more advanced East Asian NICs, led by Korea and Taiwan and also now China, are already seeking to move ahead into more capital-intensive and technologically sophisticated industries in which low labor costs are less important, such as shipbuilding, chemicals, and jet aircraft. These efforts are being made through a combination of promoting national firms where possible and forging strategic alliances with MNEs where necessary. In most of these East Asian NICs, strong states have been able to insist on obtaining transfers of technology that will enable emerging domestic industries to stand on their own in the future.

In contrast, the Mexican government has turned over control of domestic industrial development to the foreign MNEs that can operate freely in the country under NAFTA. While these companies are sure to notice Mexico’s attractions as a low-wage manufacturing zone, they are unlikely to want to transfer their more advanced technologies to Mexico in the absence of any political pressure to do so. On the contrary, NAFTA allows MNEs to concentrate their more capital-intensive and technologically sophisticated operations in North America in the United States or Canada, abandoning some facilities they formerly had to maintain in Mexico under the IS regime. As an example, some European luxury automobile manufacturers have recently chosen to locate their North American assembly plants in the southern United States, rather than in Mexico. At the same time, U.S.-located auto producers (regardless of their ownership) are increasingly sourcing low-tech parts such as brakes and windshield wipers from Mexico as well as

assembling some finished cars there. This flexibility in terms of where to locate different production activities in North America helps U.S. corporations to compete with Japanese and European rivals, but could leave Mexico stuck at the low end of the industrial spectrum.

It could be argued that Mexico has no choice but to specialize in these types of labor-intensive activities at this point in its history, and there is some truth to this. The problem, however, is that Mexico has locked itself into a set of trade agreements that will make it more difficult to use industrial policies to move up the industrial “ladder” later, as many East Asian countries have. It could also be argued that the Mexican political system has much less autonomy in these matters, in part because of the domestic legitimacy crisis of the PRI-dominated, one-party state, and in part because Mexico is much more susceptible to American pressure due to Mexico’s financial indebtedness to U.S. creditors and recurrent need for financial bailouts. Similarly, it could be claimed that the Mexican government lacks the ability to “discipline capital” (in the words of Alice Amsden) as East Asian governments have, or that the swings of the political pendulum have led to an overreaction against the interventionist excesses of the IS era. Again, there is much truth in such arguments. But while these factors may explain why the Mexican state has agreed to tie its hands so tightly in regard to strategic industrial and trade policies, such considerations hardly prove that the current policy direction is optimal from the standpoint of Mexico’s long-run economic development.

5. Conclusion: Policy Options for Mexico

One must be careful not to project the current depressed circumstances of the Mexican economy too far into the future, or to ignore the possibilities for some limited successes of the

current economic strategy. A recovery from the 1995 depression is already under way, and there is at least a reasonable chance that the following “optimistic” scenario will ensue. The devalued peso succeeds in rectifying Mexico’s trade imbalance, while the fiscal austerity lessens the need for net new borrowing from abroad (aside from the need to service past debts). Assuming that the political system stabilizes, DFI floods into the country, attracted by wages that are less than 10 percent of U.S. wages at the current exchange rate. Lessons learned by financial speculators and the Mexican government alike prevent another speculative bubble in the foreign exchange market, while the peso is kept at a “realistic” real value in terms of external competitiveness. Inflation is dampened by the combination of contractionary fiscal and monetary policies and a weakened labor movement. As the Mexican economy recovers, per capita incomes and real wages eventually begin to rise again, albeit on a lower growth path than previously.

The preceding is the “hopeful” scenario, on which the Zedillo government seems to be banking. This scenario still depends on a number of optimistic assumptions that may yet turn out to be untrue. These assumptions include: high sensitivity of net exports and DFI inflows to the devalued peso; success in containing inflation via macroeconomic means; avoidance of future speculative bubbles in Mexican financial markets; and the stabilization of the Mexican political situation (with a peaceful transition to a more democratic and less corrupt regime). None of these conditions can be guaranteed.

Moreover, even if this “hopeful” scenario works out, Mexico will be left with two chronic difficulties. First, the growth that would occur would be like that described earlier in the model of “conflictive stagnation”: there would be high profit rates and accumulation rates for corporate capital, but at the cost of low utilization of capacity and high unemployment for the labor force. Indeed, chronically depressed domestic aggregate expenditures (“absorption”) seem to be

required by the current strategy for both suppressing inflation and avoiding large trade deficits in the foreseeable future. Mexicans would thus have to accept increased inequality and a diminished standard of living for a prolonged period as the price of attracting continued DFI inflows and winning rising market shares abroad.

Second, it is not coincidental that the trade part of this scenario looks suspiciously like the one predicted by U.S. and Canadian opponents of NAFTA before the agreement went into effect. Just as NAFTA opponents argued, the increased DFI would move some manufacturing jobs to Mexico and to that extent Mexican exports would displace domestic U.S. or Canadian production.²⁸ With Mexico's domestic demand and real wages chronically depressed, Mexico would not become the prosperous market for U.S. exports predicted by NAFTA supporters, although it would continue to be a good market for U.S. (and other industrial countries') exports of capital goods and intermediate goods destined for labor-intensive assembly or processing plants. Fundamentally, it is a conflictive trade regime, along the lines of what Robinson (1978) called "the new mercantilism" in which countries compete for trade surpluses and employment creation. Such a trade regime has the potential to unleash a hostile political reaction to Mexican trade in the United States, with unpredictable future consequences.

For all of these reasons, it is essential to explore what alternatives exist for Mexico in the present situation. These alternatives have to be divided into two categories: alternatives that can be pursued without violating NAFTA, and alternatives that would require renegotiation or abrogation of NAFTA.

Without violating NAFTA, there are a number of alternatives to the current policy direction that Mexico could potentially pursue. López G. (1995, p. 16) suggests several measures "to stimulate greater utilization of idle productive capacities," including help for highly indebted firms

(especially in obtaining working capital at reasonable interest rates), increased public spending on infrastructure investment, and employment subsidies for firms that create industrial jobs. López G. does not discuss the budgetary implications of such policies, which could worsen Mexico's budget deficit. Given the proclivity of Mexican governments to finance budget deficits through external borrowing and the disastrous consequences to which such borrowing has always led, it would seem prudent to finance such expenditures or subsidies instead through domestic taxation. The results would still be expansionary, due to the logic of the balanced-budget multiplier. Indeed, one could envision a policy of "progressive balanced-budget expansion" in Mexico, in which the types of expenditures advocated by López G. were combined with tax measures that would target capital income. These measures could include: high taxes on income from short-term portfolio investments (which would also help to prevent excessive speculation in Mexican asset markets); higher personal income taxes on the wealthiest households; and increased corporate profit taxes that would help to capture some of the excess profits from firms taking advantage of depressed wages.²⁹

Externally, NAFTA does not preclude Mexico from pursuing bilateral trade initiatives with other countries. The East Asian countries are increasingly trade with each other, and a Mexico that produces a similar mix of exports (see Gaisford, et al. 1995) could seek to join in such intra-industry trade among the NICs. The European Union might be amenable to a bilateral market-opening agreement with Mexico, parallel to what it is now pursuing with the Mercosur countries (Brazil, Argentina, Uruguay, and Paraguay). Mexico already has a free trade agreement with Chile, although the volume of trade between these two countries is still small. A Mexican-Mercosur trade agreement is another possibility. South American countries have a more primary-commodity-oriented export pattern, allowing for greater complementarity with Mexico's

manufactured exports (although Mexican and South American primary exports are more substitutes for each other). Overall, diversification of Mexico's export markets is important for relaxing the constraint that the likely slow growth of the U.S. market places on Mexico's long-run export growth and for lessening trade tensions with the U.S. (see Chimerine and Cohen 1992).

Finally, Mexico needs to reconsider its macroeconomic and exchange-rate policies. It is essential to reestablish some kind of incomes policy, but one that does not rely on the exchange rate as a nominal anchor (which runs the risk of engendering real overvaluation, as we have seen). This is necessary in order to have another means to control inflation besides fiscal and monetary austerity. A good place to start would be to legislate a jump in the minimum wage to restore its 1980-level real purchasing power,³⁰ which would restore some balance to class relations and give a boost to the internal market. (Most Mexican workers don't actually get the minimum wage now, but it is an important benchmark for private sector wages). Then, starting from this higher base, the government could target nominal wage increases that (taking expected price inflation into account) would make real wages rise at about the average rate of productivity growth. The exchange rate should be managed to remain roughly constant in real terms, with a target zone somewhere around the mid-range of the currency values shown in Figure 2. The government should be willing to tolerate an inflation rate in the low double-digits in exchange for encouraging greater distributional equity and a more prosperous internal market, and the inflation rate could come down gradually once workers and firms became convinced that the new incomes policy would work.

Although all of these measures would help, Mexico will not be able to take control of its destiny in regards to industrial development unless it either abrogates or renegotiates the NAFTA framework. What Mexico needs is the freedom to pursue more of the East Asian-style industrial

policies that would be required in order to move beyond its current status as a low-wage export platform. For example, Mexico should seek the right to impose performance requirements on companies (national or foreign) that invest in the country, and the right to use selective tax incentives or subsidies to encourage targeted industries. Mexico also needs the right to make DFI or imports conditional on obtaining technology transfers in selected industries, as China and other Asian countries have done.

These suggestions raise the question of what Mexico should offer in exchange for such modifications of NAFTA. A sensible place to start would be by offering to accept tougher and more enforceable “side agreements” on labor rights, environmental standards, and consumer protection. The Mexican government has thus far opposed such initiatives, claiming that they would infringe on national “sovereignty” — a claim that is hard to take seriously, given how much Mexico gave up its sovereignty in other areas such as financial services, property rights, and investment rules in the NAFTA negotiations. In fact, the violations of internationally recognized labor rights (e.g., freedom of organization, prohibition of child labor, protection from hazardous substances) in Mexico — especially in the export-oriented “*maquiladoras*” — are well documented (see Levinson 1993), as are similar violations of environmental and consumer protection. The PRI-led government seems to think that it has to tolerate such abuses and protect the violators from international scrutiny in order to attract investment into the country. A more progressive Mexican government would see that greater enforcement and upward harmonization of labor, environmental, and consumer standards are in Mexico’s own interest, and that international agreements to this effect would strengthen Mexico’s ability to enforce its own laws in these respects.

The preceding are just some tentative suggestions, not a complete economic alternative for Mexico.³¹ But it is essential for economists concerned with Mexico's future — and that of all of North America and the western hemisphere — to begin discussing alternative paths to the one currently seen as the only option for Mexico. The two basic problems that Mexico needs to address are: how to ensure more rapid expansion of the internal market based on rising wages and middle-class income; and how to promote long-term industrial development as something more than a low-wage appendage of globalized corporate production. Evidently, these two problems are closely related to each other, and solving them is essential for recreating an internal “engine of growth” for the Mexican economy, in place of a growth model that is so exclusively dependent on serving as an export platform for low-wage manufactures destined for the U.S. market. To achieve this objective will require a radical rethinking of the new free-market orthodoxy that currently holds sway in Mexico and the rest of Latin America.

Notes

1. Some economists such as Rudiger Dornbusch urged Mexico to devalue earlier in 1994, and Guillermo Calvo foresaw a financial collapse (see Nasar 1995). But to this author's knowledge, only Faux made his prediction of a financial collapse *before* the 1993 NAFTA vote, and only Faux predicted eventual U.S. government involvement.
2. Faux emphasized the fragility of the Mexican banking system, which is opened up to foreign ownership in some of the longer-term provisions of the NAFTA. The Mexican financial crisis of 1994-95 actually occurred before those banking provisions went into effect, and started in the stock and bond markets, but quickly spread to the banking system as a result of high interest rates and nonperforming loans (see Robberson 1995).
3. Based on data from the International Monetary Fund, *International Financial Statistics* (February 1996).
4. Mexican Action Network on Free Trade (1996), p. 6.
5. See, for example, the analysis of Gould (1995) and Weintraub (1995).
6. To his credit, McKinnon places the blame for the Mexican crisis squarely on the international banks and other financial institutions that "have a lemming-like bent to overlend in emerging markets." McKinnon notes that Mexico's current efforts to refinance its government debt at exorbitant interest rates "will leave Mexico with a crippling future burden" and urges Mexico to adopt "a long-term policy of reducing dependence on foreign capital." He endorses "setting limits on the amount that foreign banks can invest or ... taxing all large foreign investments."
7. See Taylor (1996) for a more comprehensive statement of the Washington consensus policy perspective.
8. See López G. (1995) for an analysis of how the assumption of full utilization biases conventional analyses of the Mexican economy.
9. This section and the following one draw upon and update extensive parts of the analysis in Blecker (1996).
10. In this light, the guarantee of permanent preferential access for Mexican exports to the United States in NAFTA is significant not merely for opening up the U.S. market to the products of Mexican firms, but more importantly for signaling to American and other foreign firms (European, Japanese, and other Asian) that they can locate production in Mexico and still produce with virtually no restrictions for the U.S. market. Moreover, NAFTA contains numerous specific provisions designed to protect foreign investors' rights in the three signatory countries. These provisions include national treatment of foreign producers, abolition of performance requirements, restrictions against expropriation, guaranteed freedom of foreign investors to move funds across borders in convertible currencies, strong protection for intellectual property rights, and the

liberalization of trade in financial and other services. Essentially, the NAFTA negotiators went to great lengths to make sure that the rights of foreign investors in Mexico would be respected, and that the continent would be open to virtually unrestricted flows of capital and services as well as commodities in the future. These trade and investment liberalization provisions are backed up by strong enforcement mechanisms, including specified penalties for violations.

11. Two prominent trade-theory based NAFTA models that ignored international capital mobility were Roland-Holst, Reinert, and Shiells (1992) and Brown, Deardorff, and Stern (1992). Robinson, Burfisher, Hinojosa-Ojeda, and Thierfelder (1993) allowed for capital inflows into Mexico, but assumed that these did not come from the United States! For further discussion of alternative ways of modeling NAFTA, see Stanford (1993) and Blecker (1996).

12. The investment share for 1994 shown in Figure 3 was extrapolated using the proportional increase in the same variable (total investment as a percentage of GDP) calculated from another source (IMF, *International Financial Statistics*, February 1996). Although the *IFS* series is not strictly consistent with the *World Tables* series used in Figure 3, the proportional year-to-year fluctuations are very closely correlated in the two series.

13. Both of these figures for the bilateral trade balance are biased upwards by the inclusion in U.S. exports to Mexico of goods transshipped through the U.S. from other countries into Mexico. The true bilateral “net export” balance, excluding such shipments, is lower for both years, as shown by U.S. Congress, Joint Economic Committee (1994) and Scott (1996).

14. This calculation is based on the implicit figure of about 19,000 jobs per \$1 billion of net exports used by Hufbauer and Schott (1993). The -\$22 billion figure is the difference between their projected surplus of \$6.6 billion and the actual deficit of \$15.4 billion for 1995. In their earlier study, Hufbauer and Schott (1992) projected the same improvement in the U.S.-Mexican trade balance but used a smaller jobs multiplier.

15. See the discussion of how such overly optimistic predictions were used to sell the NAFTA agreement in Lee (1995). Hufbauer and Schott were taken to task for misrepresenting a free trade agreement as a job-creating device by Krugman (1995), who called their predicted job gains “an intellectual cheap shot” (p. 851). See also Blecker (1996) for a detailed, critical survey of this and other models of NAFTA’s employment effects.

16. I am indebted to Thea Lee for suggesting the following point.

17. A similar perspective on inflation is shared by many post-Keynesian economists (e.g., Rowthorn 1977; Weintraub 1978). Also, note that this post-Keynesian Sidney Weintraub is not the same as the other Sidney Weintraub cited in note 5, above.

18. The argument that the Mexican economy can be characterized as having a chronic deficiency of aggregate demand since the 1980s has also been made by Williamson (1996), who uses a more conventional Keynesian analysis.

19. In this literature, there are subtle but important differences in how the level of economic activity (measured by output or the utilization rate) and the rates of profit and capital accumu-

lation are affected by shifts in the functional distribution of income. These subtleties are ignored here, but are alluded to below where relevant to the Mexican case.

20. In addition, this author has noted elsewhere that more progressive income taxation tends to make an economy more likely to be stagnationist, while less progressive (“flatter”) income taxation tends to make it more likely to be exhilarationist, for given values of other parameters (see Blecker 1993).

21. Bhaduri and Marglin (1990) and Marglin and Bhaduri (1990) point out that some of the earlier literature assumed an investment function that implicitly assumed a “strong accelerator effect” by double-counting the influence of the utilization rate (as a component of the profit rate as well as independently).

22. Evidence that international competition makes the Canadian economy more profit-led than it would be otherwise is reported by Stanford (1996).

23. The following discussion draws partly upon the structuralist macro model of a semi-industrialized, semi-open economy in Seguino (1994, 1995).

24. Panić (1995) points out that accelerator effects on investment are likely to be weakened by the globalization process, insofar as it involves an emphasis on export-oriented production by transnational corporations.

25. I am indebted to Lance Taylor for suggesting this point.

26. See Boltvinik (1995) for evidence showing that the Mexican minimum wage has bought a falling proportion of the poverty-line standard of consumption (“normative basket of essential satisfactions”) in Mexico in recent years, to the point where it took about 6 minimum-wage jobs to reach the poverty line consumption standard as of mid-1995. Even at the average wage — which has been higher than the minimum wage since the mid-1980s — it took two jobs to reach that standard as of 1993.

27. In spite of these incentives to save, the private saving rate actually fell in Mexico in the late 1980s and early 1990s. The consumption boom of this period is probably due to three factors: (i) sluggish per capita income growth, which depresses saving rates according to the evidence in Bosworth (1993); (ii) financial liberalization also enabled Mexicans to increase their borrowing for consumption, and indeed household as well as business debt soared in that period; and (iii) trade liberalization along with the appreciation of the peso encouraged greater consumption of imported goods. Nevertheless, it is only the *difference* between the saving rates out of wage and profit income that matters for the issue of whether growth is wage- or profit-led.

28. However, some of the displacement of jobs and output would come at the expense of other newly industrializing countries, especially in East Asia.

29. Needless to say, these types of policies could run into enforcement problems due to the ability of wealthy households or MNEs to hide income abroad. But such difficulties must be overcome if Mexico is ever to get its fiscal house in order. It is also possible that some DFI could

be driven out of the country by such tax policies, but given the attractions of producing so close to the U.S. market it is likely that most foreign firms — and certainly the most productive ones — would remain.

30. See Boltvinik (1995) and Rothstein (1993) on the Mexican minimum wage.

31. For other suggestions see Stanford (1993), Alliance for Responsible Trade et al. (1993), and Mexican Action Network on Free Trade (1995).

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Table 1
Key Macroeconomic Indicators for Mexico, Selected Years, 1965 to 1995
 (average annual percentage rates)

Year(s)	GDP Growth Rate	Inflation Rate ^a
1965-1980	6.5	13.1 ^b
1980-1986	0.4	63.7 ^b
1987	1.9	130.8
1988	1.2	114.3
1989	3.3	20.1
1990	4.4	26.6
1991	3.6	22.7
1992	2.8	15.5
1993	0.6	9.7
1994	3.5	6.9
1995 ^c	-7.0 ^d	35.0

Sources: For 1965-1986, World Bank, *World Development Report* 1988; for 1987-1995, author's calculations based on data in International Monetary Fund, *International Financial Statistics*, 1995 Yearbook and February 1996 (except as noted).

Notes:

^a Based on consumer price index, except as noted.

^b Average annual inflation rates for 1965-80 and 1980-86 are based on the GDP implicit price deflator.

^c Preliminary data.

^d From United Nations Economic Commission for Latin America and the Caribbean, *CEPAL News*, January 1996.

Table 2
Mexican Balance of Payments Data and Foreign Exchange Reserves, 1987-1995
(in billions of U.S. dollars)

Year	Merchandise Exports	Merchandise Imports	Current Account Balance	Foreign Direct Investment ^a	Foreign Portfolio Investment ^b	Overall Balance of Payments	Foreign Exchange Reserves ^c
1987	27.6	18.8	4.2	1.2	-1.0	4.1	11.8
1988	30.7	28.1	-2.4	2.0	1.0	-10.1	4.9
1989	35.2	34.8	-5.8	2.8	0.4	-0.2	5.9
1990	40.7	41.6	-7.5	2.5	3.4	2.2	9.4
1991	42.7	50.0	-14.9	4.7	12.7	8.0	17.1
1992	46.2	62.1	-24.4	4.4	18.0	1.7	18.4
1993	51.9	65.4	-23.4	4.4	28.9	7.2	24.9
1994	60.9	79.3	-28.8	8.0	8.2 ^d	-17.7	6.1
1995 ^e	76.6	70.4	-1.2	5.1	-23.0	-27.0	9.6 ^f

Sources: International Monetary Fund, *International Financial Statistics* (1995 Yearbook and February 1996) and author's calculations.

Notes:

^a Net inflow, excluding debt-equity swaps.

^b Net increase in Mexican liabilities to foreigners.

^c Stock position, end-of-period.

^d This figure is the sum of a net inflow of \$13.7 billion in the first three quarters of 1994 and a net outflow of \$5.5 billion in the fourth quarter.

^e First half measured at an annual rate (except as noted).

^f Position as of June 30, 1995. Foreign exchange reserves rose to \$15.3 billion in preliminary figures for December 31, 1995.

Table 3

**Bilateral U.S.-Mexican Merchandise Trade, and
Net Private Capital Outflows, 1987 to 1995
(in billions of U.S. dollars)**

Year	U.S. Exports	U.S. Imports	Bilateral Trade Balance	Direct Foreign Investment ^a	Private Portfolio Investment ^a
1987	14.6	20.3	-5.7	0.3	-0.6
1988	20.6	23.3	-2.7	0.6	-4.0
1989	24.7	27.1	-2.4	1.4	-1.9
1990	28.1	30.5	-2.4	1.9	-1.6
1991	33.1	31.5	1.6	2.3	4.9
1992	40.5	35.6	4.9	1.3	5.2
1993	41.5	40.4	1.1	2.4	12.3
1994	50.7	50.1	0.6	3.3	7.1
1995	46.3 ^b	61.7 ^b	-15.4	NA	NA

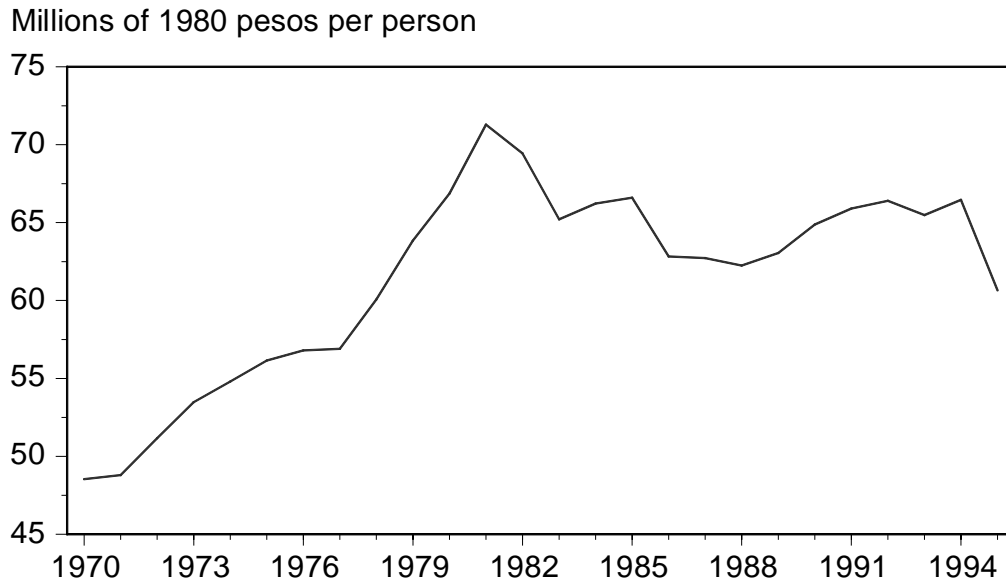
Sources: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, June 1995; U.S. Department of Commerce, Economics and Statistics Administration, *U.S. International Trade in Goods and Services*, December 1995 (released February 28, 1996).

Notes:

^a Net increases in U.S. private assets in Mexico. Portfolio investment includes increases in all U.S. private assets in Mexico except direct investment in productive enterprises.

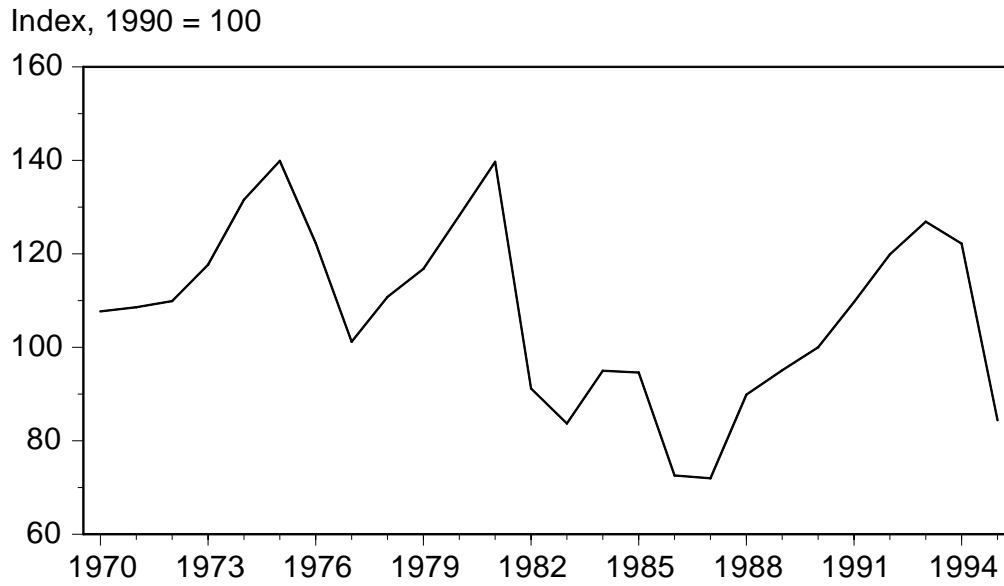
^b Preliminary Census-basis data, not consistent with data shown for earlier years (which are from the Bureau of Economic Analysis, International Transactions Accounts). The corresponding Census-based figures for 1994 are 50.8 for exports and 49.5 for imports.

Figure 1
Real Per Capita GNP in Mexico, 1970-1995



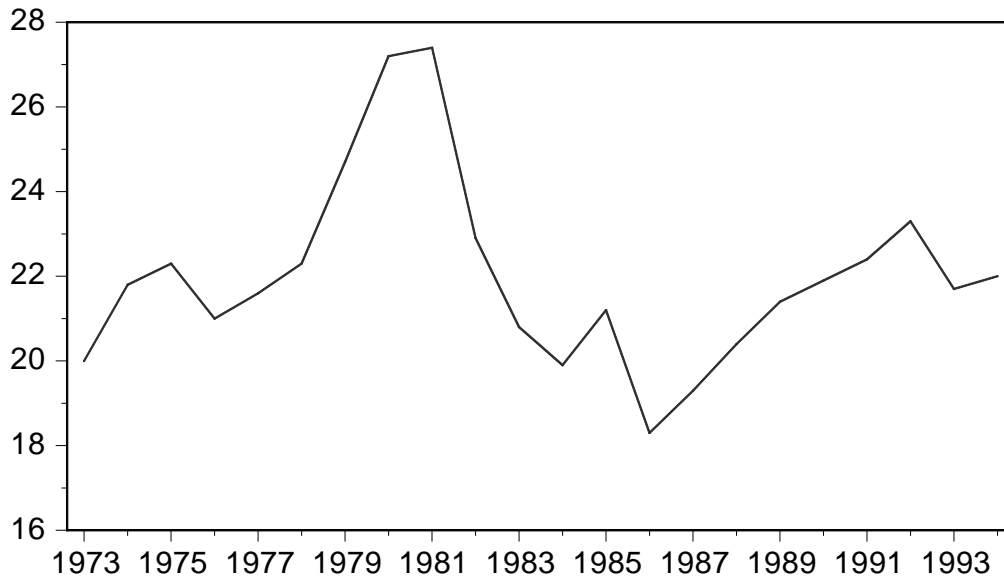
Source: Boltvinik (1995), based on official Mexican government sources for 1970-93. Data for 1994-95 were extrapolated by the author using data from the IMF, *International Financial Statistics*, February 1996, for real GDP and population.

Figure 2
Real Value of the Mexican Peso, 1970-1995



Source: Author's calculations based on data from the IMF, *International Financial Statistics*, 1993 and 1995 Yearbooks and February 1996, using the reciprocal of the period average peso/dollar exchange rate adjusted by relative Mexican/U.S. consumer price indexes.

Figure 3
Gross Investment as a Percentage of GDP in Mexico,
1973-1994



Source: World Bank, *World Tables 1995*, for 1973-93. The series was extrapolated to 1994 using the proportional change in total investment as a percentage of GDP from the IMF, *International Financial Statistics*, February 1996.